From: John Wilson
Sent: Friday, 10 August 2007 11:35 a.m.
To: ^MOF: Chris MacKenzie
Cc: Robert Barton; Stephanie Ward
Subject: Rail: Advancing an outcome
Attachments: 993764_2.DOC

Chris

Attached is the note on rail rolling stock we've been promising.

Does this look like a useful way forward. We should review all this after our Monday night discussion.

John

Rail: Advancing an Outcome

Over recent months Treasury and Toll NZ have been exploring options for a stable long-term future for rail freight in New Zealand. The options being explored all involve the Crown in future owning more of the assets of the rail system than it does at present.

The central option in the discussion with Toll NZ has been one that involves the Crown purchasing the rail rolling stock and the rail lease, and granting Toll NZ a franchise to operate the freight and long-distance passenger rail systems for ten years. At the end of that 10 year period the Crown would be free to select a franchisee to operate the rail freight and long-distance passenger system. (The “franchise option”)

In the meantime we understand ONTRACK is writing to you seeking to discuss other options for the long-term future of rail freight. While we have not seen ONTRACK’s proposal, based on previous discussion with them we expect it will reflect a preference for a more extensive Crown role in owning rail assets, and for less fragmentation in the rail industry.

One potential approach along these lines would be for the Crown to purchase the rail assets and then operate them as an integrated business with the rail track. (The “purchase option”)

In any case choosing a precise direction among these approaches will take some time, and negotiating and implementing any of these approaches satisfactorily, and at a realistic cost, will also take some time. Later sections of this paper set out some of the challenges with either of these approaches.

<u>Present Situation</u>

The situation at present is relatively stable, but probably not sustainable in the medium term. Toll NZ is at present paying a concessional track access fee of $54 million a year, with the proviso that it must continue to negotiate in good faith with the Crown, and continue to operate the full range of services it currently operates, to be eligible for that concessional access fee. That access fee is most likely less that Toll NZ could afford. There should be no near-term threat to rail services, but in the longer term the quality of the rail service will erode as the quality of the rolling stock erodes.

<u>A Possible Next Step</u>

The Crown could minimise this medium term risk by buying some new locomotives and rolling stock and leasing them to Toll NZ. That would involve agreeing the following with Toll NZ:

- *The number and type of rolling stock and locomotives to be purchased, and the price and timing of purchase payment*. This would include clarifying who specifies the locomotives and rolling stock. Toll NZ’s view, which Treasury largely shares, is that it would make most sense for Toll NZ to specify and choose the number and type of locomotives and rolling stock, with the Crown simply having a right of veto over any locomotives and rolling stock that it deemed not worthy of long-term financing. We understand that would replicate the kind of arrangements commercial lessors of aircraft and rail rolling stock have with lessees. A more hands on Crown role in specifying the number and type of rolling stock would be more difficult and slower to negotiate with Toll NZ.

- *The basis on which Toll NZ would lease the locos and rolling stock from the Crown*. (Including rate of return, depreciation, provisions for maintenance, length of lease term; end of lease provisions). The logic of such a transaction is that it would offer Toll NZ concessional finance, thus making operation of new locomotives and rolling stock commercially viable.

- *Whether the parties would agree that such a transaction would foreshadow a future broader transaction, or whether alternatively the parties would leave that open*.

The Crown would need to decide what Crown agency would hold the rolling stock, be responsible for receiving Toll NZ's lease payments on the rolling stock, and ensure that Toll NZ was meeting the maintenance requirements of the lease. To the extent that the lease was largely a financial agreement, the skills required are largely financial/banking related. To the extent, on the other hand, that the agreement involved detailed Crown involvement in specifying the rolling stock, technical rail skills would be much more important.

Such a step would not rule out, or even make significantly more difficult, any of the broader options for the future of rail freight. The most significant risk is that, to the extent new (and thus more reliable and economical) rolling stock and locomotives improved the return from Toll NZ's business, that improved return would be reflected in the price that Toll NZ expects for the substance of its current (and overvalued) rail assets.

There is of course a risk that, if the current $54 million a year access charge were to be entrenched, and with a new set of locomotives and rolling stock, there would be little continuing pressure from Toll NZ for a more comprehensive agreement around the future of rail freight in NZ.

<u>Broader Transaction I: the "franchise option"</u>

Of the two broader transactions referenced above, the "franchise option" would present the following challenges:

- Toll NZ revalued its existing rolling stock to reflect the price its parent paid for the NZ business. That price does not, in Officials' view, reflect the commercial value of the assets. Resolving that will be difficult.

- The "franchise option" would leave Toll NZ as owner and operator of the Interislander ferries, and as owner of the Tranzlink trucking business and thus holder of some important freight contracts, including the Fonterra contract. This would be difficult to manage, and would severely constrain the capacity of the

Crown to allocate the rail freight franchise to a party other than Toll at the end of the first term.

- There are a number of problematic assets that would pass back to Crown ownership as part of such a transaction (the Hillside workshop is the most obvious example). Although they would be franchised back to the rail operator, the Crown would be increasing its responsibility for them.

- There would be a good deal of detail to work through about the extent to which the Crown's role in this transaction simply replicated a financier leasing rolling stock (e.g. the GATX role in leasing rolling stock to Toll NZ), or if it was acquiring a more hands-on role over the number and type of rolling stock Toll would be operating, and the deployment of that rolling stock.

The "franchise option" would provide a vehicle for new investment in locomotives rolling stock. It would leave operation of the commercial aspects of the railway with Toll NZ in the medium term. It would not provide the Crown with materially more control over what services the rail operator delivers than it has at present.

<u>Broader Transaction II: the "purchase option"</u>

The "purchase option" would present the following challenges:

- The valuation issues inherent in the franchise option would remain. In particular Toll would be seeking to secure its book value for the existing rail assets, which in Officials view is substantially in excess of the commercial value of those assets.

- Beyond that, Toll is not an enthusiastic seller of its New Zealand business, and that would be reflected in any price that could be agreed. Toll probably sees the rail business as delivering the core of its NZ ambitions. Rail enables Toll to deliver greater freight volumes and thus secure more significant cash flows. If Toll sold to the Crown the rail business, but not the Interislander ferry business or the Tranzlink trucking business (thus excluding some major freight contracts), the Crown would face major additional challenges maintaining the viability of rail freight.

- The Crown would be reassuming direct responsibility for a number of problematic assets (e.g. the Hillside workshops) which appear to be material medium-term liabilities.

- The Crown would clearly not be taking ownership of the rail operating system for commercial reasons. That would raise 3 issues:

    - Clearly the integrated rail system would need a considerable amount of Crown funding, and so it would need to be structured as an organisation with mixed objectives. A stand-alone SOE would not work.

    - Secondly, the fact that the Crown had committed to rail for non-commercial reasons would encourage various rail stakeholders to press for the Crown to fund rail projects of benefit to them.

o Thirdly, the Crown's various objectives in owning the rail business might divert rail from a more single-minded focus on providing the services rail customers require.

- Toll Holdings has recently agreed to buy out the minority shareholders in Toll NZ for $3 a share. If the Crown were able to buy Toll NZ for $3 a share (which of itself is unlikely) it would represent a gain (over the original purchase price) of almost $400 million for Toll Holdings, [withheld under section 9(2)(g)(i)].

Conclusion

Either of the broader transactions would take some time to negotiate and agree. On the assumption that the Government wishes to see new rolling stock acquired sooner rather than later, as an interim step we could explore with Toll the option of financing new locomotives and rolling stock. This step is in any case likely to form part of any broader agreement with Toll.