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# PRIVATISATION OF RAILWAYS IN UKRAINE

Emperical project

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# CONTENTS

- ABSTRACT ..... 3
- 1 ACTUAL SITUATION ..... 4
- 2 EXPERIENCES IN OTHER COUNTRIES ..... 6
- 3 POSSIBLE SOLUTIONS..... 7
- SUMMARY..... 9
- SOURCES..... 10

## **ABSTRACT**

Privatisation is becoming an increasingly popular solution in many countries with different levels of economic development. This is because the results of companies that are in the power of the state, show the inefficiency, low quality products and services and high costs and lowering overall GDP and eliminates the need for the state to cover the losses of the enterprise. Privatisation also leads to the need to remove state management from the control and demonstrates its low level of competence and high level of corruption, say Kikeri and Nellis (2002) in their study.

About half a year ago, the government of Ukraine banned the privatisation of Ukrainian state-owned railway monopolist “Ukrzaliznytsia”, despite the active policies of privatisations of state enterprises in the period of 2016-2017 years. The reason for this decision is unknown and not commented. Given the current state, this step seems unnecessary and unreasonable.

The main aim of the paper is to describe actual situation, show what we lose because of prohibition of privatisation and offer possible solution to the problems in Ukrzaliznytsia by method of situational analysis of experience in other countries and industries.

This project is divided into three parts, reviews recent situation on Ukrainian national railways, dissects some experiences of privatisation in other countries and proposes solutions.

# 1 ACTUAL SITUATION

“Ukrzaliznytsia” is state-owned monopolist railway operator in Ukraine. “Now the company supplies 82 percent of cargo carriages and about 50 percent of passenger carriages, which are provided by all types of transport in Ukraine“, says official web page of „Ukrzaliznytsia“(author’s translation). According to Railway Statistics 2015 Report by the International Union of Railways Ukrainian railway is on the 8<sup>th</sup> place in chart passenger-kilometres of rail transport per year (data per 2014 year) and on the 7<sup>th</sup> place in the world on tonnes carried by rail transport per year chart (data per 2011 year).

Online news Otrazheniya (Отражения) with reference to ex-Prime Minister Arseniy Yatsenyuk, says, that in the year 2015 the company was reorganized from state company under Ministry of Infrastructure into state-owned public joint company «Ukrainian Railway» towards to the separation of management and regulation functions. As stated in Consolidated Financial Statements per year 2015 we can see, that company is in huge losses and in technical default situation, which they have tried to eliminate by prices on tickets. Quality of the services and comfort is not becoming higher. According to Biznes censor (Бизнес цензор) with reference to “Ukrzaliznytsia”, the rate of deterioration of freight carriages is now above 90 percent and their shortage are not able to provide as many operations as the market demands. Same situation with passenger carriages, where the rate of deterioration is 86.6 percent as reported by RBC Ukraina (РБК-Україна), which gave reference to Ministry of Infrastructure data. But tenders for buying new carriages in year 2016 were cancelled because of no need. One of the main reasons of it is occupation of some parts of Ukraine and insufficient funding from state budget. At the meeting of Cabinet of Ministers 2.11.2016 Volodymyr Hrojsman, the Prime Minister of Ukraine described situation in “Ukrzaliznytsia”: “Repairs of carriages did not happen, locomotives — zero, fuel at exorbitant prices, spare parts at exorbitant prices, thousands of contracts with intermediaries — billions out of "Ukrzaliznytsia". And what for the citizens of Ukraine? Dirty carriages, inability to buy tickets and so on, and for producers — the inability to transport goods within the country” (translated by author).

BBC Ukraine says that Cabinet of Ministers appointed Wojciech Balczun to a position of Chief Executive Officer of that company. Mr. Balczun is the ex-head of PKP Cargo (department of Polish railways, which carried freight carriages). He restucturalised

that company and turned it from unprofitable outsider on European area with the loss of 178 million Zloty into the second biggest transporter in Europe, after Dutche Bahn. And just before his PKP decided that they will provide initial public offering.

Next important issue is that the President of Ukraine, Petro Poroshenko signed a law, which was approved 2.6.2016 by the Parliament about adding “Ukrzaliznytsia” to the list of companies, whose privatisation is prohibited. This is a very unexpected step, because in the year 2016 there was a huge privatisation wave in Ukraine, initiated by the President. He said that it is a good way to involve foreign investors who Ukraine relays on, writes UNIAN informational agency (УНІАН інформаційне агентство).

In my opinion, Ukrainian Government’s point of view on privatisation of “Ukrzaliznytsia” is not right. The strategical importance of that company cannot be the only reason why it should not be privatised. But from the commercial point of view it is just that Government loses one of the biggest companies in Ukraine, because dividends were so low, but expenses on services of carriages and modernisation, which is not happening, are on the taxpayers. Soviet system of management, corruption and low quality of carriages made Ukrainian railway totally unable to be a competitor on European area.

The status of fully state-owned company may be the biggest problem of “Ukrzaliznytsia”. Unfortunately, in Ukraine this status means that a company like this will not be able to be a competitor in the modern market economy. The biggest problem is in fact that authorities do not want to invest in modernisation because of losses. And one of the reasons of the losses is the poor quality of railway transport.

