

# **GEORGIAN RAILWAY PROBLEMS AND PERSPECTIVES**

The following report was prepared within a framework of an in-house project of  
Open Society Georgia Foundation–  
“Georgian Railway LLC – Drafting an Analytical Report”.

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## ***Introduction***

Present report was prepared within a framework of an in-house project of “Open Society Georgia Foundation” – “Georgian Railway LLC – Drafting an Analytical Report”. Project was implemented from October 2007 through January 2008. In light of significance of Georgian Railway for country’s political and economic development, the project aimed at analyzing and assessing the railway policy pursued by the Georgian authorities.

On 16 August 2007, the Government of Georgia issued an Ordinance (#423) on Transferring “Georgian Railway” LLC to the company “Parkfield Investment Limited” under Management Right. Pursuant to the Ordinance, 100% in state ownership was transferred to the above investment company under a management right for 99 years. As it became known later, this transaction failed and the normative act on transfer of the company under management right was invalidated by Ordinance #622 of the Government of Georgia dated 13 November 2007. However, privatization of the Georgian Railway is still of current importance: in November 2007 the Ministry of Economic Development of Georgia made an announcement on alienation of share of “Georgian Railway” LLC in the state ownership. January 25, 2008 was fixed as a deadline for submitting applications.

In view of public interest and relevance of the topic, “Open Society Georgia Foundation” found it important to elaborate an analytical report that would examine legal grounds of privatization of the Georgian Railway and its transfer under management right, as well as in general, relevance of the railway for Georgian economy in light of country’s transit potential. Report reviews the following issues: (1) Relevance of the railway reform and its significance in international context; (2) Development of transit function of the Georgian Railway; (3) Transit potential of the Georgian Railway; (4) Role of the railway in Georgian economy; (5) Relevance and results of ongoing railway reform in Georgia: legislative changes; (6) Privatization and transfer under management right of the Georgian Railway; (7) Economic Analysis of the railway functioning; (8) Conclusions and recommendations.

## ***Implementation Methodology***

During a work on the project, experts studied international experience of the railway reforms and available materials on the Georgian Railway. Meetings were held with independent experts working in this field.

Working process on the present document coincided with a failure of transaction on transfer of “Georgian Railway” LLC to “Parkfield Investment Limited” under a management right and announcement of *expression of interest* by the Ministry of Economic Development regarding privatization of “Georgian Railway” LLC. This unfortunately hindered expected cooperation with the Georgian Railway. Leadership of the Georgian Railway, as well as representatives of the Ministry of Economic Development refrained from issuing any information related to the railway activities and avoided disclosing potentially confidential information until final resolution of the issue. Therefore, it was impossible to obtain sufficient information directly from

“Georgian Railway” LLC and the Ministry of Economic Development of Georgia needed for analysis of existing situation in the railway sector. Accordingly, results of various studies of the Georgian railway and information received from the interviews with experts were used throughout the work process.

In the beginning of 2005, upon the request of management of “Georgian Railway” LLC and funding of the United States Agency for International Development (USAID), an in-depth analysis of existing situation in the Georgian Railway was carried out within a scope of Railways Restructuring Assistance Project. International consulting firm Booz Allen Hamilton authored this study.<sup>1</sup> This document comprises a highly professional and rather detailed analysis of existing situation in the railway. Thus, within a project framework this study was mainly used to assess the existing situation in the railway. At that, research foresaw a review of assessments and reports<sup>2</sup> of the World Bank developed in recent years, as well as those international agreements and political decisions based on which a rehabilitation and development of Georgian Railway infrastructure became possible throughout the last decade.

## **1. Relevance of the Railway Reform and its Significance in International Context**

Last two decades are marked with significant changes in the railway industry over the Eurasian continent. Economic changes led to decreased demand on railway transportations, which was also caused by implemented restructuring in the mining and heavy industries, development of automobile transportation, dissolution of large economic blocks, and military conflicts in several regions. New challenges and market economy turned a demand on increased incomes in the railway industry into the issue of concern. This was especially applicable to countries with economies transiting to market relations. Authorities of these countries faced a need to develop a new strategy aimed at revamping the railway industry existing in the state ownership and increasing its profitableness.<sup>3</sup>

One of the primary objectives of pending railway reforms in the countries with transitional economies on the Eurasian continent is to increase the profitableness of passenger and cargo transportation. Transformation of the railway into a commercially profitable enterprise and provision of its effective functioning is important from several perspectives: (1) for development of railway infrastructure and investing in it; (2) for saving state financial resources spent on the railway, i.e. reducing state subsidies.

Accordingly, a political will emerged in a number of states to carry out the railway reform, aimed at transforming the railway into a commercially profitable organization.

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<sup>1</sup> *Georgian Railways Restructuring Assistance. Assessment Report.* May 2005, Booz Allen Hamilton

<sup>2</sup> Amos, Paul: *Reform, Commercialization and Private Sector Participation in Railways in Eastern Europe and Central Asia.* In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

<sup>3</sup> It is noteworthy as well that similar tendencies are identified in the recent period in majority of Latin American states, where the railway industry underwent serious reforming.

This transformation should be carried out through the following means<sup>4</sup>: introduction of new effective organizational forms; clear demarcation of commercial rights and obligations between the state and the railway organization; boosting a degree of managerial freedom of the railway; identification of new forms of management and accountability.

Reforms in many Eastern European and Asian countries were implemented through introduction of new railway legislation or gradual amendment of the old legislation. EU member candidate states adopted new railway legislation promoting excessive commercialization of the field. For instance, this took place in Hungary, Poland, Romania, Bulgaria, and Estonia. In these countries use of trunk-railway is viewed as a railway “business”, because they sell the right to use trunk-line to third party train operators.

Involvement of private sector in the railway industry significantly increased in **Latin America, Canada, Australia, New Zealand, United Kingdom, and Estonia**. On the American continent railway cargo transportations are carried out almost by the private sector only (in several cases under private ownership of the railway, or under long-term concession). In these countries a major portion of passenger transportation is in state possession and is managed by the state.

Up to twenty new independent state railway companies were established in the **countries of Central and Eastern Europe and central Asia** after dissolution of the Soviet Union, Yugoslavia, and Czechoslovakia (several of them, for example Kazakhstan, Russia, and Ukraine are largest railways in the world). In majority of these countries state still fully owns the railway infrastructure. Only a part of the Estonian railway, 66% of which were privatized by a private company, is commercially oriented and its outputs are rather successful.<sup>5</sup>

**In most EU states** ownership of the railway, as well as management, is in the state hands. Yet, due to ongoing new railway policies in these countries, railway infrastructure and railway management segments were separated off from each other.<sup>6</sup>

Most profitable area of the railway, which can attract private sector and efficiency of which may be significantly affected, is the rail freight activity. Based on the statistical data it can be assessed that compared to the rail freight activities, passenger

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<sup>4</sup> Amos, Paul: *Reform, Commercialization and Private Sector Participation in Railways in Eastern Europe and Central Asia*. In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

<sup>5</sup> Since August 2001 the Estonian railway company Eesti Raudtee AS was privatized. Company was responsible for major international trunk-railways and cargo transportations. This organization achieved significant success in almost all spheres of commercial management, including volume of shipments, profitability, capital spending, labor efficiency, and financial accountability. This is an indicator of high standards and culture of commercial business. Estonia turned its railway, which was a separate subdivision of regional administration of Soviet Railway Ministry, into a successful and best developed railway company in Europe. Refer to Amos, Paul: *Reform, Commercialization and Private Sector Participation in Railways in Eastern and Central Asia*. In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

<sup>6</sup><http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTTRANSPORT/EXTRAILWAYS/0,,contentMDK:20543164~menuPK:515253~pagePK:148956~piPK:216618~theSitePK:515245,00.html>

transportation requires more resources and this sector is relatively less profitable. Accordingly, as the report of the World Bank expert group demonstrated, railway systems of the countries where a role of the state was minor in the rail freight activity sector, achieved highest indicators of shipments in the conditions of smallest proportions of passenger transportations.<sup>7</sup> Among these countries are: Russia, Kazakhstan, Baltic States, Uzbekistan, Georgia, and Azerbaijan. Whereas in countries with a smaller share of rail freight activities and larger passenger transportation, serious financial difficulties prevailed. This concerns large railway systems in Poland, Romania, Russia, and Bulgaria. Countries with proportionally larger share of passenger transportations faced hardest financial conditions. These are Croatia, Macedonia, and Albania.

At that, according to evaluation of the World Bank experts, in countries where the state still retains an ownership right on the railway and a commercial interest in the railway business is envisaged only through involvement of third parties in rail freight activities, an incompatibility may arise, because the railway in state ownership will have difficulties in being a competitor to private transportation companies. Accordingly, its profits will be lower and a value of the company will be affected. In the experts' opinion, there is the only way out of this situation – the state should alienate the freight operations sector as soon as possible, until the railway retains value. Only after this should the state introduce to the market third parties, who would be worthy competitors to the acting operator and would regulate a market.

Hence, a transit role of the Georgian Railway and potential increase of its international function have to be taken into consideration when examining the future perspectives of the Georgian railway. Ongoing reforms in the railway sector and experience of other states of Eastern Europe in the field build a foundation for assessing an ongoing railway reform in Georgia and analyzing whether there are relevant conditions set up for the state to decide on either privatization or transfer through concession (management right) of the railway.

## **2. Formation of Transit Function of the Georgian Railway**

Georgia's economic growth and sustainable development mostly depends on effective use of its, as a transit country's, potential. Since 1990s Georgia's function, as a part of the Europe-Caucasus-Asia Transport Corridor, grew significantly. Increased transit role between East and West implies both traditional types of transport traffic and transfer of power resources. Such an international function strengthens an interest of Western and Eastern states toward democratic and stable development of Georgia, as a country on the transport axis. This interest includes a promotion of democratic institutes, free market relations, and attractive investment environment in Georgia. Further, carrying out a transit function requires development of tight economic ties with neighboring states, and strengthening regional cooperation in general.

