1. Country and Sector Background

**Transport is critical to Ukraine’s economic development.** Ukraine’s economy is very transport intensive, generating more than five times the transport volume per unit of GDP than the EU-15 countries. This means that transport costs make up a proportionately large part of the final price of many goods. Ukraine’s natural resource endowments and strong metallurgical industries give rise to very large, concentrated flows of bulk materials, which are much cheaper to move by rail than by road. In addition, Ukraine is an important transit country for bulk traffics such as oil and grain moving from Russia and Kazakhstan to the Black Sea Ports.

**The Government’s Transport Strategy until 2020 foresees balanced development between roads and railways.** Priorities for road include investment in the highway system (supported by the Road and Safety Improvement Project). Priorities for rail development include introduction of higher speed passenger trains between Kiev and five main cities, increase in railway infrastructure capacity on lines to Crimea (supported by this project) and development of logistics centers.

**The railways carry 80 percent of non-pipeline freight in Ukraine.** Unlike many European countries, the road sector in Ukraine carries only 14 percent of freight traffic. While the road share may increase somewhat with greater investment in road infrastructure, railway transport will remain vital to Ukrainian industries that transport heavy materials over long distances. These would include mining, steel, chemicals and agriculture, which are critical exports for Ukraine.
Unlike many European countries, Rail provides around 60 percent of public long-distance passenger transport. Ukraine has many large cities located 200-600 km from Kiev. These are distances at which inter-city rail transport can be an effective and energy efficient competitor to bus, private auto and airline transport.

Ukrzaliznitsya (UZ), the State Administration for Railway Transport of Ukraine, is the managing body for state owned entities engaged in provision of railway transport services and provision of railway infrastructure in Ukraine. UZ is a government administration subordinated to the Ministry of Transport and Communications. By orders of the Ministry of Transport and Communications of Ukraine, UZ manages six Regional Railways and 22 main auxiliary services entities owned by the state. The Regional Railways carry out railway operations in Ukraine. The auxiliary services entities carry out railway operational activities that are unified across the Regional Railways (e.g., centralized communications) and railway supply services (e.g., sleeper manufacturing). Together, UZ, the six Regional Railways and the 22 auxiliary services entities form the Ukrzaliznitsya Group (UZ Group).

The UZ Group operates a 21,873 km, broad gauge (1530 mm) network covering all regions of Ukraine and providing main trade links to neighboring countries. About a third of the network is double or triple tracked. Some 9,750 km of the network is electrified. Rollingstock includes about 1,800 locomotives, 2,400 EMU and DMU units, 8,000 coaches and 150,000 wagons. The UZ Group operations are quite efficient by many measures, with track productivity comparable to US freight railways and high wagon utilization. Staff productivity is less high—comparable to Germany or France, even though those railways carry a substantially higher proportion of passenger traffic.

Railway freight traffic was growing robustly until the economic crisis began in 2008. UZ Group carried 400 million tons (257 billion ton-km) in 2008. This is nearly three times the freight traffic volume of railways in Germany and six times as much as in France. Freight traffic grew at a robust CAGR of 4.7 percent between 2000 and 2008. The global economic crisis began to be felt in the fourth quarter of 2008, however, and traffic in 2009 was 392 million tons (196 billion ton-km). Traffic in January-February of 2010 is up 7 percent compared to the same period in 2009.

Railway passenger traffic is substantial, with growing intercity and regional segments until the economic crisis. UZ Group carried 445 million passengers (53 billion passenger-km) in 2008. This is about seventy percent the passenger traffic carried by railways in France or Germany. Intercity and regional services grew robustly between 1999 and 2008, averaging more than five percent per year. Traffic dropped, however, in 2009 to 426 million passengers (48 billion passenger-km). Passenger service is loss-making and less than 5 percent of losses are compensated by Government. UZ Group aims to minimize the losses on passenger trains by converting intercity trains from overnight to daytime service, raising fare for intercity and commuter services, optimizing of services to match demand (e.g., cancel or reduce service on trains with low ridership), reducing fare evasion on commuter trains, and reducing uncompensated fare privileges.

Growing transit traffic has been creating congestion on the north-south corridor to the Crimea, which also carries heavy passenger traffic in summer months. Transit traffic represents
over a quarter of freight traffic. About three-quarters of the transit traffic is from Russia. Most is received by rail, with about forty percent forwarded onward by rail and sixty percent forwarded through Ukrainian ports. As Russia reduces the discriminatory railway pricing that favored Russian ports over Ukrainian ones to enter WTO, transit traffic is expected to continue to grow.

