

The Strategy Report and Action Plan (“Strategy Report”) is intended to outline one feasible way forward for the Royal Government of Cambodia (“RGC”) to deal with the present deteriorated state of the Cambodian railway. The way forward that the Consultant has identified relies heavily on the availability of concessionary loans from the Asian Development Bank (“ADB”) and other lenders to finance the rehabilitation of the railway. The proposed strategy contained in this Strategy Report has been shaped in large part by the constraints imposed by the physical condition of the Cambodian railway and the conditions the ADB has imposed on the availability of concessionary loans.

Strategic Options Are Narrowly Constrained

There are three primary constraints on the available options. First, the Cambodian railway is in severely deteriorated physical condition and its financial condition is deteriorating apace. Rail operations continue only because of the ingenuity of the staff of RRC and continuation of rail operations in the future will present a growing risk of serious accidents. The western most 48 km of the railway connecting to Thailand are completely destroyed, between Sisophon and Phnom Penh there are numerous bridges that need repair or complete rebuilding, and the 30 kg rail on that line is in poor condition. South of Phnom Penh a very high percentage of the sleepers need replacing and work needs to be done on bridges and to deal with subsidence issues.

Another Technical Assistance project is being conducted by Japan Railways Technical Assistance Service (JARTS) to determine the rehabilitation requirements and their cost. JARTS’ preliminary report is due in mid-June. For the purposes of the Strategy Report and the Preliminary Financial Report, Canarail itself has made an estimate of the rehabilitation requirement and the cost based on prior studies updated to current prices. The preliminary estimate is that the essential rehabilitation work to bring the entire main line to a 50 kph standard will cost approximately \$60 million. JARTS has indicated that this number is generally consistent with its more detailed technical assessment, though that assessment is still in preliminary form and subject to change.

The second constraint is the relatively limited traffic base for the railway. To a large degree the railway’s present traffic base (approximately 269,000 metric tonnes in 2005 compared to a high of 557,000 metric tonnes in 2002) reflects the railway’s deteriorated condition and its inability to compete with the rapidly improving highway system in Cambodia. An analysis of future traffic that would be available to a rehabilitated railway suggests that the lost traffic could be recaptured and substantial new traffic brought to the railway, once rehabilitated. This traffic will have to be diverted from competing modes, mainly trucks, which will severely constrain the rehabilitated railway’s ability to price its services at non-competitive rates.

The third constraint is the perceived risk of infrastructure investment in general, and in Cambodia in particular. Infrastructure investors in Cambodia will require a very high rate of return to compensate for perceived risk. The capital required for rehabilitation of the railway

and the modest future revenue potential will not support that type of return needed for the large scale private investment in the railway that would be needed in the absence of concessionary multilateral and bilateral financing.

Concessionary Loans are the only Feasible Financing without RGC Subsidy

The Consultant has made a financial analysis of a rehabilitated Cambodian railway (contained in the Preliminary Financial Report previously submitted). The key assumptions of that financial analysis were:

- Rehabilitation cost to 50 kph standard is \$ 60 million.
- Financing is 30 years, first 8 are interest only, and interest is 2.5 %.
- The railway operator pays the full financing cost of the rehabilitation once the rehabilitation is completed.
- Railway pricing is constrained only by competition which would permit a tariff increase by the rehabilitated railway to a point 20 % below trucks.
- The low (conservative) traffic scenario.

Under these assumptions, the base case traffic with above noted re-pricing is favourable for an entrepreneurial investment in the operating company. There are negative cash flows, however, in the first two years following the completion of the rehabilitation which would increase the perceived risk. The financial analysis for the project as a whole is extremely sensitive to the cost of debt financing, and in order to avoid the need for an RGC subsidy the rehabilitation financing must be at concessionary rates.

The ADB has Imposed Strict Conditions on a Concessionary Loan

ADB has stated that before a concessionary loan for rehabilitation of the Cambodian railway will be considered by the Board, RGC must commit itself to restructuring the railway to place its management in private hands, and Canarail must present to ADB a Pre-Qualification Report containing a list of pre-qualified bidders for the railway. The last date that the ADB staff can take a concessionary loan to the Board for approval from 2006 funding is November 2006. This Strategy Report is designed expressly to meet the ADB's conditions.

Concessioneering the Railway

The only feasible way of transferring the railway to private hands is through a concession or long term lease. The Cambodian Constitution and the Land Law prohibit non-Cambodians from owning land, thus, the option of selling the railway would not be possible unless foreign investors were to be excluded. As foreign investors may be the only ones with the financial and particularly the operating capacity to undertake the project, this was not viewed as a feasible option. Under a concession or long term lease arrangement, RRC would retain

ownership of the infrastructure, but its use and maintenance would be placed in the hands of a railway operating company (ROC).

Accordingly, the Strategy Report recommends that RGC concession the operation of the railway, granting ROC the exclusive right to operate on the infrastructure for a term of at least 32 years. ROC would have the right to lease RRC's equipment on nominal terms. The concession would assure ROC pricing and service freedom subject to review in exceptional circumstances where there was no competitive alternative for the shipper's traffic.