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<sup>7</sup> Amos, Paul: Reform, *Commercialization and Private Sector Participation in Railways in Eastern and Central Asia*. In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

Accordingly, the idea of promoting Western-Eastern railway transit function via Caucasus attracted vast interest of the European Union, United States of America, and other developed democratic states since the outset of 1990s. However, process of dissolution of Soviet Union prevented a development of this potential.

Georgian Railway was a part of integral railway network of the Soviet Union and handled 50 million tons of freight and 13 million passengers annually. Then and after independence, function of the Georgian Railway was mostly reflected in its transit role and significance for transport relations of neighboring countries. As the experts recognize, during the Soviet period functioning of the Georgian Railway was more crucial for import-export turnover of regional countries rather than country's internal needs.

Since 1991 Georgian Railway played a significantly decreased role in international rail traffic due to dissolution of the Soviet Union and ensuing political crisis in Georgia. Under the statistical data, volume of freight turnover of Georgian railway reduced to 9% of turnover existing prior to 1990.<sup>8</sup>

During the same period oil producing companies of the EU, USA, and other states drew their attention to the oil of the Caspian Sea, and increased oil production naturally led to search for means of carrying energy sources and promotion of their development by the EU and the United States.

TRACECA<sup>9</sup>, a regional program developed under the initiative of European Commission in 1993, became a first possibility for Georgia and states of the South Caucasus to promote modernization of transport infrastructure in the region, including construction, reconstruction, and modernization of the railway. TRACECA initiative aimed to stimulate regional cooperation for the purpose of trade development; promote integration of Transport Corridor Europe-Caucasus-Asia with trans-European networks. Later, the World Bank, the European Bank for Reconstruction and Development, Japanese Government, and others became involved besides the EU in the projects aimed at development of the transport corridor. Within a framework of the EU technical assistance project TACIS<sup>10</sup>, implementation of the TRACECA program enhanced the involvement of the Georgian railway in international transport traffic. In 1995-1996, the EU funded rehabilitation and renovation of the 27 km Khashuri-Zestaponi railway line; since 1996, based on the so-called "Sarakhs Agreement" the

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<sup>8</sup> If freight turnover was 53.8 million tons in 1990, in 1995 it comprised only 4.6 million tons, which gradually increased and reached 16.4 million tons in 2003. Refer to *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

<sup>9</sup> TRACECA – Transport Corridor Europe-Caucasus-Asia. TRACECA program was elaborated in 1993 in Brussels at the conference organized by the European Commission, based on the adopted declaration. Initially the South Caucasus and former Soviet republics of Central Asia were parties to the program. Due to further development of the program a number of participant states increased. In addition to the South Caucasus and Central Asian states, in 1996-1998 Ukraine and Moldova joined the program, and in 2000 Romania, Bulgaria, and Turkey expressed official interest toward joining the TRACECA. Thus, currently there are 13 states affiliated within the TRACECA program.

<sup>10</sup> TACIS – Technical Aid to the Commonwealth of Independent States.

“Shevron” oil was transported out of Kazakhstan via Georgia from Azerbaijan to the Batumi port, where oil is taken out to international market.<sup>11</sup>

On 8 September 1998, a multilateral treaty on development of international transportation along the Transport Corridor Europe-Caucasus-Asia was signed in Baku. The treaty improved a legal foundation of international transit rail traffic and promoted enhancement of managerial and institutional spheres. Activation of transit rail traffic revealed also weaknesses that were characteristic to the Europe-Caucasus-Asia rail transit line at the time. In particular, a need for establishing railway links between the Georgian ports and ports of Eastern European countries emerged.

At the BSEC-TRACECA joint conference (8-9 April 1997, Tbilisi) Ukraine and Georgia expressed interest toward improving transport links between the Poti and Ilychevsk ports, which could have made a rail freight turnover between these two countries possible. At the conference an initiative was announced also regarding establishment of transport links corresponding international standards between the IX corridor defined at the Crete Ministerial and the TRACECA corridor.<sup>12</sup> In response to a specific interest, with the EU support a rail ferry facilities started operating in 1998-1999 between the Georgian port of Poti and Ilychevsk of Ukraine, serving both rail and land transport.<sup>13</sup> Infrastructure was rehabilitated, additional premises were built, and cargo safety protection systems were improved. Furthermore, establishment of the computer system links facilitated the effectiveness of transport links and commercial attractiveness of these transportations. A railway cargo terminal was built in Poti. With the support of EU, cargo services extended between Ilychevsk and Varna by the end of 1999.

Consequently, by the end of 1990s railway traffic between the Black Sea and Caspian Sea witnessed a significant increase in volume. A large share of traffic fell on the oil products. Obtaining guarantees of safe transportation and commercially attractive transit deadlines became more difficult.<sup>14</sup> Therefore, within a scope of the TRACECA program presidents of Georgia, Armenia, and Azerbaijan demanded safeguarding communication between 133 railway stations on the Poti-Baku railway line through an optical cable system. In 2000-2002, with the support of EU Siemens laid along the railway line an optical-fiber cable and renovated communication and signaling systems for the Caucasian railway lines. The project covered Tbilisi-Yerevan railway line as well. This optical communication system became a natural extension of the links between information systems of Ilychevsk and Poti. Within a project framework, equipment was installed, staff was trained, and technical supervision was safeguarded

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<sup>11</sup> “Sarakhs Agreement” was signed in 1996 by the Governments of Georgia, Azerbaijan, Turkmenistan, and Uzbekistan. The agreement aimed at reducing rail traffic tariffs for the purpose of increasing rail freight turnover.

<sup>12</sup> Pan-European corridors were defined at the Ministerials held in 1994 on the Crete and in 1997 in Helsinki. These corridors were a part of the trans-European network and currently, after latest enlargement of the EU, are entirely in the EY territory.

<sup>13</sup> [www.traceca-org.org](http://www.traceca-org.org) Project: Design and construction of Rail Ferry Facilities in the Port of Poti, Georgia.

<sup>14</sup> [www.traceca-org.org](http://www.traceca-org.org) Project: Supply of an optical cable system for communication and signaling to the railways of Armenia, Azerbaijan and Georgia.

### 3. Transit Potential of the Georgian Railway

As already noted, main distinction of the Georgian railway is reflected in following characteristics: (1) Georgian Railway connects the Caspian and Central Asian region to the Europe through an alternative route; (2) ports and terminals with strategic location (Poti, Batumi, and Khulevi) are directly connected to the railway lines of Azerbaijan, Ukraine, Bulgaria, and Russia; (3) after the implementation of a new project "Baku-Tbilisi-Kars" Georgia will connect to the Turkish railway line as well.

Today Georgian Railway transports Caspian oil to the world market. It is a significant passage connecting Central Asia to the Europe through an alternative route. Notably, future calculation of potential of rail freight turnover via Georgia is rather difficult, as chief freight turnover falls on the transit, which makes it significantly dependant on the external factors. At that, oil products are the major portion of rail traffic, thus contributing to the specificity of the Caucasian segment of TRACECA.<sup>15</sup>

In 2004 the Georgian railway transited 9.4% of the oil produced in Azerbaijan. Therefore it could be stated that if oil production in Azerbaijan meets the assessed expectations (annual production rate increases from 84.5 million tons to 192.5 million tons by 2010) and market share is sustained, then by 2010 volume of the oil transit through Georgian railway will constitute 18 million tons. In such instance, even if the transit share reduces (due to competitiveness with the oil pipeline), a volume will still significantly exceed the 2004 data. Hence, even under roughest calculations it is expected that a transit freight turnover of oil products will increase in the nearest future.<sup>16</sup>

In recent period, safety and efficiency of rail traffic increased by the projects implemented within the TRACECA project contributed as well to an increase of rail traffic volume along the Caucasian corridor. A possibility has emerged to increase future traffic intensiveness not only through the Poti port, but a new Khulevi terminal. Overall this provides a possibility to increase a volume of freights forwarded to Armenia and Azerbaijan.<sup>17</sup>

Accordingly, due to geographic location and increase of transit capacity, Georgian Railway acquired a possibility to attract and transit a major portion of import and export (not oil and other types of fuel) of Azerbaijan and Armenia in the nearest future (freights in Georgia itself are imported more by the land transport).

At that, existing situation attests that for the markets of Central Asian republics TRACECA corridor is not competitive enough with the Russian Railway due to existing low tariffs. Eastern-Western transit direction also seems to be less perspective for the Georgian railway. It is difficult to realize the transit function of the Caucasus by exporting cotton from the Central Asian republics, as the competitors in face of

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<sup>15</sup> By 2003, transit of oil on the Caucasian sector of TRACECA constituted 73% of annual freight turnover. Major share of other types of transit falls on satisfying the demands of oil processing enterprises operating in Azerbaijan (14%).

