



JAPAN INTERNATIONAL
COOPERATION AGENCY



MINISTRY OF INFRASTRUCTURE
REPUBLIC OF POLAND

**THE FEASIBILITY STUDY
OF
POLISH STATE RAILWAYS S.A. (PKP S.A.)
PRIVATIZATION
IN
THE REPUBLIC OF POLAND**



**FINAL REPORT
MAIN REPORT**



May 2004



**JAPAN RAILWAY TECHNICAL SERVICE
NIPPON KOEI CO.,LTD.**

SD
JR
04-02

1 US Dollar = 3.83 PLN = 106.69Yen
(April 2004)

PREFACE

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

JICA sent to Poland a study team headed by Mr. Sadaaki Kuroda, President of Japan Railway Technical Service (JARTS), four times between March 2003 and March 2004.

Furthermore, JICA established a advisory committee chaired by Mr. Tatsuhiko Suga, Chief Executive of Transportation Culture Promotion Foundation, to conduct specialized and technical deliberations for the Study.

The study 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 persons concerned in Poland and Japan for their close cooperation extended to the study team.

May 2004

Kazuhisa Matsuoka

Vice-President

Japan International Cooperation Agency

Letter of Transmittal

May 2004

Mr. Kazuhisa Matsuoka
Vice-President
Japan International Cooperation Agency

We have the pleasure of submitting herewith our report for the Feasibility Study of Polish State Railways S.A. (PKP S.A.) Privatization. The report describes the results of the Study conducted by Japan Railway Technical Service and Nippon Koei Co., Ltd. in accordance with the contract with the Japan International Cooperation Agency (JICA).

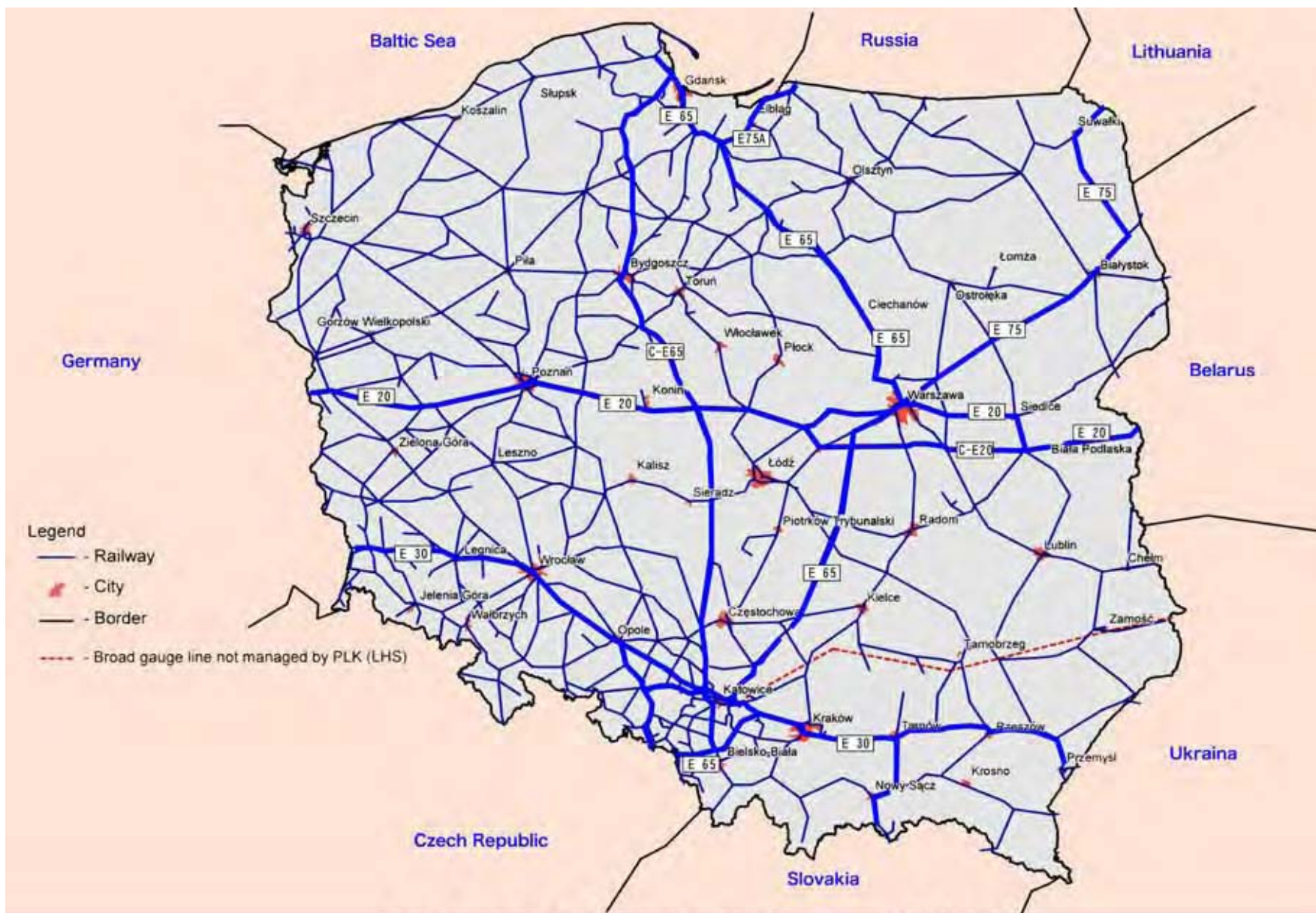
In the Study, our Study Team carried out field surveys four times during the period between March 2003 and March 2004. The Team held sufficient consultations with the Polish Government and organizations concerned regarding the results of the field surveys and study activities in Japan, and drew up plans for the implementation of the privatization of the Polish State Railways S.A. (PKP S.A.). In close cooperation with the Polish side regarding these plans, the Team thereafter studied such subjects as the management downsizing, main measures for the privatization, procedures for step-wise 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 Land, Infrastructure and Transport, the Japanese Embassy in Poland, and the JICA Poland Office for their valuable advice and support rendered to us throughout the Study

Yours faithfully,

Sadaaki Kuroda
Leader of the Japanese Study Team
for the Feasibility Study of
Polish State Railways (PKP S.A.) Privatization



Railway Network in Poland (2003)

THE FEASIBILITY STUDY OF POLISH STATE RAILWAYS S.A. (PKP S.A.)

PRIVATIZATION IN THE REPUBLIC OF POLAND

【Executive Summary】

1. Objective of the Study

The Government of the Republic of Poland (hereinafter referred to as “Polish Government” is undertaking the privatization of its largest enterprise, the Polish State Railways (hereinafter referred to as “PKP”). This study aims at reviewing the operations and management of the PKP Group with reference to their current status, formulating management strategies and financial measures to rationalize its operations and enhance the competitiveness of various PKP companies, and making policy recommendations to facilitate the restructuring and privatization of PKP.

Through its implementation, the study also aims at establishing close communications with policymakers and counterparts on the Polish side to extend policy assistance to the Polish Government.

2. Basic Principles of the Study

In general, privatization refers to the transfer of the ownership of an entity to the private sector. The JICA Study, however, aims not merely at transferring ownership to the private sector but also realizing a sound form of corporation that will enable the entity to operate independently from the government in terms of finance, etc. The restoration of corporate health and the approach to privatization are referred to in this Study as “restructuring and privatization,” and these are what the Study is aiming at accomplishing.

Why does the JICA Study aim at restructuring the PKP Group first before proceeding to privatization? If the business operations of the PKP railway operators are not restored to a sound state that sustains viable corporate activity, the value of those companies will be appraised lower by prospective investors, thus the government will not be able to obtain the expected capital gain from the sale of the companies.

Once the PKP railway operators are purchased by prospective investors, due to the railways’ lack of management capacity, the investors will most probably shut down unprofitable parts of the railways, and dispose of the assets by selling them piecemeal. Since the sell off of railways is an irreversible action, proper measures taken now will ensure the survival of railway service in the future, inaction will likely lead to their decline.

To effectively restructure and privatize the PKP Group companies, it is necessary to take into account Poland’s current financial situation and adopt methods that will involve the least financial burden. To this end, the most effective method is cutting down on the scale of operations (hereinafter referred to as “downsizing”). Downsizing here does not stop at achieving a smaller railway network but includes also the reduction of surplus workforce and excess facilities.

On the other hand, downsizing alone may not develop businesses that meet market needs. In order to provide services that adapt to market needs, it is necessary to focus business resources on the downsized railway services, modernize railway infrastructure facilities and rolling stock selectively, and upgrade the level of various services.

Therefore, the basic principle of this Study is to first aim at building “a railway system adaptable to the market” through downsizing and then to “selectively modernize railway transport services and upgrade the services of businesses that have been downsized to the appropriate size”.

3. Support of the Polish Government Needed for PKP Restructuring and Privatization

With today’s rapid increase in road transport, keeping a huge conventional railway network in Poland is a drawback to the country. A transport policy that can draw financial resources to transport services and effectively utilize the strength of railways is needed.

To put this transport policy into practice, the government must support the restructuring and privatization of the PKP Group companies by first helping them resolve the various problems they are facing to establish a stable operation base.

4. Overview of the Study

The ministries and agencies of Poland, including the Ministry of Infrastructure; local governments (hereinafter referred to as “voivodship”); PKP S.A.; PKP PLK, which is maintaining and managing the railway infrastructure, and the three transport companies must work together to realize the restructuring and privatization of the PKP Group companies as soon as possible.

To resolve the pending issues pertaining to the restructuring and privatization of the PKP Group companies, this Study analyzes the roles that shall be played by the national government and voivodships as well as measures that need to be taken by the various PKP companies to select the most suitable scenario for the restructuring and privatization. Policies and measures that shall be implemented by each of the related agencies and organizations towards their realization are summarized as follows:

(1) Polish Government

1) Downsizing

Because the restructuring and privatization of PKP is one of the most important issues, the Polish Government shall exercise strong leadership to facilitate phased reduction of the network maintained and managed by PKP PLK and reduction of the operation scales of the various PKP transport companies. This is the approach that will exert the least financial burden on the Polish Government and with it, the PKP Group companies can realize restructuring and privatization efficiently.

Although this Study proposes that, through downsizing, the route length to be maintained and managed by PKP PLK in the future shall ultimately be 11,000 km, the

national government shall consider the balanced development of the national land to determine the future scale.

2) Dealing with Surplus Workforce

The PKP Group companies covered in this study had a total workforce of 124,000 in FY 2002. It is estimated that through downsizing, as many as 60,000 workers will eventually become redundant. As there is a limit to what the PKP companies can do with this surplus workforce, the government shall play an active role in resolving this issue. With an early retirement program as the core, redundant workers can be relocated to railway-related undertakings and governmental organizations.

3) Utilizing Excess Properties

Through downsizing, the railway network that shall be maintained and managed by PKP PLK and the business scope of the PKP transport companies will be limited; as a result, there will be surplus portions of land and properties not required for the railway business. Laws shall be enacted to simplify property registration necessary for asset classification and suitable measures for these properties shall be taken as soon as possible. At that time, city-planning projects shall be considered to add value to land with good development potential, such as land adjacent to stations and marshalling yards, etc. to increase their sales values.

4) Settling Accumulated Debts

Settling the accumulated debts is an urgent issue that has deterred the restructuring and privatization of PKP; the Polish Government and PKP S.A. must take the lead to tackle the issue. Thus, (i) taking suitable measures to deal with the surplus workforce will increase the sales values of the stocks of PKP Group companies; and (ii) the redevelopment and effective utilization of sites not needed for the railway business will not only secure funds but also sell off unnecessary land to help repay the accumulated debts. In the case that PKP S.A. still cannot settle the debts after having taken these measures, the government shall temporarily provide the funds.

5) Modernizing Railway Infrastructure

Because the insufficient maintenance and management of infrastructure facilities (hereinafter referred to as “maintenance backlog”) in the PKP PLK railway network has been caused by a shortage of funds that the government should have furnished, the government shall take responsibility in taking the necessary measures. Given the urgency that PKP PLK must make its lines accessible to the transport companies of other countries when the transition period after Poland’s accession to the EU comes to an end in 2007, the maintenance backlog on important lines must be resolved by the end of 2006.

Modernization of the under-productive train operation control systems and modernization of lines operating under international treaties according to the EU technological standard must be prioritized. The Polish Government must take measures to optimize the use of EU funds to lessen the financial burden.

6) Improving Administrative Entities, etc.

The restructuring and privatization of the PKP Group must be implemented in conjunction with administrative organizations including the Ministry of Infrastructure. To do so, a “PKP Restructuring and Privatization Committee” must be set up under the direct control of the Prime Minister and comprised of members representing various ministries and agencies. The Committee will work at strengthening the coordination among ministries and agencies and allocate the necessary personnel for policymaking. Matters deliberated at the Committee shall be made public to make it easier to gain the public’s support. For this reason, it is necessary to add to its membership opinion leaders who represent the various sectors in Poland such as academic experts and representatives from the financial sector.

7) Developing Legislation

Legislative actions required for implementing the restructuring and privatization of the PKP Group include amendments to the new Railway Transport Law, enactment of the Law for Establishment of the PKP Restructuring and Privatization Committee, enactment of law for simplifying property registration, etc. and amendments to the ministerial ordinance for track access charge (hereinafter referred to as “TAC”) and that mandating the stationing of gatemen at level crossings.

Because these legislative reforms are indispensable for facilitating the restructuring and privatization of the PKP Group, the executive branch of the government, including the Ministry of Infrastructure, shall take immediate action to advance legislative development.

8) Strengthening UTK Functions

Implementation of vertical separation and open access may lead to the neglect of safety control in train operations, which is said to be the goal of a railway undertaking. The mentality that PKP PLK will not be privatized takes away the incentive to rationalize the organization and the workforce, reduce expenses, and upgrade the maintenance standards of railway infrastructure, etc.

UTK shall play a central role in ensuring that PKP PLK maintains the railway infrastructure at the appropriate technological level and providing strong supervision and direction to PKP transport companies regarding safety control. To do so, UTK must strengthen its organization.

(2) Voivodship

Among the train services originally offered by PKP Regional, operation of the loss-making trains will be abolished through downsizing. However, to secure transport means for local residents, the voivodship must review if it shall take the lead in continuing the train operations or agree on abolishing the train and switch to buses. In the case of continuing train operations, the voivodship must determine if it will enter a transport contract with PKP Regional or decide on the transport company through open bidding. With the application of the Law of Income of Government Units, the voivodship can play a central role in selecting transport services.

The abolition of loss-making trains needs to be carried out with the consensus of the local community. Therefore, the national government and PKP Regional shall make joint efforts to form agreement with the voivodships as soon as possible.

(3) PKP Companies

1) Dealing with Surplus Workforce

The priority for PKP Regional and PKP Cargo in downsizing is to deal with the redundant workers or rationalize the workforce to raise productivity. In dealing with the redundant workers, PKP companies must first make an effort to utilize human resources effectively by reviewing personnel assignment between departments and offering job transfers.

2) Strengthening Business Structure

The three transport companies must expand business by improving customer services, upgrading productivity, strengthening the business organization, and taking marketing initiatives to develop business.

3) Upgrading Rolling Stock

The PKP transport companies share the common challenge of having to upgrade superannuated rolling stock, which has become a hindrance to improving productivity. Improvement must be pursued within the financial scope of the companies. One way is through a rolling stock modernization agency set up by the government as recommended in this Study. In particular, PKP Intercity must renew rolling stock to upgrade services so that it can be competitive against transport companies from other countries entering the market.

4) TAC

To lower the TAC level, PKP PLK must take immediate action to upgrade productivity by modernizing train operation control systems and rationalizing the workforce, etc.

(4) Implementation Schedule for Restructuring and Privatization

It is recommended that the restructuring and privatization of the PKP Group companies be implemented in three phases, in view of the financial situation of the Polish Government and the feasibility of its financial policies.

1) Phase I (2004–2006)

After Poland becomes a Member State of the EU in May 2004, it will be subject to EU directives, etc. It has a grace period until the end of 2006, during which time, issues critical to the restructuring and privatization of the PKP Group must be resolved. In particular, the route length of PKP PLK shall be downsized to 15,000 km during this period.

The government's role in this period is especially large. It must implement important measures such as downsizing, eliminating the maintenance backlog of important lines,

dealing with the surplus workforce, settling accumulated debts, and enacting related laws and regulations, etc.

2) Phase II (2007–2010)

Besides tackling mid-term issues in this phase, the transport companies shall be privatized sequentially. Policies and strategies shall be implemented to downsize the route length of PKP PLK to 11,000 km by the end of 2010. In this phase, because transport companies of other countries will enter the Polish market, the various transport companies must modernize railway lines and strengthen their business organization.

While the government will continue to have a large role in this period, the various PKP transport companies will be making improvements to their businesses by upgrading rolling stock and improving productivity.

3) Phase III (2011 and after)

Due to downsizing, the railway system has become adaptable to the market. The PKP transport companies need to further strengthen their business organization as commercial companies. The government needs to continue implementation of measures to modernize important routes and review/strengthen the safety control system.

Contents

CHAPTER 1	INTRODUCTION -----	1-1
CHAPTER 2	STATUS OF THE POLISH STATE RAILWAYS AND MEASURES FOR RESTURCTURING AND PRIVATIZATION -----	2-1
2.1	Changes in Transport Demand -----	2-1
2.1.1	Passenger Transport	
2.1.2	Freight Transport	
2.2	Changes in Business Condition -----	2-3
2.3	Status of PKP Group Companies -----	2-4
2.4	Measures Taken for Railway Restructuring and Privatization -----	2-5
2.4.1	Law on Restructuring, Commercialization and Privatization of PKP and the Restructuring Program (1999)	
2.4.2	Revamping the Regional Passenger Transport System	
2.4.3	Utilizing Findings of Aid Implementation Organizations	
2.4.4	Pending Issues	
CHAPTER 3	CONDITIONS FOR EFFECTIVE RESTRUCTURING AND PRIVATIZATION-----	3-1
3.1	Concepts of Railway Restructuring and Privatization and Basic Principles of JICA's Study -----	3-1
3.1.1	Need for Restructuring and Privatizing the Polish Railways	
3.1.2	Restructuring and Privatization of the Japanese National Railways	
3.1.3	Basic Principles of JICA's Study	
3.2	Circumstances Faced by the Polish Railways -----	3-3
3.2.1	Trends in Railway Demand	
3.2.2	Changes Accompanying the Accession to EU	
3.3	Analysis of Pending Issues -----	3-7
3.3.1	Oversized Railway Network	
3.3.2	Lack of Railway Transport Services Meeting Market Needs	
3.3.3	Lack of Financial Resources for Settling Accumulated Debts	
3.3.4	Legislative, Organizational, and Structural Aspects Hindering Railway Operations	
3.3.5	An Overview of Issues	
3.3.6	Relationship between the Issues and the Study's Basic Principles	
3.4	Railway System Adaptable to the Market -----	3-15
3.4.1	Precautions at the Time of Downsizing	

3.4.2	Basic Principles of Downsizing	
3.4.3	Provisional Analysis of Downsizing Strategies	
3.5	Selective Modernization of Railway Transport Services and Upgrading of Services -----	3-18
3.5.1	Elimination of Maintenance Backlogs and Modernization of Inefficient Infrastructure Facilities	
3.5.2	Modernization of Rolling Stock	
3.5.3	Offering of Services that Satisfy Customer Needs	
3.5.4	Development of Marketing Systems	
3.6	Management Approach Adaptable to Market Economy -----	3-20
3.6.1	Elimination of External Interference	
3.6.2	Awareness Reform	
3.6.3	Human Resources Development	
3.6.4	Dealing with Labor Unions	
CHAPTER 4	ROLES OF THE NATIONAL AND LOCAL GOVERNMENTS -----	4-1
4.1	Clarifying the Role of Railways in Future Transport Sector -----	4-1
4.1.1	Need for a Comprehensive Transport Policy	
4.1.2	Areas in Which Rail Transport Excels	
4.1.3	Tackling Various Problems	
4.2	Adapting to EU Rail Policy -----	4-3
4.2.1	Vertical Separation and Open Access	
4.2.2	Developing Railway Infrastructure	
4.2.3	Subsidies for Railway Undertakings	
4.3	Roles of PKP S.A. and UTK -----	4-5
4.3.1	PKP S.A.	
4.3.2	UTK	
4.4	Surplus Workforce -----	4-7
4.4.1	Workforce Restructuring	
4.4.2	Specific Approaches	
4.5	Effective Utilization of Surplus Properties -----	4-9
4.5.1	Stations	
4.5.2	Marshalling Yards (including freight terminals)	
4.5.3	Conclusion to the Division of Properties	
4.6	Settlement of Accumulated Debts -----	4-12
4.7	Upgrading and Modernizing Superannuated Infrastructure Facilities and Rolling Stock -----	4-13

4.7.1	Modernizing Infrastructure Facilities	
4.7.2	Introduction of New Rolling Stock by Governmental Rolling Stock Renewal Organization	
4.8	Improvement of Administrative Organizations -----	4-15
4.9	Legislative Development -----	4-17
4.9.1	Amendments of the New Railway Transport Law	
4.9.2	Establishment of the PKP Restructuring and Privatization Committee	
4.9.3	Legislation to Simplify Property Registration	
4.9.4	Other Legislation	
4.10	Revamping the Regional Passenger Transport System -----	4-19
4.10.1	Basic Concept of Reforming the Regional Passenger Transport System	
4.10.2	Ways of Handling Loss-making Train Operations	
4.10.3	Handling the Debts of PKP Regional	
4.10.4	Abolishing the Practice of Internal Transactions	
4.10.5	Japan's Measures for Local Lines	
4.11	Revising TAC-related Regulations -----	4-24
4.11.1	Current TAC	
4.11.2	TAC in Other European Countries	
4.11.3	Recommendations for TAC-related Regulations	
4.12	Financial Measures and Sources of Funds for the Railways -----	4-28
4.12.1	Expanding Public Finance	
4.12.2	EU Funds	
4.12.3	Utilizing PPP (Public-Private Partnership)	
4.13	Building National Consensus for Restructuring and Privatization -----	4-31
CHAPTER 5	MEASURES TO BE TAKEN BY PKP COMPANIES FOR RESTRUCTURING AND PRIVATIZATION -----	5-1
5.1	PKP PLK -----	5-1
5.1.1	Business Environment	
5.1.2	Management Issues	
5.1.3	Management Objective	
5.1.4	Management Strategies	
5.1.5	Measures	
5.1.6	Viable Levels of TAC Reduction	
5.2	PKP Regional -----	5-4
5.2.1	Business Environment	
5.2.2	Management Issues	

5.2.3	Management Objective	
5.2.4	Management Strategies	
5.2.5	Measures	
5.2.6	Future Operation Scale	
5.3	PKP Intercity -----	5-9
5.3.1	Business Environment	
5.3.2	Management Issues	
5.3.3	Management Objective	
5.3.4	Management Strategies	
5.3.5	Measures	
5.3.6	Future Operation Scale	
5.4	PKP Cargo -----	5-12
5.4.1	Business Environment	
5.4.2	Management Issues	
5.4.3	Management Objective	
5.4.4	Management Strategies	
5.4.5.	Measures	
5.4.6	Future Operation Scale	
CHAPTER 6	TOWARDS THE IMPLEMENTATION OF RESTRUCTURING AND PRIVATIZATION -----	6-1
6.1	Overall Assessment of the Effects of Downsizing -----	6-1
6.1.1	Precautions for the Overall Assessment	
6.1.2	Selecting the Best Option	
6.2	Financial Effects and Required Amount of Funds -----	6-4
6.2.1	Financial Effects	
6.2.2	Amount of Necessary Funds	
6.3	Recommendations for the Restructuring and Privatization Implementation Plan -----	6-5
6.3.1	Policies for Realizing the Restructuring and Privatization Plan	
6.3.2	Implementation Schedule for Restructuring and Privatization	

Acronyms and Abbreviations

AGC	European Agreement on Main International Railway Lines (<i>Accord Européen sur Les Grandes Lignes Internationales de Chemin de fer</i>)
AGTC	European Agreement on Important International Combined Transport Lines and Related Installations (<i>Accords Généraux sur le Transport Combiné</i>)
CIT	Corporate Income Tax
CMK	Central Trunk Line (<i>Centralna Magistrala Kolejowa</i>)
COTIF	Protocol to the Convention Concerning International Carriage by Rail (<i>Convention Relative aux Transports Internationaux Ferroviaires</i>)
CTC	Centralized Traffic Control
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
EMU	Electric Multiple Unit
ERDF	European Regional Development Fund
ERP	Enterprise Resource Planning Package
ERTMS	European Rail Traffic Management System
ETCS	European Train Control System
EU	European Union
FFP	Frequent Flyers Program
ID/OS	Institutional Development / Organizational Strengthening
ISPA	Instrument for Structural Policies for Pre-Accession
IDIM	Institute of Road and Bridge, Warsaw University of Technology (<i>Institut Drog Mostow Politechnich Warszawa</i>)
JICA	Japan International Cooperation Agency
JR	Japan Railways
LOT	Polish Airlines (<i>Polskie Linie Lotnicze</i>)
MIS	Management Information System
MOI	Ministry of Infrastructure
MOF	Ministry of Finance
NIK	Supreme Chamber of Control (<i>Najwyższa Izba Kontroli</i>)
PFI	Private Finance Initiative
PHARE	Poland and Hungary: Action for Restructuring of the Economy (<i>Fundacja na rzecz Restrukturyzacji Polski i Węgier</i>)
PIT	Personal Income Tax
PKP	Polish State Railways (<i>Polskie Koleje Państwowe</i>)
PKP S.A.	<i>Polskie Koleje Państwowe Spółka Akcyjna</i>
PKP PLK	<i>PKP Polskie Linie Kolejowa</i>
PLN	Polish New Złoty (<i>Polski Nowy Złoty</i>)
PPP	Public-Private Partnership
PSO	Public Service Obligation
SWOT	Strength-Weakness-Opportunity-Threats
TAC	Track Access Charge
TEN	Trans-European Network
TERFN	Trans-European Railway Freight Network
TINA	Transport Infrastructure Needs Assessment

TOCS	Train Operation Control System
UIC	International Union of Railways (<i>Union Internationale des Chemins de fer</i>)
UTK	Railway Transportation Office (<i>Urząd Transportu Kolejowego</i>)

CHAPTER 1 INTRODUCTION

The Government of the Republic of Poland (hereinafter referred to as “Polish Government”) is undertaking the privatization of its largest enterprise, the Polish State Railways (hereinafter referred to as “PKP”). It has enacted relevant laws and implemented various measures to prepare for the privatization. In this backdrop, the Polish Government made a request to the Government of Japan in April 2000 to conduct this Feasibility Study, expressing a strong desire for specific policy recommendations formulated based on the privatization experience of the Japanese National Railways.

In response to this request, the independent administrative agency Japan International Cooperation Agency (hereinafter referred to as “JICA”) dispatched a team to Poland in October 2002 to conduct a preliminary study. The team concluded an agreement with the Polish Government on the Scope of Work, based on which JICA organized a professional team and set up an advisory committee to facilitate the Study.

This Study aims at reviewing the operation and management status of the PKP Group, formulating management strategies and financial measures to rationalize the scale of operations and enhance the competitiveness of various PKP companies, and making policy recommendations to facilitate the restructuring and privatization of PKP. Through its implementation, the Study also aims at establishing close communications with policymakers and counterparts on the Polish side to extend policy assistance to the Polish Government.

This report comprises six chapters.

Chapter 1 explains the background and objectives of the Study and gives an overview of the report.

Chapter 2 describes Poland’s transportation environment, the state of railway transport, and operating conditions of the PKP Group. It summarizes the policies that the Polish Government has taken towards privatization, the laws and regulations enacted, and the new Restructuring Program.

