INFRASTRUCTURE

Pulling Transnet back on track

Work to be done: The rail network requires maintenance catch-up Paul Ash

Mining profits, employment and tax collection will be boosted, along with the currency

Brendon Hubbard

One of President Cyril Ramaphosa's key reforms under Operation Vulindlela has been rail reform, to provide additional capacity to Transnet.

The inability of Transnet to rail out South African exports has cost anywhere from R150bn, as calculated in 2022 by the Minerals Council South Africa, to R1bn a day as calculated by Jan Havenga, professor of logistics and supply chain management at Stellenbosch University.

Transnet, in its March 2023 results presentation, said it left behind R37.6bn in rail revenue, a hefty figure considering Transnet Freight Rail's (TFR's) reported revenue of R34.2bn.

The obvious benefits of rail reform are higher employment, higher tax collection and a stronger rand. But how will this work?

Rail reform is a similar concept to the structure of South Africa's major toll roads. The road is owned by the government, the management of the toll road is outsourced to an operator such as Tolcon on the N3 – which, in turn, allows vehicle owners to use the road on condition they pay. Rail reform is not privatisation. The government maintains ownership of the asset but outsources the management of the asset to allow higher utilisation.

The rail reform process began when the department of transport published a white paper in March 2022 on national rail policy. The department, at the time led by Fikile Mbalula, highlighted the issues at Transnet: "The foregoing challenges have resulted in uncompetitively positioned, ineffectively equipped, operationally inefficient railways that have lost their ability both to dominate local logistics and mobility markets, and to support global exports."

This white paper was approved by the cabinet on March 23 2022. It remains the key blueprint.

The pace of reform continued. On October 31 2023, Transnet split the track infrastructure from the rail operating company. The new entity was called Trim, which stands for Transnet Rail Infrastructure Manager. As the name indicates, it will manage, operate, and maintain the Transnet rail network infrastructure. In addition, six rail regulators were appointed to the board of the Economic Rail Regulator – which will set toll fees, compliance requirements and penalties. In March this year the draft Network Statement was published. This is a brochure for potential rail operators, laying down the requirements to operate and the costs of accessing the network. Written responses to the draft have now closed and the Economic Rail Regulator is convening workshops this month to cover the areas of concern.

These concerns centre principally on price. The industry was looking for 8c-10c a ton per kilometre net weight, but the draft published 19.79c a ton per kilometre gross weight. Policymakers and Transnet generally agree that this figure will be lowered with the final decision sitting with the Economic Rail Regulator, who needs to balance the existing debt and track maintenance requirements with the need for a cost-effective logistics requirement to boost the struggling economy.

Stakeholders agree that government

rail policies are best in class. What's frustrating is the pace of implementation. Thousands of people across the mining sector have been retrenched as mines have scaled back operations because they were unable to move their products. This is why the National Union of Mineworkers and rail union Uasa have publicly endorsed rail reform.

Brazil is a case study to understand what is about to unfold in South Africa. The Brazilian state rail operator, in which Transnet owned a stake, collapsed in 2008. The Brazilian government invited the private sector to step in and assist with logistics. Rumo Brazil, a rail logistics company, was quickly able to source and rebuild old locomotives in the US and could begin operations in six months.

Today Rumo Brazil is listed on the Brazilian Stock Exchange with a market cap equivalent to R142bn, with revenues equivalent to R40bn and 51% earnings before interest, tax, depreciation and amortisation (ebitda) margins.

This is what makes bulk commodity rail logistics interesting for investors. Margins are high in the 40%–50% ebitda range, with even TFR margins in the mid-40s in the years before state capture.

Barriers to entry are high. Much like running an airline, rail is highly regulated, needing qualified staff and requiring hefty balance sheets to finance rolling stock. In addition, where a truck is financed over five years and lasts marginally longer, a locomotive is a 30-year-plus life asset. Many Transnet locomotives are more than 50 years old.

