THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Rail and Toll NZ

Date:	5 September 2007	Treasury Priority:	High
Security Classification:		Report No:	T2007/1710

Action Sought

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Minister of Finance (Hon Dr Michael Cullen)	**Note** the risks with the ONTRACK proposed strategy; and **Agree** to include several points in the acquisition strategy.	ASAP

Contact for Telephone Discussion (if required)

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Enclosure: **No**

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1. We understand that the Government has taken a decision to purchase Toll NZ in its entirety from Toll Holdings (with the intention of subsequently on-selling the trucks). In doing so, we understand that Ministers see this as the best way of resolving the long-running concern that Toll NZ is not only failing to fulfil its obligations to pay the full cost of the track but also is failing to make any investment in new rolling stock.

<u>Change of ownership will not remove rail's problems</u>

2. Regardless of ownership, some form of ongoing government subsidy will be required to retain existing services. As we have reported previously, there is no prospect of a rail operator being profitable if it continues to operate a nationwide rail service transporting a range of goods. We have identified several key problems with the rail freight business in New Zealand: few routes are commercially viable; it faces high fixed costs and has difficulty competing with ships; it is not really a "network"; and investments in new rolling stock are uneconomic.

3. Returning ownership of the assets and full control of the railways to the Government will not remove these fundamental problems.

   - Most of rail is in long-term decline in New Zealand. That is not a result of particular ownership structures, or of lack of "vision". It simply reflects that fundamental economic pressures (competition from road and shipping; demand for faster service) have been steadily impacting on rail.

   - Government ownership will provide greater control over rail decisions without the need to negotiate with Toll and rely on it to deliver. But it would also bring the Government closer to rail's problems and make it more accountable for them.

   - Acquisition risks paying too much for the rail business as the current subsidies will be capitalised into the share price demanded by Toll.

4. Purchasing Toll NZ therefore risks costing the Crown significantly more than continuing to subsidise it and adopting other measures to support rail.

<u>Risks with the strategy as proposed by ONTRACK</u>

5. We understand the acquisition strategy proposed by the ONTRACK board is for you to make a "take it or leave it" offer to Toll Holdings for the purchase of all of Toll NZ. In the event that the offer is declined, ONTRACK proposes that the government should declare that all negotiations are therefore concluded and that the full access charges and obligations under the NRAA will now be fully enforced.

6. Our overall concern with this strategy is that if Toll Holdings rejects the offer, there is no credible fall-back strategy for the Crown. Although we do not know Toll Holdings attitude towards its New Zealand investment, we think it will be a reluctant seller of the whole business with consequent effect on the price. In summary, we think:

   - Toll would likely reject the offer as framed by ONTRACK's paper because it will see it as being both insufficient on price and contrary to Toll's wider business strategy intentions in NZ; and

   - ONTRACK's proposed tactic at that point of enforcing the NRAA would not lead Toll Holdings to backdown as Toll NZ would still be profitable in the short term of one-to-two years.

<u>Toll is under little financial pressure to sell</u>

7. As Toll is currently earning a comfortable cash flow from its New Zealand operations, its present strategy appears to be to retain the customers and the cash flows while avoiding having to invest capital into the business. (This would explain its suggestion that the Crown buy its rolling stock and some of its other physical assets and lease them back to Toll NZ as rail operator. The risk of the capital intensive nature of the business would effectively be transferred to the Crown, while Toll NZ could continue to have the benefit of the customer contracts.)

<u>Toll therefore likely to be an unwilling seller</u>

8. Ultimately, if the price on offer is high enough Toll Holdings will sell. But we think it will be reluctant because it is contrary to its overall strategy, and would also, we understand, represent the first time anywhere it has sold a major asset it has acquired. Moreover it is demonstrating every intention of building on its New Zealand presence – it has bought out the minority Toll NZ shareholders; in trucking it is looking to expand by purchasing more trucks and/or a competitor's business; in port facilities (it owns a Tauranga stevedoring company); and most recently, with the entry of Pacific Blue, aviation. It would however like to relieve itself of the need to invest capital in its New Zealand rail business.

<u>Enforcing the NRAA unlikely to work quickly</u>

9. Enforcing the full provisions of the NRAA and charging Toll the full TAC and WACC and depreciation on renewals is very unlikely to move Toll Holdings swiftly to sell. This is because, in the short term of the next one-to-two years, the extra amount the NRAA would cause Toll to pay would lower, but not remove, Toll NZ's profitability. The cash flows would remain positive and Toll would continue to fail to invest any new capital on rolling stock.

10. This assumes that Toll wishes to retain relatively good relations with the Government. It could alternatively choose to pressure Ministers by closing services on a few of its least commercial routes, without incurring any material adverse financial consequences. Toll may also seek to place Ministers in the position of having to explain to the public why the Government had chosen to make an offer which Toll's board had found too low, and why the Government had then jeopardised rail services by withdrawing its interim agreement to cap the TAC and capital repayments at $54 million.

11. Whatever Toll's response, unless the Government has additional negotiating positions, the impasse would last until such time that the WACC and depreciation payments really start to bite on Toll NZ's profitability.

12. Accordingly, the acquisition strategy advised by ONTRACK runs a major risk of failure, and has the potential not only to strengthen Toll's hand in demanding further subsidies next year but also of leading to a more acrimonious relationship with Toll.