Chapter 3 explains the basic principles of the JICA Study and gives a detailed analysis of the various conditions necessary for the effective restructuring and privatization of the PKP Group. It describes downsizing, selective modernization and productivity improvement on the railway transport sector as the ways for realizing these conditions.

Chapter 4 gives recommendation of policies that the Polish Government shall adopt in order to realize the conditions described in chapters 2 and 3. Here, PKP S.A., the holding company of the PKP Group, is identified as the entity to implement policies of the national government. Treatment of the regional passenger transport is also discussed because not only the national government but also the local governments will have an important role to play.

Chapter 5 recommends measures to the various PKP Group companies for realizing the conditions described in Chapter 3 as well as measures for pursuing restructuring and

privatization under the policy framework of the national government described in Chapter 4.

Chapter 6 gives the recommendation and conclusion of this report. Based on the policies and recommendations described in the previous five chapters, it analyzes multiple scenarios for downsizing, identifies the most feasible scenarios for the Polish Government, set up the schedule for implementing the policies, and recommends policies that shall be implemented by phase.

CHAPTER 2 STATUS OF THE POLISH STATE RAILWAYS AND MEASURES FOR RESTRUCTURING AND PRIVATIZATION

2.1 CHANGES IN TRANSPORT DEMAND

The political and economic frameworks of countries in Central and Eastern Europe underwent reforms at the end of 1980s and early 1990s, which drastically transformed the transportation systems of these countries. Both the passenger and freight transport of the Polish railways were greatly affected. Such changes in the business environment of the Polish railways had far-reaching effect on the transport demand as well as the financial soundness of PKP.

2.1.1 Passenger Transport

Table 2.1.1 shows the changes in the number of passenger journeys by transport mode in Poland.

Table 2.1.1 Changes in the Number of Passengers by Transport Mode

(Unit : million passengers)

Transport Mode	1990	1992	1994	1996	1998	2000	2002
Railway	789.9	549.3	494.6	434.2	401.5	360.7	304.1
Bus	2,084.7	1,513.1	1,215.3	1,085.4	1,038.3	954.5	815.0
Air	1.7	1.3	1.6	2.0	2.6	2.9	3.7

Source: Statistical Yearbook, IDIM

Table 2.1.1 shows the secular changes in the number of passenger journeys by transport mode in Poland, excluding private vehicles and urban public transport. The Table indicates that the numbers of passengers transported by railways and buses declined sharply between 1990 and 2002. This was probably caused by the rapid shift from public to private transport modes. Table 2.1.2 shows the changes in the volume of passenger transport in Poland from 1995 to 2000.

Table 2.1.2 Changes in the Numbers of Passengers by Public and Private Transport Modes

Item	Unit	1995	2000
Population	1,000 persons	38,588	38,646
GDP at 1995 constant prices	million US dollars	127,100	163,300
Passenger (Public + Private)	million passengers	2,997	2,990
	%	100.0	100.0
Passenger (Public)	million passengers	1,601	1,320
	%	53.4	44.1
Passenger (Private)	million passengers	1,396	1,670
	%	46.6	55.9

Source: Statistical Yearbook, IDIM

Note: Public = public transport excluding urban public transport,

Private = private vehicles

Table 2.1.2 shows that the share of public transport in all transport modes from 1995 to 2000 on a per capita basis drops from 53.4% to 44.1%, a result of the popularization of private vehicles. As the rate of passenger car ownership rises, this trend is expected to become even more prominent in the future and the share of railways will erode rapidly. Table 2.1.3 shows the rate of passenger car ownership in Poland in the recent years.

Table 2.1.3 Changes in Passenger Car Ownership

Item	Unit	1990	1995	2000	2001
Population	(1,000 persons)	38,183	38,588	38,646	38,641
Passenger car ownership	(unit/1,000 persons)	137.8	194.7	258.5	271.8

Source: Statistical Yearbook, IDIM

2.1.2 Freight Transport

According to statistical data, although the GDP rose in the 1990s, some countries did not experience any change in the distribution volume or even saw a reduction. Poland is one of these countries. Table 2.1.4 shows the changes in the volume of freight transport in Poland.

Table 2.1.4 Changes in Freight Volume by Transport Mode

Transport Mode	(Unit: million tons)						
	1990	1992	1994	1996	1998	2000	2002
Rail	281.7	201.7	214.7	223.5	206.4	187.2	223.0
Road	1,292.4	1,121.7	1,060.7	1,091.9	1,077.3	1,083.1	1,002.3
Air	0.01	0.01	0.02	0.03	0.03	0.03	0.03

Source: Statistical Yearbook, IDIM

Table 2.1.4 demonstrates that compared to 1990, the overall volume of freight transport shows a downward trend in recent years. This is mainly caused by a decrease in the transport demand for coal, and iron and steel products. Table 2.1.5 shows the changes in the volume of coal transport by rail.

Table 2.1.5 Changes in the Volume of Coal Transport by Rail

Item	(Unit: million tons)		
	1995	2000	2001
Volume of coal transport in Poland (a)	173.1	131.3	132.1
Export	31.9	23.2	23.0
Import	1.5	1.5	1.9
Domestic transport	139.7	106.6	107.2
Volume of coal transported by PKP (b)	107.5	82.2	79.2
PKP share (b/a)	62.1%	62.6%	59.9%

Source: Statistical Yearbook, IDIM

Change in the transport demand of major transport items impacts the modal share of road and rail in freight transport. Table 2.1.6 shows the changes in the shares of the two transport modes in freight transport.

Table 2.1.6 Changes in the Modal Share of Road and Rail in Freight Transport

(Unit: %)

Item	1990	1995	2000	2001
Total transported volume by rail and road	100.0	100.0	100.0	100.0
Rail transport	17.9	17.2	14.7	13.5
Road transport	82.1	82.8	85.3	86.5

Source: Statistical Yearbook, IDIM

According to Table 2.1.6, the share of railways in freight transport by road and rail declined from 17.9% to 13.5% on a tonnage basis from 1990 to 2001. The volumes transported by motor vehicles in this table are those of freight forwarding companies. Since there are no statistical data on freight volumes transported by privately owned trucks, the actual share of rail freight is estimated to be even lower than these figures.

As shown above, changes in passenger and freight transport from 1990 to recent years show that road transport has become dominant in both passenger and freight transport and the volume of transport by rail is in decline. This is the major reason for the deterioration in PKP Group's business condition.

2.2 CHANGES IN BUSINESS CONDITION

Table 2.2.1 shows the financial situation of Polish railways in freight and passenger transport.

Table 2.2.1 Changes in PKP Financial Situation

(Unit: million PLN)

Fiscal Year	1999	2000	2001	2002
Freight	683.0	558.1	226.2	370.2
Passenger	-1,479.7	-1,288.4	-1,362.6	-1,155.0
Total	-796.7	-730.3	-1,136.4	-784.8

Source: Program of further restructuring and privatization of PKP Group companies to 2006

Historically, the Polish railway undertakings had been making profits from freight transport and suffering losses from passenger transport, and profits from freight transport were used to cover the losses from passenger transport. Unfortunately, profits from freight transport could not fully subsidize the losses from passenger transport; and railway undertakings in general were operating in the red. In passenger transport, losses from regional passenger transport accounted for most of the deficits. As a result of the division of PKP in 2001 pursuant to the Railway Transport Law, cross-subsidization from freight transport undertakings to passenger transport undertakings became no longer available, thrusting regional passenger transport into a critical shortage of funds.

Furthermore, due to insufficient government subsidies for making new investment in infrastructure, the Polish railway undertakings became heavily dependent on external loans. Table 2.2.2 shows the changes in outstanding liabilities from 1995 to 2002.

Table 2.2.2 Changes in PKP Outstanding Liabilities

(Unit: million PLN)

	1995	1996	1997	1998	1999	2000	2001	2002
Liabilities	1,503.1	2,114.6	2,976.8	4,166.8	6,312.4	7,193.4	8,510.6	10,610.5

Source: Program of further restructuring and privatization of PKP Group companies to 2006

The increased reliance on external loans augments interest payments, thus further deteriorating the financial condition of Poland’s railway.

In this way, the privatization process went ahead without having taken adequate measures to reform regional passenger transport and settle the liabilities of the Polish railways, thus making resolution of these problems even more difficult.

2.3 STATUS OF PKP GROUP COMPANIES

In June 1997, the Railway Transport Law was enacted to adopt vertical separation between railway operations and infrastructure management and to ensure open access. In September 2000, the Law on restructuring, commercialization and privatization of the Polish State Railways was enacted. In 2001, PKP was divided into PKP S.A. (PKP Group holding company), PKP PLK (infrastructure management company), PKP Regional (regional passenger transport undertaking), PKP Intercity (intercity passenger transport undertaking), PKP Cargo (freight transport undertaking), and other companies pursuant to the Railway Transport Law. Figure 2.3.1 shows the current relationship between the Polish Government and the PKP Group companies.

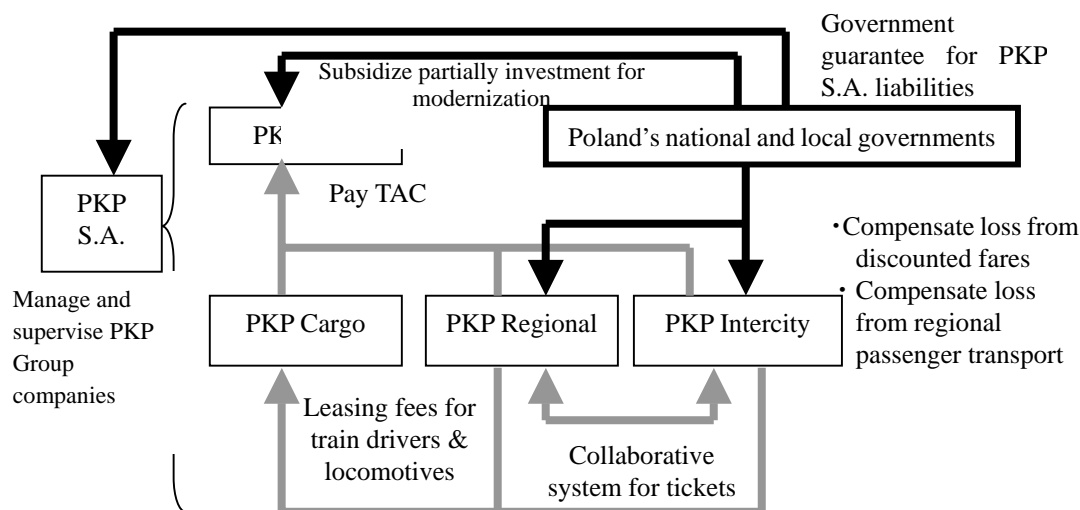


Figure 2.3.1 Relationship between the Polish Government and PKP Group Companies

Table 2.3.1 summarizes the current operation status of PKP Group companies.

Table 2.3.1 Operation Status of PKP Group Companies (FY 2002)

Item	Unit	PKP S.A.	PKP PLK	PKP Regional	PKP Intercity	PKP Cargo
Operational Revenues	million PLN	1,087	2,797	2,209	694	5,923
Operational Costs	million PLN	1,367	3,109	3,222	718	5,549
Operational Profits	million PLN	- 280	- 312	- 1,013	- 24	375
Net Profit	million PLN	- 886	- 895	- 1,045	- 33	153
Passenger Transport	million persons	-	-	250	9	-
	billion passenger-km	-	-	17	3	-
Freight Transport	million tons	-	-	-	-	155
	billion ton-km	-	-	-	-	45
Train-km	million train-km	-	-	146	21	73
Network Served	km	-	20,150	14,800	*15,830	*218,550
Employees (end of fiscal year)	person	3,803	46,004	21,449	2,016	49,786
Rolling Stock						
Locomotive	car	-	-	-	-	3,816
Wagon	car	-	-	-	-	90,185
Coach	car	-	-	4,144	1,340	-
EMU	car	-	-	1,074	-	-

(*1) Excludes foreign territory (3,400 km)

(*2) Estimated by JICA Study Team

2.4 MEASURES TAKEN FOR RAILWAY RESTRUCTURING AND PRIVATIZATION

To date, the Polish Government has taken the following measures: enacting the Law on restructuring, commercialization and privatization (2000); establishing the Governmental Program of PKP Restructuring of September 1999 (hereinafter referred to as "Restructuring Program (1999)"); revamping the regional passenger transport system; and utilizing the findings of international cooperation organizations.

2.4.1 Law on Restructuring, Commercialization and Privatization of PKP and the Restructuring Program (1999)

The main objectives of the Restructuring Program (1999) and the Law on Restructuring, Commercialization and Privatization (2000) are to modernize the organizational structure (organizational restructuring), review financial liquidity (financial restructuring), adjust the composition of assets and human resources (restructuring of assets and human resources), and undertake privatization of the PKP Group.

Unfortunately, due to various reasons, the restructuring initiatives implemented under

the Law and the Restructuring Program were not effective enough. The reasons are as follows:

- Delay by PKP S.A. in implementing procedures for the restructuring of assets and finances
- Delay in revamping the regional passenger transport services
- Increases in financial burden due to operation of an oversized railway network
- Lack of business strategies for meeting market needs

In addition to the above problems, the circumstances for the railways have changed, making it imperative to make some adjustments to the Restructuring Program (1999) and the management strategies of various PKP companies.

To resolve these problems and to further promote restructuring, the Polish Government drastically amended the Railway Transport Law as well as revised the Law on Restructuring, Commercialization and Privatization of the Polish State Railways (2000) (the revised laws are hereinafter referred to as “new Railway Transport Law; new Law on Restructuring, Commercialization and Privatization,” respectively). Based on these legislative amendments, the Program of further restructuring and privatization of PKP Group companies to 2006 was drawn up in November 2003 (hereinafter referred to as “new Restructuring Program”). The following are the priority issues identified in the new Restructuring Program.

- Financial restructuring
- Organizational and financial reforms of regional passenger services
- Privatization of PKP Group companies
- Promoting the new Law on Restructuring, Commercialization, and Privatization and the restructuring of various development plans for railway transport

2.4.2 Revamping the Regional Passenger Transport System

A drastic reform was proposed to revamp regional passenger transport services. It tackled the deteriorating financial condition of PKP Regional and incorporated the Law on Income of Local Government Units to take effect from FY 2004. Pursuant to the Law on Income of Local Government Units, the rights for providing regional passenger transport services and its finances have been transferred to the governments of regional provinces (hereinafter referred to as “voivodship”). The proposed reform recommended that PKP Regional transfer regional passenger transport services to transport companies set up under the voivodships and that PKP Regional receive operational contracts from these companies.

2.4.3 Utilizing Findings of International Cooperation Organizations

In the process of implementing various measures, the Polish Government utilizes the findings of international cooperation organizations such as JICA, the World Bank, and EBRD, etc. The Japanese Government provided assistance to support the market-oriented economic reform of Poland's transport sector through "The Study on the National Transport Plan in the Republic of Poland" conducted by JICA from 1991 to 1992. The Study recommended an early restructuring of PKP. Furthermore, in order to formulate a master plan for privatization, JICA conducted "The Study on Privatization of Polish State Railways in Poland from 1996 to 1998," using the experience of the restructuring of the Japanese National Railways as reference. The Polish Government adopted recommendations from the latter Study in the restructuring of the Polish State Railways.

2.4.4 Pending Issues

Although measures have been taken to reform and privatize various railway undertakings, the PKP privatization process cannot be described as a smooth ride. The environment in which PKP must undertake restructuring and privatization is changing. With Poland scheduled to become a Member State of the EU in May 2004, it must comply with EU's railway policy, making it necessary for the Polish railway companies to maintain a strong business structure in order to build international competitiveness.

Satisfactory solutions for the following issues, in particular, have not yet been found:

- (1) The railway network is too extensive, given today's rapid and continuous growth of other transport modes such as automobile and airplanes.
- (2) The Polish railways are not providing rail transport services that meet the market needs.
- (3) The financial resources for liquidating the accumulated debts are insufficient.
- (4) The legislative, organizational, and structural aspects are hindering railway operations.

Resolving the above issues holds the key to the restructuring and privatization of railway operations in the future.

CHAPTER 3 CONDITIONS FOR EFFECTIVE RESTRUCTURING AND PRIVATIZATION

3.1 CONCEPTS OF RAILWAY RESTRUCTURING AND PRIVATIZATION AND BASIC PRINCIPLES OF JICA'S STUDY

3.1.1 Need for Restructuring and Privatizing the Polish Railways

The railway was the major transport mode for everything in the planned economy era. However, after the transition to a market-oriented economy, the rapidly developed motor transport eroded rail's share of the transport market, leading to a drastic decrease in demand for rail transport. As a result, the profitability of railway operations deteriorated. The railways had to depend heavily on state subsidies to stay afloat, which strained national finances.

To tackle this issue, the Polish Government has been making attempt to reduce the financial burden on the state through restructuring and privatization of the Polish railways. However, the various restructuring and privatization measures implemented so far have not fully succeeded in downsizing the operations to a scale compatible with the sharp decline in transport demand and in upgrading operational efficiency to enable the railways to survive in the competitive marketplace. For this reason, the Polish railways have not yet reached the stage of sound operation, making it difficult to pursue privatization. For the PKP Group to achieve privatization, further reforms are needed.

3.1.2 Restructuring and Privatization of the Japanese National Railways

In the past, the Japanese National Railways also experienced the same situation now faced by the Polish railways, and underwent restructuring and privatization.

There was also an period in Japan when road construction and car ownership were pursued at a dizzying speed and railways had a difficult time adjusting properly to the increasingly competitive transport market. At that time, although the Japanese railway industry had lost its monopoly in the marketplace because of competition from motor transport, the government, management of the Japanese National Railways, labor unions, media, and the public all failed to recognize this fact; resulting in a marked delay in structural and organizational reforms.

Furthermore, because important decisions regarding the operations of the Japanese National Railways required the approval of the government and the Diet, business management was always tied to politics. The political sector also interfered sometimes in the operations of the Japanese National Railways, pressuring the management to construct and operate loss-making railway lines. Another weakness of the Japanese National Railways was the volatile labor-management relations. The Japanese National Railways was an enormous business entity; it was extremely difficult to communicate the intentions of the management to every corner of the worksites. The management, which relied heavily on politics, lacked the ability to negotiate with labor unions on an equal basis, leading to frequent strikes. Consequently, the Japanese National Railways became an entity not meeting the social needs.

In April 1987, the Japanese railways were reformed pursuant to the “Passenger Railway Companies and Japan Freight Railway Company Law” to resolve these problems. The Japanese National Railways was divided into six regional passenger railway companies and one national freight company; these started operations as joint stock companies wholly owned by Government. It was deemed necessary that the government should act as guardian of the new companies for certain time to ensure the effective operation of business. The reform intended to have the government own all the stocks at first and then offer them up for sale in the stock market later. The restructuring of the Japanese National Railways is a major factor contributing to the revitalization of railways. The following three reasons can be cited:

- The railway industry was rid of the many constraints imposed on it during the monopoly era.
- An environment was created in which railway operations could be separated from politics and managers could concentrate on business management.
- The consciousness of railway employees was reformed, making it possible to render customer-oriented services.

The “restructuring of the Japanese National Railways” is characterized by the adoption of basically the same form of organization as a private corporation and the commitment to use the same decision-making principles as a conventional private company. Thereby, the kinds of “political dependency” and “political interference” at the times of the Japanese National Railways were eradicated. Managers in the era of the Japanese National Railways were too busy dealing with the Diet, making it impossible for them to concentrate on railway management. Because the newly inaugurated JR companies are separated from politics, managers can concentrate on their primary job, which is business management.

Another characteristic of the “restructuring of the Japanese National Railways” is the success in reforming the consciousness of railway employees. During the days of the Japanese National Railways, many employees lacked the “customer-oriented” concept. The notion that the “Japanese National Railways would never go bankrupt” took shape in low morale among the workers and actions lacking in moderation by the labor unions. Privatization brought fundamental changes to these aspects. The “customer-oriented” consciousness permeated to every corner of the organization. The newly inaugurated JR companies also put efforts into employee education and training to point out that “they are different from the former state enterprise.” These efforts bore fruit in better services and more customers today.

3.1.3 Basic Principles of JICA’s Study

In general, privatization refers to the transfer of the ownership of an entity to the private sector. The JICA Study, however, aims not merely at transferring ownership to the private sector but also at realizing a sound form of corporation that will enable the entity to operate independently from the government in terms of finance, etc. The restoration of corporate health and the approach to privatization are referred to in this Study as “restructuring and privatization,” and these are what the Study is aimed at accomplishing.

Why does the JICA Study aim at restructuring the PKP Group first before proceeding to privatization? If the business operations of the PKP railway operators are not restored to a sound state that sustains viable corporate activity, the value of those companies will be appraised lower by prospective investors, thus the government will not obtain the expected capital gain from the sale of the company.

Once the PKP railway operators are purchased by prospective investors, due to the railways' lack of management capacity, the investors will most probably shut down unprofitable parts of the railways, and dispose of the assets by selling them piecemeal. Since the sell-off of railways is an irreversible action, proper measures taken now will ensure the survival of railway service in the future, which inaction will likely lead to its decline.

To effectively restructure and privatize the Polish railways, it is necessary to take into account Poland's current financial situation and adopt methods that will involve the least financial burden. To this end, the most effective method is cutting down on the scale of operations (hereinafter referred to as "downsizing"). Downsizing here does not stop at achieving a smaller railway network but includes also the reduction of surplus workforce and excess facilities.

On the other hand, downsizing alone may not develop businesses that meet market needs. In order to provide services that adapt to market needs, it is necessary to focus business resources on the downsized railway services, selectively modernize railway infrastructure facilities and rolling stock, and upgrade the level of various services.

Therefore, the basic principles of this Study is to first aim at building "a railway system adaptable to the market" through downsizing and then to "selectively modernize railway transport services and upgrade the services of businesses that have been downsized to the appropriate size."

3.2 CIRCUMSTANCES FACED BY THE POLISH RAILWAYS

Restructuring and privatization of the Polish railways must be implemented taking into full consideration various other factors such as the "trend in railway demand," "changes resulting from accession to the EU," etc.

3.2.1 Trends in Railway Demand

According to the results of demand forecast conducted in this Study, the trend of railway demand is forecasted as follows:

(1) Volume of Passenger Transport

The spread of car ownerships advances the shift from public transport to motor vehicles, resulting in a decrease in public transport users. If demand for the railways is not maintained and no expansion measures are taken, rail's share of passenger transport, excluding urban public transport, is projected to be 7.9–8.5% in 2006 and 6.9–7.7% (214.5–240.4 million passengers) in 2010. If the current trend continues, railway users are estimated to decrease by 30% by 2010, using 2001 as the base year.

Rail's share of international travelers in passenger transport is projected to be less than 1% in the future. If the current mobility pattern continues, journeys to Germany and Belarus will each comprise 30% of the total international rail market.

(2) Volume of Freight Transport

In terms of freight transport, the Polish Government has been able to project transport demand based on the respective demand forecast of major high-volume transport items. The result shows that the share of the railway among all transport modes is projected to be 11.1–12.1% of tons transported in 2006 and 9.5–11.2% in 2010. The volume of domestic freight transport by rail is projected to decrease 3–25% by 2010, using 2001 as the base year.

On the other hand, the share of future international freight transport demand by rail is projected to be 4.9–5.3% in 2006 and 4.2–4.4% in 2010. From the current mobility pattern, it is estimated that exports by rail will be carried to a wide range of areas. In the case of imports, rail transport is seen as a major player in transactions with countries in Eastern and Central Europe in the future.

(3) Overview of Demand Forecast

The transport demand for railways is in decline. If no measures are taken to effectively maintain demand, the transport demand for railways is expected to continue to decline in the future.

With regard to passenger transport, due to advance in road development, spread of private vehicles, and progress in air transport, the railway will likely be confined to markets of mainly mid-to-long distance passenger transport and passenger transport in large cities and conurbations where the railway has a relative edge in terms of time and cost. In freight transport as well, the same trend of restricted market is evident. With the different transport modes becoming more specialized in transport according to product item, transportation time, and distance, the railway will likely become specialized in the mid-to-long distance transport of bulk freight and combined freight transport such as containerization, etc.

Furthermore, liberalization and deregulation of the transport market is expected to expand the transport share of road and air run by the private sector, which has few business constraints, while shrinking the transport share of the railway.

3.2.2 Changes Accompanying the Accession to EU

(1) EU Directives

Following Europe's market integration in 1993, it becomes necessary for EU and its Member States to cooperate in reforming their current railway operations in order to build truly competitive railway systems that can be integrated into Europe's future transport framework. To this end, the Council of the European Union formulated a Council Directive (91/440/EEC) in July 1991 for the development of railways in the European Community. It laid down the ground rules for the reformation of railway systems.

The contents of the Directive include ensuring the management independence of railway undertakings, separating the accounts of businesses managing railway infrastructure from the accounts of businesses providing railway transport services, improving the financial structure of railway undertakings by reducing indebtedness from the past, and ensuring the access and transit rights, the so-called open access, to the networks of Member States for international groupings of railway undertakings and for railway undertakings engaged in the international combined transport of goods. Furthermore, the Council Directive (95/18/EC) on the licensing of railway undertakings and Council Directive (95/19/EC) on track access charges (hereinafter referred to as “TAC”) were formulated to supplement the Directive (91/440/EEC).

As part of market integration, EU has proceeded with the liberalization of railways to introduce the concept of competition into the Community’s rail transport market. In reality, however, liberalization has not proceeded as originally planned due to the fact that companies that can be awarded open access are international groups made up of multiple railway undertakings, that open access is limited to undertakings engaging in the international combined transport of goods, and that the setting of TAC is different in different Member States, etc.

In January 2001, a new transport policy promoting open access in the field of freight transport was put into effect. That is, as the first package of railway reform, the Directive (91/440/EEC) and Directive (95/18/EC) were amended to become Directive (2001/12/EC) and Directive (2001/13/EC). The Directive (95/19/EC) was repealed and the new Directive (2001/14/EC) was enacted.

(2) Amendments to the EU Directives

The major amendments to the three new directives are as follows:

- As compared to before the amendment, “freight forwarders engaging in international transport within the Trans-European Rail Freight Network” were added as a business eligible for entry from 2003.
- The options “to have organizational separation within a single undertaking for the management of infrastructure and provision of railway services or to delegate infrastructure management to a separate entity” were added.
- The allocation of railway infrastructure capacity and the levying of TAC were clarified, providing that the infrastructure manager shall ensure that “infrastructure capacity is allocated on a fair and non-discriminatory basis” and that “although the infrastructure access charge is set according to the operations of train services, it may take into consideration the costs of congestion and environmental effects.”

In addition, as the second package, the European Commission is reviewing and preparing various directives related to (i) responsibility for the Community’s railway safety and unification of safety certificates; (ii) expansion of interoperability; (iii) establishment of a European railway agency; (iv) further development of the Community’s railways, and (v) accession to the Convention concerning International Carriage by Rail (COTIF).

In light of the above-mentioned directives and Poland's accession to the EU in May 2004, the Polish railways will face a business environment with the following changes:

- With open access granting entry to international transport companies and powerful foreign transport companies, competition in the railway business will intensify.
- The inland transport network linking the whole EU region and neighboring regions will expand.
- Modal shift with emphasis on EU's basic policies of environment and safety will be promoted.

(3) Effects on Strategically Important Lines

Although PKP PLK is not an entity scheduled for privatization, it has the responsibility of contributing to sound development of the railway industry by providing good infrastructure facilities, achieving appropriate TAC through cost reduction, and realizing an appropriate network scale, etc. It also has tremendous influence on the operations of various transport companies that are to be privatized.

