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| PROJECT NAME: | RAILWAYS RESTRUCTURING PROJECT |
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LOAN AMOUNT: US\$184.7 million
DURATION: 2005-2009

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BACKGROUND: Turkey's geopolitical position as a link between Europe and Asia makes the transport sector crucial for the economic development of the region. Turkey is a major player both as a transit country and as an origin and destination of freight. The severe fiscal instability and the recent positive political developments with regard to EU accession and the growing role of Turkey in trade between Central Asia and the South Caucasus make the focus on transport even more important.

The **Turkey Country Assistance Strategy** (approved by the Board on November 6, 2003) recognizes that raising the efficiency of Turkey's transport sector will contribute to economic growth, environmental sustainability and poverty alleviation. Key priorities for the medium term include inter-alia: (i) continuing the restructuring and privatization of public utilities coupled with sector reform; and (ii) implementing the reform process inherent in the EU "*acquis communautaires*".

The restructuring of the transport sector is challenging for two main reasons: (i) strategic decisions have to be taken regarding the optimal transport modal split and the future of the railways; and (ii) the scope and pace of TCDD restructuring has to be carefully assessed, in compliance with EU "*Acquis Communautaire*" to facilitate Turkey's integration within the EU in the near future.

Optimal transport modal split: Turkey has to decide the structure of its transport system and particularly the role of the railway and its economic value. The decision could lead to an investment program or, on the contrary, to a substantial reduction of the railway service in Turkey. Decisions have also to be taken in regard to price of the services (passengers and freight are both carried at substantial losses), to competition (at what pace and under what forms competition should be introduced), and to the introduction of the private ownership in the sector. The results of such decisions could change the transport system and thus influence the economic and social future of the country.

TCDD Restructuring: TCDD has to be restructured to – ideally – become a financially viable enterprise able to provide good quality services (the amount of which depends on the role attributed to the railway mode) and to meet the E.U. requirements. A successful restructuring process will produce a substantial reduction of the State expenditure. The restructuring also entails the separation and eventually the privatization of the affiliated companies and of the ports operations and requires reshaping of the labor force, and reduction in redundant staff. Given the size of the Company, the redundancy program could have a substantial impact on the labor market in Turkey.

PROJECT OBJECTIVE: The overall objective of the project is to improve the financial viability, productivity, and effectiveness of railway operations. This will be achieved through separation of infrastructure from operations, increasing accountability and competitiveness in rail operations,

restructuring and rationalization of passenger services, staff adjustment, as well as corporatization and privatization of non-core activities.

More specifically, the project aims at: (a) setting up a new legal framework for unbundling ports and railways and allowing TCDD to operate on a commercial basis and receive public service obligations (PSO) payments for services rendered to the government for social and/or political reasons; (b) increasing the transparency and accountability of TCDD operations through the separation of the infrastructure and operating (freight, passenger) entities; (c) adjusting TCDD work force through a acceptable gradual reduction of staff and unjustified services; (d) modernizing TCDD's core infrastructure and operating assets; (e) decentralizing the system devolving responsibilities for local passenger services to Istanbul, Izmir and Ankara municipalities; (f) developing and implementing a system of access charges for the use of infrastructure in accordance with EU standards; (g) divesting from all non-core services; and (h) involving the private sector in freight operations.

At the same time, it is expected that the project will contribute to increase the competitiveness of the Turkish economy by reducing the logistic costs associated with the inefficiencies of the railway and port sub-sectors; and to support Turkey's accession process to the European Union. The benefits of restructuring to the national economy and to the national budget are expected to be quite substantial.

PROJECT DESCRIPTION: The Project is an Adaptable Program Lending (APL) with a total cost of about US\$450 million (of which US\$300 million is expected to be Bank financed). The APL includes two phases. The APL1 (with a total cost of US\$221.0 million of which US\$ 184.7 million are Bank finance) would include: (a) advisory services to implement the restructuring of the TCDD under current Railway Law and to prepare APL2; (b) initial staff adjustment program; (c) line capacity increase along Mersin-Toprakkale and Yenice-Bogazköprü corridors; (d) training for TCDD staff; and (e) support for improved internal and public communication.

The APL2 (with a total cost of about US\$230 million of which at least US\$115 million is expected to be Bank financed) that will be finalized during the implementation of the APL1 would include: (i) advisory services to complete the restructuring of the TCDD and assist in the implementation of the new institutional and regulatory setup resulting from the new laws; (ii) support for continuing the staff adjustment program; (iii) line capacity increase along Irmak-Zonguldak corridor; and (iv) other components as deemed necessary to ensure the success of the of the overall program.

Through its first APL, the project will assist in setting up a new legal framework allowing TCDD to operate on a commercial basis; increase the transparency and accountability of TCDD operations through the separation of the infrastructure and operating (freight, passenger) entities; shift from current regional based organization toward a "lines of business" organization; and modernizing some of TCDD's core infrastructure and operating assets to improve safety level. In the short term, establishing a new structure with accrued accounting, operating, bidding procedures, transparency, and efficient governance, will permit pinpointing the flaws of the company, so as to be able to solve them more efficiently in a subsequent phase of the reform.

IMPLEMENTING AND MONITORING: The Project is implemented through a Project Implementation Unit, formed within the TCDD.

BENEFITS: (a) setting up a new legal framework for unbundling ports and railways and allowing TCDD to operate on a commercial basis and receive public service obligations (PSO) payments for services rendered to the government for social and/or political reasons; (b) increasing the transparency and accountability of TCDD operations through the separation of the infrastructure and operating (freight, passenger) entities; (c) adjusting TCDD work force through gradual reduction of staff and unjustified services; (d) modernizing TCDD's core infrastructure and operating assets; (e) decentralizing the system devolving responsibilities for local passenger services to Istanbul, Izmir and Ankara municipalities; (f) developing and implementing a system of access charges for the use of infrastructure in accordance with

EU standards; (g) divesting from all non-core services; and (h) involving the private sector in freight operations.

RESULTS ON THE GROUND: This project will support the transformation of TCDD into a commercial and market oriented railway. Over time, this will improve the railway delivery of both passenger and freight services. It should also reduce the subsidy needs of the railway, freeing public funds for other uses.

PROJECT STATUS: The Bank approved a loan of euro 143.7 million (US\$ 184.7 million) on June 9, 2005 to finance the first phase of the Project. The loan agreement was signed on March 13, 2006, and the project launch workshop took place on March 28-29, 2006. The first supervision mission took place in June 2006.