<sup>16</sup> *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

<sup>17</sup> [http://railway.ge/\\_Railway/File/Privatization/eng/Assessment%20report.pdf](http://railway.ge/_Railway/File/Privatization/eng/Assessment%20report.pdf)

Iranian (Bandar Abbas) and United Arab Emirates (Dubai) ports are distinguished by extremely low prices for transportation.<sup>18</sup>

Thus, as the experts suppose, in the nearest future development of Georgian transport infrastructure and increase of transit potential of railway traffic, besides transporting energy carriers, will be mainly related to the demands of countries of South Caucasus region and development of their political or economic ties with the West and East (demands of the countries neighboring the region from East on the use of TRACECA Caucasian sector for transit purposes will remain quite limited). Moreover, EU's interest toward the Caucasus gradually increases, which may play a pivotal role in the future increase of international function and traffic capacity of the TRACECA corridor. In 2004, enlargement of the EU entailed development of exclusive relations with the new neighbors within a scope of the European Union Neighborhood Policy. Georgia, together with Armenia and Azerbaijan, became a state party to the EU Neighborhood Policy that was reflected in further strengthening of relations with the EU in the field of transportation. EU recognizes that effective functioning of transport systems connecting EU with its neighbors is of significance for several reasons:

- Sustainable growth of economy and well-being among the EU and its neighbors;
- Fostering regional and bilateral cooperation among the neighbors;
- Fostering transport links and trade in direction of Asia, Sub-Saharan Africa, and America.

At that, in 2004 the EU adopted an ambitious plan (Decision 884/2004/EC on the Guidelines for Trans-European Networks), pursuant to which it was decided to allocate investments along main Trans-European transport corridors. In order to implement the decision, in 2004 European Commission set up the so-called "High Level Group"<sup>19</sup>, which was assigned to draft a report on "Extension of Chief Trans-European Transport Corridors to the Territories of Neighboring States and Regions".<sup>20</sup> A report published by the "High Level Group" in November 2005 contains recommendations for the governments of the states aimed at promoting the development of effective transport relations among the EU and its neighbors. Document identified five main trans-national corridors and the priority projects were pinpointed on the already selected transport corridors, the fourth out of which relates to the development of the Georgian railway - South-Eastern corridor direction.<sup>21</sup>

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<sup>18</sup> The World Bank, *Trade and Transport Facilitation in the South Caucasus: Georgia Policy Note*, November 2003, p.17.

<sup>19</sup> *Networks for Peace and Development*. Report from the High Level Group chaired by Loyola de Palacio, November 2005.

<sup>20</sup> The Group included 25 EU member states, Bulgaria and Romania, 26 neighboring states, European Investment Bank, European Bank for Reconstruction and Development, and the World Bank. From October 2004 to November 2005 the Group held 10 meetings. In November 2005 the "High Level Group" published a report on "Extension of Chief Trans-European Transport Corridors to the Territories of Neighboring States and Regions", which is a guiding document for the EU member and their neighboring states.

<sup>21</sup> The Group drafted and presented for consideration 100 project proposals, as the priority projects for investments. Their total value constituted 45 billion Euros. Proposals were divided in two categories: 1) projects to be launched prior to 2010 - 35 billion Euros; 2) long-term projects (to be launched from 2020) - 10 billion Euros.

South-Eastern corridor connects the EU to the Caucasus and Caspian Sea via the Balkans and Turkey. EU intends to develop multi-modal relations in the direction of South via Georgia, Azerbaijan, and Armenia. Particularly in Georgia, through short and medium-term projects the EU plans to modernize a railway line from Poti-Batumi to the Azerbaijani border, which will be extended by a project to be implemented in Azerbaijan, aimed to rehabilitate a railway line from the Georgian border to Baku.

Recommendations elaborated by the "High Level Group" drew particular attention to planning and implementation of horizontal activities. Namely, recommendations advocate for the effort of two legal systems (COTIF<sup>22</sup> and OSJD<sup>23</sup>) to set up an integrated information base for the freight carriage services and to develop transport legislation closely associated with the European legislation.<sup>24</sup>

Nowadays Georgia and the two South Caucasian republics are affiliated in the organization for railway cooperation - OSJD. Georgia became a member in 1992. Organization strives to develop international rail carriage in the Europe-Asia direction. Within the Organization's framework, special rule for the use of rail wagons was elaborated, and agreements were concluded on international rail traffic that provide the railway with advantageous conditions for carrying out freight transportation on member state railways under beneficial tariffs. Hence Georgia, as a member state of OSJD, is given an opportunity through cooperation with the EU to harmonize its legislation with the transport legislation in effect in the EU. Further, owing to different technical standards, the EU "High Level Group" recommended to carry through the following measures: (1) open up a multi-modal cargo supply centers at the border check points, similar to an existing one at the Ukrainian-Polish border; (2) carry out transportation mainly by means of containers; (3) in case of passenger carriage to change train or locomotive (in exceptional circumstances) at the border.

These issues will become more relevant to the Georgian Railway after the launch of Baku-Tbilisi-Kars railway main line, which will directly link the Georgian Railway to the Trans-European transport infrastructure. On 21 November 2007 the presidents of Georgia, Azerbaijan, and Turkey signed a document on the launch of construction of the Baku-Tbilisi-Kars railway main line. It is expected that the construction of the Baku-Tbilisi-Kars railway will be completed in 2009. Desirably Georgian Railway will be sufficiently prepared for this event.

Based on the above-mentioned, it could be stated that future strengthening of Georgian Railway's transit function will depend on the below listed factors:

- Continued support of the EU;
- Increased transit transportation of oil and oil products;
- Irrevocable obligation of the oil-producers to export oil out of the Batumi and Poti terminals;

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<sup>22</sup> Convention concerning International Carriage by Rail, in use in the EU and several other countries.

<sup>23</sup> Organization for Cooperation of Railway Law, which was established in 1956 and united railways of the Soviet Union states and states of former communist block on the Eurasian continent. Today, transport ministries and state railway companies of 27 states are the members of the Organization.

<sup>24</sup> *Networks for Peace and Development*. Report from the High Level Group chaired by Loyola de Palacio, November 2005.

- Armenia's economic development and increased demand on rail transit transportation;
- Economic development of Azerbaijan, leading to increased export/import trends toward other countries;
- Opening up railway links with Turkey, leading to increased volume of rail traffic;
- Improvement of transport coordination at Georgia's railway borders, improvement of customs procedures, and carrying out other measures fostering trade in the TRACECA corridor, which is capable of managing main transit trends to and from Europe via Caucasus.<sup>25</sup>

#### **4. Role of the Railway in Georgian Economy**

Georgia represents a classical example of small open economy, assessing of economic state of which pays huge importance to the analysis of economic relations with a foreign sector, namely the analysis of trade and current balance. Throughout last 12 years Georgia witnessed trade balance and subsequent current balance deficit. It is more alerting that this deficit increased year by year. All of this indicates that the country consumes more than produces, and buys more from a foreign sector than sells to it.

Throughout years, this excessive consumption was financed by the grants and loans received from other states and international organizations. All of this led to an accumulation of a foreign debt, as a result of which state foreign debt exceeded 1.7 billion US Dollars. Growth of a foreign debt is associated with serious risks. Particularly, during a certain period of time, when a debt reaches a critical line, creditors lose trust of the indebted state with respect to repayment of the debt and terminate funding. This leads to a deficit on internal market, soaring prices, and economic crisis in the country.

In recent years situation changed radically. Through a launch of privatization process country found a new source of financing the excessive demand. Namely, direct investments flowing in as a result of privatization of state enterprises, buildings, and land are used to finance a big portion of current deficit, while a remaining portion is financed by loans received from private companies and commercial banks. As a result, growth of a foreign debt not only terminated but started reducing. However, country encountered new types of risks.

Alienation of state enterprises and property to non-residents implies that in the future, income and profit gained from these objects will be transferred to foreign investors proportionally to their shares, which, on its turn, means an out-flow of monetary trends from the country and has a negative impact on the current balance deficit. In order to overcome this hurdle it is crucial that the country strengthens its export potential, so that in the future satisfaction of internal demand does not occur only at the expense of loan-taking or selling property to foreigners.

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<sup>25</sup> *Georgian Railways Restructuring Assistance. Assessment Report* . Booz Allen Hamilton, 2005.

Interestingly, direct investments in Georgia are carried out mainly in non-production sector, namely construction and infrastructure development. These fields are unable to produce export goods and therefore cannot contribute to correcting trade balance in the future. Based on the Georgian reality, the following factors may have impact on improvement of current balance in the future: (1) incomes generated from development of tourism, but many countries will seriously compete with Georgia in this field; (2) export of mineral or ordinary potable water – in this respect Georgia has a competitive advantage compared to other countries; (3) formation of large transit corridor between the East and West, with a large role of railway infrastructure development. Beneficial geopolitical location provides Georgia an opportunity to be established as a main cross road on the European and Asian transit main line. Through this route Georgia in the future may generate rather significant incomes and fund internal consumption. As a result, country will be able to avoid problems associated with trade balance deficit.

Transport sector is still one of the important segments of Georgian economy. In 2006 added value on transport sector exceeded 1.5 billion GEL, which is 7% of the Gross Domestic Product (GDP).<sup>26</sup> This indicator was only 4% in the beginning of 1990s, grew during subsequent years, is relatively stable in recent few years, and fluctuates within a 7-8% range. Generally, added value accrued on the transport sector is characterized by growth. Nevertheless, growth speed is different by years. In 2006 the transport sector growth speed of the GDP share constituted 14.6%.

Unfortunately, State Department for Statistics of Georgia does not possess information about a number of added value accrued specifically in the railway sector, or its ratio with the GDP. Yet, largest share of transport carriages falls on the very railway. Therefore the data provided above draw a certain picture of value generated in the railway sector, as well as of its importance for the Georgian economy. During 2006, Georgia's revenues from transit transportations constituted 426 million USD. More than 26% out of this, approximately 112 million, accounts for the railway, 94 million – for the sea transport, 83 million – for the air transport, and only 30 million USD – for the land transport. Share of pipeline transportation among the total revenue is of relevance as well. Such revenues especially grew after the completion and launch of the Baku-Tbilisi-Ceyhan pipeline. In 2006 generated revenues exceeded 106 million USD, and constituted approximately 141 million USD for the three quarters of 2007. In a current year revenues generated from the pipeline became a largest category of transport carriage. Rail carriage is of second importance, following the pipeline. Out of this type of transport services the country generated 82.8 million USD in the three quarters of 2007. A table provided below depicts a dynamics and structure of transport revenues.<sup>27</sup>

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<sup>26</sup> Web page of the Department for Statistics of Georgia [www.statistics.ge](http://www.statistics.ge)

<sup>27</sup> Web page of department of the National Bank of Georgia [www.nbg.gov.ge](http://www.nbg.gov.ge)

Table 1. Dynamics and Structure of Revenues Generated from Transport Carriages (million US Dollars)

	2002	2003	2004	2005	2006	2007 (three quarters)
<b>Total transport</b>	<b>198</b>	<b>212</b>	<b>263</b>	<b>328</b>	<b>427</b>	<b>403</b>
	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
Sea transport	38	42	61	75	95	84
	19%	20%	23%	23%	22%	21%
Air transport	20	28	51	77	83	67
	10%	13%	19%	23%	20%	17%
Railway	83	82	86	94	112	83
	42%	39%	33%	29%	26%	21%
Land transport	12	14	17	31	29	28
	6%	6%	6%	9%	7%	7%
Pipeline	44.2	46.0	48.3	51.1	106.6	141
	22%	22%	18%	16%	25%	35%

As the table demonstrates, Georgian Railway generated rather large revenues from the transit carriages. Throughout the years revenues generated from transit carriages exceeded 80 million USD, while in recent years, parallel to a growth of the Georgian economy, railway revenues grew further and reached 112 million USD in 2006 and 83 million USD in the three quarters of 2007. As a result of expected investments in the railway, development of infrastructure, augmentation of new productive potential, as well as overall growth of the country's economy it is expected that the Georgian railway will be capable of generating more and more revenues in the future, becoming a more profitable enterprise, and contributing to the growth of both the transport sector and entire GDP.

## 5. Relevance and Results of Ongoing Railway Reform in Georgia: Legislative Changes

As it was already noted, Georgian Railway is a significant item both from the perspective of economic profitability and a transit potential. Accordingly, during its privatization or transfer under management right numerous factors have to be taken into consideration so that the country does not lose extremely important transit strategic function and the item remains operational. Railway is a multi-segment item. When carrying out reforms aimed at increasing its effectiveness, there are number of issues that have to be taken into account if considering alienation or transfer through management right of the railway.

Georgian legislation grants special status and significance to the railway. Provisions concerning the railway are found in the supreme law of the country – the Constitution. Article 3 of the Constitution defines the issues that are subject to exclusive domain of

the supreme state authorities of Georgia. Among these is a “railway of state importance”. However, effective legislation does not specifically define what is meant under “railway of state importance”. The Railway Code of Georgia, which is a major normative act (adopted on 28 December 2002) regulating railway transport, is not familiar with such a term. This causes certain confusion during the process of railway privatization. In particular, it is not clear how should the “state importance” of the railway be reflected in the agreement entered into with an investor.

### **5.1. Ownership of the Railway**

Today the existing (operating) railway transport and infrastructure belongs to a limited liability company “Georgian Railway”.<sup>28</sup> “Georgian Railway” LLC is a legal entity that was established pursuant to the Law of Georgian on Entrepreneurs and whose founding partner and owner of 100% share is the state. The state’s authorities are carried out by the legal entity of public law – “Enterprise Management Agency”, while authorities related to privatization and/or disposal of shares – the Ministry of Economic Development of Georgia.<sup>29</sup>

Main objective of the railway is to generate profit and chief components of its activities are railway transport services, passenger transportation, and freight carriages. However, pursuant to the charter, “Georgian Railway” LC, as a legal entity of private law, enjoys the right to carry out any activities not contradicting effective legislation and interests of the enterprise and a partner. Pursuant to Article 4 of the Railway Code adopted in 2002, property in the railway possession includes rolling-stock, rail and power management, communication and signaling devices, loading-discharging mechanisms, building-constructions and other property on the railway’s balance. With a given provision the new Railway Code almost reiterated the definition provided in the 1994 Law on the Railway Transport: “Main funds of the railway transport: rolling-stock, rail and power management, communication and signaling devices, loading-discharging mechanisms, building-constructions and other items on the railway’s balance, belong to the railway transport”.

On the surface, content of the mentioned provision of the Code seems logical. However, it is unclear what legal status does this provision have and what purpose does its existence in the Railway Code serve, and/or “which” property in the railway’s possession does it refer to. Existence of such a provision could have been more justified and reasonable in the 1994 Law on the Railway Transport, as when this law was adopted the railway did not exist as a separate subject (legal entity) and constituted integrity of property enumerated in the very definition. During that period the railway was managed by a structural unit of the Ministry of Transport – “Department for Railway Transport”. By the time Railway Code in effect was adopted, “Georgian Railway” LLC already existed, which represented a legal

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<sup>28</sup> A second railway company – “Marabda-Kartsakhi Railway” LLC – is established with 100% participation of the state, but this company is not functioning yet.

<sup>29</sup> From the day of registering in the entrepreneurial registry, limited liability company “Georgian Railway” became a legal successor of the Department for Railway Transport of Georgia. Charter capital of the enterprise constitutes 930,892,213 (nine hundred and thirty million eight hundred and ninety two thousand two hundred and thirteen) GEL according to the extract of the Ministry of Finance dated May 2007.

successor of the Department for Railway Transport and totally owned railway infrastructure. It is also unclear what effect will the discussed provision of the Code have with respect to other railway transport or other item (besides “Georgian Railway” LLC) that might be established in the future and carry out railway operations.

Although it is true that the domain of the Railway Code and its main content indicate obviously that this is a very general law on the railway transport, the above-discussed and other provisions demonstrate that the legislator often has in mind one specific railway company – “Georgian Railway” LLC.

During recent years the Georgian railway transferred to the state all non-profile infrastructures in its ownership, such as the railway hospital, schools, and bath-house. In the experts’ opinion, among transferred items there were ones whose operations would satisfy only railway requirements and maintenance of which would have contributed to the development of the railway infrastructure. Nevertheless, these items were still alienated (it is a bit vague which items specifically).

As of 2005 the Georgian railway possessed 12 depots and 67 stations, i.e. one station every 7.5 km on average. This number, in the experts’ opinion, significantly surmounts a needed number. This especially concerns a number of the railway stations. By reducing these items “Georgian Railway” can significantly save costs and, accordingly, increase profit and effectiveness in general. However, as the experts affirm, depots are in a poor condition and require certain renovation works.<sup>30</sup>

In line with the experts’ recommendation, a privatization process of the railway enterprises and ownership is still pending: Tbilisi station is leased out; in 2007 a list of items to be leased out and sold was published. Among those on sale were several motor ships, administrative building and the data computing center of the “Georgian Railway” LLC, and warehouses,<sup>31</sup> while the following stations were ready to be leased out – “Tbilisi Central”, “Zestaponi”, “Kobuleti”, “Kutaisi”, “Samtredia”, “Zugdidi”, “Kaspi”, and “Akhaltikhe”.

Together with the property in the railway ownership, Railway Code also defines the issue of the land in the railway ownership: land in the railway ownership comprises land allocated for the rail tracks and railway structural units, including the alienation strip (not less than 20-20 meters on both edges of the railway track of common use) and a protection zone.

On one hand, objective of the Code is clear: due to technical or safety considerations, the railway should possess the mentioned land area. Yet, on the other hand, objective is vague as well: is this norm a requirement for the railway company to obtain a permit in accordance with the construction standard or is it the state’s and/or third person’s obligation to transfer land in their ownership to the railway’s possession? It should be said that current edition of this provision in the Code, to the least, is confusing.

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<sup>30</sup> *Georgian Railways Restructuring Assistance. Assessment Report*. May 2005, Booz Allen Hamilton

<sup>31</sup> [www.railway.ge](http://www.railway.ge) six units of 2TE10M type motor ships (on sale); administrative building and data computing center of “Georgian Railway” LLC (property on sale).

It is noteworthy also that pursuant to amendments made to the Railway Code of Georgia on 20 June 2007, alienation strip may be less than 20-20 meters, which means that in several places it is possible to register land in the railway ownership with area less than 20-20 meters on both edges of the railway track of common use.

It is hard to state clear-cut how should the land ownership issue be decided in the future (after the enactment of the Code) with respect to the to-be-constructed railway tracks. Another circumstance still remains vague – if the land allocated for railway tracks, as well as land on 20-20 meters on both edges of the track is registered in the ownership of other persons, based on the mentioned article of the Railway Code what obligations will be imposed on land owners and/or the railway company owning tracks itself? Or what should be the state's role in such instance?

## **5.2. Introduction of New Organizational Forms**

Throughout years Georgian railway was managed by the “Department for Railway Transport”, which represented a structural unit of the Ministry of Transport and whose chairman was appointed by the President of Georgia. Parallel to an increase of transit freight turnover on the railway, reforms affected organization's status and management forms. Particularly, in 1998 based on the Ordinance of the President of Georgia, "Georgian Railway" LLC was established on the property basis of "Department for Railway Transport". Prior to 2003, the Ministry of Property Management of Georgia exercised partner's authority and share management rights toward "Georgian Railway" LLC.

In 2003 a legal entity of public law - "Enterprise Management Agency" (EMA) - was established under the President's Decree. It still exercises partner's authority toward "Georgian Railway" LLC. EMA, as a legal entity of public law, aims at:

- a) protection of state interests in the enterprises with state share participation, promotion of growth of dividends attributable to the state;
- b) coordination of management of shares and stocks in state ownership;
- c) raising degree of liquidity of enterprises and speeding up the privatization process.

A decision regarding "Georgian Railway" LLC made within a scope of the EMA's authority represents a decision of the partners' meeting.

EMA is headed by a chairman, who is nominated by the Minister of Economic Development and appointed by the President of Georgia.

Prior to August 2007, partners' meeting, supervisory board, and the directors' board represented management bodies of "Georgian Railway" LLC. Pursuant to amendments made to the Law on Entrepreneurs in 2007, a supervisory board was abolished and a main portion of its powers was transferred to the directors' board.

Railway Code of Georgia regulated various aspects of railway transport activities in detail<sup>32</sup> and to a certain extent increased a degree of managerial freedom. However, with respect to contractual relations it is characteristic to the Railway Code to contain number of imperative provisions regulating relations between the railway and the client. This contradicts a principle of contractual freedom and raises certain practical problems in terms of business flexibility.

Imperative requirements of the Code created certain awkward situation for the railway, as a business organization. When a specific norm directly sets out person's obligation toward the railway, railway leadership is obliged to fully exercise its right to respective claim, and subsequently apply the mechanisms established under the Code if these claims are not satisfied. For instance, Article 26 of the Code stipulates: "In the railway station of destination, cargo shall be issued to the recipient of the cargo as indicated in shipment documents after full payment of the fees for cargo carriage and other related services (carrying out work)".

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<sup>32</sup> The Code regulates following issues: - rights and obligations of the railway and passengers/freight operators during carriage-transportation;  
- establishes technical norms and standards in relation to transport means and equipment of railway carriage-transportation, as well as general rules and criteria that have to be taken into account during the fixation of tariffs and additional levies for passenger transportation and cargo, luggage, and mail carriage;  
- establishes general rules for cargo transportation and defines normative acts that should regulate these issues in detail;  
- establishes obligations of the railway with respect to passenger transportation, cargo, luggage, and mail carriage, and degree of adequate services;  
- establishes specific rights and obligations of passengers when traveling by various types of trains (international, local, suburban);  
- regulates issue of responsibility of the railway, passengers, and freight operators in case of violations of the Code, other normative acts, and contractual obligations;  
- identifies legal documents that should prove circumstances related to responsibility of participants of railway traffic; establishes types of these documents and rules for drafting them;  
- establishes general rules for transportation safety, organization of safety, protection of cargo and railway transport items, etc.  
- rights and obligations of the railway and passengers/freight operators during carriage-transportation;  
- establishes technical norms and standards in relation to transport means and equipment of railway carriage-transportation, as well as general rules and criteria that have to be taken into account during the fixation of tariffs and additional levies for passenger transportation and cargo, luggage, and mail carriage;  
- establishes general rules for cargo transportation and defines normative acts that should regulate these issues in detail;  
- establishes obligations of the railway with respect to passenger transportation, cargo, luggage, and mail carriage, and degree of adequate services;  
- establishes specific rights and obligations of passengers when traveling by various types of trains (international, local, suburban);  
- regulates issue of responsibility of the railway, passengers, and freight operators in case of violations of the Code, other normative acts, and contractual obligations;  
- identifies legal documents that should prove circumstances related to responsibility of participants of railway traffic; establishes types of these documents and rules for drafting them;  
- establishes general rules for transportation safety, organization of safety, protection of cargo and railway transport items, etc.

Similar approach may not be always profitable. In specific situations, in light of various views issuing cargo prior to payment of the service fee might be profitable for the railway, as a business organization.

Regardless of the fact that the Code recognizes possibility to enter into agreements between the railway and the client on a number of matters, certain confusion may arise under Article 44 of the Code: "All types of agreements concluded between cargo sender/recipient, passenger, and the railway that limit or free them from responsibilities established under Georgian legislation, are null and void".

It should be noted when discussing this issue that in the opinion of lawyer-experts, railway, as business organization experiences less problems due to imperative nature of the Railway Code norms than due to disadvantageous legal mentality, interpretation of legal norms, and Georgian reality, as during the decision-making process the Director, in view of business interests may be accused for refusing to demand specific claim in the name of the railway (non-use of right to claim).

Desirably, Railway Code will be revised prior to privatization of the railway and vague and restrictive provisions that prevent railway administration from pursuing profitable business policies will be either deleted or specified.

### **5.3. Designation of Commercial Rights and Obligations between the State and Railway Organization**

**Tariff regulation:** today the state does not practically exercise tariff regulation of the railway activities. Article 64 of the Railway Code of Georgia stipulates that prior to exercise of tariff authorities by the regulating body in the railway transport, the railway independently fixes tariffs and additional levies for passenger transportation and cargo, luggage, and mail carriage. At this stage there is no independent regulating body undertaking railway tariff regulation. Accordingly, a tariff policy document in force is adopted by the General Director of "Georgian Railway" LLC.

When the legislator provided through transitional provisions of the Code for a possibility to fix tariffs and additional levies for passenger transportation and cargo, luggage, and mail carriage prior to the exercise of tariff powers by the regulating body, it is less probable that current situation was thought of, when the regulating body does not exercise tariff regulation simply because such a body does not exist.

In furtherance to internal regulation mechanisms, Georgia's tariff policy is affected by interstate agreements between the railway and other relevant agencies of the state. In such agreements "Georgian Railway" participates within a framework of Commonwealth of Independent States (CIS). It has entered into agreements with CIS member states, Latvia and Lithuania, which are based on the results of the Tenth Tariff Conference (28-30 October 2002) of the Railway Authorities of the CIS,<sup>33</sup> as well as the Tariff Agreement of CIS Railways and the Railways of Latvia and

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<sup>33</sup> The Tenth Tariff Conference of the Railway Authorities of the CIS, Tbilisi October 28-30, 2002. *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

Lithuania that was signed on 17 February 1993.<sup>34</sup> During calculation of international and transit freight tariffs Georgian railway also takes into account the International Rail Transit Tariffs that are valued in Swiss Franks.<sup>35</sup>

Moreover, analysis of experts affirms that "Georgian Railway" intends to bring railway regulatory issues in compliance with the established standards in the EU,<sup>36</sup> as the EU member states or states closely cooperating with the organization are obliged to reflect the EU Directives in their domestic legislation. Georgian railway faces the following tasks: sharing EU policies with respect to need to designate rights between the railway and the state and functions between the railway and infrastructure management. At the same time, it will be necessary to secure more transparency during the use of public finances, as well as to set up an improved mechanism for controlling work of this agency.

Significant problem may arise in terms of tariff regulation if the railway is privatized without implementing legislative amendments. Formally the state loses the right to control tariff policy, as pursuant to the rule in force currently the Director of "Georgian Railway" LLC approves the tariff policy documents. It is unclear to whose jurisdiction will the tariff policy be subjected to. Expectedly, the state will not lose a hand on tariff regulation levers in the passenger transportation sector. However, it is still unclear what policies will be pursued in the freight carriage sector.

**Technical regulation:** the 13 September 2002 Law of Georgia on Independent National Regulatory Bodies establishes independent regulatory bodies and defines their functions and scope of regulation. Original version of this Law did not foresee the existence of body regulating railway activities. However, under legislative changes of 1 July 2005 the "Transport Regulatory Commission of Georgia", whose regulatory domain includes railway, was added to the list of independent regulatory bodies operating in Georgia (transitional provision of the Railway Code - Article 64 was also adopted on 1 July 2005). The same law of amendments and supplements established that "functions of Transport Regulatory National Commission of Georgia should have envisaged technical regulation of the Georgian railway transport".

The Decree of the President of Georgia dated 12 October 2006 approved a statute of the Transport Regulatory National Commission of Georgia, which specifically notes that with respect to the railway transport the Commission is in charge of regulating the safety/security of the transport process only.

As a result of another legislative changes dated 30 March 2007, the Transport Regulatory National Commission of Georgia was taken off from the list of regulatory bodies. It is true that the Law on Management and Regulation of Transport Field was adopted on the same day, but it clearly stipulates that the scope of the Law does not extend to the railway transport. The same Law established that an independent

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<sup>34</sup> "Tariff Agreement of CIS Railways and the Railways of Latvia and Lithuania," of 17 February 1993. *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

<sup>35</sup> "International Rail Transit Tariffs" (ITT). *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

<sup>36</sup> *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

regulatory body - legal entity of public law Transport Regulatory National Commission of Georgia - should have been reorganized into a sub-agency institution of the Ministry of Economic Development of Georgia - the United Transport Administration (Article 10).

Accordingly, pursuant to the Order of the Minister of Economic Development of Georgia dated 12 April 2007, a statute of the Ministry's sub-agency institution United Transport Administration was approved. However, the functions of the Administration do not include regulation of the railway transport. Thus, currently in Georgia there is no institution with direct function of technical regulation and control of the railway transport, just like there is no body exercising tariff regulation.

#### **5.4. Demarcation between the Railway Infrastructure and Operational Functions**

In accordance with recommendations of western experts and policies in effect in the EU, it is desirable that operational function of the railway becomes independent. This means that the railway, as a commercial unit, is fully managed under business autonomy (including relations with international organizations, as well as decisions made with respect to budgetary, staffing, and procurement policies) oriented on provision of effective and adequate services for prices commensurate to a quality of service, etc.<sup>37</sup>

Railway infrastructure and operational functions are not demarcated in the Georgian railway.

Yet, a commercialization of operational (use, operation of the railway) function took place in the Georgian railway: in the Georgian railway system it is allowed for the third parties to transport passengers and organize freight carriage. This, according to already existing experience, largely contributes to formation of the railway as a commercially profitable body.<sup>38</sup> Pursuant to Article 8 of the Railway Code of Georgia, it is allowed that passenger transportation and cargo, luggage, and mail carriage takes place through transport means and equipment in ownership of the railway or other persons. At that, new rolling-stock should have a confirmation of compatibility with existing requirements (certificate). As already noted, in the western experts' view, full commercialization of railway's operational function is reasonable in order to achieve utmost efficiency.

### **6. Assessment of Georgian Railway Reform**

Complex industrial reform is a long-term and phase-to-phase process, as implementation of simultaneous and harmonious changes in adequate legislative, institutional, and governing structures requires long-term period and effort.

Assessment of ongoing and implemented railway reform in Georgia compared to railways of other Eastern European countries is provided in the analytical study

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<sup>37</sup> *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

<sup>38</sup> *ibid*

"Reform, Commercialization, and Private Sector Participation in Railways in Eastern and Central Asia", commissioned by the World Bank group. In his report, author Paul Amos ranks the countries where railway reforms were carried out under three groups: "Successful Reformers" (1 point during the assessment), "Less Successful Reformers" (2 points), and "Unsuccessful Reformers" (3 points).<sup>39</sup> Railway reforms in Eastern European and Central Asian countries yield following results: seven countries are considered to be "High" reformers; these are Estonia, Bulgaria, Hungary, Kazakhstan, Poland, Romania, and the Slovak Republic. "Medium" and "High" reformer states in recent years adopted new laws on the railway, established commercial business structures, found specific solutions to covering losses from passenger transportation, privatized several secondary businesses, and created competition on the suppliers' market. Main railway transport was privatized only in **Estonia**, while several other countries such as Kazakhstan and Romania set up third party freight operators covering significant portion of the market.

**Russia** is classified as a "medium" reformer, where reforms were just launched. However, in light of structural scale and degree of complexity, this reform will be a huge achievement if commercialization occurs.

Out of 27 countries of Eastern Europe and Central Asia, railway reforms are too slow in approximately ten countries. Not all countries under the "slow" group are "low" reformers as well. For instance, significant structural changes have not taken place in the railway industry of Ukraine and Azerbaijan, but nevertheless financial state of the railways is gradually improving. Notably, Albania, Macedonia, and Turkey are in extremely poor condition among the countries under this group.

Based on the analysis of railway reforms undertaken in Georgia, the author assesses Georgian railway as follows:

- New railway laws - 2 points;
- Organization forms - 2 points;
- Management structures - 3 points;
- Competition and private participation - 2 points;
- Funding of passenger services - 3 points;
- Labor restructuring - 2 points;
- Commercial processes - 2 points.

Hence, as Paul Amos assesses, Georgia is a "medium" reformer country. Accordingly, commercial activities of Georgian railway will be more successful and profit will increase if restructuring process continues, management's efficiency grows, and legislative base improves, thus attracting more private investors in this sector.

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<sup>39</sup> Amos, Paul: Reform, *Commercialization and Private Sector Participation in Railways in Eastern and Central Asia*. In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

## **7. Disposal of State Property: Privatization and Transfer under Management Right of Georgian Railway**

The Law of Georgia on Privatization and Transfer under Right to Use of State and Local Self-governance Unit Property regulates major legal, economic, and organizational issues related to disposal of state property in Georgia. “State property”, pursuant to definition provided by the Law, includes stocks and shares in relevant enterprises in the state ownership, along with other objects and non-material assets. State share in “Georgian Railway” LLC is among these.

State share in “Georgian Railway” LLC, as well as state property may be disposed of through its privatization (sell of share) or transfer under right to use. Notably, prior to July 2007 the Law directly prohibited privatization of “railway of state importance”. Under legislative changes of 11 July 2007, railway was deleted from the list of state property that cannot be privatized.

Transfer under right to use of shares and stocks in state ownership also implies its transfer under management right. The Law foresees privatization of state property through auction and direct sale. President of Georgia makes a decision and sets relevant conditions for direct sale of the state and local self-governance unit property. As for the enterprises with state share participation, the 11 May 2003 Decree of President of Georgia on Approval of the Rule for Transfer under Management Right of Stocks and Shares from Enterprise Management Agency to Other Entities regulates a transfer under management right of their shares and stocks from Enterprise Management Agency to other entities.

Pursuant to the Decree, the Minister of Economic Development of Georgia makes a decision on reasonableness of transfer under management right of shares and stocks from Enterprise Management Agency to other entities. Transfer itself takes place only on competitive basis, pursuant to a statute approved by the Minister of Economic Development.

Decree establishes a rule for transferring stocks and shares without competitive basis. In particular, transfer under management right of shares and stocks of enterprises with state participation from the Agency to other entities without competition may take place only: a) based on the decree of the Government of Georgia; b) [.....].

As the discussed provision demonstrates, in case of transfer under management right of shares and stocks without competition by the Government, the Decree does not foresee a need for any existing pre-requisites. It is granted with “unrestricted discretion” and can transfer under management right the stocks and shares any time without meeting any preconditions.

Interestingly, this Decree of the President did not originally foresee a transfer of shares and stocks without any competition and set conditions.

Based on amendments implemented on 12 May 2005, 11 July 2006, and 19 April 2007, all preconditions necessary for transferring under management right of

shares/stocks without competition were declared null and void. As a result, the Government enjoys a possibility to transfer under management right state shares and stocks in enterprises without any limitations and met conditions.

Last amendment to the Decree raised certain questions and doubts among the experts in the field. The amendment forestalled a transfer under management right of the railway to “Parkfield Investment Limited” for only couple of months.<sup>40</sup>

As already noted, last amendment took place on 19 April 2007, and on 16 August 2007 the Government of Georgia issued an Ordinance on Transfer of 100% Share of “Georgian Railway” LLC in State Ownership to “Parkfield Investment Limited” under Management Right. Pursuant to the Ordinance, managing company took an obligation to invest 1 billion USD in “Georgian Railway” LLC over a ten year period. In exchange of management of 100% share in state ownership the company would have received a royalty (management royalty) in face of enterprise’s annual net profit. Specific aspects of investment and other important issues should have been regulated under an agreement between an investor and the Ministry of Economic Development of Georgia. However, this agreement has not been concluded. Two months after issuing the Government Ordinance, word was spread that “Georgian Railway” LLC would not be transferred to “Parkfield Investment Limited” under management right. 16 August 2007 Ordinance of the Government of Georgia was revoked by the 13 November Ordinance #622.

During a work on this report “Open Society Georgia” Foundation expressed interest in the origin of above-mentioned company. Project team could not identify company named “Parkfield Investment Limited” on the web. Yet, the web hosts a page <http://www.parkfieldcapital.com>, which belongs to a company carrying similar title “Parkfield Capital”. Project team addressed this company with official e-mail requesting “Parkfield Capital” to provide information at its disposal concerning transfer of “Georgian Railway” LLC under management right. “Parkfield Capital’s” response mail states that company has never been in contact with the “Georgian Railway” LLC. Accordingly, experts involved in the project assume that “Parkfield Capital” is a different company that has nothing to do with “Parkfield Investment Limited”, whereas information on “Parkfield Investment Limited”, a company that

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<sup>40</sup> Since 1990, a tendency of transferring the railway to private sector under management right emerged among the developing states. By the end of 1997 fourteen governments of the developing states transferred the railway infrastructure to private sector under management right. For example, in Latin America 81% of the railway sector is transferred to the private companies under management right. Almost all railway projects in the Latin American countries represent concession types. Advantage of such contracts lies in a fact that through concession key items such as railway remain in the government’s ownership. At the same time private sector invests in these items and the government is freed from subsidizing. In Latin American countries, concessions are mainly transferred to consortiums of local companies under the conditions of cooperation with some experienced international operator or sponsorship of large freight consumer. During the transfer of the railway sector under management right, for instance in Latin America a standard model is applied, which divides a sector between the railway infrastructure and operational activities. In these countries private companies undertake operational activities, while railway infrastructure remains in state ownership. Division of infrastructure also balances out between the state and private sectors. Main infrastructure may remain under the prerogative of state planning and provision, while the rail main line service may be split between the state and private companies.

expressed interest in transfer of the Georgian railway under management right, is not available on-line. Unfortunately, project team failed to obtain even verbal information on this company, as neither the Ministry of Economic Development of Georgia, “Georgian Railway” LLC, nor Enterprise Management Agency could/did not provide any piece of information.

As noted in the introduction, in November 2007 the Ministry of Economic Development of Georgia announced expression of interest aimed at alienating share of “Georgian Railway” LLC in state ownership.<sup>41</sup> 25 January 2008 was announced a deadline for filing applications. Information posted on the web is rather general: participants of the expression of interest concerning privatization of “Georgian Railway” LLC should present: (1) purchase price (in currency); (2) enterprise development plan (volume and term of investments). Web page contains also the following disclaimer: “this publication and announcement of expression of interest does not put any obligation on the Ministry of Economic Development to sell any share to any interested party; parties may not claim or exercise any rights with respect to the Ministry. The Ministry of Economic Development, upon its own discretion, reserves a right any time to (1) break up the sale procedure; (2) suspend or change the procedure; or (3) exclude any interested party from the sale procedure without a right to file a claim against the Ministry of Economic Development for any compensation or reimbursement of damages”.

Experts involved in the present report met with the contact persons from the Ministry of Economic Development responsible for privatization of “Georgian Railway” LLC, who stated that there are no conditions set prior to filing the applications. Also, there is no decision as to what portion of the state share should be put up for sale. Following the review of submitted proposals, specific conditions for privatization will be defined. This means that during a work on the report no official decision on this matter had been made. This does not in any way ignore the fact that the authorities may already have agreed on conditions for privatization and a minimum price.

## **8. Economic Analysis of the Railway Functioning**

### **8.1. Analysis of Current Situation in the Railway**

In order to assess the effect of expected investment in “Georgian Railway” LLC on both the future development of this sector and Georgian economy as a whole, it is necessary to analyze current situation in the railway. In the first place, current capacity of the “Georgian Railway” should be assessed, followed by the assessment of future potential of this sector.

As it is widely known, railway activities split up in two main directions: freight carriages and passenger transportation. In general, freight carriages are a chief source generating revenues in the railway, while passenger transportations are mostly unprofitable operations, as a low tariff for traveling by train is not sufficient for maintaining and serving the railway. As a result, in many countries of the world

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<sup>41</sup> [www.privatization.ge/spp/spp/news\\_view.php?lang=ge&action=article&news\\_id=128](http://www.privatization.ge/spp/spp/news_view.php?lang=ge&action=article&news_id=128).

railway is an unprofitable organization. Unlike these organizations Georgian railway is a profitable enterprise, i.e. share of freight traffic in total operations is sufficient to cover losses incurred from passenger transportation and to generate additional revenues. Volume of revenues in 2006 between the passenger and freight traffic sectors constituted the following percentage data: 90% of revenues – freight carriages, 5% of revenues – passenger transportation, and 5% - other carriages.<sup>42</sup>

According to the data of three quarters of 2007, 65% of freight traffic fell on transit freight carriages, 16% – import, 13% – local carriages, and 6% – export traffic.<sup>43</sup> Based on the same data, in 2007, during 9 months, 30% of freight volume trafficked through the Georgian railway fell on the crude oil, 29% – other dry goods/cargo, 22% – oil products, and the remaining percentage – various products (e.g. sugar, nonferrous metals, etc.). Revenues generated from the Georgian railway were as follows (9 months in 2007): 35% – revenues generated from transportation of other dry products/cargo, 25% – revenues generated from transportation of oil products, 22% – revenues generated from crude oil. Oil and oil product traffic comes from Azerbaijan, Turkmenistan, and Kazakhstan, heading to the Batumi port.

This is mainly due to Georgia's geographic location, i.e. in Georgia, as a country located at European-Asian transit juncture, freight turnover can generate rather significant volume of revenues.

Today operational length of the main line of Georgian railway is 1554km, comprising 1422 bridges, 32 tunnels, 22 passenger stations, and 114 freight stations.<sup>44</sup> It represents a part of the railway connecting Caspian and Black Seas. Freight turnover mainly consists of oil and oil product transits trafficked from Azerbaijan and Kazakhstan to the ports of Batumi and Poti. Advantageous location of Georgia provides an opportunity for the railway to benefit from increased demand on rail traffic due to economic growth of the region and concentration of power resources.

According to the assessment of Booz Allen Hamilton<sup>45</sup> (BAH), mainline network is in relatively fair condition, main line is fully electrified, and the mainline is double track. Aging infrastructure, locomotives, wagon fleet, etc. are the main obstacle of the railway.

Infrastructure of the Georgian railway consists of several components: bridges, tunnels, trunk-railway, communication means, power supply, depots, stations, and related equipment. As BAH notes, mainline is in a fair condition. However, it requires renovation works (particularly, insufficient depth of the rail ballast is viewed as a major disadvantage of the mainline) so that the railway becomes capable of faster trafficking heavier freights. Renovation of bridges and tunnels is important as well. Currently a majority of bridges on the mainline is older than 85 years. Authors of this study believe that renovating bridges and tunnels should be one of the priorities of the railway. Regardless of the fact that condition of the tracks, bridges, and tunnels

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<sup>42</sup> Georgian Railway Overview 2007. [www.railway.ge](http://www.railway.ge)

<sup>43</sup> *ibid*

<sup>44</sup> [www.railway.ge](http://www.railway.ge)

<sup>45</sup> *Georgian Railways Restructuring Assistance. Assessment Report* – May 2005, Booz Allen Hamilton

provides possibility of continued operations, renovation works in critical spots, namely replacement of damaged rails, strengthening of bridges, strengthening of drainage system in tunnels, etc. are of huge importance. As regards the communication system, old dispatching system needs to be replaced by a new digital communication and signaling system, which will improve communication between the locomotive engineers and dispatchers and ensure more flexible and timely movement of the trains. According to BAH's assessment, implementation of this system requires investment of approximately 20 million USD.

Despite full electrification of mainline in Georgia, BAH experts believe power supply system requires revamping. Completion of revamping program is possible by 2015 and requires 3-4 million USD annually.

Undertaking measures preventing environmental pollution connected to the railway activities is of concern as well. In this respect four chief sources of pollution may be identified: (1) oil spillage from damaged wagons; (2) pollution in places where trains stop; (3) spillages in loading and discharging places; (4) management of fallouts. Thus, in the experts' opinion, a most serious threat is caused by spillage of oil during loading-discharging of oil in the Batumi and Poti terminals and a subsequent environmental pollution. In light of mentioned BAH recommends to develop a special program designed for prevention of environmental problems, requiring approximately 1 million USD worth investment.

The BAH study sets out cost evaluation for three different scenarios of improving Georgian railway's infrastructure. In order to achieve least level of infrastructure, volume of required investment is assessed as 100 million USD. This foresees attracting the capital that will provide for safe and financially viable railway operations. Desired level of improvement implies infrastructure development up to the standards of former Soviet Union, which requires approximately 222 million USD worth investment. Experts also evaluate required costs for improving railway infrastructure up to the EU standards (significant growth of train speed), which is approximately 526 million USD. Notably, these evaluations are made at the start of 2005, i.e. volume of required investments to achieve same levels in current conditions will increase in view of the inflation factor.

BAH's assessment of the rolling-stock is also of interest. According to the 2005 data, rolling-stock of the Georgian railway consisted of 12,636 units. This comprised locomotives, as well as passenger and freight wagons. Remarkably, almost half of the wagons is out of order. Only 53% of wagons are in working condition. However, more than 70% of them are older than twenty years and will require replacement in several years. As time goes by this problem becomes more relevant. According to our estimate<sup>46</sup>, 900 million USD investments will be needed to fully replace aged wagons.

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<sup>46</sup> Our estimate is derived from multiplying a number of aged wagons by a market price – each separately, according to the wagon type. Market price is taken from the prices of different types of wagons available on-line. However, “Georgian railway” may have a possibility of acquiring wagons from specific suppliers at different prices.

Need of renewal of rolling-stock with modern trains raises new challenges in front of the Georgian railway. Together with renewal of infrastructure it will be necessary to undertake several capital investments to establish a modern diagnostic center of equipment, which will contribute to avoiding late or improper repair of the rolling machinery. Establishment of a diagnostic center requires purchase of relevant equipment and training of the employee staff, based on which the latter will use and maintain new equipment.

Therefore, under rough estimates, safe and effective operations of the Georgian railway require 1,2-1,4 billion dollar investments to be made throughout coming 10-15 years.

## **8.2. Potential Economic Effect generated from the Investments**

As already noted, investing in “Georgian Railway” LLC might have a quite serious impact on the Georgian economy. This effect can be viewed from several main aspects: (1) Georgian railway is one of the largest employer organizations in Georgia, and therefore enlargement of the railway is directly linked to a growth of number of employees and their salary rates. All of this overall contributes to increase of income, and, in general, economic well-being. (2) Transport services, one of the main components of which is the railway transport, hold a significant share in the formation of Gross Domestic Product. Thus, implementation of expected investments in the railway sector will contribute to a growth of additional value in the country and economic growth in general. (3) Revenue generated from transport services is one of the most important articles of Georgia’s balance of payment. Growth of transit traffic volume and revenues generated from this traffic is crucial for improvement of the current balance, which, on its part will slow down generation of a foreign debt. Detailed examination of these tendencies separately should be of interest.

### *8.2.1. Formation of Additional revenues*

“Georgian Railway” LLC is one of the largest employer organizations in Georgia. As of 2006, 15 041 people were employed in the organization.<sup>47</sup> Average salary constitutes 300 GEL, which is equal to an average of salary of the employed in Georgia.<sup>48</sup> According to rough estimates, monthly salary fund exceeds 4,5 million GEL. Parallel to an increase in volume of operations of the Georgian railway and financial outputs it is expected that average salary of the employed in the railway, and labor revenues accordingly, will increase as well. Further, it should be noted that in 2002-2004 “Georgian Railway” LLC annually paid to the Georgian budget profit tax worth approximately 15 million GEL. This demonstrates that the railway has an indirect impact as well on the formation of country’s revenues. In addition, investments implemented in the railway envisage repair and construction of tunnels, bridges, roads, depots, etc., that on its part generates new work places and additional income. Increased income for Georgian citizens connotes a growth of total demand in the country, which overall is reflected in the growth of GDP/economy.

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<sup>47</sup> Georgian railway. Overview 2007. [www.railway.ge](http://www.railway.ge)

<sup>48</sup> According to the Department for Statistics of Georgia, by the end of 2006 an average salary in Georgia constituted 299,2 GEL.

### *8.2.2. Growth of Gross Domestic Product (GDP)*

As already noted, additional value generated by the transport sector constitutes approximately 7% of the GDP, and a major portion of transport services account for the railway. This confirms that the railway is a rather significant segment of the Georgian economy. According to the 2006 data, additional value generated by the transport sector increased by 14.6% compared to a previous year. If this growth speed is sustained in the future or increased further (investments made in the railway should guarantee this), than GDP i.e. economy will grow by 1%, which is a huge share attributable to only one sector of economy. In order to stress the importance of this growth speed, we can recall that due to economic blockade of Georgia by the Russian Federation, damage inflicted on Georgian economy was estimated at approximately 1% of the GDP growth.