PKP PLK maintains and manages 20,150 km of railway tracks. This railway network includes important lines such as the lines of national importance designated by the Railway Transport Law, lines operating under international treaties such as AGC and AGTC, and TINA (Transport Infrastructure Needs Assessment) corridors the infrastructure of which must be maintained in compliance with EU standards, etc. Table 3.2.1 shows these strategically important lines.

Table 3.2.1 Strategically Important Lines

Line	Relevant Laws and Agreements, etc.	Route Length	
Lines of National Importance	Railway Transport Law (Article 6)	Approximately 12,000 km	
AGC Lines	European Agreement on Main International Railway Lines dated May 31, 1985	Total: Approximately 5,000 km	
AGTC Lines	European Agreement on Important International Combined Transport Lines and Related Installations dated February 1, 1991		
TINA	Transport Infrastructure Needs Assessment by TINA Secretariat, Vienna, in 1999	Truck line network: 3,741 km	Total: 5,632 km
		Additional network: 1,891 km	

Of these, Poland is placing priority on the modernization of internationally important railway lines that pass through Poland, which are shown in Table 3.2.2. These are corridors designated by TINA as lines for modernization.

Table 3.2.2 Priority Corridors for Modernization

Corridor	Line	Alignment
I	E-75	Baltic countries–Białystok–Warszawa
II	E-20 and CE-20	Berlin–Poznań–Warszawa–Minsk–Moscow
III	E-30	Dresden–Wrocław–Katowice–Lvov
VI	E-65 and CE-65	Gdynia–Gdańsk–Warszawa–Katowice–Czech

3.3 ANALYSIS OF PENDING ISSUES

The objective of this Study is to present measures for eliminating the “pending issues” in the restructuring and privatization of Polish railways described in Section 2.4.4 of Chapter 2 by pursuing the Study’s basic principles of building “a railway system adaptable to the market” and “selectively modernizing railway transport services and upgrading services.” Table 3.3.1 shows an analysis of the specific aspects of the “pending issues.”

Table 3.3.1 Specific Aspects of the “Pending Issues”

Pending Issue	Specific Contents
Overly extended network	Surplus workforce
	Excess facilities
Lack of railway services that meet market needs	Slow in modernizing infrastructure facilities and rolling stock
	Slow in transferring ownership of assets
	Lack of marketing expertise and resources
Lack of financial resources for settling accumulated debts	Slow in taking action to liquidate assets owned by PKP S.A.
Legislative, organizational, and structural aspects hindering railway operations	Railway operations hindered by administrative organization
	Railway operations hindered by legislation
	Need for revamping the regional passenger transport system
	Need for revising TAC regulations

3.3.1 Oversized Railway Network

(1) Surplus Workforce and Excess Facilities

With today’s rapid growth in automobile, airplanes, and other transport modes and the decline in both the transport volume and share of the railways, the current size of Poland’s railway network is excessive. An oversized railway network leads to a surplus workforce and excess facilities, which become a major burden to sound operation. This distortion is especially acute in regional passenger transport services.

According to PKP PLK’s profit-and-loss statement for FY 2002, the operating revenue failed to cover the operating expenditure, resulting in an operating deficit. Furthermore, because PKP PLK wrote off the debts of PKP Regional in FY 2002, PKP PLK suffered a substantial loss. These problems are believed to have been caused by an oversized railway network. Figure 3.3.1 shows the revenue and expenditure structure of PKP

Regional in FY 2002.

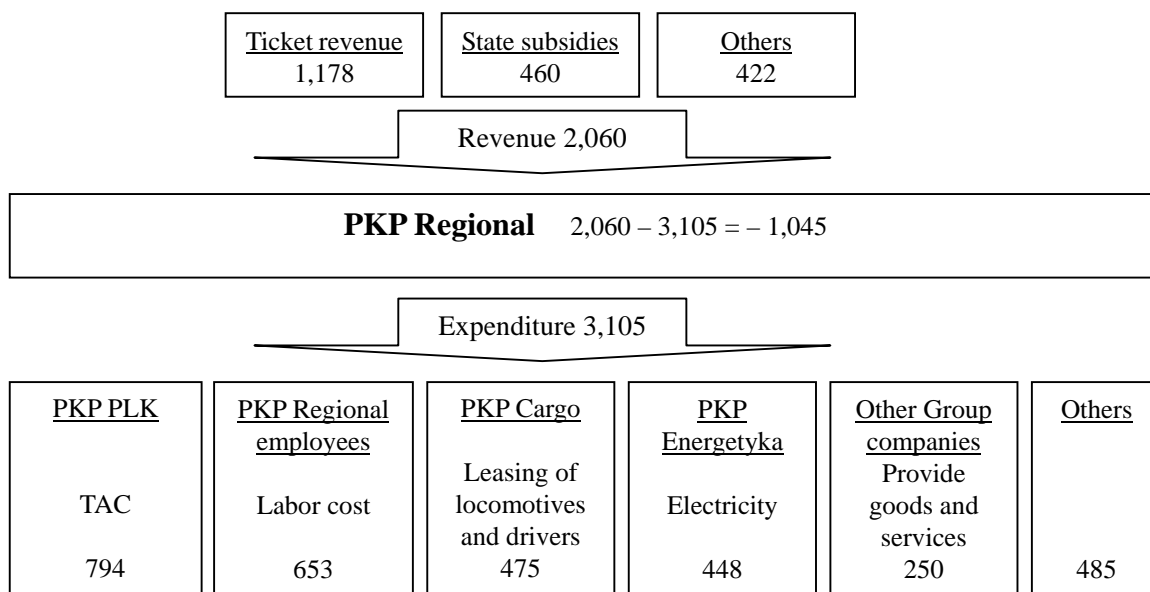


Figure 3.3.1 Revenue and Expenditure of PKP Regional (Unit : million PLN)

According to Figure 3.3.1, PKP Regional was not able to balance its revenue and expenditure, incurring a loss of over 1 billion PLN in FY 2002. This was because the regional passenger transport industry in Poland had more personnel and facilities (hereinafter referred to as “surplus workforce” and “excess facilities”) than were required by the market. The surplus workforce and excess facilities burdened the operations.

An oversized railway network affects not only regional passenger transport services but also other aspects. For example, some marshalling yards that were designed in the past to handle large volumes of freight transport are of a scale no longer matching today’s transport needs. Some stations too, because they were built according to the railway network in the past, are not functioning effectively.

Railway undertakings require a huge amount of fixed cost to maintain the lines. Therefore, lines that are not compatible to market needs or have low traffic demand will have a relatively high cost compared to its traffic volume, posing a threat to their operations.

(2) Effects of an Oversized Railway Network on Various Companies

Specifically, the oversized railway network gives rise to the following problems:

1) Lack of Funds for Maintaining Infrastructure Facilities

At present, the Polish railways has a network of 20,150 km. The Polish Government and PKP PLK are responsible for maintaining and managing this network. PKP PLK cannot cover the cost of maintaining and managing the infrastructure with TAC revenues from transport companies, and the Polish Government does not have

sufficient funds to make up the shortfall. It is estimated that only about 30% of the funds needed to maintain and manage the infrastructure facilities can be secured. For this reason, infrastructure facilities deteriorate rapidly. If this situation continues, the survival of the Poland's railway industry will be at risk.

2) Loss-making Trains of Regional Passenger Transport Undertakings

Regional passenger transport undertakings incur a loss of over 1 billion PLN every year because of their loss-making train operations. Some of the transport services within the voivodships are operated based on contracts made between PKP Regional and the voivodship. However, PKP Regional does not receive enough compensation from these contracts. In addition, among the remaining non-contracted train operations, only some of them are profitable. Due to the operation of these loss-making train services, the regional passenger transport system is plagued by financial problems.

3) Potential Risk in the Freight Transport Industry

Freight transport is the most important business area in Poland's railway business. PKP Cargo, especially, is the largest of the PKP Group companies. It is considered the most important target for privatization. On the other hand, PKP Cargo has too many employees and idle assets. Its large business scale obscures the burden of a surplus workforce and idle assets and it has the tendency of not being able to fully rationalize operations. In the future, if demand for freight transport continues to be sluggish, the burden resulting from a surplus workforce and idle assets will become more prominent, posing the danger of deficits.

3.3.2 Lack of Railway Transport Services Meeting Market Needs

At present, Polish railway undertakings have not been able to provide railway transport services that meet market needs.

(1) Delay in the Modernization of Infrastructure and Rolling Stock

1) Delay in the Modernization of Infrastructure

With Poland's accession to the EU in May 2004, EU's technological standard will become applicable to PKP PLK's main lines, making modernization necessary in order to be in compliance. EU's technological standard provides that the maximum speed for passenger trains shall be at least 160 km/h, maximum speed for freight trains shall be at least 120 km/h, and the largest axle load shall be 22.5 tons. However, only parts of E-20 and E-65 (CMK = Centralna Magistrala Kolejowa, the central trunk line) can be operated at a maximum speed of over 160 km/h for passenger trains.

2) Insufficient Maintenance and Management of Infrastructure Facilities

Due to the shortage of funds for maintenance and government funds for modernization, PKP PLK is not able to provide good track facilities to the various transport companies.

According to the result of PKP PLK audit conducted by the Supreme Chamber of Control (NIK) directly under the Polish parliament, the upgrading of tracks by PKP PLK in year 2000 has dropped to one-third, and upgrading of turnouts has dropped to

one-tenth of the levels achieved in year 1990. Because track facilities, signaling/communication facilities, and grade crossing safety facilities have become superannuated, it has been found that 14%, 19%, and 7% of the respective facilities require urgent upgrading. Furthermore, according to the 2003/2004 Network Statement, because of poor track condition, many lines have to be operated at a speed limit of 30 km/h. To make matters worse, operations on about 1,980 km of the main lines have been suspended.

In this way, the lack of maintenance and management of infrastructure facilities (hereinafter referred to as “maintenance backlog”) accumulates and speed limits on trains are imposed at many places, drastically reducing the competitiveness of railways against other transport modes.

3) Superannuated Rolling Stock

About half of the electric trains owned by PKP Regional are more than 25 years old and almost no new rolling stock has been added in the last ten years. PKP Intercity only has old passenger cars. Although the interior of some cars has been refurbished and the overall level has been improved, compared to the cars in Western European countries, their functions are inferior, showing that they lack international competitiveness.

(2) Delay in Procedures for Transferring the Ownership of Assets

Currently, the assets owned by PKP S.A. are being divided between PKP PLK and various transport companies in the form of investment in kind (hereinafter referred to as “division of assets”). In the process of dividing the assets, it is necessary to apportion them properly within the PKP Group. In planning the division of assets, the following requirements must be taken into consideration:

- Secure the necessary assets for railway operations
- Divide assets according to EU directives
- Secure financial resources for debt settlement

In particular, stations and marshalling yards are important assets from the viewpoint of railway management; decisions on them must be made as soon as possible. However, no method has been determined yet. Delay in the decision-making of asset division may hinder effective operation and weaken the competitiveness of the PKP Group as a result.

(3) Lack of Marketing Expertise

At present, the various transport companies in Poland do not have sufficient know-how in marketing. For example, PKP Regional and PKP Intercity do not have enough expertise in ticket sale systems and price setting mechanisms to respond to customer needs. PKP Cargo too, because it has been operated as a transport undertaking dependent on the coal and iron and steel industries, lags behind in the development of adequate marketing skills. In the future, when foreign companies enter Poland’s railway market through open access, the highly sophisticated marketing methods of these foreign companies may rapidly take away the share of railway business from

Poland's transport companies.

3.3.3 Lack of Financial Resources for Settling Accumulated Debts

(1) Financial Status of PKP S.A.

When PKP was incorporated in 2001, PKP S.A. took over the accumulated debts of the Polish railways.

The book values of PKP S.A.'s assets and liabilities as of the end of FY 2002 were 22.2 billion PLN and 11.4 billion PLN, respectively. Pursuant to the new Law on Restructuring, Commercialization and Privatization of the Polish State Railways, PKP S.A. procures funds, repays short-term liabilities, and provides financial support to PKP Regional. The Ministry of Finance (hereinafter referred to as "MOF") guarantees loans taken by PKP S.A. PKP S.A.'s major assets, such as the stocks of transport companies, are offered to MOF as collaterals.

On the other hand, due to various problems, most of the assets owned by PKP S.A. cannot be converted into capital easily, making it impossible to use them to pay off debts. For this reason, PKP S.A. may not be able to repay all the debts by itself. Restructuring the assets and liabilities of PKP S.A. has become an urgent issue from the perspective of finding a solution to this problem.

(2) Problems Relating to the Settlement of Accumulated Debts

There are two problems related to the settlement of PKP S.A. debts. One problem is that it is not easy to plan the cash flow of PKP S.A. due to difficulty in predicting the amount of funds needed to support PKP Regional financially. Another problem is that the time will come when a huge amount of capital will be needed to repay PKP S.A.'s loans and bonds; there is the possibility that the necessary capital will not be available.

The following summarizes the precautions to be taken in the settlement of accumulated debts.

- 1) PKP S.A. may not be able to repay all the debts by itself. Government bailout is necessary to repay the remaining debts.
- 2) Privatization of the related companies through the sale of stock is expected to be the largest source of funds for debt repayment. Failure in these privatization attempts may doom the cash planning.
- 3) Additional financial assistance to PKP Regional may force PKP S.A. to change cash planning.

In the case that PKP S.A. fails to acquire enough funds from privatization to repay the debts, MOF may sell off the assets used as collaterals to compensate for losses incurred in providing the guarantee. In such case, PKP Group may no longer be able to maintain its position in Poland's domestic market because whoever buys the liquidated assets will employ them in such a way as to optimize profits, without paying heed to the policies of the Polish Government. In addition, the Polish Government may not be able to effectively implement policies such as the policy to boost employment. Poland's

railway undertakings may fail even before wear and tear take a toll on the rolling stock and infrastructure facilities

To solve problem 1), efforts must be made to increase the sources of funds to pay off the debts of PKP S.A. With regard to problems 2) and 3), the financial situation of various related companies must be improved wherever necessary.

In the new Restructuring Program, the importance of a swift privatization process for various PKP companies, PKP Cargo in particular, is emphasized. For implementing this privatization process effectively as well, the financial situation of the related companies must be improved as quickly as possible.

(3) Risk of Reduction in Financial Resources for Settling Accumulated Debts

In addition to the above problems, there is the danger that the amount of debts that PKP S.A. fails to repay on its own may increase. At present, revenue from the sales of the stocks of related companies is expected to account for the largest source of funds for debt settlement. The book value of the stocks and equity of the related companies is about 4.5 billion PLN. However, there are contributing factors that can lower the sales value of stock. The biggest factor is the surplus workforce at various related companies. The existence of redundant personnel and powerful unions may deprive investors of their incentive to invest. Under such circumstances, investors may make the purchase with a lower evaluation of the companies' values, thus reducing the financial sources for repaying the debts.

3.3.4 Legislative, Organizational, and Structural Aspects Hindering Railway Operations

(1) Operations Hindered by the Organizational Aspect of Government

The Railway Bureau under the Ministry of Infrastructure is in charge of railway administration. However, due to the shortage of manpower, it is not an agency equipped for carrying out the restructuring and privatization of the railway industry. In addition, as it is necessary to coordinate not only with the Railway Bureau but also with the policies and organizational strategies of other ministries and agencies in the drafting of railway policies, such coordination is not yet in place, creating an obstacle to railway operations.

(2) Operations Hindered by the Legislative Aspect

In terms of the legislative aspect, various regulations that are not applicable to the current state of railway operations exist, hindering the operations of various PKP companies. The fare discounting system is an obvious example. The system is prescribed by the Railway Transport Law; losses from fare discounting are to be compensated by the government. However, due to the current budgetary constraint, the government can only subsidize part of the losses. Therefore, companies engaging in passenger transport must shoulder part of the losses of this system, which is implemented under a government policy. The existence of such system constitutes a major obstacle to railway operations.

(3) Revamping the Regional Passenger Transport System

As described in Section 3.3.1 of Chapter 3, problems resulting from the “oversized railway network” become obvious in the regional passenger transport system. Downsizing is indispensable in order to improve the regional passenger transport system. On the other hand, because the various burdens related to the operations of the regional passenger transport system are now concentrated at PKP Regional, if this structure is not revised, reform of the regional passenger transport system is not likely to succeed.

At present, about 67% of the operating expenses are incurred from transactions within the PKP Group. These are expenses that PKP Regional cannot reduce on its own. In other words, this huge amount of losses is not caused by problems peculiar to PKP Regional. The transaction structure of the whole regional passenger transport system is to blame.

Another problem is that PKP Regional does not have sufficient capacity to negotiate transaction conditions with outside suppliers such as PKP Cargo and PKP Energetyka. This is caused by the fact that PKP Regional does not have a department to calculate the appropriate costs of services required of a regional passenger transport undertaking. Furthermore, because of the practice of trying to procure goods and services from within the PKP Group as much as possible, PKP Regional may be purchasing goods and services at prices higher than the market prices.

In addition, as all locomotive and train drivers are now employed under PKP Cargo, PKP Regional must hire them through a lease contract. Train operation is an important factor in railway operations and safety management, the fact that this is contracted to another company constitutes a major obstacle to independent operations.

(4) Revising TAC-related Provisions

Presently, TAC rates are determined by dividing the operating expenses of PKP PLK in the last fiscal year by the projected train kilometers, while taking into account other factors. As a consequence, the cost performance of PKP PLK is reflected in TAC. Thus, when the cost performance of PKP PLK is poor, it will affect transport companies through TAC. Methods for setting TAC must be reviewed to avoid such interference. Furthermore, because the method of setting TAC affects the burden sharing of railway’s operation costs between the passenger and freight transport, it must be reviewed carefully.

3.3.5 An Overview of Issues

Table 3.3.2 gives a summary of the various tasks and the institutions which are responsible for them. “O” indicates the entity that shall handle the issue and “M” indicates the main entity that is dealing with the issue.

Table 3.3.2 Issues and the Role of Various Entities

Summary of Issues	Polish Government PKP S.A.	Various PKP PLK Companies
Dealing with the surplus workforce	M	O
Effective utilization of excess assets	M	O
Liquidation of accumulated debts	M	O
Upgrading and modernization of superannuated facilities and rolling stock	M	O
Development of marketing system	-	O
Other management improvements	-	O
Improvement of administrative organizations	O	-
Legislative improvement	O	-
Reform of regional passenger transport system	O	-
Revision of TAC-related provisions	O	-

3.3.6 Relationship between the Issues and the Study’s Basic Principles

Figure 3.3.2 shows the relationship between the various problems/issues and the basic principles of the Study.

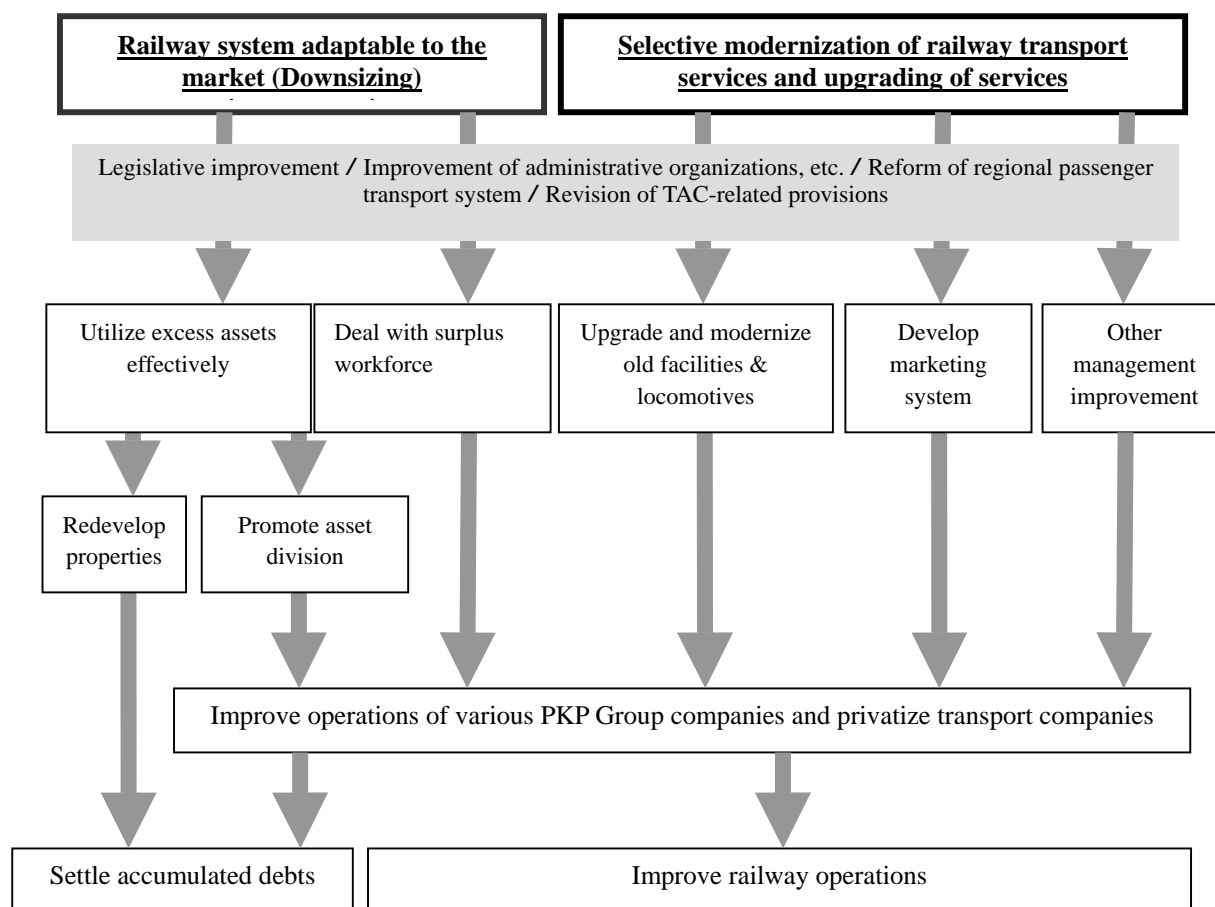


Figure 3.3.2 Relationship between the Issues and the Basic Principles of the Study

3.4 RAILWAY SYSTEM ADAPTABLE TO THE MARKET

Downsizing needs to be carried out to build a railway system that is adaptable to the market. The concept of downsizing is as follows:

3.4.1 Precautions at the Time of Downsizing

(1) Effects of Downsizing on Various PKP Group Companies

Because the downsizing of each company will also affect the operational scale of other companies, the degree of downsizing must be determined taking into consideration its effects. It is also necessary to take into account the railway policy of the country and local needs. Figure 3.4.1 shows the current operation scales and operation kilometers of the various companies.

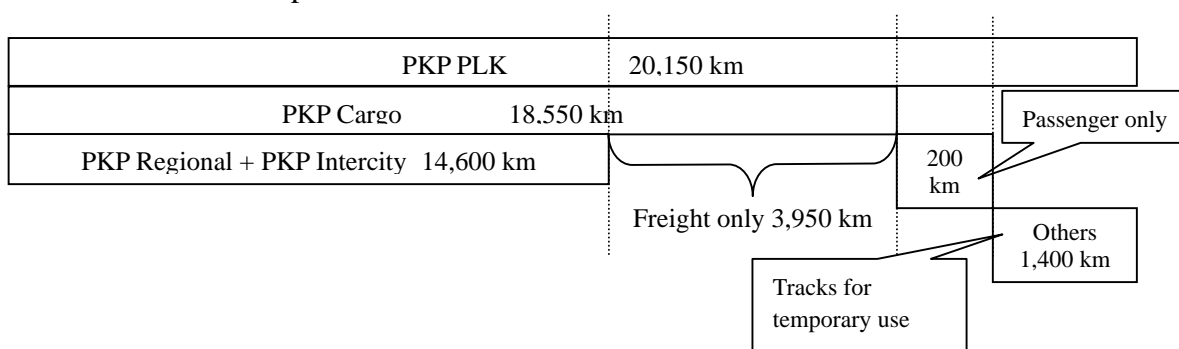


Figure 3.4.1 Operation Scales of Various Companies

Because PKP PLK is an infrastructure management company, it cannot determine its own operational scale. For the most part, this is determined according to the needs of various transport companies. Thus, as shown in Figure 3.4.1, the operational scale of PKP PLK is dependent heavily, among other transport companies, on that of PKP Cargo.

Through TAC, downsizing at the various transport companies will affect the profit and loss of the other companies. For example, if PKP Regional carries out downsizing unilaterally to reduce its operation scale, the share of TAC shouldered by PKP Cargo, which transports freight, may increase, posing a threat to the soundness of its business. Therefore, the degree of downsizing pursued by the various transport companies must take into consideration the kind of effects it may have on the other companies of the Group.

(2) Effects of Downsizing on Voivodships

It is necessary to examine how voivodships will handle the loss-making regional passenger transport lines that PKP Regional closes down due to downsizing.

If the Law of Income of Government Units takes effect, local tax revenues (PIT for personal income tax and CIT for corporate income tax) will increase substantially, while most of the special subsidies that voivodships have been receiving from the national government until then will be abolished. The original subsidies for regional passenger transport undertakings are included in these special subsidies. Figure 3.4.2

shows the basic concept of the Law of Income of Government Units.

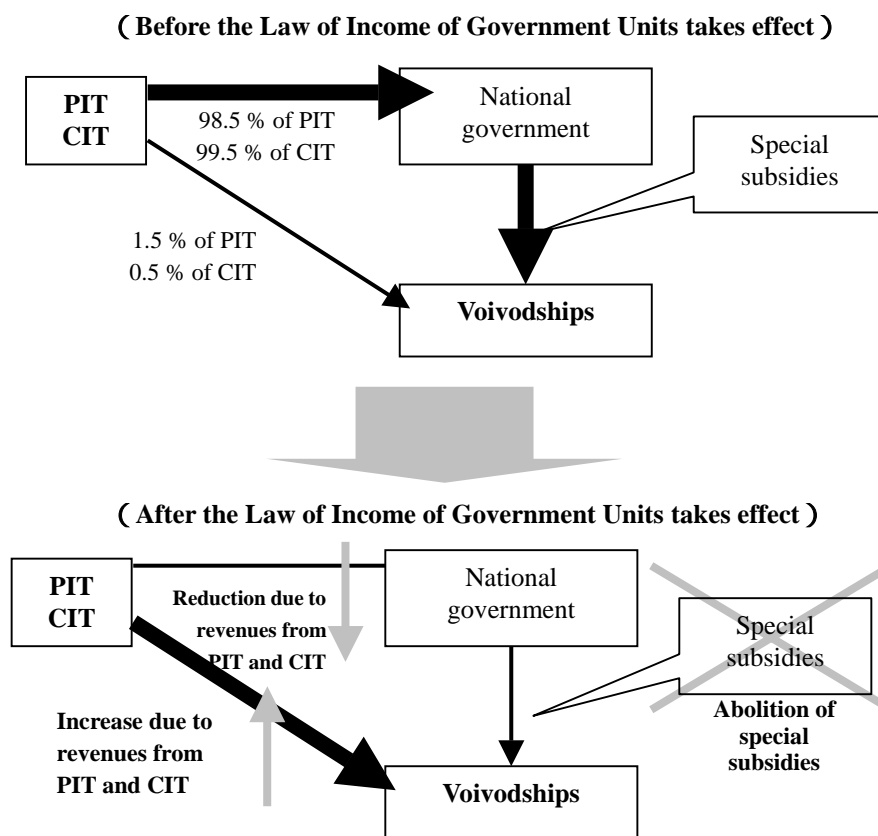


Figure 3.4.2 Basic Concept of the Law of Income of Government Units

With the effectuation of the Law of Income of Government Units, voivodships may utilize the increased tax revenues to make innovative improvements to regional passenger transport services to fulfill the mobility needs of local residents. Regional passenger transport services also include the operation of loss-making trains that PKP Regional has closed down.

On the other hand, because voivodships can also use the increased revenue from the Law of Income of Government Units for other transport modes besides railways, they might choose other alternative modes such as bus operation, etc. rather than running loss-making trains. In the case that voivodships do not have enough revenue income, the number of loss-making trains that can be operated may be limited.

Thus, when implementing downsizing, the scale of downsizing must be determined taking into account the readiness of voivodships in continuing the operation of loss-making trains and their revenue income. In addition, as voivodships are expected to have different policies for regional passenger transport services, regional passenger transport systems that can respond to different requirements should be established.

3.4.2 Basic Principles of Downsizing

How downsizing should be implemented will be determined by the basic strategies of various companies and the railway policy of the Polish Government. The following are two basic principles for determining the degree of downsizing.

- (1) Downsizing should emphasize that the various companies are independent corporate entities and aim at optimizing profits. In this case, loss-making trains and lines will be completely abolished. Hereinafter this concept is referred to as “profit-optimization strategy.”
- (2) Downsizing should aim at a break-even operation scale. This method aims at moderating the degree of downsizing by using profits from profitable businesses to subsidize losses from loss-making businesses. Hereinafter this concept is referred to as “break- even strategy.”

Table 3.4.2 summarizes the characteristics of the two strategies.

Table 3.4.2 Comparison of the Concepts of Downsizing

Strategy	Strengths	Weaknesses
(1) Profit-optimization strategy	Basic strategy for private companies. Can expect investment from outside investors if high profitability is maintained.	Compared to the break-even strategy, this strategy requires drastic layoff because of downsizing and may trigger disputes between the labor and management. Also, it may not be in accord with national policies.
(2) Break-even strategy	Compared to the profit-optimization strategy, its moderate degree of downsizing can ease labor-management disputes and the employment issue.	Because this strategy cannot bring in profits, the chance of obtaining investment from outside investors is slim.

PKP PLK is not scheduled for privatization; it is expected to remain as a state enterprise. Although it is not obliged to pay dividends to stockholders, it needs to balance its income and expenditure to attain the minimum condition for a company to survive. Consequently, PKP PLK shall adopt the break-even strategy. On the other hand, transport companies that plan to privatize can adopt either one of the above-mentioned strategies.

3.4.3 Provisional Analysis of Downsizing Strategies

When applying the above-mentioned two strategies to PKP Regional and PKP Cargo, the combinations in Table 3.4.3 can be conceived.

Table 3.4.3 Various Strategy Combinations

	PKP Regional	Break-even strategy	Profit-optimization strategy
PKP Cargo			
Break-even strategy		Scenario A	Scenario C
Profit-optimization strategy		Scenario B	Scenario D

Combinations of strategies in Table 3.4.3 produce four scenarios. The strengths and weaknesses of various scenarios must be assessed taking into account the social needs for regional passenger transport and freight transport. In particular, as it is desirable to develop regional passenger transport in areas that have significant demand, it is necessary to maintain a relatively large network. On the other hand, while there is

social need to transport a bulk freight between specific locations, it is not necessary to choose the shortest routing. Thus, freight transport can have more flexibility in increasing or reducing the network size.

Specifically, when determining the degree of downsizing, the following procedures can be used to facilitate the analysis of effects on various organizations.

- 1) Calculate the feasible level of overall TAC reduction by assuming an achievable level of productivity improvement at PKP PLK.
- 2) Assume an achievable level of productivity improvement at PKP Regional.
- 3) Calculate a workable network size for regional passenger transport based on the assumed level of productivity improvement. At that time, the state of regional passenger transport must be taken into consideration to determine whether PKP Regional shall adopt the break-even strategy or the profit-optimization strategy.
- 4) Calculate the network size of PKP Cargo based on the assumed level of TAC reduction and the network size of regional passenger transport. At that time, the network size of PKP Cargo when adopting the break-even strategy and the network size when adopting the profit-optimization strategy shall both be calculated.
- 5) From the viewpoint of balanced development for the country, the network size shall be determined taking into account the lines (lines of national importance) that the country must maintain.

According to the above analysis, the network size that is adaptable to the market is estimated at about 11,000 km to 15,000 km. Detailed analyses will be given in chapters 5 and 6 to recommend an optimal network size.

3.5 SELECTIVE MODERNIZATION OF RAILWAY TRANSPORT SERVICES AND UPGRADING OF SERVICES

After a network size adaptable to the market is achieved through downsizing, railway businesses that have reached an appropriate scale must be modernized to improve services to satisfy customer needs. The following are items that shall be implemented with emphasis.

- Eliminate maintenance backlogs and modernize inefficient infrastructure facilities
- Modernize rolling stock
- Provide services that satisfy customer needs
- Develop marketing systems

3.5.1 Elimination of Maintenance Backlogs and Modernization of Inefficient Infrastructure Facilities

(1) Elimination of Maintenance Backlogs

With Poland's accession to the EU, it is necessary to make urgent investment to eliminate slow sections caused by maintenance backlogs on lines operating under international treaties. Under the severe financial situation, it is important to always quantify maintenance backlogs and be aware of the cost required for their elimination in order to draw up effective maintenance plans.

(2) Re-examining Priority in the Modernization of Infrastructure Facilities

Investment in the modernization of lines needs to be carried out by first taking into account the restructuring and privatization of the PKP Group. Priority must be given to those railway lines that can not only improve the profitability of PKP PLK but also those of the various transport companies including PKP Regional, PKP Intercity, and PKP Cargo, etc. In other words, priority must be given to lines that can effectively utilize the limited investment capital, have high investment return, and can increase the competitiveness of the railway undertakings.

3.5.2 Modernization of Rolling Stock

When western European companies with high-quality rolling stock enter the market through open access after Poland's accession to the EU, the current PKP Group transport companies may find themselves at a disadvantage. The gap in the competition with other transport modes such as motor vehicles and airplanes, etc. may widen. Highly efficient and comfortable new vehicles must be introduced to bridge the gap.

Since financial constraints make it difficult to make replacement with all new rolling stock, ways to utilize the existing passenger cars shall be considered such as by selecting relatively new rolling stock and refurbishing them completely to increase competitiveness.

3.5.3 Offering of Services that Satisfy Customer Needs

(1) Shorter Trainsets and Higher Frequency Services

In addition to the high speed of urban transit and short-distance intercity transport, high-frequency operations and a standardized timetable without the need of checking the time are important elements for raising the competitiveness of railway transport undertakings. Efforts shall be made to attain shorter trainsets and higher frequency in order to realize these elements. By further raising the operation frequency, it is possible to upgrade services by offering transport services that combine high-speed and slower services.

(2) Expanding Intercity Transport

Because there is a potential need for intercity transport that links major cities, efforts shall be made to actively offer qualified train services to connect these regional

transport centers. Issues for intercity transport include strengthening of international competitiveness following accession to the EU and actively upgrading the speed of modernized sections to increase competitiveness with other transport modes.

(3) Construction of Logistics Centers

Combined transport, together with bulk transport, is expected to become the mainstay of rail freight transport in the future. However, if a freight company can provide only the rail element of combined rail transport, it does not have the base to adequately accommodate customer needs, making it difficult to develop businesses that can respond to customer needs. To avoid this, it must aim at becoming an intermodal transport company. Logistic centers, which are the bases for responding to customer needs, must be developed as soon as possible.

3.5.4 Development of Marketing Systems

Expertise in developing marketing skills, including the review of price-setting methods, improvement of ticket sales system, etc, must be acquired in order to develop marketing systems for the transport companies. Besides acquiring the know-how for developing marketing systems, it is also necessary to secure facilities and resources for conducting marketing activities.

For example, stations are important assets for PKP Regional and PKP Intercity, which operate passenger transport. The marketing methods and ticket sale systems will change dramatically depending on how the stations are utilized. Similarly, marshalling yards are important assets for PKP Cargo. They have great influence on the structure of the distribution system. Therefore, it is important to divide these assets as soon as possible.

3.6 MANAGEMENT APPROACH ADAPTABLE TO MARKET ECONOMY

3.6.1 Elimination of External Interference

The Polish Government, especially the Ministry of Infrastructure, must make efforts to create an environment that prevents external organizations from interfering inappropriately in railway operations. In particular, because the PKP Group was originally a state entity, it would be easy for politicians to interfere in management decisions such as withdrawal from loss-making businesses and selection of procurement partners, etc. However, such kind of political interference must be eliminated after privatization.

3.6.2 Awareness Reform

Both the management and employees of a company in a market economy must be “customer-oriented.” Only when there are customers then can a company have income, its employees have wages, and shareholders have dividends. All managers and employees shall work to satisfy customers, each in his/her own capacity. In other words, they must carry out work always keeping in mind the trust, safety, convenience, and amenity of the customers.

3.6.3 Human Resources Development

(1) Human Resources Development Workshop

Resources must be invested into human resources development in order to reform the awareness of employees and enable them to acquire job skills. Many tools have been developed for human resources development. As part of this Study, a “Human Resources Development Workshop” was implemented using these human resources development tools to enable middle-management executives from various PKP Group companies to participate in a pilot training program aimed at cultivating customer-oriented awareness. Table 3.6.1 gives an overview of the workshop.

Table 3.6.1 Overview of the Human Resources Development Workshop

Purpose	The Workshop aimed at reviewing actions that should be taken to train desirable workers and develop customer-oriented culture for various transport companies and enticing awareness reform in light of accession to the EU.
Method	The “ID/OS (Institutional Development/Organizational Strengthening) Method” and “SWOT (Strength, Weakness, Opportunities, Threat) Analysis,” participatory methods widely used in Europe, were employed to enable participants to analyze the status of the PKP Group themselves and to make them realize the problems in today’s operation conditions.
Result	The Workshop was effective in enabling its participants to identify problem areas in PKP companies. It helped sort out problems that should be resolved and identified feasible measures that should be implemented by the various companies. The group presentation helped clarify the relationship between the participants’ companies and other Group companies.

Participants expressed strong interest in similar workshops in the future.

(2) Other Methods

In addition, small group activities and suggestion schemes at railway jobsites are effective in motivating participation, upgrading services, and improving work attitude. Utilizing in-house training facilities is effective in reforming awareness. For a corporate entity that has as many employees as the PKP Group, the existing training facilities can be put to better use.

3.6.4 Dealing with Labor Unions

Although inappropriate interference in operation by outsiders shall be discouraged, active support from the government is needed in dealing with the labor unions.

Historically, the labor unions have contributed immensely to the sound operation of businesses by preventing unnecessary disputes between the management and workers and directing management resources to where they were needed. However, with changes of the times, companies must be managed in a flexible way to adjust to the economic environment. In such times, the rigid stance of labor unions may obstruct the mobility of human resources and lower the productivity of businesses.

At the time of restructuring with a view to raising productivity, negotiation with the

labor unions is necessary in order to deal with the surplus workforce. Negotiating this issue with the labor unions is one of the important tasks of the management. The PKP Group was originally the largest state entity, its labor unions were huge and their ties to politics were strong. For this reason, it is difficult to negotiate with the labor unions on a non-governmental level. Negotiations must be carried out with adequate support from the government.

Furthermore, as negotiations with the labor unions may result in different levels of financial burden for the public, it is necessary to keep the public well informed during the process of negotiation. The government, companies, labor unions, and politicians should be aware of public opinion. To avoid making wrong judgments in the negotiations, it is important to inform the public of the negotiation process and establish venues to facilitate communications between the railway undertakings and the people.

CHAPTER 4 ROLES OF THE NATIONAL AND LOCAL GOVERNMENTS

4.1 CLARIFYING THE ROLE OF RAILWAYS IN FUTURE TRANSPORT SECTOR

With today's rapid increase in road transport, keeping a huge conventional railway network in Poland is a drawback to the country. A transport policy that can draw financial resources to transport services and effectively utilize the strength of railways is needed.

To realize this transport policy, the PKP Group, the entity responsible for the implementation, must have a stable operation base. The government must lend support to the PKP Group companies to help resolve the various problems they face in order to put Poland's transport policy into practice.

4.1.1 Need for a Comprehensive Transport Policy

In the provision of financial means for infrastructure development, it is necessary to formulate a comprehensive plan reflecting the needs of society, clarify priorities, and give priority to investment in the public sector. To that end, a comprehensive transport plan must be formulated. It is also necessary to establish and implement a comprehensive transport policy from the perspective of implementing various policy issues and transport measures.

In Poland, because the railway played a central role as the main transport mode for passenger and freight transport in the planned economy era, no comprehensive transport policy was required. In the 1990s, due to the immense changes that took place in the political and economic systems and the rapid shift to road transport, a need to determine the allocation of public investment between the road and rail transports emerged. However, because Poland had not given much thought to allocating public investment to the transport industry until then, PKP ended up running a huge inefficient system and seeing its operation condition deteriorate year after year.

In Europe, car ownership and road freight increased considerably in the 1950s and 1960s. From the perspective of a comprehensive transport policy and in a form matching the actual needs of the transport market, many loss-making railways were abolished. Services became concentrated in areas that could utilize the characteristics of rail transport. Besides the fact that many lines were abolished, considerable amounts of income from Germany's petroleum tax and France's office tax are used to subsidize regional transport including railways. Without such financial backup, public transport would have been threatened by the growth of motorization.

4.1.2 Areas in Which Rail Transport Excels

The following are areas that can utilize the characteristics of rail transport in light of Poland's geographical condition, city distribution, and industrial structure:

(1) Intercity Passenger Transport

Besides the railway, air and road transport are other means of intercity passenger transport. Air transport has the merit of being able to cover a relatively long distance in a short time while road transport is extremely flexible in meeting transport needs as compared to other transport modes. On the other hand, air transport is not suitable for mass transport and it is not economically effective for mid-distance transport.

Compared to other transport modes, road transport has a disadvantage in travel time in transport longer than mid-distance. In terms of intercity passenger transport, the railway has a niche in high-speed passenger transport within the range of a maximum travel time of four hours.

(2) Passenger Transport in Urban Areas

Besides the railway, road transport is a viable means of transport in urban areas. Compared to the railway, road transport has the merit of being more flexible and can adjust easily to the needs of the traveling party. On the other hand, because urban development needs to be pursued while utilizing the city's limited space effectively, excessive development of road transport can create problems such as traffic congestion. One way to tackle this problem is to utilize the railway, which is suitable for high-volume transport in suburban areas, to provide commuting and regular transport services to the cities.

For areas other than large cities, although they do not need to be concerned about "pursuing urban development and utilizing limited space effectively," some have no choice but to continue train operations because (i) there is no alternative transport means (e.g. bus) to replace the railway, or (ii) the railway is more economical compared to other transport modes. In this case, the national and local governments need to work out policies to maintain the railway such as by contracting out train operations or injecting capital to secure the transport means for citizens living along the railway lines.

(3) Combined Freight Transport

Conventionally, bulk transport accounts for most of the freight transport business. In line with changes in future transport demand, it will be necessary to meet various freight transport needs. The flexibility of road transport is expected to be an important element in freight transport as well. On the other hand, the railway will always have economical advantage in the transport of high volume goods. The railway industry must cooperate with other freight transport modes to establish a system that can facilitate the so-called combined freight transport, develop container transport, provide direct transport between centers, expand the scope of coverage, clarify the arrival time and so on. It must transform itself into an enterprise that can play a central role in combined freight transport.

(4) Transport of Bulk Freight

Rail transport is most suitable for the mid-to-long distance transport of bulk freight; this trend will not change in the future. On the other hand, the demand for bulk freight

transport is greatly influenced by the demand for the commodities to be transported. In Poland, because coal transport accounts for the greater part of the bulk freight transport market, the trend of coal demand must be taken into full consideration when reviewing how the railway shall handle the bulk freight transport business in the future.

(5) Environmental and Safety Concerns

When reviewing role sharing between the rail transport and other transport modes, it is necessary to take into consideration the possible increase of external diseconomy brought about by other transport modes, such as road transport, on the entire nation with regard to safety, environmental and other aspects. In land transport, the railway has remarkably low accident and fatality rates. Its low carbon dioxide emissions exert little burden on the environment. A modal shift policy shall be considered because it is possible to restrain these external diseconomies by utilizing rail transport.

4.1.3 Tackling Various Problems

In order to put the basic concepts of the above-mentioned comprehensive transport policy into practice, the Polish Government must help resolve the problems faced by the various PKP Group companies. If privatization is carried out prior to solving these problems, the Polish Government may not be able to effectively implement its policies such as the policy to boost employment. Of the issues pointed out in “Analysis of Pending Issues” in Section 3.3 of Chapter 3, Table 4.1.1 shows the issues that the government shall tackle and their required measures.

Table 4.1.1 Various Issues and Governmental Measures

Summary of Issue	Governmental Measure
Deal with surplus workforce	Utilize PKP S.A., etc. to deal with the surplus workforce
Utilize excess properties effectively	Utilize PKP S.A., etc. to employ excess properties
Settle accumulated debts	Increase financial resources for debt settlement through reduction of redundant workers and utilization of excess properties
Upgrade and modernize superannuated facilities and rolling stock	Provide financial allowances for upgrading facilities and rolling stock, etc.
Improve administrative organizations, etc.	Set up a committee to coordinate opinions of the organizations
Legislative development	Make amendment in the new Railway Transport Law and enact the new Law on restructuring, commercialization and privatization of the Polish State Railways
Revamp the regional passenger transport system	Implement structural reform for PKP Regional
Revise TAC-related regulations	Revise ministerial ordinance on TAC-setting method

4.2 ADAPTING TO EU RAIL POLICY

Poland's accession to the EU is slated for May 2004. The transition period will be until the end of 2006. During this period, transport companies and railway infrastructure must make adaptation in the following areas:

4.2.1 Vertical Separation and Open Access

To liberate railway infrastructure from the monopoly of state railways and to provide reasonable rail transport to the people through competition between service providers, the EU Directive (91/440/EEC) provides the following: (i) ensuring the management independence of railway undertakings and (ii) separating the management of infrastructure from the provision of railway transport services. In Poland also, the state enterprise PKP was separated vertically into PKP PLK and various transport companies in 2001 pursuant to the Railway Transport Law.

On the other hand, further actions relating to legislation and administrative organizations need to be taken to ensure open access in railways. In terms of legislation, a ministerial ordinance on TAC is currently being prepared. It will serve as the guideline for open access. Regulations for line usage and standards for reviewing qualifications are also being developed. In terms of organizations, the Railway Transport Office (Urząd Transportu Kolejowego, hereinafter referred to as "UTK") was inaugurated to establish a system for examining qualifications and checking TAC. The Polish Government must also establish conditions in which this organization, legislation, and regulations can be effectively utilized.

4.2.2 Developing Railway Infrastructure

In the transformation of the transport structure, although the car has an overwhelming advantage, a trend focusing on energy efficiency, safety cost (traffic accidents), traffic congestion, environmental load, etc. has emerged in recent years to seek a shift from automobile to the railway. This attitude is prominent in the EU, as shown in the EU-Commission White Paper "European transport policy for 2010: time to decide" and the EU directive COM(2002)107 final. Revitalizing the railway is the basic principle of EU's railway policy. The railway policy of the Polish Government, which is to become a Member State of the EU in 2004, should also follow this principle.

For this reason, railway infrastructure facilities must comply with EU standards. In particular, Poland must focus on "eliminating maintenance backlogs," "prioritizing the modernization of railway lines operating under international treaties," and "ensuring interoperability," etc.

4.2.3 Subsidies for Railway Undertakings

Pursuant to EU directives 1192/69/EEC and 1893/91/EEC, EU Member States are forbidden to impose on railway undertakings the responsibility to maintain loss-making railway operations as a necessary service for the society without appropriate compensation, the so-called Public Service Obligation (PSO). Herewith, train operations that are unprofitable but are necessary from the viewpoint of public interests shall be operated under contracts between the railway undertakings and the

national or local governments.

At present, the Polish Government is negotiating the treatment of loss-making trains of the regional passenger transport undertakings with the voivodships. Restructuring of the regional passenger transport system must take into consideration these EU directives.

4.3 ROLES OF PKP S.A. AND UTK

In the process of restructuring and privatizing the PKP Group, not only the governmental agencies led by the Ministry of Infrastructure but also PKP S.A. and UTK must play an important role in resolving effectively the issues identified in the “Analysis of Pending Issues” in Section 3.3 of Chapter 3. The Ministry of Infrastructure shall fully utilize these organizations and implement various measures to promote the restructuring and privatization of the PKP Group companies.

4.3.1 PKP S.A.

PKP S.A. is required to take account of the requirements of the whole group and of the government when tackling problems that cannot be resolved by the individual companies. These problems include the settlement of accumulated debts, measures to deal with the surplus workforce, and liquidation of properties. Figure 4.3.1 gives an overview of the corresponding measures.

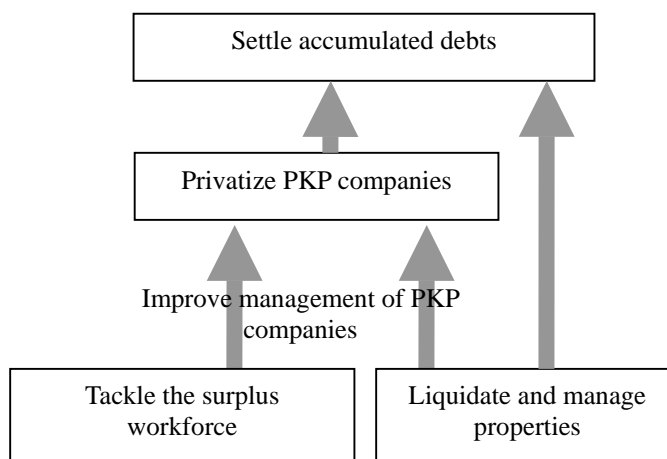


Figure 4.3.1 Utilizing PKP S.A. to Resolve Problems

The above issues can be tackled with the following methods:

- Promote workforce restructuring of the whole PKP Group taking into consideration financial sources
- Promote the restructuring of properties, taking into consideration the “redevelopment of properties with low capacity operating rate” and “increased utilization of existing facilities” (specifically, effective utilization of stations and

- redevelopment of marshalling yards, etc.)
- Settle accumulated debts by increasing the sales price of the stocks of related companies through the restructuring of workforce and securing financial sources through the restructuring of properties.

As indicated above, it is necessary to position PKP S.A. as the policy implementation organization of the Ministry of Infrastructure. An example of such organization is the Japanese National Railways Settlement Corporation established in 1987 for the privatization of the Japanese National Railways. The Japanese National Railways Settlement Corporation inherited the properties of the Japanese National Railways, including long-term debts, sites, etc. Besides redeeming the long-term debts it took over and liquidating properties such as railway sites, the Japanese National Railways Settlement Corporation also carries out activities to facilitate the reemployment of laid off former employees of the Japanese National Railways. Its work is almost complete today.

4.3.2 UTK

(1) Role of UTK

UTK was inaugurated on June 1, 2003 pursuant to Article 74 of the new Railway Transport Law. It is established as an organization prescribed by the EU Directive (2001/14/EC) to provide information on and regulate the infrastructure usage standards. It is independent of infrastructure managers and train operators. It oversees the competition of railway transport services and imposition of TAC. The UTK is an independent administrative body. Among the original responsibilities carried out by the Railway Bureau of the Ministry of Infrastructure, a wide range of services have been transferred to UTK, including the certification of railway enterprises, certification of TAC, certification of technological safety, adjustment of competitive relationship among various transport companies, and survey of the railway market, etc. The head of UTK is appointed by the Prime Minister.

With the restructuring and privatization of the PKP Group companies and the 2004 accession to the EU just around the corner, UTK must have in place various implementation systems. Table 4.3.1 shows the functions required of UTK.

Table 4.3.1 Functions Required of UTK

Item	Contents
Certification of permit for railway undertakings	Permit application by new domestic railway undertakings in Poland due to vertical separation and open access, and the entry of international transport companies due to accession to the EU are expected, the system for reviewing and approving permits needs to be strengthened.
Certification of TAC	UTK is positioned as the organization for reviewing the validity of TAC described in Section 4.11. It needs to supervise PKP PLK in such a way as to give incentive to cost reduction and modernization of facilities, and to review TAC in such a way as to improve the operations of various PKP transport companies.
Safety management	It is necessary to regulate the various operators to ensure the safety of train operations, which is said to be the mission of railway undertakings. After the implementation of vertical separation, in particular, there is high possibility of losing incentive to pursue safety, as demonstrated in the case of the U.K., UTK needs to exercise strong supervision to ensure safety.

(2) Fair Assessment of TAC

In order that the low productivity at PKP PLK does not affect the PKP transport companies, TAC shall be determined not by assessing TAC based on the performance of PKP PLK in the past but by taking into full account the modernization and cost reduction. In this case, it is desirable to have an independent auditing body, such as UTK, to review the validity of the annual budget. By using this budget to assess TAC, PKP PLK will find the incentive to rationalize, improve operation, and modernize facilities, leading to reduction in TAC. If the government subsidizes PKP PLK for part of its operating expenses, a review conducted by an independent auditing body such as UTK will be effective in reducing the amount of subsidies.

(3) Importance of Safety Management

A weakness of the vertical separation policy in terms of safety or safety maintenance standards management is the lack of incentive for infrastructure management companies to upgrade the level of maintenance and management of the railway facilities. If the infrastructure company is a commercial enterprise, the emphasis of the business will be on paying out dividends to shareholders; the maintenance and management of infrastructure tend to be neglected. If it is a state enterprise, because it is separated from the various transport companies and is isolated from the market, it is slow in responding to the needs of various companies, resulting also in low maintenance level. Given these considerations, infrastructure management companies must have a system to ensure the maintenance and management of railway infrastructure in order to put a stop to the decline of technological standard in railway infrastructure.

Specifically, regulations need to be established regarding the maintenance level and penalties. There shall be contracts between PKP PLK and the government or UTK,

which should include provisions for imposing penalties on the infrastructure company when the contracted technological level is not met. A mechanism to prevent the decline of technological standard in railway infrastructure must be established.

4.4 SURPLUS WORKFORCE

In terms of the handling of redundant personnel, because it is related to the country's employment policy, it is necessary to conduct thorough discussion with the Ministry of Economy, Labor and Social Policy and other ministries and agencies to determine such measures. The Polish Government can utilize PKP S.A. to take care of the redundant personnel effectively. It shall delegate PKP S.A. to carry out the following procedures for the surplus workforce and supervise the process.

4.4.1 Workforce Restructuring

(1) Basic Concept

When restructuring the workforce, it is necessary to have in place an early retirement system and job transfers to railway-related undertakings or government-related organizations. It is desirable to have a program that gradually changes the conditions of early retirement.

According to the actual figures of workforce restructuring of the PKP Group thus far, the cost of workforce restructuring per employee is estimated to be about 14,000 PLN. On the other hand, the annual personnel cost per employee is about 30,000 PLN. Thus, only a small amount of restructuring cost can produce considerable cost savings. As workforce restructuring is a highly cost-effective measure for improving operations, it is desirable for the various PKP Group companies to raise their own funds for the implementation of workforce restructuring.

However, in view of the financial condition of the various PKP Group companies, it is conceivable to have PKP S.A. or the Polish Government to temporarily shoulder part of the expenses. Because PKP S.A. can recover the restructuring costs of PKP Regional and PKP Cargo through revenue from their privatization, it can take care of the workforce restructuring cost of these transport companies. Another way is to have the government shoulder the workforce restructuring cost of PKP PLK. This is because the government has the obligation to maintain the railway infrastructure in good condition. At the same time, it can eventually recover the PKP PLK workforce restructuring cost from reductions in personnel cost.

(2) Other Options

The next best option is to restructure the workforce of PKP Cargo and PKP Regional after their privatization. It is an option if PKP S.A. cannot raise enough funds to cover the workforce restructuring cost. This option means that investors will have to raise the funds for restructuring the workforce of PKP Cargo and PKP Regional.