One of the reasons why the Government forbids privatisation of railways monopolist can be the fear of the failure. If something will go wrong, then Ukraine can lose one the biggest player on transport market, which means transport and logistical collapse as result.

## 2 EXPERIENCES IN OTHER COUNTRIES

Negative examples like that are real. The process of privatisation in Estonia, which also a post-Soviet country, is described by Lust from Post-Communist Economies journal describes situation like that: “In 2000–2001, Estonia sold the passenger carrier and a portion of the track to domestic businessmen posing as a British strategic investor, and the main freight carrier and most of the track to an American-led consortium. The passenger carrier continued to receive government subsidies but closed several rail lines, which led to protests by passengers. The freight carrier earned large profits from the transit of Russian oil to Europe, but invested its money in buying used American locomotives, rather than rebuilding the track. Both companies laid off about half of their workforce, provoking the first private-sector strike in Estonia since the collapse of Communism. In 2006, a new government bought back the freight services and track at more than twice the sale price, an expensive lesson in the perils of privatization.”

The next example concerns railways in the United Kingdom. The numbers of passengers and freight transportations increased, but because of high regulation measures from UK Government they are still in lose. That can be a lesson for Ukraine.

Having analysed more than 100 studies, which were provided in different times and by different methods, Kikeri and Nellis (2002) concluded, that if privatisations is provided properly, then it leads to the better performance of a company. Also they concluded, that colleration between economical growth and privatisation is high and that privatisation does not nesecerely results in the lower level of empoyment. It shows that the keystone to success is right leadership and carring out reforms.

### 3 POSSIBLE SOLUTIONS

First and obvious solution is privatisation. But due to new law it is not a real possibility during the Poroshenko's presidential term.

The most suitable solution for Ukrainian reality can be partly privatisation with the small share for private investors. The crux of the matter is in the primary placement of shares of only a small part of the total size of "Ukrzaliznytsia", which reduces any risk of its merger. For example it can be only five percent like it is happening with Saudi Arabia "Aramco", almost monopolist state-owned petroleum company, where they are going to start selling 5 percent share to decrease government's expenses and to get new investors involved, describes newspaper Vedomosti (Ведомости). That innovation can help solve a lot of problems of the Ukrainian economy.

There are some risks in that solution. First of them is full audit, which requires not only a lot of time and recourses to provide it, but also reluctance to provide the necessary information. The second problem can be possible price increase and a fundamental change in pricing policy. Prices are the main reason that can inhibit the desire to attract private capital to this company. Increases of price primarily affected the passenger transport sector, which has a high level of competition with bus transportation.

But the main part of income is freight transportations, the huge share of which is the logistics of coal, iron, wheat and other resources. Any increase in prices, even at the minimum of 0.1-1 percent can lead to a significant shift of the financial costs of customers, mainly major corporations in Ukraine. In the context of high credit debt this increase in prices can be fatal.

The third problem is corporate governance. In case of a successful IPO, it is necessary to decide who will manage that all. The choice probably will fall on the state Top-managers, whose low quality of work can cause big problems.

The fourth problem is to choose the place for the IPO. Based on the size of the company, the listing of "Ukrzaliznytsia" can be provided on any stock exchange in the world. And this is a reason to make a choice in favor of places like London, Frankfurt etc.

The privatisation of "Ukrzaliznytsia" may have an effect not only on the internal development of the company and railway sector, but also stimulate the entire economy. At least because "Ukrzaliznytsia" is one of the biggest employer in Ukraine. Today the company employs about 375 thousand people. And in state-owned enterprises salaries and competition are extremely low. If the company is privatised it can be a chance to increase the wealth of part of citizens, which means higher consumption and as result a higher of GDP.

That solution can prosper also for "Ukrzaliznytsia" Ukrainian suppliers, which now have fewer of orders because of absence of orders from Russia. Absence of orders from Ukrainian railways, in which quality of carriages is extremely low, is nonsense.

The privatisation of state-owned company will lead to the situation, when investors and key shareholders of the company will require renewal of the railway park. And from that point of view domestic producer could be a competitive supplier.

Such enterprise as "Ukrzaliznytsia" at the first time will be priced extremely low according to many fundamental circumstances as I have described above. The reason is the downward adjustment of the company's development. After successful providing of necessary changes, the increase in the market value of the shares can create a beneficial price for further implementing small packages of stocks in the secondary placement. This is real and profitable for everyone.

Thus, after the privatisation of 5 percent of shares of "Ukrzaliznytsia" we will be able to attract only a small share of the finances and start changes and also get an occasion for further reforms.



## **SUMMARY**

To reach the main goal of my paper actual situation of Ukrainian state-owned joint venture company “Ukrainian Rail”, the experiences and results of more than 100 empirical studies and the solutions for to make this enterprise more profitable were described.

Based on the experience of privatisation in different countries and industries, as decision for Ukraine I propose full privatisation of railway enterprise, which unfortunately is not possible now. Secondly, a more realistic solution is the privatisation small shares of the company, which will lead to the solution of problems of this company and will benefit the economy in general.

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