Providing adequate rail capacity will allow traffic to move by a more fuel efficient and environmentally friendly mode. In Ukraine, transporting freight by road produces more than three times as much greenhouse gas emissions as moving freight by rail. So for every million ton-km shifted from truck to rail or retained by rail rather than shifting to truck, 53 – 55 million tons of CO2 will be saved.

The Ministry of Transport and Communications and UZ Group have implemented a number of reforms in the railway sector in recent years. Social, housing and educational activities that were within the railway structure have been moved to more appropriate administrations. Over 200 non-core entities have been divested. Metro Systems in Dnepropetrovsk, Kharkov and Donetsk have been divested. UZ Group has established a medium-term rolling business planning cycle, and provided its 2009 Business Plan to the Bank. UZ Group has now completed independent IFRS audits of its 2007 and 2008 account.

A Reform Concept was developed by UZ with technical assistance provided by European Bank for Reconstruction and Development (EBRD) over the course of several investment projects. In 2006, UZ prepared and submitted a 10 year Reform Concept to the Cabinet of Ministers. The purpose of the reform was to make the Ukrainian Railway sector more commercial and market responsive, improve its financial sustainability and ability to attract investment, and improve conditions for staff. The Reform Concept was approved in December 2006. The next steps to implement the reform were to (a) elaborate the Reform Concept in a Reform Program with an action plan, and (b) prepare legislation for implementing the first stage of the program. Progress on the railway reform agenda stalled during 2007-2008, in a political dispute over how the corporatization of the UZ Group would be implemented. In 2009, however, with World Bank support, the Reform Program was finalized.

The Reform Program will create a more commercial railway sector in Ukraine. Key elements of the program include: (a) the separation of railway economic functions and state management activities between railway and government, (b) gradual reorganization of railway activities along lines of business, (c) elimination of the cross subsidy from freight to passenger, and (d) introduction of competition.

2. Objectives

The project development objective (PDO) is to increase transport capacity and reduce transit time between Znam'yanka and Dzankoy on Ukraine’s existing north – south railway line. Upgrading this line with double tracking, signaling and electrification will improve service by eliminating delays inherent to operating on a single track with station based train control. Upgrading the line will also relieve congestion on parallel route, which carries significant traffic from Russia.
The key development indicators are: (a) increase in the average number of trains operated on the line, (b) reduction in transit time between Znam’yanka and Dzankoy and (c) reduction in the average number of delays waiting at signals.

3. Rationale for Bank Involvement

The project resulted from a policy dialogue between the Government of Ukraine and the Bank that has been ongoing since 2005. It builds on recommendations from analytical work carried out during 2005 and 2006, including a comprehensive Transport Sector Policy Note, prepared by the Bank in 2006 at the Government’s request and based on a detailed review of the transport sector carried out by Ecorys in 2005 under a grant from the Netherlands. The project addresses one of the critical issues identified in the policy note—renewing aging infrastructure. It would also support the railway to improve its management information systems, the first of the Ecorys’ recommendations for railway management improvements.

The proposed project complements EBRD support to Ukraine Railways in developing its reform program. The project has helped leverage concrete actions on railway reforms that were developed with EBRD assistance. With its depth of experience worldwide in restructuring and commercial operations of railways, the World Bank is well positioned to provide operational advice and support to the government and railways through the transition to a more commercial, efficient and sustainable railway sector.

The proposed project complements World Bank support to the road sector in Ukraine provided through the Road and Safety Improvement Project. To maintain a balanced transport sector that provides people and businesses strong competitive options for meeting their transport needs investment in both road and railway infrastructure are needed.

4. Description

The total project cost is estimated at US$874 million, of which the Bank loan will finance US$500 million. The project will finance the upgrade of the railway line between Znam’yanka to Dzankoy and technical assistance to Ukraine Railways for implementation of modern management systems. The project will be implemented over five years. Table 1 below summarized the costs.

Component 1: Upgrade Infrastructure from Znam’yanka to Dzankoy. Total cost of this component including contingencies and VAT is US$866 million. The component will increase the capacity of the north – south corridor from Znam’yanka to Dzankoy (474 km) from its existing capacity of 30 train pairs per day to over 100 train pairs per day. It will include:

- Construction of a second track between Znam’yanka and Dzankoy (US$473 million)
- Electrification of the Znam’yanka and Dzankoy line (US$219 million)
- Upgrade of signaling on existing track and installation of signaling on new track between Znam’yanka and Dzankoy, US$173 million)

Component 2: Institutional Strengthening. Total cost of this component is US$2.5 million. The component will finance the (a) design and implementation of a management information
technology for automating key business process such as waybills, electronic passenger tickets, and UZ Group management directives and tax filings, (b) training to support implementation of the reform, and (c) cost of technical audit of the project.