Care needs to be taken in adopting this option. As it is extremely difficult to properly assess the influence of Poland's labor unions, investment incentive may drop due to various problems that may occur with the labor unions, making the sales price of the

companies lower than the cost needed for the restructuring of the workforce.

4.4.2 Specific Approaches

There are several approaches to workforce restructuring.

(1) Company-led Approach

This approach entails that PKP S.A. formulates the plans for workforce restructuring and provides the capital, while the various companies carry out the actual restructuring. With this approach, because the whole PKP Group carries out the restructuring of the workforce, it is likely to gather strong momentum for the restructuring. On the other hand, because the various companies need to use business resources not only for their own operations but also for the restructuring of the workforce, the restructuring may take away some of their business capacities.

(2) PKP S.A.-led Approach

This approach entails that PKP S.A. takes over the redundant personnel and carries out workforce restructuring. With this approach, PKP S.A. will set up a special department to implement workforce restructuring, freeing the PKP companies to devote business resources to their primary businesses. On the other hand, when transferring the redundant personnel to PKP S.A., vigorous resistance from the labor unions can be expected. If the special department set up inside PKP S.A. does not have enough capacity to handle the restructuring, the restructuring of the workforce may end up in a deadlock.

(3) Compromise Approach

In view of the status of the PKP Group at this time, implementation of the “PKP S.A.-led Approach” is deemed difficult. For this reason, the “Company-led Approach” is more realistic. The treatment of PKP Cargo’s drivers shall be determined through talks among concerned companies. Because PKP Cargo and PKP Regional cannot resolve this issue on their own, the “PKP S.A.-led Approach” shall be adopted in this case.

4.5 EFFECTIVE UTILIZATION OF SURPLUS PROPERTIES

The new Restructuring Program reviews the utilization of PKP S.A.-owned properties in relation to the settlement of accumulated debts owed by PKP S.A. Specifically, the “increased utilization of existing facilities such as stations” and the “redevelopment of properties with low capacity operating rate” are viable means. The Polish Government can utilize the excess properties effectively through PKP S.A., as in the case of workforce restructuring. The Polish Government shall have PKP S.A. perform the following procedures and supervise their implementation.

Figure 4.5.1 shows the basic concept for the division of properties.

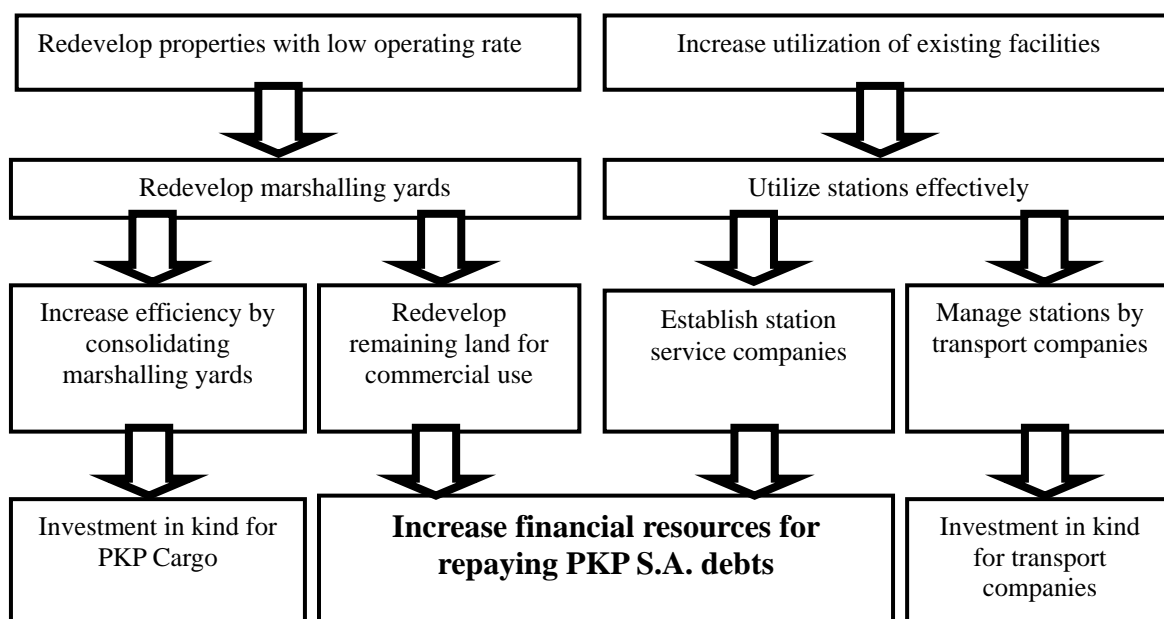


Figure 4.5.1 Basic Concept of Property Division

4.5.1 Stations

(1) Status

From the viewpoint of conventional railway infrastructure management, the station facilities currently owned by PKP S.A. can be transferred to PKP PLK. On the other hand, passenger stations are important facilities that can serve as a foundation for the development of passenger transport railway undertakings. Because many people pass through the stations, they are important venues for business expansion. In this sense, it is desirable to develop the passenger transport business and passenger station business in synergy. In the current situation, however, PKP PLK has no incentive to utilize these facilities effectively; the merit of transferring these facilities to PKP PLK is questionable.

(2) Managed by Transport Companies

One alternative is to transfer the stations to transport companies. In this way, because these companies have enough incentive to develop business, the stations are likely to be developed effectively for both “passenger transport business” and “passenger station business.” However, the adoption of this approach may lead to one company monopolizing the use of stations and developing exclusive business practices. From the viewpoint of “equity” sought by the EU, this can pose a problem.

(3) Managed by an Independent Station Service Company

Another alternative is to establish an independent station service company and transfer the stations to this company. This approach is premised on a mechanism in which the

station service company will manage the stations and charge the transport companies fees for using the stations. This approach can ensure the “equity” sought by the EU. Furthermore, the company can increase business profitability by utilizing the expertise of professionals to develop station buildings and related businesses. These profits can be a viable source of funds for settling debts owed by PKP S.A. However, since only stations in relatively big cities have the potential to gain enough profits from station service businesses, this approach is not applicable to all stations.

It is most realistic, therefore, to transfer stations in big cities such as Warszawa, Gdańsk, Katowice, Poznań to independent station service companies and small stations to transport companies that have jurisdiction over them.

4.5.2 Marshalling Yards (including freight terminals)

(1) Status

Presently most of the marshalling yard facilities and sites are used by PKP Cargo and the rest is managed by PKP PLK. However, compared to the business volume of PKP Cargo, most of the sites are of an unnecessarily large scale. This is because the size of a marshalling yard was determined by the huge transport volume in the past, and is no longer appropriate to today’s transport volume.

Land that is of a relatively small scale is adequate to handle the current and future transport volume. However, for a smaller site to handle the same operations, the various facilities at the marshalling yards need to be reorganized.

(2) Redevelopment of Marshalling Yards

It is necessary to secure the required areas for the operations of PKP Cargo and make investment in order to utilize the idle land effectively. For areas not needed for the PKP Cargo business, PKP S.A. can develop them commercially for real estate use. This will help raise the necessary funds for repaying the debts and making investments. Furthermore, investment in land development needed for the PKP Cargo business can be recovered through sales of the PKP Cargo stocks.

(3) Cooperative System for Redevelopment

This redevelopment aims at consolidating the marshalling yard facilities, increasing operational efficiency, and redeveloping the land left over after consolidation for commercial use. To do so, PKP S.A., PKP Cargo, and PKP PLK need to have a cooperative system. It is recommended that these companies set up a joint committee to review redevelopment methods. Through this cooperative system, PKP S.A. and PKP Cargo can share the various burdens that accompany the development. Furthermore, participation of other developers or local governments can enable development that is even more effective.

(4) Conclusion to the Redevelopment of Marshalling Yards

The cooperation of related parties is necessary for the effective redevelopment of marshalling yard facilities. Negotiations with the national and local governments regarding redevelopment are inevitable. At the time of negotiation, it is recommended

that PKP S.A. retain developers with expertise in such development to facilitate negotiation for the development of targeted areas. It is also necessary to expedite the process of resolving the ownership issues. To this end, cooperation from the Polish Government and local governments is indispensable. Figure 4.5.2 gives an overview of this cooperative system.

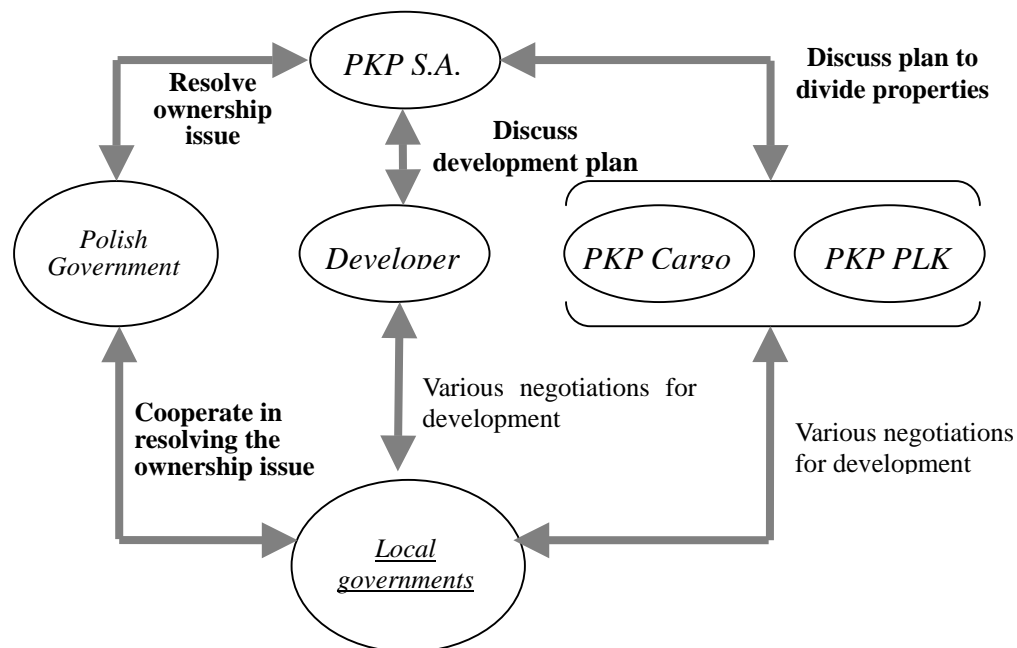


Figure 4.5.2 Cooperative Relationship in the Redevelopment of Marshalling Yards

4.5.3 Conclusion to the Division of Properties

Two precautions need to be taken in the division of properties. One is that additional funds will be needed to develop and utilize properties effectively. In terms of the source of funds, it is possible to secure funds from banks or investors using as collateral the land slated for development. However, without a well thought out development plan, it will be difficult to obtain adequate funds from banks or investors. Cooperation between the various PKP Group companies and developers will be essential for preparing such redevelopment plans.

The other prerequisite is that the ownership issue must be resolved. For this reason, priority shall be given to the redevelopment of marshalling yards and effective utilization of stations when dealing with the ownership issue.

4.6 SETTLEMENT OF ACCUMULATED DEBTS

One of the remaining problems in the restructuring and privatization of PKP Group companies is that there are not enough funds to repay the accumulated debts owed by the Polish railways. Some of the means to increase financial resources for debt settlement are (i) to increase the sales price of the stocks of various PKP Group companies scheduled for privatization by laying off redundant workers, as explained in Section 4.4 and (ii) to increase the sources of funds by effectively utilizing the excess

properties, and so on.

On the other hand, it is necessary to fully consider the cash flow of PKP S.A. in the debt settlement. In particular, the repayment of corporate bonds and debts after 2010 needs to be carefully reviewed. Specifically, the Polish Government shall assume the debts that cannot be repaid by 2009 using the above-mentioned methods. A plan to use funds recovered from the redevelopment of marshalling yards to be completed after 2010 has a higher chance of accomplishing the objective.

4.7 UPGRADING AND MODERNIZING SUPERANNUATED INFRASTRUCTURE FACILITIES AND ROLLING STOCK

4.7.1 Modernizing Infrastructure Facilities

(1) Need for Government Support

The infrastructure facilities were reassessed when PKP PLK was inaugurated. However, most of the assets were already superannuated at the time of reassessment. Therefore, the depreciation allowance calculated based on the current book value is not enough to cover the replacement cost. The current infrastructure facilities will not be replaced automatically with the depreciation allowance or TAC. Government subsidies are necessary in order to return the infrastructure facilities to the former level.

The loans that PKP S.A. borrowed from EIB have been used for the modernization of PKP PLK infrastructure facilities and PKP PLK is scheduled to repay them. PKP PLK is also planning to raise funds through loans and corporate bonds backed by government guarantee. Caution needs to be applied, because funds that are raised from loans or corporate bonds will incur interest expenses and TAC may rise as a result. Financial aid from the government for new investments is necessary to lessen the financial burden on the PKP transport companies.

(2) Basic Principle

Modernization of infrastructure facilities covers the following three areas: eliminating maintenance backlogs, modernizing train operation control systems, and upgrading the technological standard for accession to the EU. Among them, the elimination of maintenance backlogs is the basic responsibility of railway undertakings and the modernization of train operation control systems is imperative from the viewpoint of upgrading operation efficiency. On the other hand, the various responsibilities for infrastructure maintenance because of Poland's accession to the EU are not issues inherent to the railway industry; they are issues resulting from the negotiation process with the EU. They must be reviewed in a perspective different from the elimination of maintenance backlogs and modernization of train operation control systems. In other words, financial measures for the elimination of maintenance backlogs and modernization of train operation control systems are pressing issues compared to the various responsibilities for infrastructure maintenance accompanying the accession to EU. Financial measures for the latter need to be re-examined and renegotiated with the EU.

Through TAC, the financial burden of PKP PLK will become the financial burden of

the transport companies scheduled for privatization. Therefore, the government must pay attention not to have PKP PLK shoulder these funds.

(3) Modernization of Important Lines

Currently, PLP PLK is modernizing its major corridors. As explained in Chapter 3, the modernization is faced with the issue of prioritization. From the viewpoint of improving the operation condition of various PKP Group companies and promoting privatization, modernization shall be implemented based on the following concepts:

1) Modernization of Lines based on Transport Situation and Future Forecast

According to an analysis based on the numbers of passenger and freight trains operated in 2001 and projected demand, it is necessary to prioritize the modernization of lines and sections in the TINA corridors shown in Table 4.7.1 in order to increase the profitability of various PKP Group companies and increase the competitiveness of the railway.

Table 4.7.1 Lines and Sections Required to be Modernized with Priority

TINA Corridor	Line	Section
III Corridor	E-30	Katowice–Kraków–Tarnów
VI Corridor	E-65	Gdańsk–Warszawa
	CE-65	Bydgoszcz–ZD Wola
Additional Networks	E-59	Szczecin–Poznań Poznań–Wrocław
	CE-59	Szczecin–Wrocław

2) Modernization of Lines based on Passenger Transport Requirements

In terms of intercity passenger transport, the railway has a competitive edge over automobile and airlines at distances that can be covered in about three hours. In light of this, although the journey times between Warszawa–Katowice, Warszawa–Krakow, and Warszawa–Poznan are about 2 hours and 40 minutes, the journey time between Warszawa–Gdansk took a minimum of 3 hours and 10 minutes (190 minutes) in 1993 and currently takes 3 hours and 46 minutes (226 minutes), an increase of 19%. Priority shall be given to the modernization of this line (E-65) to speed up the journey time to about three hours in order to recover the share of railway in passenger transport in the trunk route between Warszawa–Gdansk.

With regard to the 133-km rail line linking Warszawa, the largest city (population 1.8 million) in Poland and Łódź, the second largest city (population 790,000), it is recommended that modernization be carried out as soon as possible because of the tremendous effect of investment judging from the population of the two cities and the potential for shortening the journey time.

3) Modernization based on Freight Transport Requirements

According to the demand forecast results of freight transport in 2010, the movement of freight along the North–South axis (CE-65, E-59, and CE-59) centered around Katowice in the south, will be greater than that going in the east–west direction. The Polish Government has formulated a plan to develop infrastructure for inter-modal

transport in the report “Strategy of Transport Infrastructure Development in 2004–2006 and the Following Years” (July 2003). As combined transport is also emphasized as a future marketing strategy for PKP Cargo, priority shall be given to the development of lines linking the ports of Gdynia and Szczecin with mining and industrial areas in the south.

Furthermore, in a report that reviewed the TEN program, Mr. Karel Van Miert, former Member of the European Commission responsible for transport (currently Member of the European Commission responsible for competition policy), recommended giving priority to the modernization of the dedicated freight line (CE-65) between Gdańsk and Katowice, and to the Czech Republic, which is indispensable to combined transport.

Based on the above and the need for freight transport, it is recommended that priority be given to the modernization of lines and sections of CE-65 and CE-59 shown in Table 4.7.1.

4.7.2 Introduction of New Rolling Stock by Governmental Rolling Stock Renewal Organization

All the PKP transport companies are running superannuated cars. PKP Regional and PKP Intercity, in particular, because of their weak operation base, they do not have enough credit with banks and leasing companies and have no means to purchase new rolling stock. Even if the financial situation of the transport companies improve, they cannot secure the financial sources and credit for introducing new rolling stock within a short or medium term. One way to introduce new rolling stock is for the Polish Government to set up a rolling stock modernization agencies with government guarantee so that transport companies can lease new cars through this organization.

There are already several rolling stock leasing companies in Europe. In general, leasing fees are determined based on country risk, industry risk, and company risk. Due to the industry risk of the various PKP Group companies, the leasing fees will be high and may exert financial burden on the transport companies. Therefore, the government needs to guarantee the rolling stock modernization agency to reduce the financial burden resulting from the industry risk.

A concept similar to that of the rolling stock modernization agencies was advocated in the new Restructuring Program. It is important for the agency to have enough capability to review the investment plans of various PKP transport companies. In relation to this, the PKP transport companies need to have the capability to formulate sound investment plans. If the agency runs into financial trouble, the government-backed guarantee may add burden to the government. Therefore, it is necessary to study and learn from foreign leasing companies when setting up such an organization in order to acquire the business know-how.

4.8 IMPROVEMENT OF ADMINISTRATIVE ORGANIZATIONS

Due to the shortage of funds and manpower, administrative organizations for the restructuring and privatization have not been functioning fully. Not only is the Ministry of Infrastructure involved in tackling the issues related to the restructuring and privatization, other governmental organizations including the Ministry of Finance,

Ministry of Treasury, and Ministry of Economy, Labor & Social Policy are also involved. A considerable amount of time and energy is spent in coordinating among the ministries and agencies. The establishment of a PKP Restructuring and Privatization Committee can resolve this problem.

(1) Strengthening the Railway Bureau of the Ministry of Infrastructure

The Railway Bureau under the Ministry of Infrastructure is in charge of the restructuring and privatization of various PKP companies. To fulfil its responsibilities, it must secure the necessary budget, draft bills, establish the necessary network to facilitate balanced development of national land, and have a clear picture of the efficiency of various companies. For this reason, the Railway Bureau must strengthen its organization.

(2) Establishment of the PKP Restructuring and Privatization Committee

One way to resolve the shortage of funds and manpower is to utilize the information and policymaking capability of other related organizations. To this end, a “PKP Restructuring and Privatization Committee,” reporting directly to the Prime Minister and made up of multiple ministries and agencies as its members, shall be established to allocate the necessary personnel for a certain time to draft policies. The issues deliberated at and determined by the “PKP Restructuring and Privatization Committee” shall be submitted to the competent governmental organizations as policies for implementation.

It is also necessary to establish an administration office for the “PKP Restructuring and Privatization Committee,” to be made up of working groups from various related ministries and agencies, to coordinate the ministries and agencies. The establishment of this administration office can remove the barriers between the various ministries and agencies, making it possible to put the Committee’s review results into practice efficiently and effectively.

Disclosure of the issues deliberated will enable the public to obtain information on the restructuring and privatization. In order to reflect the public’s opinions to the “PKP Restructuring and Privatization Committee,” opinion leaders from various sectors of Poland, including academic experts, representatives from the financial sector, and government officials, etc., shall be included as members of the Committee.

(3) Japan’s Supervisory Committee for JNR Reconstruction

When Japan restructured and privatized its railway industry, the Supervisory Committee for JNR Reconstruction, similar in nature to the “PKP Restructuring and Privatization Committee,” was set up. Under its close supervision, various measures related to the privatization of the Japanese National Railways (JNR) were implemented.

In Japan, the Second Ad Hoc Commission on Administrative Reform, which was set up to deliberate the nation’s administrative reform, recommended the division and privatization of the Japanese National Railways. The Supervisory Committee for JNR Reconstruction was founded in 1983 to formulate measures in order to drastically

improve the state railways pursuant to the Law for Special Measures to Promote JNR Rehabilitation, which was enacted in response to the report presented by the Second Ad Hoc Commission on Administrative Reform.

This Committee submitted its “Opinions on JNR Restructuring” to the Prime Minister in 1985. They served as the basic guideline for the division and privatization of the Japanese National Railways. Upon receiving the Opinions, the government vigorously pushed forward the restructuring of the Japanese National Railways. In the “Opinions on JNR Restructuring,” the following issues were reviewed: (i) need for the restructuring of JNR; (ii) reasons for the financial failure of JNR; (iii) need for division; (iv) need for privatization; (v) liquidation of long-term liabilities; and (vi) measures to deal with the surplus workforce; and specific policies were recommended. In the process of implementing the various measures, the Supervisory Committee for JNR Reconstruction made remarkable achievements in “removing the barriers between ministries and agencies,” “facilitating the implementation of policies,” and “building public consensus,” etc. By the same token, the PKP Restructuring and Privatization Committee is likely to function effectively in the restructuring and privatization of the Polish railway industry.

4.9 LEGISLATIVE DEVELOPMENT

Amendment of relevant laws and enactment of new laws are necessary for the implementation of necessary policies and management improvement in the restructuring and privatization of the various PKP Group companies.

4.9.1 Amendments of the New Railway Transport Law

Table 4.9.1 shows the articles requiring amendment in the new Railway Transport Law.

Table 4.9.1 Items Requiring Revision (New Railway Transport Law)

Article	Revised Contents
Article 6 (Lines of National Importance)	<p>[Reason] 12,000 km of nationally important lines are included in the 20,150 km-network managed by PKP PLK. Due to a reduction in operation scale, some of the lines may no longer be under the scope of PKP PLK management.</p> <p>[Content] (1) The government is to bear any cost of modernizing the lines of national importance. The maintenance of nationally important lines not under PKP PLK management is subject to national policy; the government needs to guarantee the funds for maintaining these lines. (2) With the reduction of the PKP PLK railway network, lines of national importance that are designated by ordinances shall be revised.</p>
Article 39 (Fare discounting system)	<p>[Reason] Although the government is obliged to subsidize the losses incurred from the fare discounting system, only part of these losses is compensated due to the government's budget shortage. The various passenger transport companies are making up the losses, which worsens their business condition.</p> <p>[Content] A discount rate within the scope of the national budget shall be set. Another option is to abolish the fare discounting system.</p>
Article 41 (Regional passenger transport)	<p>[Reason] It is interpreted that when there are no alternative railway operators, the operation of service by the existing carrier cannot be discontinued.</p> <p>[Content] It is amended that even without alternative railway operators, it is possible to discontinue train operations.</p>
Article 58 to Article 64 (Railway police)	<p>【Reason】 The railway police (about 3,000 people nationwide) currently under PKP PLK are an organization for maintaining safety on railway sites and trains, although maintaining law and order should in principle be the responsibility of a public body. By separating the railway police from PKP PLK, PKP PLK can cut operating expenses.</p> <p>【Content】 The Article has been repealed. The railway police no longer are under PKP PLK but are transferred to the General Headquarters of Police.</p>

4.9.2 Establishment of the PKP Restructuring and Privatization Committee

In order to establish the PKP Restructuring and Privatization Committee described in “Improvement of Administrative Organizations” in Section 4.8 of Chapter 4 and increase its effectiveness, the government must delegate certain authority to the Committee. The base for the existence of the PKP Restructuring and Privatization Committee must be created with the enactment of special measures such as a law for the establishment of the Committee.

4.9.3 Legislation to Simplify Property Registration

To facilitate the management of track facilities, the new Law on restructuring, commercialization and privatization of the Polish State Railways simplified property registration for the ownership and leasing rights of land under rail tracks. For other properties, the ownership issue must be resolved quickly to facilitate the “redevelopment of properties with low capacity operating rate” and “increased utilization of existing facilities.” The enactment of a new law is recommended to simplify the registration of other properties in order to resolve the ownership issue quickly.

4.9.4 Other Legislation

(1) Abolition of Requirement for Stationing Gatemen at Level Crossings

The Ministerial Ordinance “Ordinance regarding technical conditions for railway level crossings with public roads and their location” of the Ministry of Transport and Marine Economy (now Ministry of Infrastructure) issued on February 26, 1996 mandates the stationing of gatemen at railway level crossings with public roads. PKP PLK has about 8,000 gatemen nationwide; this is one of the reasons for the high personnel cost and high TAC level. When the signaling facilities are modernized and safety is ensured, the Ministerial Ordinance must be amended to abolish gatemen at railway level crossings.

(2) Transferring the Control of Railway Police

In order to transfer the control of railway police mentioned in Table 4.9.1, the Ministry of Infrastructure must conduct talks with the Ministry of Internal Affairs and Administration, which has jurisdiction over the General Headquarters of Police, about transferring the control of railway police and preparing related legislation.

(3) Amending the Ministerial Ordinance for TAC

Revision of the TAC setting method entails amending the ministerial ordinances that stipulate the standard and method for calculating TAC and the government’s subsidies for the reduction of TAC.

4.10 REVAMPING THE REGIONAL PASSENGER TRANSPORT SYSTEM

4.10.1 Basic Concept of Reforming the Regional Passenger Transport System

The operation of loss-making trains must be suspended to reduce losses incurred by the regional passenger transport undertakings. However, the suspension of all loss-making trains will have great economic impact on all parties involved in the regional passenger transport system. To lessen the damages, profitable trains shall increase their train kilometers and loss-making trains shall reduce their train kilometers.

Some of the trains can continue operation through productivity improvement. Not only PKP Regional but also all parties in the regional passenger system shall work together to upgrade productivity. PKP Regional must build the ability to appropriately evaluate the goods and services supplied by various companies and set the target cost. Trains that cannot be sustained on a commercial basis and receive no subsidies from the

voivodship must be abolished.

After PKP Regional has set the target cost, the Group companies shall make their best effort to attain that goal. On the other hand, PKP Regional shall make effort to invest its business resources in profitable areas in order to increase profitable train services. Figure 4.10.1 shows the concept mentioned above. Meanwhile, the Polish Government will need to determine the size of the regional passenger transport network, taking into consideration the goals of the PKP Group and its productivity level.