<u>Government's objectives</u>

13. We understand that your three key objectives from these acquisition negotiations are:

- To buy all of Toll NZ (rather than just some assets Toll Holdings may wish to sell to us);

- To complete the transaction for a realistic price; and

- To have the substance of the transaction, and any substantive disputes with Toll about it, resolved before the end of calendar 2007 (ie over the next four months).

14. We expect that there will be major trade-offs between these objectives. To achieve a purchase price you may consider reasonable (e.g. less than $3 a share) for the whole of Toll NZ is likely to require a sustained period of negotiation and almost certainly could not be settled in 2007. Alternatively, to achieve an agreement in 2007 is going to require you to compromise on the price and/or the composition of what is being acquired.

15. We understand that of the above three objectives, the Government is most prepared to compromise over price. In order to develop a negotiation strategy, it would be helpful for your agents to have confirmation of this.

<u>Timing for completion</u>

16. The timing of a successful transaction is largely in the hands of Toll Holdings. If Toll is frustrated with its New Zealand venture and is looking for an early exit, then the only real debate will be over the price and agreement should be able to be reached quite quickly (before the end of 2007). If, however, Toll sees its New Zealand business as part of an integrated transport and logistics network, it will likely seek to hold onto at least the customer relationships and contracts and the ferries, leading to a protracted negotiation which is likely to carry on into 2008.

17. You should also be aware that the transaction will fall into three phases: agreeing the basic shape and terms of a sale (this is the hardest and likely to take the most time); agreement in detail and legal drafting of the agreement; and due diligence. While it may (just) be possible to reach agreement over the basic shape of the sale by the end of December 2007, the consummation of the deal (drafting and due diligence) will almost certainly stretch into 2008. There is always the risk that a provisional agreement will unravel during these subsequent phases.

Key measures in initiating the acquisition process

18. In initiating the process, we suggest the following measures.

- **Engage expert external advisors early**. The advisor selection process itself may shed light on what a realistic sale price might be (through the proposal they forward and the structure of their fee and reward incentives). Once a firm of advisors has been appointed, it is recommended that they begin by making discreet enquiries with Toll Holdings in Melbourne as to how interested it is in selling Toll NZ and on what terms. This information should contribute towards framing an offer which can keep Toll interested in talking further.

- **Keep your personal involvement in the negotiations in reserve**. ONTRACK envisaged you making the offer in person to Toll Holdings. While your personal involvement will be necessary towards the end game of the negotiations, it would be unwise to initiate talks in that way. Normally, principals intervene once it is clear that a deal can be achieved and its basic shape is largely in place. Principals tend to broker the final agreement over, for example, the final price or specific unresolved details. Involvement too early in the negotiation process could compromise your ability to intervene effectively at this late stage.

- **Do not produce a bottom line as an opening position.** It is axiomatic in any negotiation that the parties will want to leave room to manoeuvre as talks progress. Putting a "final offer" up too soon can leave a party with one of two unpalatable options: either to walk away or be ratcheted way above the price they had initially contemplated as their limit.

- **Equally, ensure that the initial offer is sufficiently pitched to keep Toll interested in talking further.** Any offer needs to be seen by the other side as being realistic, otherwise there is a risk that it will feel it is being treated with disrespect.

- **Have somewhere to retreat to if a sale proves impossible (i.e. a fallback position).** As mentioned above, unfortunately we do not think ONTRACK's alternative of enforcing the NRAA is credible. Consequently, we think that the Government must have in mind a temporary solution that would last for at least two years if the acquisition strategy fails.

  There are several possibilities, some of which we have reported on previously. None of them is totally satisfactory and most of them would have a limited shelf life. One possibility however would be for the Government to commit to maintaining the current level of TAC subsidy for a period (say two years) while also agreeing to support the purchase of new rolling stock for Toll NZ.

- **Take care around the fact that Toll Holdings is still buying out minorities in Toll NZ,** and in particular the provisions of any agreements Toll Holdings might have with minority shareholders. Toll NZ will remain listed on the NZX until the buy out is cleared by the Overseas Investment Commission.

- **You might also discuss with the ONTRACK board the implications for the board and management of a substantially changed ONTRACK after acquisition.** For example, a larger and more diversified company may require a strengthened board and additional management expertise.

19. Given the commercial sensitivity with this project, we have restricted the distribution of this report to your office. You may however wish to share this report with your Associate Ministers.

Recommended Action

We recommend that you:

a. **Note** that the deep-seated problems with rail will remain regardless of ownership;

b. **Note** the risks with the acquisition strategy as proposed by the ONTRACK board; and

c. **Agree** that the acquisition strategy should include the need to:

- Engage expert external advisors early
- Not produce a bottom line as an opening position
- Ensure that the initial offer is sufficiently pitched to keep Toll Holdings interested in talking further
- Keep your personal involvement in the negotiations in reserve until the decisive stages
- Have a fall back position worked out in advance
- Note that Toll Holdings has yet to complete its buy out of Toll NZ

Agree / Disagree

d. **Agree** to discuss with the Chair of ONTRACK the implications for the board and management of a substantially changed company after acquisition.

Agree / Disagree

John Wilson
Director
for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance