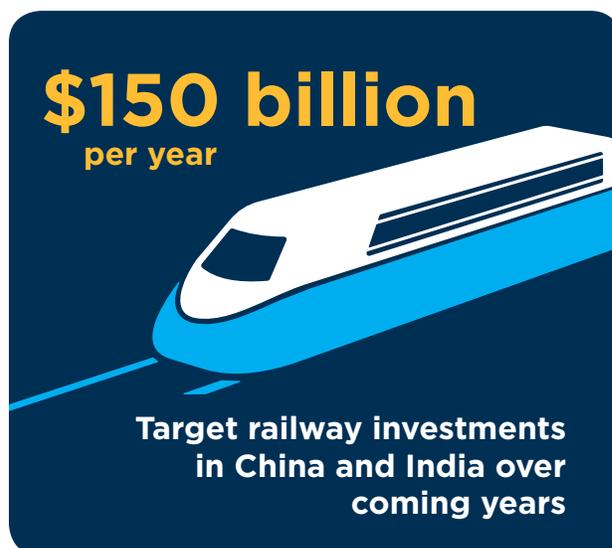


Keys to Attracting Private Capital for Railway Development

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Two of the largest railway systems in the world—China's and India's—have intensified their focus on the private sector as an indispensable source of capital to help them enlarge their rail capacity. They will find promising options if they recognize the common characteristics of successful efforts, both in their railways and elsewhere: profitability, manageable risks shared appropriately, and shared gains. Even unprofitable rail activities, such as commuter transit, can attract private capital if adequate public subsidies are in place.



The Activity Must Yield Profits

Private sector investors want to make money. If the activity is inherently profitable—rail car (wagon) operations in Russia, station development in the Hong Kong SAR metro, or freight transport in the United States—private investors will naturally be attracted to it. If the activity is not inherently profitable, then private investment will hinge on sufficient and reliable long-term government subsidies.

Risks: Must Be Manageable...

Private sector investors are willing to take risks if they believe that

- They can understand the risks;
- The risks will be well managed; and
- The returns will be sufficient.

Investors will typically pay a premium to obtain management control of an enterprise because that assures them that they have the right to manage the risks to their investment.

...and Appropriately Shared

The public sector is typically best able to manage risks such as those associated with land acquisition and government actions, while the private sector usually excels at reducing risks through, for example, marketing and customer relations. Successful collaborations between the public and private sectors share the risks so that the party best able to manage them has the responsibility and incentive to do so.

Gains Must Accrue to Both Parties

If the participation of both the public and private sectors is to be sustainable, the activity must generate value for both parties. The public sector may benefit from the private sector's expertise, whether in marketing, cost efficiency, technological know-how, or financial capacity. The private sector may benefit from the public sector's existing assets, knowledgeable staff, access to resources, or grant of an exclusive right to operate services. In any case, when the deal doesn't work well for both parties, it usually falls apart.

Successful International Experience

Successful private investment in railways has a long and broad history. Four avenues of private investment have been especially important, separately or in some combination: (1) provision of specific rail assets and services, (2) public-private partnerships, (3) leveraging the commercial value of railway assets, and (4) financing railway companies.

Providing assets and services

In a number of countries, private business rents to the railway some specific physical assets, such as rolling stock, which saves the railway from having to finance those assets itself.

For example, in 2003, Russia began allowing the private sector to rent freight wagons to the railway, making it profitable through a change in tariff rules. The new policy created a vibrant market in which the private sector provided \$50 billion toward replacing the railway's large stock of very old wagons; about 85 percent of freight wagons in Russia are now privately owned.

In addition, the private sector can sell services to the railway, such as track maintenance. In that case, the investor deploys its own equipment and facilities, finances the working capital involved, and provides the labor.

Public-private partnerships (PPPs)

In successful PPPs, the private sector makes money by accomplishing the objectives of the public sector. PPPs work best when outputs are clearly specified and monitored.

For example, Vale S.A., one of the world's largest metals and mining companies, pays fees to governments in Brazil, Malawi, and Mozambique for the right to operate railways in those countries for several decades and is responsible for supplying and maintaining the railway infrastructure and rolling stock.

Leveraging railway assets

Railway right-of-way and real estate are assets that can be leased to or jointly developed with the private sector. For example, through its subsidiary, RailTel, Indian Railway sells access to telecom and other commercial customers over about 42,000 kilometers of fiber optic cable running along its right-of-way.

The Hong Kong SAR metro, MTR, leases retail and advertising space within its stations, where it also develops residential and commercial projects. In 2013, these activities generated an operating profit of \$1.1 billion, not counting the extra passenger traffic generated by the property development. Urban transit operators in China are exploring this financing model.

Financing railway companies

Private investors buy bonds and equity shares in railways when the underlying business is profitable. Examples include vertically integrated railways in China, Japan, and North America and train operators in Europe and Australia.

In China, for example, Guangshen Railway profitably carries passengers and freight between Guanzhou and Hong Kong. Shares in the company were first listed on the New York and Hong Kong stock exchanges in 1996, raising a net of CNY 4.2 billion (\$526 million).

Attracting Private Capital

In sum, private investors in railways, as with any investment, seek a return that is commensurate with the associated risk.

A variety of approaches to packaging railway assets, including those discussed here, can provide a return, mitigate risks, and thus attract private sector investment to the railway sector.

► **For more information on this topic:**
<http://documents.worldbank.org/curated/en/2014/08/20143729/1/private-capital-railway-development>

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