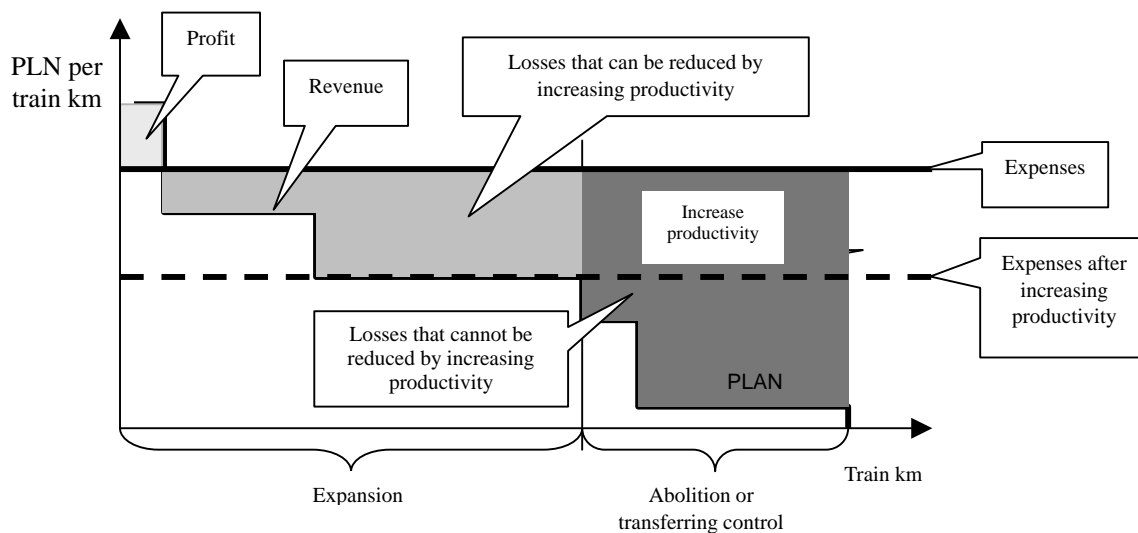


Figure 4.10.1 Relationship between Increasing Profitability and Abolishing Loss-making Trains

4.10.2 Ways of Handling Loss-making Train Operations

(1) Relationship with the Voivodship

In areas where the PKP Group cannot operate trains on its own, it needs to obtain funds from the voivodship. To do so, the PKP Group must compete with other transport companies, other transport modes, and other public services.

Currently, PKP Regional is acting as the principal contractor in negotiating with each voivodship. After the Law of Income of Government Units is put into effect, if PKP Regional goes bankrupt, the other PKP Group companies will suffer great damages. To eliminate such risk, the current system with PKP Regional assuming the role of the principal contractor providing regional passenger transport services must be changed.

As shown in Figure 4.10.2, one solution is to have PKP Regional transfer train operations to the voivodship, and for the voivodships to continue the train operations, utilizing the services of companies from the PKP Group on a contractual basis.

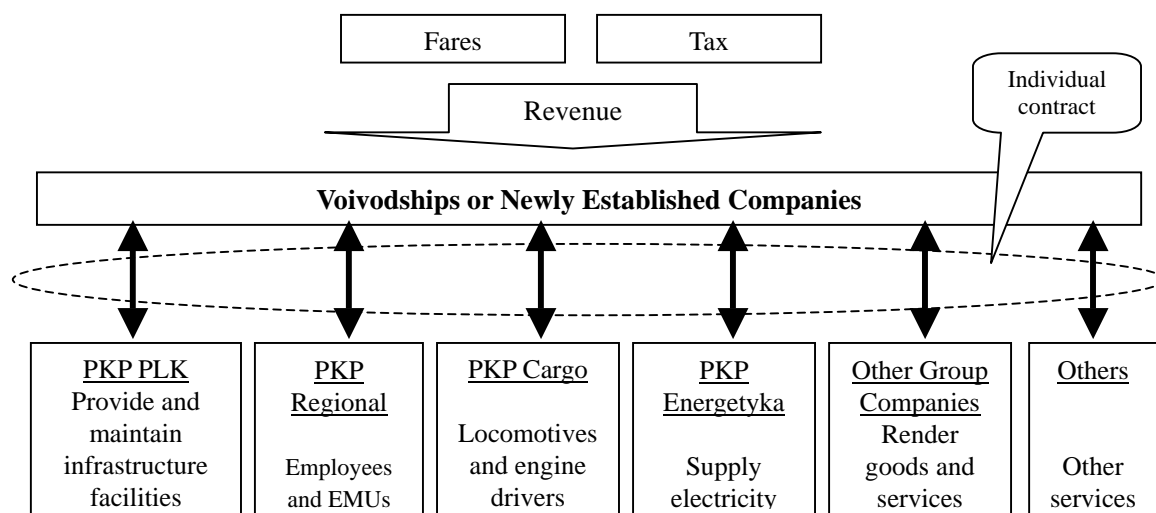


Figure 4.10.2 New Regional Passenger Transport System

This system disperses the risk and burden among related parties, which will work hard to improve services in order to maintain their own operations. The voivodship can also make its own arrangements to improve the regional passenger transport services.

After the train services are transferred to the voivodship, the voivodship must manage the train operations on its own. For this reason, the voivodship must upgrade its management skills and consider using the consulting services of PKP Regional to help it improve management capacity. Furthermore, the dispatch of personnel and transfer of properties from PKP Group companies are possible where necessary.

(2) Open Bidding

In areas where the PKP Group has abolished train operations due to the lack of profit, the voivodship can use open bidding to hire transport companies. In this case, PKP Regional can take part in the competition as a bidder for train operations the profit of which is guaranteed by contracts.

In the case that the voivodship adopts open bidding, PKP Regional must improve productivity to increase competitiveness in order to win the competition. Increased competitiveness entails that the PKP Group companies increase productivity as a whole. For this reason, it is urgent for PKP Regional to acquire the ability to coordinate with various PKP Group companies.

(3) Bus Option

Using bus as a transport means to replace trains will make it easier for PKP Regional to abolish loss-making trains. According to the data of contracts made between PKP Regional and bus companies for contingency purposes, a bus kilometer costs 2.6 PLN on the average. The cost of running one train kilometer in FY 2003 was 24.8 PLN, almost 9.5 times the cost of bus. If bus is used as an alternative transport mode, the operating expenses will be much lower, making it easier to abolish loss-making trains.

(4) Conclusion to the Handling of Loss-making Trains

The previous explanation can be summarized generally into five cases as shown in the flow chart in Figure 4.10.3.

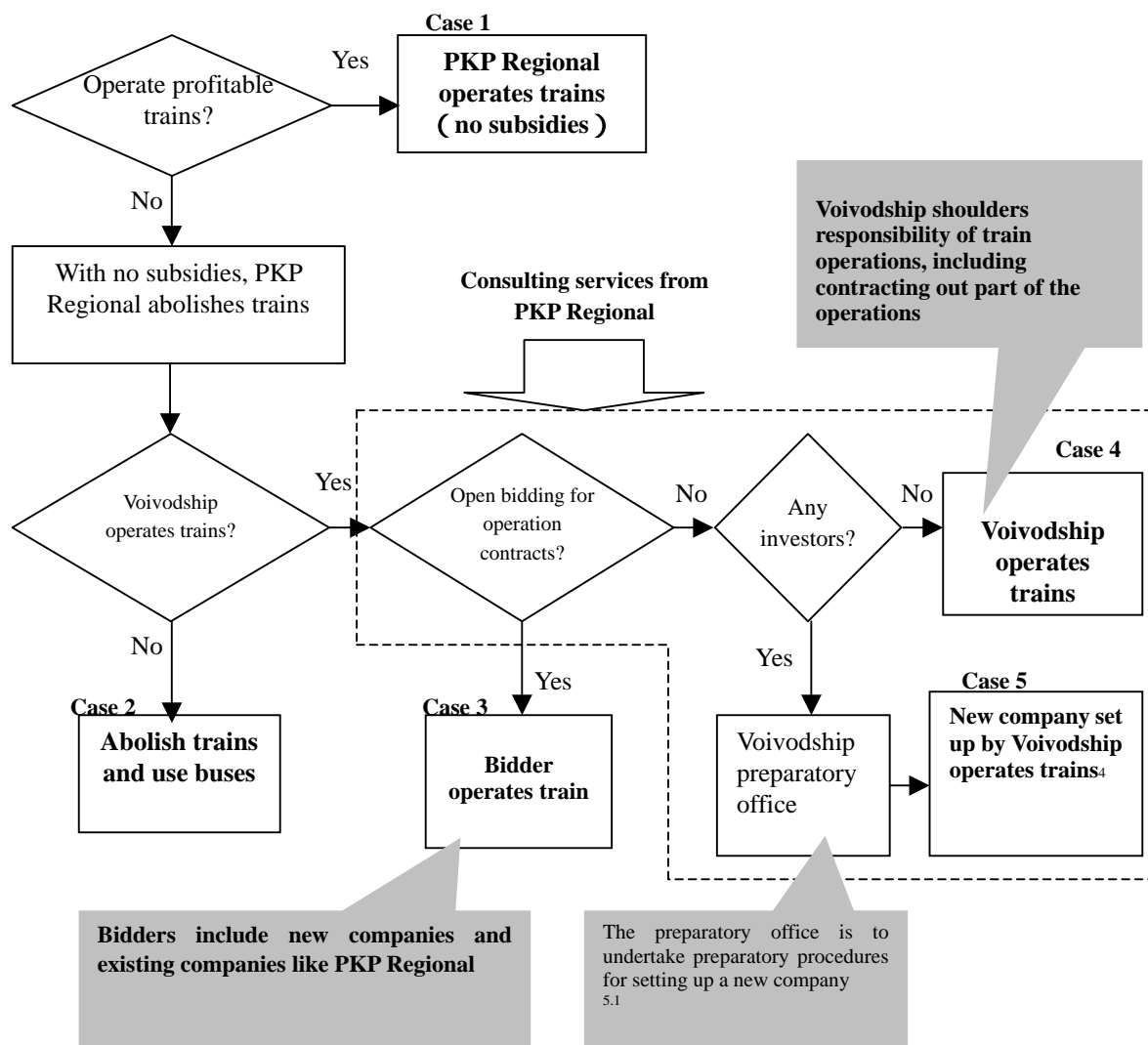


Figure 4.10.3 Flow Chart for the Handling of Loss-making Trains

(5) Reducing the Financial Burden of Voivodships

In the case that the profit-optimization approach is adopted, all loss-making trains will be abolished or transferred to the voivodships. However, since the voivodships cannot shoulder too much financial burden, there is the possibility that the transfer of loss-making trains to the voivodships will not be easy. Besides, the regional passenger transport network may not cover a wide enough area. For this reason, a break-even strategy shall be considered, in which PKP Regional operates those loss-making trains the losses of which that can be covered by profits from the profitable ones, in order to lessen the financial burden on the voivodships.

Under the new Restructuring Program, PKP Regional is divided into multiple companies and attempts are made to transfer the management to the voivodships.

However, because the voivodships' response to this management transfer policy will be different and their implementation ability differ, it is recommended that restructuring of the regional passenger transport system should be based on the basic principle shown in the flowchart in figure 4.10.3, in order to be prepared for the handling of different situations.

4.10.3 Handling the Debts of PKP Regional

At present, because the debts of PKP Regional cannot be redeemed, funds are in short supply. The infrastructure facilities of PKP PLK are deteriorating and the values of the PKP companies scheduled for sale are expected to continue to fall. Under such circumstances, PKP S.A. or the government shall consider assuming part or all of the debts.

In principle, because the government and PKP S.A. are responsible for the current situation of structural losses suffered continuously by PKP Regional, the best solution is for PKP S.A. and the government to take over the full amount of debts.

On the other hand, due to the current financial situation of PKP S.A. and the government, they may be able to assume only part of the debts. In this case, the amount of debts to be assumed must be set at a level that will prevent the various companies from defaulting on their debts. In particular, PKP Intercity has now barely started making profits. Any bad debt losses incurred at this time is likely to cause tremendous financial damage to it. Therefore, if PKP S.A. and the government can take over only part of the debts, they must analyze the cash flow of the various soon-to-be privatized companies and secure the necessary funds for assuming the debts.

4.10.4 Abolishing the Practice of Internal Transactions

The PKP Group companies procure goods and services from within the Group to prevent the outflow of financial resources. Because of this practice, PKP Regional almost has no chance of procuring goods and services from outside contractors. This practice may have weakened the incentive of PKP Group companies to raise competitiveness. It is also likely that even if there are strong business resources outside of the PKP Group, PKP Regional may not be able to utilize them. Therefore, it is recommended that PKP S.A. take the lead in abolishing this practice.

4.10.5 Japan's Measures for Local Lines

Among the local lines operated by the Japanese National Railways, quite a few of them became a burden to the operations of the Japanese National Railways because the decline in population and progress in motorization led to a substantial drop in transport demand and marked deterioration in the balance of payment.

Therefore, pursuant to the Law for Special Measures to Promote JNR Rehabilitation, lines that had difficulty in breaking-even even after productivity had been improved were designated local lines in 1981 and 175 lines (approximately 10,160 km) were so designated. Over time, 83 lines (approximately 3,160 km) that were deemed suitable to be switched to bus transport were selected as specified local lines. In the end, 45 lines (1,850 km) were switched to bus transport and 38 lines (1,310 km) were

transferred to local governmental entities, such as the third sector (companies formed with assistance from local government), to provide rail transport.

Figure 4.10.4 shows these measures.

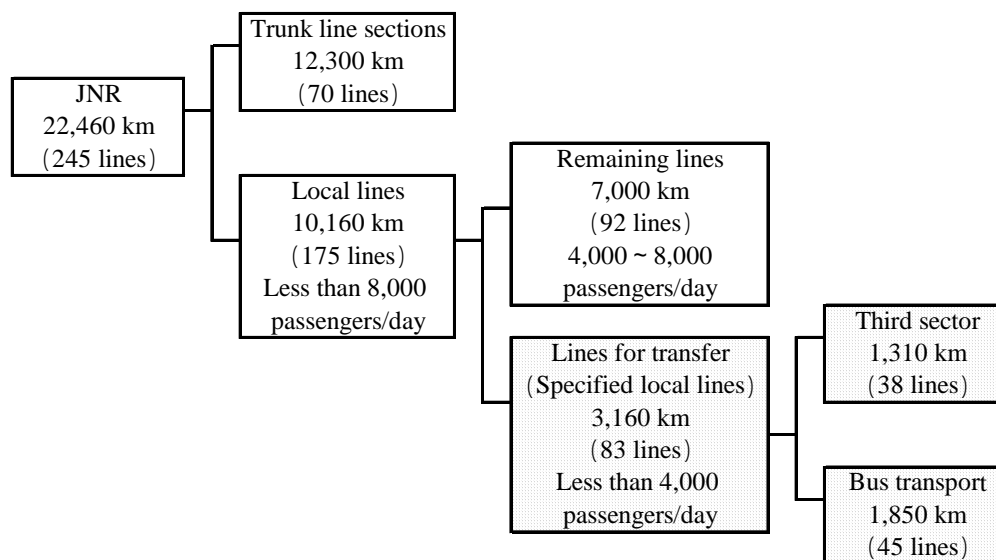


Figure 4.10.4 Downsizing of the Japanese National Railways and Regional Passenger Transport

4.11 REVISING TAC RELATED REGULATIONS

4.11.1 Current TAC

(1) Calculation Method

Article 33 of the new Railway Transport Law provides the calculation method of TAC currently in use in Poland as follows:

- The infrastructure manager determines the TAC to be paid by the transport operator.
- TAC shall be calculated by line allocation, operation and management costs, and the cost of maintaining and managing railway infrastructure.
- The basis of the fee shall be calculated by the unit rate based on the type of line or section, the type of train, and the planned train kilometers.
- The unit rate for freight and passenger are different.
- The basic unit shall be determined based on train kilometers.
- The infrastructure manager shall clarify the basic fees by train type and the contents of additional charges. These fees shall be set for passenger and freight separately and the fees shall be announced.

The method for calculating the TAC unit cost is prescribed by a ministerial ordinance. Two methods of calculation have been announced.

- 1) The actual figure from the previous fiscal year multiplied by the inflation rate.

- 2) The actual figure from the previous fiscal year multiplied by the gravimetric factor of the train and the inflation rate. The gravimetric factors are 0.8–1.2 by train weight in the case of a freight train and 1.0 in the case of a passenger train.

(2) Announced TAC

TAC used in Poland differs by line section and train type. Table 4.11.1 shows the average TAC.

Table 4.11.1 Average TAC for Passenger Trains and Freight Trains (Unit: PLN/train km)

Passenger	Qualified train (IC, EC, EX)	Intercity passenger train	Regional passenger train	Rail bus
	13.08	10.83	7.19	2.64
Freight	High-speed freight train	Wagon-load freight train	Bulk freight train	Branch line freight train
	22.74	14.65	25.80	24.23

Source: "Mutual relations of companies in PKP Group" (conference paper on May 6, 2003)

(3) TAC of PKP Transport Companies

Table 4.11.2 shows the average TAC per train-kilometer calculated from the actual TAC paid by PKP transport companies.

Table 4.11.2 Average TAC of PKP Transport Companies (2002 figures)

Train	Passenger Train		Freight Train	Total
Company	PKP Regional	PKP Intercity	PKP Cargo	
TAC (million PLN) (a)	794	212	1,645	2,651
Train-km (million) (b)	144	21 (Note)	75.6	240.6
Average TAC (PLN/train km) (a/b)	5.52	10.1	21.8	11.0

Note: Domestic share only.

(4) TAC-related Issues

The approach to TAC calculation must be changed in order to improve the operation of PKP transport companies and to give PKP PLK incentive to cut cost. The current TAC calculation method has the following problems:

- 1) Although the TAC calculation method is made public, PKP PLK does not show the transport companies how TAC is calculated, making it difficult for the three transport companies to make any detailed business plans.
- 2) Because only the actual figure of infrastructure maintenance cost is used, reduction in maintenance cost realized from the modernization of tracks is not reflected.
- 3) PKP PLK is charging the PKP transport companies unit prices lower than the average TAC, which is necessary for maintaining its business soundness. Therefore, government subsidies are needed to maintain the financial balance of PKP PLK.

4.11.2 TAC in Other European Countries

(1) TAC in EU Countries

With the implementation of vertical separation and open access—railway reforms prescribed by the EU railway policy - major EU Member States set up their own TAC. However, because the railway policy of each country is different, the treatment and contents of TAC are different.

This is because the pricing system and the level of TAC are affected by the way the transport market system is operated in each country. Above all, the price level is dependent on the operation condition of the entity that owns the line or the availability of public funds for meeting the costs for the construction, maintenance, and management of the line.

To further promote deregulation and competition in railway transport, EU issued the Directive (2001/14/EC) in February 2001. Although it prescribes that TAC shall be set taking into account the operation of the railway services, congestion, and environmental cost, the content of the Directive basically confirms the current situation of Member States. The adjustment of TAC will continue to be an issue attracting attention in the future.

(2) Comparison with Poland

In Poland, revenues from TAC are used to balance the maintenance and management costs of railway infrastructure and the maintenance and operating costs of train operation. Table 4.11.3 is a comparison of TAC between Poland and France, Germany, and Italy, which have systems for subsidizing the maintenance and management of railway infrastructure.

Table 4.11.3 Comparison of TAC between Poland and EU Countries

(Unit: EUR/train km)

Country	Passenger Train		Freight Train
	Qualified Train	Regular Train	
Poland	3.9	2.1	4.2~7.4
France	1.6~6.4	10.8	1.1
Germany	2.1~6.1	3.5	1.1~4.3
Italy	1.5~2.5	7.1	1.6~2.6

Source: Price Water House Coopers (PwC) data, Oct. 2000.

In the case of passenger trains, the TAC level for qualified trains in Poland is almost the same as in other EU countries, the TAC level for regular trains is lower. On the other hand, freight trains are charged higher TAC. In EU countries, the governments provide subsidies to cover part of the railway infrastructure maintenance and management cost. In Poland too, if the maintenance backlog continues to be eliminated and the government subsidizes the infrastructure maintenance cost, Poland will be able to reduce TAC to the same levels as in other European countries.

4.11.3 Recommendations for TAC-related Regulations

At present, the Ministry of Infrastructure is drawing up ministerial ordinances pursuant

to the new Railway Transport Law. The following precautions shall be taken in their formulation:

(1) Reduction in the Average TAC Level

PKP PLK suffered huge deficits in FY 2002. The main reasons are the cost for maintaining excessive railway facilities due to the length of the 20,150 km of tracks managed by PKP PLK and their surplus workforce, the increased repair and maintenance costs caused by the maintenance backlog of infrastructure facilities and their surplus workforce, and low productivity resulting from the continued use of old train operational control systems. It will be possible to lower TAC as the above-mentioned problems are resolved gradually in the process of the PKP restructuring and privatization.

(2) New Standard for Calculating TAC

To tackle the problems with the TAC calculation method and make improvement, it is necessary to set up a new TAC calculation method. In doing so, the following matters need to be taken into consideration:

- 1) The new TAC calculation method shall be simple and be made public.
- 2) The actual cost for maintaining the railway infrastructure of PKP PLK shall be reflected.
- 3) Reduction in the railway infrastructure maintenance cost achieved by the modernization of rail track facilities shall be reflected.

(3) Required Government Actions in the Revision of TAC Regulations

In order to lower TAC to a level that can improve the financial condition of various PKP transport companies, the government must make a strong commitment to pursue downsizing, secure the necessary funds for modernizing railway facilities, deal with the surplus workforce, and establish related legislation and organizations.

In international transport, high TAC for freight trains may encourage senders of freight to choose other transport modes or use the railways of other countries to avoid PKP PLK routes. Furthermore, as more roads are developed in Poland, the rail freight transport industry will lose competitiveness against road transport, resulting in lower share for the rail freight transport companies, including PKP Cargo.

In addition, if the short-trainset-high-frequency measure ends up burdening passenger transport companies with a substantial increase in TAC, the measure defeats its own purpose. Therefore, TAC shall be set taking into consideration the measures taken by the transport companies.

(4) Government Subsidies for Lowering TAC

The TAC level can be lowered when PKP PLK completes its investment in infrastructure and the restructuring of the workforce. On the other hand, before PKP PLK can complete the various restructuring and infrastructure investments, it will need government subsidies for TAC as one of the adjustment items. Specifically, the government shall provide subsidies to make up the difference between the personnel expense incurred on the premise of an ideal condition after the workforce restructuring has been completed and the actual personnel expense estimated for that year.

The number of employees depends heavily on government policies and the business strategies of PKP PLK. Therefore, if the government and PKP PLK management make efforts to restructure PKP PLK's workforce, the amount of subsidies can be reduced. In other words, the more progress is made on workforce restructuring, the smaller the amount of subsidies will be needed.

4.12 FINANCIAL MEASURES AND SOURCES OF FUNDS FOR THE RAILWAYS

A range of financial measures needs to be taken in order to implement government measures for dealing with the various problems mentioned above.

4.12.1 Expanding Public Finance

Table 4.12.1 compares the annual national spending on railways between Poland and Germany.

Table 4.12.1 Comparison of National Spending on Railways (Poland and Germany)

Country	FY	Railway Expenditure (A)	National Spending (B)	(A)/(B)
Poland	2002	659 million PLN	183 billion PLN	0.36%
Germany	2001	5,949 million EURO	244 billion EURO	2.44%

The amount of national spending made by the Polish Government on the railway is about one-sixth of that of neighboring Germany. In other words, the Polish Government gives relatively little financial support to its railway sector. It shall consider increasing financial aid to facilitate development of the railway business.

(1) Government Bonds

To increase financial support, the Polish Government shall consider loans and government bonds as ways to raise funds. The major EU countries rely heavily on loans. In FY 2002, the debt/GDP ratios of Germany and France were about 60% and Italy over 100%. On the other hand, Poland's debt/GDP ratio in FY 2002 was about 42.5%. In the future, because Poland is also expected to achieve a high GDP growth rate, it will be possible for it to raise more funds through loans and government bonds.

(2) Taxation Measures

As a means to resolve the environmental and safety problems arising from motor transport, a fuel tax shall be levied to promote modal shift and provide funds to the railways.

1) Fuel Tax

At present, a portion of the fuel tax is specified as road funds. The railways are also paying fuel tax because of the use of diesel fuel. In other words, the current tax system runs counter to the idea of modal shift, which is a basic EU principle. To resolve this problem, the portion of fuel tax levied against the railways that is specified as road funds shall be eliminated. Furthermore, transferring the currently specified road funds to the general account can help secure part of the funds for making railway investment.

2) Introduction of Environmental Taxes

Road Tax: This was introduced by Switzerland in 1998 to levy tax against long-distance motor trucks; half of the amount raised is used for investment in railways. Austria and other European countries are reviewing the adoption of road tax from the viewpoint of environmental protection. This tax can also be applicable to Poland.

Eco Tax: This was introduced by Sweden in 1991 and levied according to the amount of CO₂ emissions. It is believed to be an effective measure for environmental conservation, which is a basic EU stance.

3) Traffic Demand Management

From the viewpoint of traffic demand management, some countries levy congestion charges in big city areas that suffer severe congestion. This was first introduced in Singapore. The recent enforcement of this tax in the central part of London has attracted attention. Introduction of this tax will be effective in areas, such as Warszawa, where traffic congestion is likely to worsen rapidly.

4.12.2 EU Funds

The Structure Fund and Cohesion Fund are EU funds that will be available for use in the future. These funds can be used for infrastructure investment and the procurement of some rolling stock. With the Polish Government contributing a portion of the necessary amounts, various investments can be made. The following are EU funds that can be employed.

Table 4.12.2 Available EU Funds

Name of Fund	Description
Structure Fund	The Fund was founded with the objective to correct regional disparities and structural barriers in Member States in order to build an integrated economic society in the EU. This Fund includes the European Regional Development Fund (ERDF), which is used for the development of social infrastructure to promote regional policies. Railways are also part of the infrastructure development. To use the Fund, Poland must prepare its own funds to pay for 25% of the project cost.
Cohesion Fund	The Fund was founded pursuant to the Maastricht Treaty. It aims at getting rid of economic disparities in the EU and providing stability in the transition to a single currency. It is available to economically adverse countries with GDP less than 90% of the average EU Member States. TEN (Trans-European Network) projects and environment-related projects are eligible for the Fund. Railways are included in the projects. To use the Fund, Poland must prepare its own funds to pay for 15% of the project cost.

In reality, however, because the Polish Government is facing a financial crisis and it takes time to prepare and issue work orders and to obtain EU approval, only 19% (2002 figure) of the available EU funds were used. In order to make the most of the EU funds, the government needs to procure its own funds and expedite the procedures for various projects.

4.12.3 Utilizing PPP (Public-Private Partnership)

The PKP companies are expected to modernize various facilities from now on. However, as there are limits to the ability of PKP PLK to contract and supervise engineering works and limits to the financial strength of the operators, it is necessary to consider utilizing the capabilities of the private sector.

Under such circumstances, it is recommended to use the PPP (Public-Private Partnership) approach for various kinds of modernization. PPP enables proper risk sharing with the private sector, stable and long-term investment using private funds, and utilization of the private sector's project management technology, etc. PPP is a generic term to describe the practice in which the operations of a public service area are open to the private sector while the expertise and funds of the private sector are utilized through cooperation of the government and the private sector. This practice takes many forms, including outsourcing to private contractors, PFI (Private Finance Initiative), independent administrative entities, and privatization, etc. In applying PPP to railway modernization projects, it is necessary to review the characteristics of PPP thoroughly, draw up the most appropriate scheme for each individual project, estimate the cost effectiveness by comparing with the scenario in which the project is implemented as a public works project, and make the final decision.

In this context, the Polish Government is working on the enactment of a PPP law with a view to promoting PPP. Even within the current legal framework in Poland, it is possible to undertake a project using the PPP method. However, the PPP practice has

not yet taken root in Poland and the procedures are complicated, creating a barrier to the use of PPP. In view of this, the Polish Government plans to establish legal backing for the PPP method by way of a PPP law, and to simplify the various procedures that accompany execution of the PPP method.

Based on this new law, the Polish Government shall utilize the PPP method to improve regional passenger transport and develop logistics centers in the short term, and modernize tracks and promote the new Warszawa–Berlin high-speed train project in the future.

4.13 BUILDING NATIONAL CONSENSUS FOR RESTRUCTURING AND PRIVATIZATION

By gaining the consensus of the people for the restructuring and privatization of PKP, the government will have the backing of public opinion, making it easier for it to implement policies to address various issues. To that end, opinion leaders representing various sectors shall be invited to join the “PKP Restructuring and Privatization Committee” proposed in Section 4.8. Information on the restructuring and privatization shall be shared with the public.