### *8.2.3. Improvement of current Account Balance*

Revenues generated from rail traffic in 2006 constituted 112 million USD, and in three quarters of 2007 – 83 million USD. This is a rather significant source for funding trade balance deficit. Throughout 2006, revenues generated from rail traffic funded approximately 6% of trade deficit, while in three quarters of 2007 this indicator equaled approximately 4.5%. Yet, this is an insufficient amount for fully covering the trade balance deficit. Accordingly, Georgia's current balance has experienced deficit over the years. In 2006 current balance deficit amounted to 1,153 million USD, and in three quarters of 2007 – 1,186 million USD. This deficit in recent years was funded through foreign investments and loans, thus accumulating foreign debt. This is disadvantageous for the economy, as in such instance investors lose trust toward country's solvency. To conclude, enlargement of railway operations and increase of revenues generated from transit traffic are crucial factors for reduction of current balance deficit and foreign debt in the future.

## **8.3. Issues of Concern for Privatization of “Georgian Railway” LLC**

Intention to sell a certain item or transfer it under management right requires a clear vision on financial capacity of this item. As of 31 December 2004, total assets of “Georgian Railway” LLC exceeded 528 million GEL. Remarkably, assets are mainly funded at the expense of the capital. Total liabilities, both short and long term, constituted 87 million GEL only. Hence, Georgian railway is not an organization facing larger liabilities compared to the assets.

Structural analysis of company's incomes-expenses is interesting in order to estimate its financial capacity. Total operational revenue of the Georgian railway in recent years ranges between 200-300 million GEL. In 2004 this figure exceeded 265 million GEL. However, railway has to bear large expenses to ensure uninterrupted operations. As a result, net profit prior to paying taxes fluctuated within a 40-60 million GEL range. In recent years this indicator is steadily growing as well. If net profit in 2004 amounted to 44.1 million GEL, in 2006 it constituted 87 million GEL.

Biggest share among the structure of expenses, approximately 20%, falls on tear and wear costs. Remarkably, tear and wear costs are not related to cash flow. In such instance this is a book entry that reduces net profit. In order to estimate financial capacity of the Georgian railway more correctly, attention should be drawn to capacity

to generate company's cash flow, i.e. net profit prior to taxation, not including wear and tear costs. This figure in recent period fluctuates within the 100 million GEL range. A table below depicts the dynamics of financial capacity of the Georgian railway.

Table 2. Revenues of "Georgian Railway" LLC (thousands GEL)<sup>49</sup>

	2001	2002	2003	2004
Gross operational income	215,135	268,346	311,695	265,884
Net profit	13,074	51,778	60,431	44,100
Net profit prior to taxation, not including wear and tear costs	53,377	99,570	106,816	81,705*

\* Estimate of wear and tear costs was applied to calculate the data.

As a table demonstrates, starting from 2002 annual cash flow of the Georgian railway amounts to approximately 100 million GEL. In accordance with the information posted on the web site of "Georgian Railway" LLC, net profit in 2005 and 2006 prior to taxation and not including wear and tear costs increased further and amounted to 100 and 140 million USD respectively. Predicted data for 2007 exceeds 150 million USD.<sup>50</sup> Investments and growth of regional economy might lead to increased demand on rail traffic, which means additional values generated by the company. We may assume for the purposes of our estimation, that "Georgian Railway" LLC will be capable of attracting on average 100 million, and maximum 150 million GEL revenues annually. As known, in case of privatization annual financial output remains in 100% ownership of the investor. In order to derive quantitative estimate of property that will be transferred in investor's ownership as a result of privatization, we need to compare a current value of cash flows to be generated in the future with a current value of expected investments, i.e. need to compare current values of cash inflow and outflow.<sup>51</sup> Based on this calculation, current value of investor's expected revenues under optimistic prognosis (150 million GEL of income annually) amounted to approximately 1,170 million USD, and under pessimistic prognosis (100 million GEL of income annually) – 780 million USD. As already noted, we estimated that approximately 1,2-1,4 billion USD worth investments are required for rehabilitation of the Georgian railway's infrastructure. It is expected that this amount will be invested during 15 years, and a major portion of it will be spent during the first decade. In order to calculate a current value of investments, we also took into account the dynamics of these cash flows. As a result, a current value of 1,4 billion USD to be invested over 15 years is 680 million USD. Hence, current net value of an entire project under pessimistic calculations amounts to 100 million USD, and under optimistic – approximately 490 million USD.

<sup>49</sup> *Georgian Railways Restructuring Assistance. Assessment Report.* Booz Allen Hamilton, 2005.

<sup>50</sup> Georgian railway. Overview 2007. [www.railway.ge](http://www.railway.ge)

<sup>51</sup> A formula provided below is applied to calculate current value. 
$$PV = \frac{C}{1+i} + \frac{C}{(1+i)^2} + \frac{C}{(1+i)^3} + \dots + \frac{C}{(1+i)^T}$$
 where

PV stands for current value of cash flows, C – cash flows, T – number of years, and *i* – interest rate, which is applied for discounting the income to be generated in future. Interest rate applied is 8% - an average interest rate on bank deposits in Georgia.

Based on the above mentioned, when privatizing Georgian railway to the investor, we have to take into consideration a current value of those projected revenues, which will be generated by the investor through possession of entire profit of the Georgian railway.

## **9. Conclusions and Recommendations**

As already noted, importance of the railway for Georgian economy can be viewed from three main perspectives: (1) growth of GDP at the expense of additional value accumulated directly in the transport service sector; (2) increase of income of the employed in the Georgian Railway; (3) improvement of a current book value. As a result of investments and growth of regional economy, it is expected that the country will witness economic benefit in all three directions.

Current condition of railway infrastructure and technical provision of “Georgian Railway” LLC is sufficient for maintaining existing level of operation at a current stage. In line with the economic growth of the region in future, improvement of infrastructure (repair or new construction of trunk-railway, bridges, tunnels) and renewal of rolling-stock of the company will be necessary to meet an increased demand on rail traffic. Today majority of the rolling-stock in the railway is aged and requires replacement or will have to be replaced in several years. According to our estimates, such replacements require approximately 1,2-1,4 billion USD worth investments.

Privatization of the item purports the right of an investor to receive 100% of profit. In order to calculate optimum price of privatization, and accordingly transfer of revenues to be generated in the future, it is necessary to calculate a current value of these revenues. Under our estimates, a current value of projected net profit generated by the Georgian railway amounts to 490 million USD under optimistic prognosis, and 100 million USD – under pessimistic one.

In the market economy, gradually developing competitive market and economic growth entailing new demands point out to a need of the railway reform. One of the tasks of the railway reform is to set up a type of industry that will gain competitive potential on a changing market in the future.

Based on the study of the World Bank<sup>52</sup>, in 2005-2008 the railway reform will be mainly oriented on further commercialization of railway infrastructure through maintenance of the state ownership.

According to the study, it is expected that “High” and “Medium” reformer states such as Russia, Georgia, and Latvia will continue implementing reforms, while Turkey, Macedonia, Moldova and others, who are still ranked as “Low” reformers, will speed

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<sup>52</sup> Amos, Paul: *Reform, Commercialization and Private Sector Participation in Railways in Eastern Europe and Central Asia*. In: Transport Papers, January 2005. The World Bank Group, Washington, D.C.

up the reform implementation process. Overall, it is assumed that the railway sector will less depend on the state subsidies.

Railway reform is of a multi-phase and complex nature. The state may wish to be the owner; however, if the state is not capable of being an effective possessor, introduction of new mechanisms is necessary for adequate management and better control. Structural change is one of the steps on the way to success, though. Adoption of new laws and structural changes do not guarantee that these changes will be effectively implemented in practice, as the latter mostly depends on the management. If the railway remains in state ownership, work experience should be further gained under the market economy conditions and investments should be made aimed at changing business-management environment, sharing new experience and skills, and establishing a commercial structure.

Transfer of the Georgian railway under management right, as well as its privatization should be welcomed for the purpose of increasing effectiveness and profitability of this enterprise. Under the transfer through management right (concession), this key item will remain in state ownership while the private investor will be in charge of its management. Similar concessions are successful in many countries in light of management of enterprises in state ownership.

Estonia is a successful example of privatization of railway sector. Growth of the Russian economy, effective management of Estonian railway, and profitable use of available resources contributed to this success. Possession and operation of national railway networks is a legitimate choice of the state policy. It is not mandatory for the states to follow the Estonian example and privatize major railway network. Numerous factors have to be taken into account if the state share in the railway is privatized. In the first place, state interests should be protected to a maximum extent, etc.

- Entire process of privatization should be transparent at the most and should observe the law.
- Experience, capital, and international reputation of an organization have to be taken into account when selecting the investor company.
- Privatization price should be calculated based on a current value of projected net cash flow in the future (difference between inflow and outflow).
- Agreement between the state and investor should clearly define rights and obligations of both parties and protect their interests.
- A specific list of projects that the investor will be obliged to implement within specific deadlines should be identified in the process of alienation of the railway. This foresees projects aimed at improvement of railway infrastructure (repair or new construction of roads, bridges, tunnels) and repairing/purchasing new pieces of rolling-stock.
- During the alienation of railway, several issues such as determination of state tariff policy should preferably remain within the state domain.
- A bill of legislative amendments foreseeing a rule for tariff and technical regulation, control of the railway transport, as well as deletion from the Railway Code of vague provisions and provisions undermining contractual freedom, should be drafted.

- Harmonization of transport legislative basis and standards with the EU legislation, and implementation of international and regional projects through introduction and development of modern technologies, should be continued.
- Resolution of the railway ownership issue should not hinder further implementation of the TRACECA program, as a pivotal component of regional cooperation and European integration.

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