This is why listed rail businesses trade at high earnings multiples, with Rumo on a 54 multiple and Canadian Pacific on 26, along with BNSF Railway, which is one of Warren Buffett's largest business units in Berkshire Hathaway. Locally, the only exposure to rail is through JSE-listed Grindrod, which runs extensive rail operations in Mozambique, Zimbabwe, Zambia, Namibia and Sierra Leone. In time rail company Traxtion may list on the JSE as it raises capital to build its fleet.

The most frequently asked questions are about the state of the track and cable theft.

Rail infrastructure needs to be viewed as three different buckets. The first and most profitable is the heavy-haul bulk commodity and high-volume lines carrying coal, iron ore, manganese, chrome and containers. The second is the low-volume branch network, where volumes make maintenance difficult to fund. The third is passenger rail corridors through urban areas, which have been extensively plundered. Passenger rail requires high subsidies and needs to be state-managed.

With regard to cable theft, the private sector won't purchase electric locomotives that are reliant on overhead copper wires. Heavy-haul commodity rail corridors in the US and Australia use locos powered by diesel and liquefied natural gas. This obviates the copper theft issue.

Undoubtedly the rail network requires many billions of rand in maintenance catch-up.

But on these high-volume corridors it's easily funded. Consider that the coal corridor, with a capacity of 81Mt at 10c a ton per kilometre, would earn R4.8bn in toll fees annually (R60 a ton, very reasonable when compared with road tolls). Of this, possibly R2bn would be needed to finance the existing Transnet debt, leaving R2.8bn in maintenance capex.

Maintenance backlogs are normally reflected in train speeds. Consider that speeds on the iron ore line average 30km/h and that the design speed is 90km/h. The implications of operating at design speeds are significant. And technology has advanced rapidly from the days of red and green control lights. Modern tracking technology could significantly increase corridor capacity when this capex starts to deliver.

With rail infrastructure unbundled out of Transnet Freight Rail (now named TFROC, for Transnet Freight Rail Operating Co) the question is: what is the future for Transnet and its enormous debt?

Rail reform is a similar concept to the structure of South Africa's major toll roads

TFROC will remain relevant for many decades. The quantum of commodities to be moved will require the building of assets that will cost many billions. But Transnet's source of earnings from rail should increase with the train operating company delivering ebitda of R6.7bn, adding toll fees estimated at between R8bn and R13bn and leasing from the idle rolling stock fleet of 58,462 wagons estimated between R1.2bn and R1.8bn.

TFR carries R63bn in debt, placing net debt to ebitda at 9.4 – which explains why financial institutions are reluctant to lend without a shift in business model. The new management team led by Russell Baatjies is highly regarded and is already showing positive signs of a turnaround. But the debt remains a tremendous problem. Fortunately there are solutions.

Rail reform could be a huge win for all stakeholders and for every South African. The obvious beneficiaries are mining houses such as Thungela, Exxaro, Afrimat, ARM and Kumba – which would all greatly increase bulk commodity volumes.

Another is the National Treasury, where many billions of rand in additional taxes will be collected, which is why the Treasury is insisting on rail reform as a prerequisite to any Transnet bailout. Construction and ballast suppliers will benefit from a further R10bn in annual rail capex. Grindrod and privately owned Traxtion are the two service providers with experience, rolling stock and workshops to pick up the slack.

Should employment increase across mining houses there will be more tax funding available for politicians' pet projects. Higher exports strengthen the rand, which lowers inflation. This benefits every South African.

Concern will be raised for the trucking industry, but keep in mind trucking steam coal was viable only when steam coal traded above $150/t, because trucking costs three times more than rail. Under normal market circumstances it's not viable to truck steam coal, iron ore and timber in the volumes and prices required.

As fast as rail reform is moving, it remains too slow for the stagnant economy. South Africa desperately needs Grindrod and Traxtion to be using our rail networks, as soon as possible. ✖

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