5. Financing
Source: ($m.)
Borrower 369
International Bank for Reconstruction and Development 500
Total 869

6. Implementation

The key stakeholders include Ukrzaliznytsya (UZ), the Ministry of Transport and Communications and the Ministry of Finance. UZ, as the Borrower and the Project Implementing Entity, will have a sole responsibility for project implementation, including financial management, procurement and other operational/technical aspects of the project.

The First Deputy Head of UZ will be responsible for overall project coordination, with Deputy Heads of UZ responsible for financial and technical issues. Technical specialists from UZ will be responsible for technical specifications and oversight of track, electrification and signaling installations. The two Regional Railways benefitting from the project will directly supervise the works.

UZ established a separate Department for Implementation of International Loan Agreements in 2001, which functions as a Project Implementation Unit (PIU). It is directly subordinated to the UZ General Director. To date the PIU has been supporting EBRD and EIB financed projects and its staff have over eight years of experience in implementing IFI funded projects. Additional staff could be hired to implement the World Bank funded project. The PIU will be in charge of project administration, including project related financial management (financial management and disbursement under the project), procurement activities (procurement scheduling, preparation of bidding documents, contract management, and reporting), project monitoring and other day-to-day project operations and technical support.

7. Sustainability

Providing sustainable service improvement on the Znam’yanka – Dzankoy corridor requires (a) sound construction and maintenance of assets, and (b) commercial orientation that recognizes the benefits to the railway of providing satisfactory service. Based on the Bank’s international experience with the railway sector, detailed designs and construction implementation will be closely supervised to ensure that physical assets are constructed to the highest quality standards. Inspection of existing assets on the corridor demonstrated that Ukraine Railways maintains its assets to a sound commercial standard. The project’s support for commercialization will help foster the commercial orientation needed.

8. Lessons Learned from Past Operations in the Country/Sector
Railway reform is complicated and time consuming to implement. The Bank’s experience with railway reform in many countries shows that railways are complicated businesses, which take time to reform. By contrast, project implementation has a much shorter time frame. This creates a mismatch between the pace of reform and the implementation of an individual investment project. In addition, policy reform and project delivery are implemented by two very different sets of skills and individuals.

Experience has shown that strapping a reform component to an investment project dilutes and delays the achievement of the former. In China, another country whose railway is absolutely vital to the economy, the government, the railway and the Bank agreed to pursue the railway policy dialogue on a parallel but separate path from the implementation of individual investments. The Bank’s ongoing involvement sustains a working relationship of trust, ensuring a continuing role in the policy discussions. This has allowed the Bank to offer timely and independent policy advice based on international experience, and specific technical assistance in parallel to project financing. The lessons from this successful railway program are: (a) establish trust as a prerequisite, (b) target the policy dialog to the needs and pace of the reform, not to the timing of the project cycle, (c) match the technical assistance to the specific needs of the client, based on client demand.

Link project success to actions within the government’s control, not passage of legislation. The Bank’s railway restructuring project in Turkey had to be restructured because the PDO and a number of loan covenants were linked to actions that the railway had no legal basis to take, without the passage of a railway law by the legislature. The project has since been restructured to focus on actions that are within the government’s power to implement.

Ukraine Railways has already demonstrated good technical skills, strong project ownership, and commitment to results. The three consecutive EBRD-financed projects have been and are being implemented satisfactorily within an evolving reform environment since 1999. The details of the EBRD projects are provided in Annex 2.

9. Safeguard Policies (including public consultation)

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* By supporting the proposed project, the Bank does not intend to prejudice the final determination of the parties’ claims on the disputed areas.
10. List of Factual Technical Documents

Approval of the Statute of the State Railroad Transport Administration (Ukrzaliznitsya), Regulation 262 of Cabinet of Ministers, February 29, 1996

Law on Railway Transport, Effective as of July 25, 1996

Concept of High Speed Trains, Regulation 979 of Cabinet of Ministers, December 31, 2004

Business Plan - Ukrainian Railway Development, April 2007

State Target Program 2008-2015 for Introducing High-Speed Passenger Train

Feasibility Study, Institute Dniprodiprotrans, Dnipropetrovsk 2008


Railroad Transport Reform Program, Draft Regulation of Cabinet of Ministers, March 2009

Order on Establishment of Coordination Working Group, Mykhaylo Kostyuk - General Director of Ukrzaliznitsya, April 13, 2009


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