As an example of the issues that require national consensus, the maintenance of a network out of proportion to demand will notably weaken the financial condition of the Polish Government, and may ultimately become a financial burden to the people. To enable the people to understand these issues fully, it is necessary to employ easy-to-understand indices and cultivate an environment that can facilitate constructive discussions on loss-making undertakings.

For example, in the case of Japan, an index called operating coefficient was used to show the expenses required for earning 100 yen in order to demonstrate the profitability of each line. In this example, when the operating coefficient exceeds 100, it shows that the line is operating in the red. The Japanese National Railways had the experience of gaining the consensus of the people for the abolition of loss-making lines by using this operating coefficient to explain in an easy-to-understand manner the lines that needed to be abolished.

CHAPTER 5 MEASURES TO BE TAKEN BY PKP COMPANIES FOR RESTRUCTURING AND PRIVATIZATION

Based on the various conditions mentioned in Chapter 3 that are necessary for the effective implementation of restructuring and privatization, this chapter describes the measures that the various companies need to take. In order to implement the restructuring and privatization effectively, the various companies shall change their approach to management and establish effective decision-making systems, which entails the training of human resources and delegation of authority.

In drawing up management strategies, the following four items shall be emphasized: (i) relationship to market needs; (ii) relationship with the government; (iii) relationship with other companies in the Group; and (iv) relationships within the organization.

5.1 PKP PLK

5.1.1 Business Environment

PKP PLK is facing a very severe business environment. Together with the decline in transport demand, TAC income from transport companies, especially PKP Regional, has fallen into arrears, hindering the repairs and maintenance of superannuated infrastructure. Furthermore, the maintenance of an oversized network bears heavily on the operations of PKP PLK. As shown in Section 3.2.1 of Chapter 3, this Study projects that railway demand in the future will show a downward trend.

Above all, in terms of the external business environment, Poland's accession to the EU (May 2004) will have the greatest impact on the operations of PKP PLK. With the accession to EU, PKP PLK will have to comply with the maintenance level laid down by the EU standards for the railway infrastructure of important lines in international transport, and to ensure equity and transparency in the setting of TAC.

Any delay in taking the above-mentioned measures will surely result in the Polish railways losing credit and damage the railways' competitiveness. PKP PLK must identify problem areas in its operations and take countermeasures as soon as possible.

5.1.2 Management Issues

(1) Maintenance of Railway Infrastructure and Shortage of Funds for Modernization

Although PKP PLK is the entity in charge of "eliminating maintenance backlogs," "prioritizing the modernization of railway lines operating under international treaties," and "ensuring interoperability" under the supervision of the Polish Government, it has not been able to accomplish these goals due to a shortage of funds.

PKP PLK plans to utilize EU's Structure Fund and Cohesion Fund to undertake modernization projects after Poland's accession to the EU. However, because Poland does not have enough ability to raise its own funds and PKP PLK does not have a

well-established implementation system, the amount of funds that can be used stops at about 20% of the total available.

(2) Delay in the Modernization of Train Operation Control Systems

A majority of PKP PLK's existing train operation control systems are archaic; their maintenance and management require considerable manpower. For example, the existing interlocking devices use an old mechanical system, which breaks down frequently. For this reason, many workers are needed to maintain the systems, posing a barrier to rationalization. Except on the main lines, semaphore signals are still in use, despite its manufacture has ceased. This fact illustrates that modernization of the signaling system is also in arrears.

(3) Management Information System Not Established

Information important to the operations of PKP PLK is not reflected in the decision-making of the top management, including the head of the technology department. Specifically, information on maintenance cost incurred by PKP PLK's regional offices is reported directly to the accounting department at the headquarters without going through the technology department—a structure that makes it difficult for the manager of the engineering department to have groom cost consciousness. Therefore, it becomes difficult for the head of PKP PLK's technology department to make decisions based on cost information.

(4) Problem with Outsourcing Method

At the time of its inauguration, PKP PLK signed long-term contracts with nine track work companies to outsource maintenance work. The lack of competition may have resulted in relatively high costs.

5.1.3 Management Objective

PKP PLK has set its objective at enforcing cost reduction, upgrading productivity and, based on these, providing safe and sound infrastructure facilities that match the needs of the transport companies at an appropriate TAC level. To achieve this management objective, PKP PLK is implementing organizational reform to instill the awareness of cost reduction and infrastructure maintenance, build a decision-making system, train human resources, and define responsibilities, etc.

5.1.4 Management Strategies

PKP PLK's management strategies for achieving the above-mentioned management objective can be categorized as follows:

- Resolve fund shortage by cooperating with the government
- Modernize train operation control systems
- Introduce an information management system for cost control
- Revise the outsourcing method

5.1.5 Measures

(1) Cooperating with the Government to Resolve Fund Shortage

1) Downsizing

Downsizing is an effective means for consolidating business resources as a first step to overcoming the shortage of funds for infrastructure management and operation control. It is possible to obtain satisfactory investment results by downsizing and giving priority to the modernization of lines that can increase the competitiveness of the railways.

2) Other Measures

Other measures for resolving fund shortage are as follows:

- Utilize durable materials to achieve life cycle cost reduction
- Adopt work methods that can reduce cost

In particular, the use of durable materials at places where rolling stock and infrastructure come into contact, as represented by rail, etc., can save labor for daily maintenance and contribute to life cycle cost reduction.

(2) Modernizing the Train Operation Control System

PKP PLK is merging and abolishing some of the existing train operation control systems. Although the scale is small, it is making improvement to the facilities and rationalizing the workforce. In 2003, PKP PLK employed about 43.7 million PLN of its own funds to merge and abolish operation control equipment, etc. and succeeded in rationalizing the workforce by about 500 people.

Stepping up the government's financial support can facilitate modernization of train operation control systems and rationalize the manpower required for handling train operations. Through these rationalization initiatives, personnel cost can be reduced and the TAC for transport companies can be lowered.

(3) Introducing Management Information System for Cost Control

At the PKP PLK headquarters, there is no system to keep detailed track of information on costs incurred by regional offices. Although PKP PLK has developed several plan formulation support systems to save labor in the formulation of maintenance and management plans, these have not been able to perform the recording and analysis of costs resulting from maintenance activities and formulate plans. Presently, PKP PLK headquarters is considering the introduction of the enterprise resource planning (ERP) package. The PKP PLK aims to reducing the accounting administrating cost. It may not have sufficient function to integrate information on work progress and engineering information.

Introduction of a Management Information System (hereinafter referred to as "MIS") to integrate information on work progress and cost, as well as engineering information, to support management decision is a means to instill cost awareness in the managers in

charge of PKP PLK's engineering department. With the introduction of MIS, in addition to the extremely detailed analysis integrating information on cost and engineering, it will be possible to examine cost from various perspectives ranging from the breakdown of costs to changes in construction cost, etc. For this reason, MIS will be effective in enhancing cost awareness and reducing cost of PKP PLK managers.

(4) Altering the Method for Outsourcing Work

PKP PLK contracts out most of its infrastructure maintenance work. As a cost reduction measure, it is conceivable to cut outsourcing cost by revising the unit cost for subcontract orders. Currently, PKP PLK is negotiating with the various track work companies to try to cut down on cost; however, it is possible to further reduce outsourcing cost through competitive bidding.

(5) Others

The current timetable prepared by PKP PLK cannot fully meet the needs of the operating companies. For the future, it is necessary to disclose information and set up a system that can enable the transport companies to participate in the preparation of timetables.

5.1.6 Viable Levels of TAC Reduction

At present, PKP PLK is facing problems such as the cost of maintaining an oversized railway network, rising repair and maintenance costs caused by maintenance backlogs, and huge personnel cost resulting from the use of old train operation control systems. As PKP PLK's expenses, the large amounts of costs directly affect TAC, and PKP PLK must take measures to reduce these costs. In this Study, it is estimated that the current average TAC cost of 12.8 PLN/train km can be reduced to 10.1 PLN/train km in 2010 and 9.1 PLN/train km in 2015.

Cost reduction at PKP PLK can reduce the average TAC cost by 20–30%. It is possible to further reduce the average TAC cost by increasing the number of customers through marketing development activities undertaken by transport companies and increase in the operation frequency of trains. The lower TAC will alleviate the TAC burden on transport companies and improve the operations of PKP PLK.

5.2 PKP REGIONAL

5.2.1 Business Environment

PKP Regional was set up as a passenger company to provide all domestic passenger transport services apart from the inter-city long distance passenger services provided by PKP Intercity. However, other than the mid-distance transport services radiating from Warszawa as its center and the transport services in some of the major cities such as the Silesia area, etc., PKP Regional is offering passenger transport services in regional areas with extremely low transport density. For this reason, most of the passenger services are operating in the red; deficits for the 2002 fiscal year alone exceeded 1 billion PLN.

With the entry into force of the Law of Income of Government Units from FY 2004, voivodships will no longer receive special subsidies from the national government but will secure funds through tax income. With this new law, voivodship will have more options in the choice of public transport services other than the railway. That is, the suspension of support from the voivodship will make it even more difficult for PKP Regional to maintain loss-making railway lines, forcing the company to undertake more reforms.

5.2.2 Management Issues

The major management issues are shown below. The method of decision-making, however, holds the key to improving these issues.

(1) Loss-making Trains

PKP Regional's huge deficits are caused by loss-making trains, which accounted for 90% of the 4,000 trains (2002 figure) operated by this company. Although some of the regional transport services are operated currently with subsidies from the voivodships, the fact remains that PKP Regional has not been fully compensated for its services. The operation of loss-making trains gives rise to PKP Regional's financial problem.

(2) Transactions within the PKP Group

As explained in Section 3.3.4 of Chapter 3 "Legislative, Organizational, and Structural Aspects Hindering Railway Operations," most of the current operating expenses of PKP Regional arise from transactions within the PKP Group. PKP Regional cannot reduce these costs on its own. At the same time, because PKP Regional does not have a department to review the validity of service costs necessary for the regional passenger transport, it does not have adequate capacity to negotiate transaction conditions with subcontractors. For this reason, PKP Regional may be procuring goods and services at prices higher than those of the market values.

(3) Fare Discounting System

The government should compensate any losses incurred due to the fare discounting system prescribed by the law. However, due to the government's budgetary shortfall, these losses are not fully compensated. This is a major factor for PKP Regional's escalating losses.

(4) Superannuated Rolling Stock and Inefficient Train Operations

Most of the rolling stock owned by PKP Regional is more than twenty years old, their functions and facilities are both obsolete. Because they have lost competitiveness against road transport, they require immediate improvement. For regional passenger transport, which requires mainly short distance, lower-volume transport, the current use of locomotive haulage is inefficient from the viewpoint of train employment.

5.2.3 Management Objective

It is desirable for PKP Regional to collaborate with the voivodships to work out the optimal size of regional passenger transport network throughout Poland and to

maintain it efficiently. To that end, PKP Regional shall set its objective at building a base for developing regional passenger transport in the future upon reducing cost and upgrading productivity. To achieve this management objective, PKP Regional must enhance its awareness of operating as a commercial company and implement structural reform by establishing a decision-making system, training human resources, and delegating authority, etc.

5.2.4 Management Strategies

To rid PKP Regional of its deficit-ridden status, the present 14,800 km network must be reduced and loss-making trains must be reduced drastically. As a commercial company, it would be desirable for PKP Regional to pursue optimal profits and operate only profitable trains.

However, from the perspective of national transport policy that takes into account road congestion and the global environment, regional passenger transport plays a very important role. It is recommended that PKP Regional collaborate with the voivodships to build a relatively large network. To put this into practice, various measures, based on the break-even strategy, must be taken.

The following are major strategies for PKP Regional to deal with the current business environment and to work towards restructuring and privatization:

- Downsizing
- Upgrading productivity
- Developing strategic marketing

Because the fare discounting system is an issue that cannot be resolved by PKP Regional, it is excluded from this list.

5.2.5 Measures

(1) Downsizing

As shown in Table 5.2.1, the 2002 transport data recorded that PKP Regional had an operation network of about 14,800 km, running about 4,000 trains/day and 400,000 train-km/day. The operation network for which PKP Regional shall be responsible was reviewed based on the basic concept shown in Figure 4.10.1 under Section 4.10 of Chapter 4 "Revamping the Regional Passenger Transport System."

Taking into consideration the development of transport services focusing on the suburban lines around big cities and main lines between major cities, as well as the reduction in cost from raising the productivity of train operations and the increase in revenue because of marketing activities, it was found that PKP Regional can break even at an operation scale of about 1,500 trains and 150,000 train-km/day, using 2002 as the baseline. The operation network at this time will be about 6,200 km. The transport demand in 2010 is expected to remain broadly unchanged. Thus, for the break-even scenario, the operation network shall be about 6,200 km.

This means that the current scale of regional passenger transport will have to be downsized by 60%. Other loss-making trains will have to be transferred to relevant voivodships or be abolished. Table 5.2.1 shows the simulation result of regional passenger transport premised on specified cost reduction and increased revenue effect. The unprofitable part of PKP Regional's activities which remains after downsizing, amounting to 60% of the total, will be transferred to the voivodships.

Table 5.2.1 Status of Regional Passenger Transport (FY 2010)

Item	PKP Regional	Voivodships	
		Voivodships	Abolished Trains
Percentage of train km	40%	37%	23%
Sales (million PLN)	826	353	-
Cost (million PLN)	1,002	931	-
Compensation for losses from fare discounting (million PLN)	176	77	-
Subsidies (million PLN)	-	500	-
Final profit (million PLN)	0	0	-

The following three prerequisites are necessary for building the above-mentioned scenario:

- 1) The Polish Government and the voivodships need to maintain the budget at a similar level every year.
- 2) A similar amount needs to be budgeted every year for regional railway passenger transport.
- 3) The overall productivity of regional railway passenger transport needs to be upgraded.

In particular, PKP Regional shall provide sufficient consulting services to voivodships regarding train operations to enhance productivity. Productivity is targeted at an increase of 7.5% in revenue and a reduction of 15% in expenses. Therefore, if productivity or revenue improves more than these assumed figures, fewer trains will be abolished.

To realize the 2) and 3) prerequisites, the PKP Group will have to take action to convince the voivodships of railway's merits and step up consulting services.

(2) Increasing Productivity

1) Improving Transport

The following are ways to improve transport:

(Improve operating system to increase revenue and cut expenses)

- Introduce express operation service plan

- Introduce uniform timetable (isochronic and regular operating method)

The express operation service plan is effective in increasing the volume of passenger transport through high speed as well as increasing efficiency in the turnover of rolling stock and crewmen. The uniform timetable is easy for the passengers to use and can cut the expenses of train operation by economizing the use of rolling stock and crew.

(Reducing expenses with introducing new EMU)

The introduction of electric railcars that are easy to turn back at terminal stations can improve the inefficiency of locomotive trains currently in use. Introduction of new EMU can increase speed and reduce operating expenses by improving the employment efficiency of rolling stock and crew. Furthermore, new railcars that have light body and equipped with inverter control induction motor can save electricity.

2) Abolishing the Leasing of Drivers

In actuality, PKP Regional's train operations today carried out based on an operation timetable prepared by PKP PLK and by drivers leased from PKP Cargo. In order to meet the customers' needs and to provide complete train services, PKP Regional needs to have its own drivers. In doing so, PKP Regional can play a primary role in employing drivers efficiently and reducing operation-related costs.

3) Securing a Quantity Survey Department

Currently, PKP Regional is using various kinds of outsourcing services for its regional passenger railway operations. Because it does not have the ability to calculate the quantity and prices of services required by the operations, it cannot maintain fair transactions. In order to ensure fair transactions, the company needs to set up a department equipped with adequate manpower and equipment to build quantity survey capacity.

(3) Strategic Marketing Development

1) Marketing Strategies

PKP Regional needs to set up diversified timetables such as fast trains to meet customer needs. First, it must make effort to inform customers of its improved services. To do so, it is urgent to develop employee skills and systems for sales, customer service, public relations, and advertising. At the same time, in order to develop customer base actively, it is necessary to make efforts to establish timetables in conjunction with residential development plans for the vicinity of stations in city suburbs. As this kind of real estate development can utilize the existing sites of marshalling yards, the PKP Regional shall establish a system in the future to actively exchange information with various PKP Group companies, local governments, and developers, etc.

2) Upgrading Rolling Stock

PKP Regional owns about 7,400 cars (4,100 passenger cars and 3,300 electric railcars); many of them are superannuated. The average age of passenger cars is 22 years and the average age of electric railcars is 25 years. If the usable life of rolling stock is 30 years, most of the cars will be due for replacement by 2010. However, with downsizing imminent, many cars will become redundant. Therefore, the superannuated rolling stock shall be abolished according to the operation scale and transport volume while new rolling stock shall be introduced sequentially where necessary to increase competitiveness, especially on mainline sections. At the time of replacement, it is desirable to replace with electric railcars in order to make improvement to passenger services and upgrade operational efficiency.

On the other hand, because PKP Regional is in a serious financial situation and has difficulty raising funds to purchase new rolling stock, the option of leasing them from a rolling stock modernization agency established with government aid shall be considered.

5.2.6 Future Operation Scale

Table 5.2.2 shows a comparison of the operation scale of PKP Regional in FY 2010 projected based on the review above and that of FY 2002. The 4,000/day number of trains in FY 2002 also includes the 300/day inter-voivodship trains (relatively long-distance service that traverse the neighboring voivodships).

Table 5.2.2 Operation Scale of PKP Regional

Year	No. of trains (trains/day)	Train km (train km/day)	No. of employees (persons)	Route length (km)
2002	4,000	400,000	21,449	14,800
2010	1,500	150,000	13,000	6,200

5.3 PKP INTERCITY

5.3.1 Business Environment

PKP Intercity is a long-distance passenger railway company. Its main role is to provide high-speed intercity passenger transport. It was established with a slim structure not burdened by excess properties or workforce. According to Poland's geography, the distances between Warszawa and major cities are about 300 km. In terms of domestic intercity passenger transport, the intercity passenger railway services will be in a very disadvantageous position when the currently delayed road development picks up speed.

In addition, with Poland's accession to the EU, PKP Intercity will be potentially deeply affected by competition from West Europe's high-speed passenger railway services. Geographically, because the major corridors that link the west with the east pass through Poland, PKP Intercity is expected to face severe competition in international passenger transport, including also competition against other transport modes. For this reason, while getting ready for the privatization, PKP Intercity must be prepared for the age of high-speed passenger railways by introducing new passenger services and high-speed trains to increase profitability.

5.3.2 Management Issues

(1) Marketing Development

Marketing development is an extremely important issue that will determine the operations of PKP Intercity, which is in a highly competitive intercity passenger transport market. However, according to the 2002 business results, 48.6% of PKP Intercity's revenue came from sales at PKP Regional's ticket counters. The sales of PKP Intercity depend heavily on PKP Regional's sales structure. Under such circumstances, the arrangement may become a barrier to sales increase in the long term.

(2) Leasing of Drivers

PKP Intercity has concluded a contract with PKP Cargo to lease its locomotive drivers; it faces the same problem as PKP Regional. In particular, the fact that PKP Intercity does not have its own drivers may delay its adaptation to technological innovation, which is required of high-speed passenger railway transport, and lower its competitiveness against railway companies in western European countries.

(3) Fare Discounting System

By law, the government should compensate any losses incurred due to the fare discounting system prescribed by the law. However, it has compensated only part of the losses, which deter the efforts to make management improvement.

(4) Deteriorated Rolling Stock

PKP Intercity inherited its current rolling stock from PKP, all are passenger cars hauled by locomotives. In the future, it is imperative to introduce rolling stock that is high-speed and can provide comfortable occupancy space in order for PKP Intercity to increase competitiveness and become a main force in intercity high-speed passenger transport.

5.3.3 Management Objective

In the competitive business environment, the urgent issue for PKP Intercity is to improve profitability. Its management objective is to build a structure that will enable it to survive in the intercity long-distance high-speed passenger transport market, including international passenger transport. To achieve this management objective, PKP Intercity must enhance its awareness of operating as a company and implement structural reform by establishing a decision-making system, training human resources, and delegating authority, etc.

5.3.4 Management Strategies

PKP Intercity has an operation network of approximately 9,000 km inside and outside the country. In the highly competitive intercity passenger transport market, it is necessary to maximize the use of this network and build a passenger transport service system that can optimize profits. The following are major strategies for PKP Intercity to deal with the current business environment and to work towards restructuring and privatization:

- Develop markets
- Secure locomotive drivers
- Upgrade services (introduction of new rolling stock)

Because the fare discounting system is an issue that cannot be resolved by PKP Intercity, it has been excluded from the company's management strategies.

5.3.5 Measures

(1) Marketing Development

In terms of ticket sales, a system must be established to enable speedy purchase at stations. It is desirable to strengthen collaboration with travel agencies taking into consideration the convenience of customers. Because the airline company LOT, one of the competitors, already has a Frequent Flyers Program (FFP) and is aggressively wooing customers, PKP Intercity should also develop a similar facility. It should consider developing its own customer expansion program using the Internet, and build a wide-area sales network by using interactive tools to communicate with customers. It is also extremely important to adopt a system that can offer customers flexible fare discounting services. In conjunction with these, it is urgent to develop employee skills for the handling of fare, timetable, customer services, public relations, and advertising, etc.

(2) Secure Locomotive Drivers

To be responsive to technological innovation and to ensure competitiveness against railway companies in western European countries, PKP Intercity shall cancel the contract of leasing drivers from PKP Cargo in the future and have its own drivers.

(3) Upgrading Services (Introduction of new rolling stock)

PKP Intercity is providing passenger services with deteriorated carriages inherited from PKP that are over 18 years old on average. In order to upgrade services, it is necessary to replace them sequentially with new rolling stock. Although there are the choices of locomotive-hauled trains and electric railcars in terms of train systems, it is necessary to introduce a high-speed comfortable system that can meet customer needs.

On the other hand, because PKP Intercity does not have enough funds and has difficulty raising funds to purchase new rolling stock, the option of leasing them from a rolling stock modernization agency established with government aid shall be considered.

5.3.6 Future Operation Scale

Although PKP Intercity was established with a rationalized management structure, there is scope for improving its profitability. PKP Intercity is already operating profitable lines; it cannot increase profitability by carrying out downsizing like the other PKP transport companies. Therefore, in order to increase profits, PKP Intercity must upgrade its services in the 6,000-km network in Poland and further expand its service network outside Poland.

5.4 PKP CARGO

5.4.1 Business Environment

PKP Cargo is the largest company within the PKP Group; it is also one of the largest rail freight companies in Europe. However, it faces both external and internal problems stemming from low transport demand and the huge superannuated excess properties inherited from PKP. In particular, in the highly competitive freight transport market, the demand for coal, which is one of the main commodities transported by Polish railways until now and accounts for approximately 50% (76 million tons in FY 2002) of the total volume of rail freight, is expected to decline. Therefore, although PKP Cargo was able to produce operating profits in FY 2002 in the second year of its inauguration, it will certainly face a much more severe environment considering the changes to the transport structure in the future. For this reason, it is urgent to improve profitability by carrying out thorough structural reform and raise productivity. To achieve these, it is necessary for PKP Cargo to cultivate its awareness of operating as a commercial company.

5.4.2 Management Issues

(1) Labor Productivity

PKP Cargo has 49,786 employees (as of the end of FY 2002) and the company's productivity can hardly be said high according to a comparison conducted in this Study with freight companies in other countries. Therefore, how to cut down on the number of employees is an important issue in PKP Cargo's business strategy. However, labor unions in Poland are very powerful, making it very difficult for the PKP Group companies to restructure their workforce. Under such circumstances, the labor force lacks flexibility, making it a huge challenge to try to increase productivity.

(2) Transactions with Passenger Companies

About half of PKP Cargo's 15,000 drivers are leased to the passenger companies PKP Regional and PKP Intercity. The revenue from these transactions was approximately 630 million PLN in FY 2002. However, due to the deterioration of PKP Regional's financial situation, 320 million PLN of the accounts receivable have not been collected. Therefore, if PKP Regional and PKP Cargo continue to conduct transactions under the current conditions, the accounts receivable may further increase and worsen the cash flow at PKP Cargo.

While introducing new rolling stock, the passenger companies will be forced to downsize and some of the drivers will become redundant at that time. Furthermore, because these leasing contracts may have become loss-making businesses for PKP Cargo, PKP Cargo shall stop these transactions as soon as possible to avoid the risk that accompanies these transactions.

(3) TAC

In FY 2002, PKP Cargo had a profit of 153 million PLN; this profit was premised on

TAC discount. Whether there is TAC discount or not has a substantial effect on the profit of PKP Cargo.

5.4.3 Management Objective

In the severe transport business environment, PKP Cargo sets its management objective at reducing the surplus workforce and excess properties, increasing productivity, and revitalizing the organization. To achieve this management objective, PKP Cargo must enhance its awareness of operating as a commercial company and implement structural reform by establishing a decision-making system, training human resources, and delegating authority, etc.

5.4.4 Management Strategies

To revitalize its business, PKP Cargo must take immediate action to downsize, increase productivity, and clearly identify properties that are necessary for freight transport business in the future.

It also needs to undertake strategic market development and investment to develop commodities that can replace coal transport, which is expected to reduce further. In addition, to avoid the railway's further decline in transport share, PKP Cargo shall move ahead of road transport, whose development is held back by delays in domestic road construction, to gradually switch to a combined transport system that meets new transport needs and to build a business foundation as a comprehensive distribution company while it is still being supported by coal transport over the next few years.

The following are major strategies for restructuring and privatization:

- Downsizing
- Upgrading productivity
- Marketing development and investment

Because TAC is an issue that cannot be resolved by PKP Cargo, it has been excluded from the company's management strategies.

5.4.5 Measures

(1) Downsizing

PKP Cargo shall calculate the appropriate numbers of employees and rolling stock needed based on the transport figures of 2002 and drastically reduce its excess property assets, which were built in the era of large transport volumes in the past. This measure also has the effect of reducing many superannuated and unnecessary properties.

The optimal network scale according to PKP Cargo's profit-optimization strategy is estimated to be 11,000 km, calculated based on the actual transport figures of 2002 and the projected future demand in this Study. This network size is calculated by selecting routes with a throughout transport volume of over 2,000 tons/day.

On the other hand, the optimal network size for PKP Cargo's break-even is estimated to be 15,000 km. This is the network size at which PKP Cargo can achieve break-even under the assumptions that it maintains the surplus workforce after the leasing transactions of drivers have stopped and that will use the same tracks as passenger transport.

(2) Upgrading Productivity

1) Abolishing the Leasing of Locomotives and Drivers

PKP Cargo is in a situation in which it must upgrade its management efficiency as soon as possible to pave the way for privatization and to that end, it must dedicate itself to its core business, which is freight transport. The 2002 transport figures show that the leasing contracts with PKP Regional and PKP Intercity may have become PKP Cargo's loss-making business. However, in order to dissolve these contracts, PKP Cargo must work with the labor unions to coordinate the transfer of many drivers.

2) Increasing Efficiency in the Use of Locomotives

Compared to the freight train km, the percentage of locomotive km is 20–50% larger, showing the inefficient use of locomotives. This stems from the lack of a basic commitment on the part of the transport companies to use locomotives efficiently in the process of preparing the current timetable, because after the division into various PKP Group companies, transport companies including PKP Cargo have relied on PKP PLK to prepare their timetables.

PKP Cargo must negotiate with PKP PLK so that it can participate actively in the preparation of its operation timetable. This will give an incentive to PKP Cargo to upgrade the efficiency of operation services.

3) Increasing Efficiency in the Employment of Engine Drivers

About 25% of the freight trains are operated with two drivers. One-man operation can drastically reduce the number of drivers. This shall be pursued after fully considering the working condition of drivers and ensuring safety.