The concession would require ROC to make concession payments after the completion of the rehabilitation matched to the financing requirements of the loans used to rehabilitate the infrastructure. It would require ROC to maintain the infrastructure to agreed standards after the completion of the rehabilitation, and require ROC to make certain agreed investments, primarily the equipping of an inland container depot in Phnom Penh, and to provide rolling stock to accommodate traffic growth. The concession agreement would also require ROC to enter into a safety agreement with the Ministry of Public Works and Transport to establish safety criteria and procedures for the operation of the ROC.

The Consultant has recommended a structure where it is noted there is no RGC ownership interest in ROC. The Consultant recommended this for two reasons. First, RRC's interest can be fully protected through the concession agreement. ROC will not acquire ownership of any RRC assets, and the concession agreement will require ROC to pay in full the costs of the rehabilitation financing through the concession fee for the use of RRC's infrastructure and equipment. The concession agreement will impose maintenance obligations on ROC with respect to both the infrastructure and the equipment. ROC will also be obligated to meet the capital needs of the railway for additional equipment at all times, and for the infrastructure following the completion of the rehabilitation project. Second, introduction of partial government ownership into ROC could be a disincentive to private investors. The objectives and incentives of government and of private investors are different. Combining the two in the ownership of ROC would risk frustrating both and depriving the railway of the benefits of private sector management it is the purpose of the project to introduce.

Establishing the Joint Property Development Entity

The Consultant recommends that ROC and RRC establish a Joint Property Development entity (JPD) to which RRC would contribute designated parcels of urban real estate that is not needed for rail operations. The JPD would have the right to sell, lease or develop the parcels. ROC would be the Managing Partner while RRC would be a Limited Partner. Board representation and appropriate safeguards would be built into the operating and or shareholder agreements.

ROC would have approximately 36 % interest in the JPD, while RRC would have a 64 % interest. As part of its concession bid, ROC would include a price for purchase of its interest in the JPD. This would, in effect, act as a bidding variable to determine the successful bidder

and provide funds to RRC to meet any shortfall in resources available to satisfy its obligations. The Consultant contemplates that the earnings of the JPD would be applied first to the payment of the rehabilitation debt to the ADB, and other financing entities, before distributions are made to ROC and RRC.

The Consultant has recommended use of the JPD to help defray the cost of the rehabilitation financing and ensure that the values in the concession package that RGC will offer to the investing public will be sufficient to attract substantial private sector interest to the Cambodian railway.

The Concessioneering Process to November 2006

The very tight timeframe that ADB has set will require expeditious action by all parties to the concessioneering process. Technically, the Consultant recommends that ADB bidding procedures be adopted. The following is a brief summary of the milestones on the way forward:

1. MPWT decides to proceed substantially along the lines recommended in the Strategy Report.
2. Cabinet Paper and Policy Statement are circulated to Council of Ministers.
3. Council of Ministers approves the Policy Statement and all necessary actions to implement it, subject to exceptions.
4. A Project Management Unit (“PMU”) is established to manage the concessioneering process and to administer the concession agreement¹.
5. An Invitation for Prequalification is issued inviting persons interested in bidding to submit their qualifications.
6. A Pre-Qualification Report containing a recommended list of pre-qualified bidders is prepared by the Consultant and submitted to the ADB.

At this point, the ADB’s conditions for submission of the concessioneering loan to the Board will have been satisfied. To meet the ADB’s timetable, the foregoing must be accomplished by approximately October 15, 2006.

At the same time the foregoing actions are to be taken, the Consultant has recommended that RGC make a number of legal changes. The Strategy Report has classified these changes according to their urgency for the concessioneering process, and has made suggestions as to how they might be accomplished. The most comprehensive and flexible vehicle for this purpose would be the enactment of a Railway Reform Law to implement all of the legal

¹ Because of time constraints, it may be necessary to authorize the relevant minister to whom the PMU will report to act on matters in the PMU’s jurisdiction before it is formally established and staffed.

recommendations in the Strategy Report. Ideally, a Railway Reform Law should be enacted by the time the concessionary loan is sent to the ADB Board in November 2006.

Conclusion of the Concessions Process

Following approval of a concessionary loan by the ADB and enactment of a Railway Reform Law making the necessary legal changes to support the concession, the normal ADB bidding process would be following involving the issuance of an Invitation for Bids containing all the documentation needed for bidders to bid, an evaluation of the bids received, negotiations with the successful bidder, and ultimately an award of the concession. The successful bidder would form ROC as a Cambodian corporation and RRC and ROC would form the JPD.

Concession and Rehabilitation

The Consultant recommends that ROC assume responsibility for operation of the railway contemporaneous with the beginning of the rehabilitation project. The ROC would then be in a position to act as a technical adviser for the rehabilitation, for which it would be compensated.