4) Organizational Reform and Business Improvement

In order to consolidate its position as a comprehensive distribution company, PKP Cargo must implement structural reform and establish a business group led by PKP Cargo (hereinafter referred to as "PKP Cargo Group") that includes also forwarders. To that end, it must implement the items listed in Table 5.4.1.

Table 5.4.1 Conditions for Organizational Reform and Business Improvement

Item	Description
Streamline the Headquarters' organization	Build the structure for restructuring and reduce the size of management departments, which account for 15% of all employees
Build an active sales system	Set up customer-oriented train services Establish a system to develop market for new transport items other than bulk transport
Set up profitable train services	Introduce a train unit cost calculation system
Build a PKP Cargo Group	Strengthen relationship with forwarders, etc.

(3) Marketing Development and Investment

1) Marketing Development

PKP Cargo shall strengthen its role in the consumer goods market, which is expected to grow. To do so, PKP Cargo shall develop a combined freight transport system. In particular, it is extremely effective to build a network of logistics centers that have storage function and can functionally link road transport and rail transport using containers and swap bodies.

2) Refurbishing and Upgrading Rolling Stock

Downsizing alone is not sufficient to strengthen business for the future. To build up business capacity, it is necessary to include in the funding plan the investment necessary for the refurbishing and upgrading of rolling stock after liquidating the excess properties. Because it is possible to obtain adequate funds from PKP Cargo's improved business activities, it is recommended to use these funds for new investments.

3) Dividing Properties

Changes in the distribution market necessitate investment to facilitate a complete conversion, in the form of transport, to a combined transport system. To permit this, there are opportunities to consolidate the currently idle sites of large marshalling yards and to convert them into logistics centers. On the other hand, sites not needed for the freight business can be developed by PKP S.A. for commercial use. PKP Cargo shall take the lead in formulating a master plan for the utilization of marshalling yard sites as soon as possible in order to develop land more effectively.

In freight transport, the modal shift from road to rail is a pillar of the country's freight transport policy, in which PKP Cargo plays a central role. For this reason, PKP Cargo shall work closely with the Polish Government and where necessary, request the government for support in making investment in related facilities.

5.4.6 Future Operation Scale

Table 5.4.2 shows the operation scale of PKP Cargo when it adopts the break-even strategy or the profit-optimization strategy.

Table 5.4.2 Operation Scale of PKP Cargo

Item	No. of employees (persons)	No. of locomotives (units)	No. of freight cars (units)	Network (km)
As of the end of 2002	49,786	3,816	90,185	18,550
Break-even strategy	46,800	1,500	68,500	15,000
Profit-optimization strategy	27,500	950	58,100	11,000

CHAPTER 6 TOWARDS THE IMPLEMENTATION OF RESTRUCTURING AND PRIVATIZATION

6.1 OVERALL ASSESSMENT OF THE EFFECTS OF DOWNSIZING

6.1.1 Precautions for the Overall Assessment

To achieve “a railway system adaptable to the market,” various analyses were conducted in Chapter 5 in relation to the downsizing scenario presented in Chapter 3. Information obtained from the analyses in Chapter 5 is as follows:

- 1) Reduction of the level of TAC calculated based on the level of productivity improvement that can be achieved by PKP PLK
- 2) The network size of regional passenger transport undertaking and the level of workforce restructuring calculated on the premise that the break-even strategy is adopted and based on the level of productivity improvement that can be achieved by PKP Regional
- 3) The network size of PKP Cargo and the level of workforce restructuring calculated based on 1) and 2).

Based on the results of the above-mentioned individual analyses and depending on whether PKP Cargo finally adopts the balance-of-payment strategy or the profit-optimization strategy, the overall level of downsizing that the Polish railways shall carry out will be determined. On the other hand, besides the above-mentioned items, it is necessary to consider the effect on TAC of downsizing at the various companies, the percentage of regional passenger transport services voivodships are willing to accept, and so on.

6.1.2 Selecting the Best Option

(1) Assessment of Scenarios

Table 6.1.1 summarizes the effects of the four downsizing scenarios presented in Table 3.4.3 of Section 3.4.3 “Provisional Analysis of Downsizing Strategies” in Chapter 3 based on the analysis results in Chapter 5.

Table 6.1.1 Effects of Various Scenarios

Company	Item	Unit	Status	Scenario A	Scenario B	Scenario C	Scenario D
PKP PLK	Network size	km	20,150	15,000	11,000	Regional passenger transport needs to maintain a relatively large network. If the profit-optimization strategy is adopted, the network can only be developed in limited areas, therefore, scenarios C and D cannot be selected.	
	No. of employees	person	46,004	21,500	16,800		
	Infrastructure maintenance cost	million PLN	3,100	1,800	1,400		
PKP Regional	Network size	km	14,800	6,200	6,200		
	No. of employees	person	21,449	13,000	13,000		
PKP Cargo	Network size	km	18,550	15,000	11,000		
	No. of employees	person	49,786	46,800	27,500		
Total No. of Employees		person	117,239	81,300	57,300		
Reduction in Workforce		person	-	35,939	59,939		

Because scenarios C and D, which are premised on a profit-optimization strategy for PKP Regional, do not correspond to the mission of a regional passenger transport undertaking, which is to maintain a network for a relatively large area, they are not included in the assessment.

According to Table 6.1.1, compared to Scenario A in which PKP Cargo adopts the break-even strategy, the level of workforce restructuring is greater in Scenario B in which the profit-optimization strategy is adopted. Therefore, Scenario A can alleviate various burdens resulting from the restructuring of workforce.

On the other hand, while PKP Cargo holds the key to the survival of the railway industry, its privatization also holds the key to the settlement of accumulated debts shouldered by PKP S.A. If PKP Cargo adopts the break-even strategy to reduce the level of workforce restructuring, it may not be able to secure enough profits. In such a case, it will have less chance of obtaining investments from outside investors, creating an obstacle to privatization. Therefore, it is desirable to carry out downsizing based on the profit-optimization strategy and pursue workforce restructuring over a relatively long period of time to try to alleviate as much as possible the various burdens and effects on the society that accompany workforce restructuring.

From reviewing the above-mentioned network size and the level of workforce restructuring, Scenario B is seen as the most appropriate option. However, in view of the financial situation of the Polish Government and the time factor, this Study recommends a step-by-step approach by which the Polish Government first achieves Scenario A, and then in the second phase proceeds to Scenario B.

(2) Proposed Restructuring and Privatization Process

Figure 6.1.1 shows where the scenarios A, B, C, and D for restructuring and privatization and the proposed privatization plan of the Polish Government stand from the viewpoints of profit-optimization and break-even for PKP Regional and PKP Cargo.

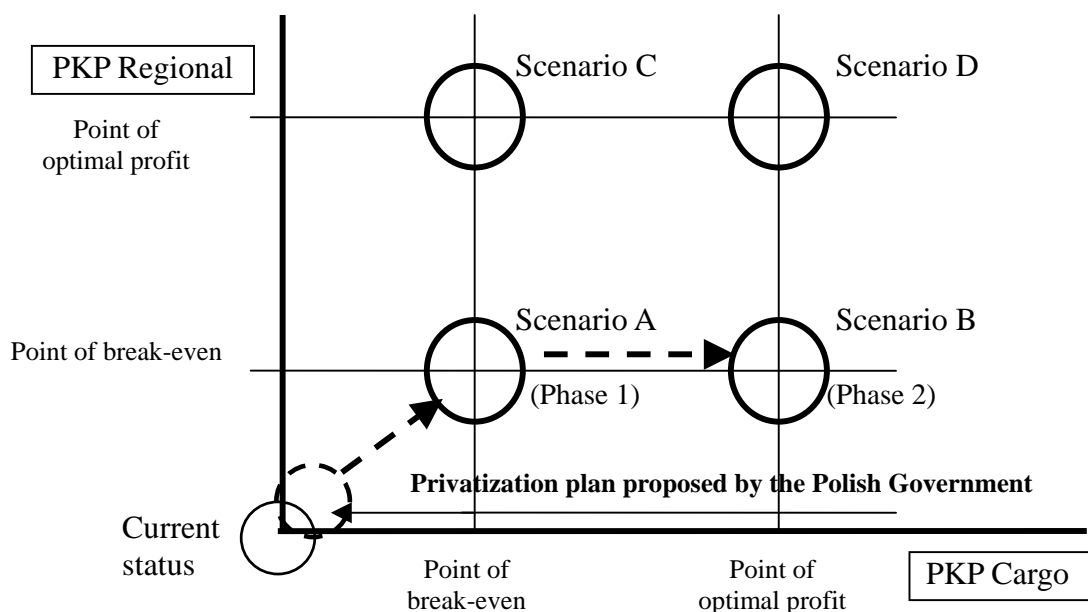


Figure 6.1.1 Proposed Restructuring and Privatization Process (JICA Proposal)

Figure 6.1.1 shows that the scenarios proposed in this Study are a continuation of the privatization currently envisioned by the Polish Government. In other words, the recommendation in this Study follows the principle of the Polish Government in implementing the privatization, but in a more efficient manner. Compared to the proposal made by the Polish Government, the JICA proposal seeks restructuring that is more thorough prior to the privatization.

Figure 6.1.1 shows the general concept of the restructuring and privatization process. In practice, it is desirable to allow for flexibility in the approach before arriving at Scenario B to respond to any changes in external conditions. However, this process must follow the principle that the railway undertakings will have additional room for corporate flexibility after privatization.

There is a plan to abolish 3,150 km of the 20,150 km of routes currently in use. However, this is only the first step to come up with the most suitable network size before reaching Scenario B; more lines need to be abolished. The scenarios proposed in this Study will result in a route scale of 6,200 km for regional passenger transport and a route scale of 11,000 km for freight transport. Because the business area of freight transport covers the business area of regional passenger transport, the total route network is calculated to be 11,000 km, a scale that will enable transport companies to maintain sound operation. In this case, the other lines will have to be transferred to the voivodships or companies that intend to use them as dedicated lines, or be abolished. In the end, the national government will have to determine the network size, taking into consideration the balanced development of national land.

6.2 FINANCIAL EFFECTS AND REQUIRED AMOUNT OF FUNDS

6.2.1 Financial Effects

Table 6.2.1 shows the projected profit and loss statements of the various PKP Group companies for FY 2010 prepared based on the recommendations of this Study.

Table 6.2.1 Projected Profit and Loss Statements (FY 2010)

(Unit: million PLN)

Item	PKP Regional	PKP Intercity	PKP Cargo	PKP PLK
(Operational Revenue)				
Passengers & Freights	850	661	3,923	1,520
Government	181	45	-	20
Others	67	2	38	8
Total Operational Revenue	1,098	708	3,961	1,548
(Operational Costs)				
Personnel Costs	369	69	887	526
TAC to PKP PLK	286	201	946	-
Leasing Costs of New Cars	185	99	-	-
Other Outsourcing Costs	72	116	186	431
Energy & Material Costs	142	64	472	174
Depreciation Costs	0	30	189	298
Other Operational Costs	39	12	850	104
Total Operational Costs	1,094	590	3,530	1,533
(Operational Income)	4	118	431	16

The profit and loss statement in Table 6.2.1 is based on an assumption that not all regional passenger transport operations are accepted by the voivodships.

On the other hand, if the percentage of train operations undertaken by the voivodships increases, PKP Intercity and PKP Cargo can share the infrastructure maintenance cost with the voivodships and the TAC level will decrease. Efforts shall be made to promote the transfer of train operations to the voivodships to lower the TAC burden for the sake of transport companies that are to be privatized.

6.2.2 Amount of Necessary Funds

Financial support from the Polish Government is indispensable for the restructuring and privatization of the railway industry. Financial support includes securing the sources of funds for resolving maintenance backlogs and modernizing the train operation control systems, sharing the workforce restructuring cost, and settling debts. Table 6.2.2 summarizes the costs that shall be taken care of by the Polish Government or PKP S.A. The amounts in this Table also include temporary funding responsibilities and amounts that can be reduced with the efforts of related parties.

Table 6.2.2 A Summary of Necessary Funds

(Unit: million PLN)

Item	2004 - 2006	2007- 2010	2011 and after	Total	Source of funds	Comments
(Infrastructure development-related funds)						
Resolve maintenance backlog and modernize train operation control systems	2,836	4,445	-	7,281	Polish Government	Utilization of EU funds
Subsidies to PKP PLK for the reduction of TAC	1,444	557	40	2,041	Polish Government	Amount of subsidies may reduce as PKP PLK restructures its workforce
Total	4,280	5,002	40	9,322		
(Workforce restructuring cost)						
PKP transport companies	392	70	-	462	PKP S.A.	Can be recovered through the sales of stocks and equity of related companies
PKP PLK	252	154	14	420	Polish Government	Can be recovered through reduction in personnel cost
Total	644	224	14	882		
(Debt assumption-related funds)						
PKP S.A.	-	2,000	-	2,000	Polish Government	Can be recovered through the redevelopment of real estate

6.3 RECOMMENDATIONS FOR THE RESTRUCTURING AND PRIVATIZATION IMPLEMENTATION PLAN

6.3.1 Policies for Realizing the Restructuring and Privatization Plan

The restructuring and privatization of the PKP Group companies cannot be implemented only with the supervision of the Ministry of Infrastructure; but all related ministries and agencies of the Polish Government, including the Ministry of Infrastructure, voivodships, PKP S.A., PKP PLK, and the three transport companies, will need to work together towards the early realization of restructuring and privatization.

In this Study, to resolve the pending issues on restructuring and privatization identified in Chapter 3, Chapter 4 explains the roles that shall be played by the national and local governments and Chapter 5 explains the measures that shall be taken by the various PKP companies. Based on these analyses, the following policies and measures that shall be implemented by each of the related agencies and organizations are recommended for the realization of the most suitable scenarios proposed in Section 6.1 of Chapter 6.

(1) Polish Government

1) Downsizing

Because the restructuring and privatization of PKP is one of the most important issues, the Polish Government shall exercise strong leadership to facilitate reduction in stages of the route network maintained and managed by PKP PLK and reduction of the operation scales of the various PKP transport companies analyzed in Section 6.1. This is an approach that will impose the least financial burden on the Polish Government and with it, the PKP Group companies can realize restructuring and privatization efficiently. Although this Study proposes that, through downsizing, the route length to be maintained and managed by PKP PLK in the future shall ultimately be 11,000 km, the national government shall consider the balanced development of the national land and add any necessary lines or sections to determine the future scale.

2) Dealing with Surplus Workforce

The PKP Group companies covered by the study had a total workforce of 124,000 at the end of 2002. It is estimated that through downsizing, as many as 60,000 workers will eventually become redundant. As there is a limit to what the PKP companies can do with this surplus workforce, the government shall play an active role in resolving this issue. This report proposes the option that the surplus workforce be handled by each PKP company, the option that PKP S.A. takes over the redundant workers, and a compromise plan. In addition, with an early retirement program as the core, redundant workers can be relocated to railway-related undertakings and governmental organizations. It is advisable to present the early retirement conditions in a step-by-step program.

3) Utilizing Excess Properties

Through downsizing, the railway network to be maintained and managed by PKP PLK and the business scope of the PKP transport companies will be limited; the portion of land and properties not required for the railway business will be surplus to requirements. Laws shall be enacted to simplify property registration that is necessary for asset classification and suitable measures for these properties shall be taken as soon as possible. At that time, city-planning projects shall be considered to add value to land with good development potential, such as land adjacent to stations and marshalling yards, etc. to increase their sales values.

4) Settling Accumulated Debts

Settling the accumulated debts is an urgent issue that has hindered the restructuring and privatization of PKP; the Polish Government and PKP S.A. must take the lead to tackle the issue. Thus, (i) taking suitable measures to deal with the surplus workforce will increase the sales values of the stocks of PKP Group companies; and (ii) the redevelopment and effective utilization of sites not needed for the railway business will not only secure funds but also sell off unnecessary land to help repay the accumulated debts. In the event that PKP S.A. still cannot settle the debts after having taken these measures, the government shall temporarily provide the funds.

5) Modernizing Railway Infrastructure

Because the maintenance backlogs on the important sections of PKP PLK's railway network have been caused by a shortage of funds that the government should have furnished, the government shall take responsibility in taking the necessary measures. Given the urgency that PKP PLK must make its lines accessible to the transport companies of other countries when the transition period after Poland's accession to the EU comes to an end in 2007, the maintenance backlog on important lines must be resolved by the end of 2006.

Modernization to EU technical standard of the under-productive train operation control systems and modernization of lines operating under international treaties must be prioritized. The Polish Government must take measures to optimize the use of EU funds to lessen the financial burden.

6) Improving Administrative Entities, etc.

The restructuring and privatization of the PKP Group must be implemented in conjunction with administrative organizations including the Ministry of Infrastructure. To do so, a "PKP Restructuring and Privatization Committee" must be set up under the direct control of the Prime Minister and comprised of members representing various ministries and agencies. The Committee shall work at strengthening the coordination among ministries and agencies and allocate the necessary personnel for policymaking. Matters deliberated at the Committee shall be made public to make it easier to gain the public's support. For this reason, it is necessary to add to its membership opinion leaders who represent the various sectors in Poland such as academic experts and representatives from the financial sector, etc.

7) Developing Legislation

Legislative actions required for implementing the restructuring and privatization of the PKP Group include amendments to the new Railway Transport Law, enactment of the Law for Establishment of the PKP Restructuring and Privatization Committee, enactment of law for simplifying property registration, etc. and amendments to the ministerial ordinance for TAC and the ministerial ordinance mandating the stationing of gatemen at level crossings.

Because these legislative reforms are indispensable for facilitating the restructuring and privatization of the PKP Group, the executive branch of the government, including the Ministry of Infrastructure, shall take immediate action to advance legislative development.

8) Strengthening UTK Functions

Implementation of vertical separation and open access may lead to the neglect of safety control in train operations, which is a key requirement of a railway undertaking. The mentality that PKP PLK will not be privatized takes away the incentive to rationalize the organization and the workforce, reduce expenses, and upgrade the maintenance standards of railway infrastructure, etc.

UTK shall play a central role in ensuring that PKP PLK maintains the railway infrastructure at the appropriate technological level and providing strong supervision and direction to PKP transport companies regarding safety control. To do so, UTK must strengthen its organization.

(2) Voivodship

Among the train services originally offered by PKP Regional, operation of loss-making trains is abolished after downsizing. However, to secure transport means for local residents, each voivodship must review if it shall take the lead in continuing the train operations or agree on abolishing the train and switch to buses. In the case of continuing train operations, the voivodship must determine if it shall enter a transport contract with PKP Regional or decide on the transport company through open bidding. With the application of the Law of Income of Government Units, the voivodship can play a central role in selecting transport services.

The abolition of loss-making trains shall be carried out with the consensus of the local community. Therefore, the national government and PKP Regional shall make joint effort to form agreements with the voivodships as soon as possible.

(3) PKP Companies

The priority for PKP Regional and PKP Cargo in downsizing is to deal with the redundant workers or rationalize the workforce to raise productivity. In dealing with the redundant workers, PKP companies must first make an effort to utilize human resources effectively by reviewing personnel assignment between departments and offering job transfers.

The three transport companies must expand business by improving customer services, upgrading productivity, strengthening the business organization, and taking marketing initiatives to develop business.

The PKP transport companies share the common challenge of having to upgrade superannuated rolling stock, which has become a hindrance to improving productivity. Improvement must be pursued within the financial scope of the companies. One way is through a rolling stock modernization agency set up by the government as recommended in this Study. In particular, PKP Intercity must renew rolling stock to upgrade services so that it can be competitive against transport companies from other countries that may enter the market.

To lower the TAC level, PKP PLK must take immediate action to upgrade productivity by modernizing the train operation control systems and rationalizing the workforce, etc.

6.3.2 Implementation Schedule for Restructuring and Privatization

(1) Implementation Schedule in Three Phases

It is recommended that the restructuring and privatization of the PKP Group companies be implemented in three phases, in view of the financial situation of the Polish Government and the feasibility of its financial policies.

1) Phase I (2004-2006)

After Poland becomes a Member State of the EU in May 2004, it will be subject to EU directives, etc. It has a grace period until the end of 2006; during this time, issues critical to the restructuring and privatization of the PKP Group must be resolved. In particular, downsizing shall be implemented up to Scenario A as explained in Section 6.1.

The government's role in this period is particularly significant. It must implement important measures such as downsizing, eliminating the maintenance backlogs on important lines, dealing with the surplus workforce, settling accumulated debts, and enacting related laws and regulations, etc.

2) Phase II (2007-2010)

Besides tackling mid-term issues in this phase, the transport companies shall be privatized sequentially. Policies and strategies for proceeding to Scenario B as explained in Section 6.1 shall be implemented by the end of 2010. In this phase, because the transport companies of other countries may enter the Polish market, the various transport companies must modernize railway lines and strengthen their business organization.

While the government will continue to have a large role in this period, the PKP transport companies will be making improvement to their businesses by upgrading rolling stock and improving productivity.

3) Phase III (2011 and after)

Due to downsizing and improved marketing, the railway system has become adaptable to the market. The PKP transport companies need to further strengthen their business organization as commercial companies. The government needs to continue implementation of measures to modernize important routes and review/strengthen the safety control system.

(2) Implementation Schedule of Policies and Measures

Table 6.3.1 shows the policies and measures to be implemented by the Polish Government and related agencies and organizations in the three phases mentioned above. Figure 6.3.1 shows the estimated railway network after implementing the recommendations.

Table 6.3.1 Schedule for the Restructuring and Privatization of the PKP Group and Recommendation of Policies and Measures

Related agencies & organizations		Phase	Phase I (2004–2006) Response to critical issues	Phase II (2007–2010) Response to mid-term issues	Phase III (2011 and after) Response to long-term issues	
National government (including PKP S.A)			Resolve issues about restructuring and privatization, and privatization		Handle remaining issues	
Policy	Downsizing		- Realize Scenario A (15,000 km) - Abolish loss-making lines	- Realize Scenario B (11,000 km) - Abolish loss-making lines	- PKP S.A. plays smaller role - Develop or dispose of surplus assets	
	Deal with surplus workforce		- Early retirement system - Job transfer to railway-related businesses or governmental organizations	- Early retirement system - Job transfer to railway-related businesses or governmental organizations		
	Utilize excess properties		- Property registration and classification	- Develop or dispose of surplus assets		
	Settle accumulated debts		- Funds from privatization	- Funds from privatization - Sales revenue from real estate redevelopment		
	Modernize railway infrastructure		- Eliminate maintenance backlog at important lines	- Eliminate maintenance backlog - Modern train operation control systems - Modernize lines to comply with EU standards		- Modernize lines to comply with EU standards
	Improve administrative organizations, etc.		- Establish the PKP Restructuring and Privatization Committee - Establish the rolling stock renewal organization - Upgrade the Railway Transport Office of the Ministry of Infrastructure	- Duties of the PKP Restructuring and Privatization Committee completed - Strengthen functions of UTK - Strengthen the Railway Transport Office of the Ministry of Infrastructure		
	Develop legislation		- Make amendment in the new Railway Transport Law, etc. - Enactment of law to simplify property registration - Amend related ministerial ordinances			
Voivodship			- Revamp regional passenger transport - Abolish loss-making train operations	- Revamp regional passenger transport - Abolish loss-making train operations		
PKP PLK			- Downsizing - Eliminate maintenance backlog at important lines - Transfer jurisdiction of railway police	- Downsizing - Eliminate maintenance backlog at important lines - Modernize lines to comply with EU standards	- Modernize lines to comply with EU standards	
Transport companies	PKP Regional		- Downsizing - Negotiate regional passenger transport with Voivodship - Stop leasing of locomotives and drivers	- Downsizing - Provide transport services through contract with the Voivodship - Upgrade rolling stock - Privatization		
	PKP Intercity		- Upgrade rolling stock - Expand sales network - Stop leasing locomotives and drivers	- Increase speed - Privatization		
	PKP Cargo		- Downsizing - Stop leasing locomotives and drivers - Upgrade rolling stock	- Downsizing - Privatization - Establish logistics centers - Modernize rolling stock		

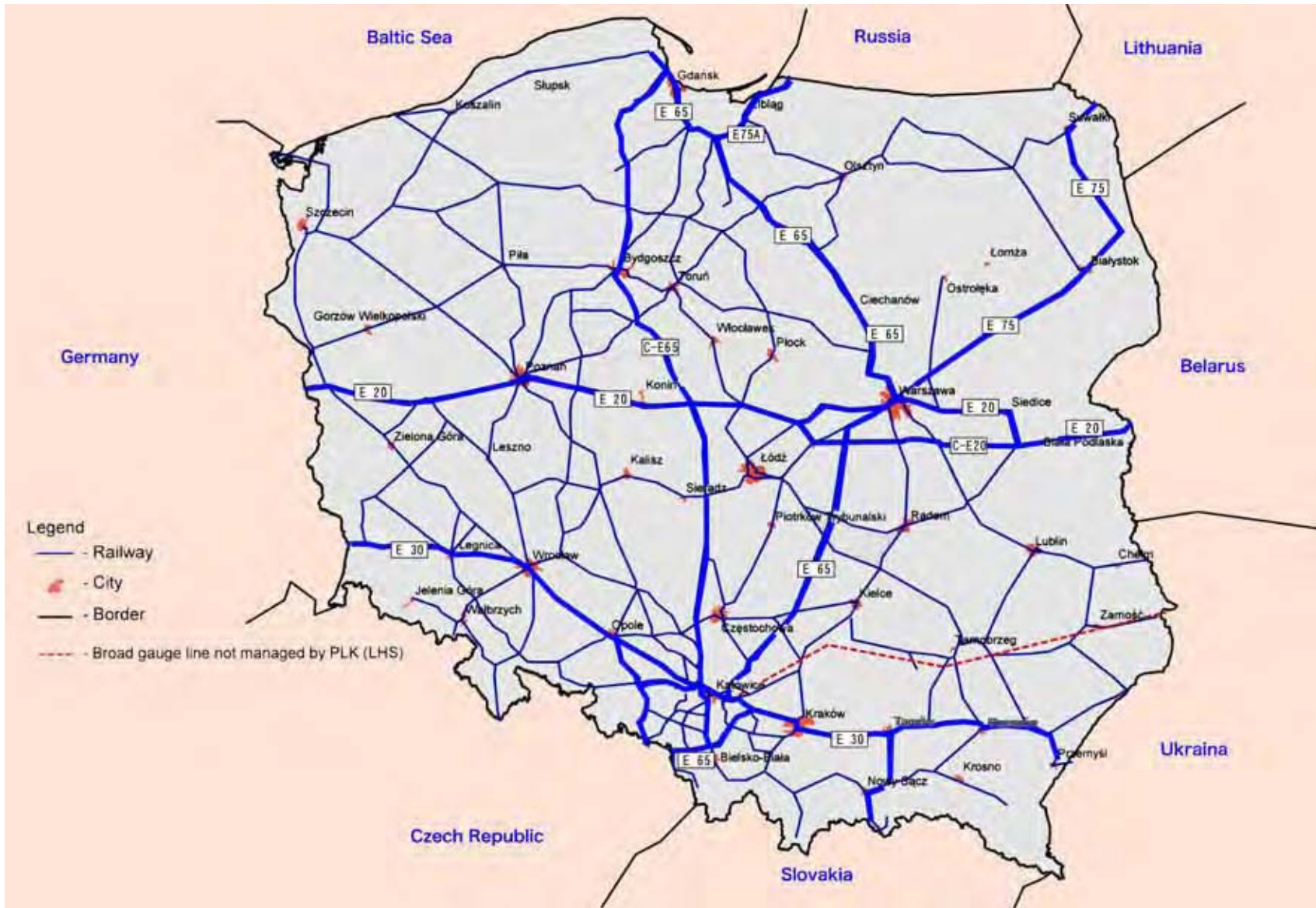


Figure 6.3.1 Future Railway Network in Poland