From: John Wilson
Sent: Friday, 11 May 2007 3:52 p.m.
To: ^MOF: Chris MacKenzie
Cc: 'William Peet'; Robert Barton; Stephanie Ward; Kwok, Ivan
Subject: Potential Agreement with Toll: Structural Issues
Attachments: 966524_1.DOC

Chris

Attached is the note we promised a few days ago which covers structural issues and options in any agreement with Toll, in particular around issues of control. We have worked it up with the help of Ontrack. Blame for the darker shades should be given to Treasury.

We're conscious the Minister is tied up with Budget issues. Over to you how best to get any feedback from him.

John Wilson

Potential agreement with Toll: Structural issues

We have been discussing with Toll NZ an option under which the Crown would own rail rolling stock, and the rail lease would be replaced by a shorter term franchise granted to the rail operator, with Toll NZ having the first such term as of right.

The following notes set out some of the questions that have arisen around the structure of any such transaction, and in particular around the day-to-day role that Crown agencies would have in the rail industry.

This note has been prepared by Treasury in consultation with ONTRACK and gives some choices about the Crown's future involvement in rail. While in some cases there are clear distinctions between the views of Treasury and ONTRACK, this does not reflect any problem in the working relationship between the two organisations, which remains excellent. It reflects rather some major choices about the direction for Crown involvement in rail freight, which should be made at the ministerial level.

There are complex contracting issues involved in establishing most of the provisions set out below. This has implications both for the length of time to reach any final agreement, and for the range of difficulties that could arise during a contract term. We recognise that this process of finalising an option will be iterative as we have not modelled fiscal consequences to the Crown or Toll in any detail.

The original trigger for this prospective transaction was the desire to ensure that new investment in rail rolling stock in fact takes place. Toll currently has around 200 locomotives. Their intention is that as a result of this transaction, 70 of those locomotives would be replaced by 30 new locomotives, and there would be a corresponding purchase of new wagons. The total capital cost would be around $200 million.

However, Toll is also seeking Crown funding for its existing rolling stock (either in terms of a purchase, or a guaranteed return on assets as part of the access charge regime). Toll revalued that existing rolling stock from around $200 million to $400 million to reflect the price it paid for the business. It is seeking that higher value as part of any agreement that either settles access charges for the long term, or that passes ownership of all the rolling stock to the Crown. In Treasury's view, unless Toll moves from that position, that $200 million margin would be too high a price to pay.

Toll is attempting to use the transaction with the Crown as part of a process of selling the substance of its New Zealand assets while retaining the cash flows. (We note they are also planning a sale and leaseback of the Aratere ferry). The danger is that the Crown will facilitate such a transaction on commercially generous terms.

The options below include a number of approaches which involve the rail operator (Toll in the first instance) giving up some control of its NZ freight business. In general Toll sees itself as more efficient than a Crown agency, and so will resist any such loss of control. Significant loss of control by the rail operator of its business will only be achieved at a price paid elsewhere in the agreement.

Rolling stock & rail ferries

Q1 How much of the rolling stock should the Crown own?

There is general agreement that the Crown will need to purchase any new locomotives and rolling stock, and make it available to the rail operator. If the Crown does not do that there is no prospect of new rolling stock and locomotives being bought. There are however questions around the approach to the existing rolling stock. The Crown could either purchase it, or could leave it in Toll ownership. The following are the issues:

- While ownership of the new rolling stock ensures that such rolling stock is in fact bought, ownership of the existing rolling stock would provide only modest gains in confidence in rail investment. (ie the Crown would be more likely to spend on rolling stock refurbishment).

- Toll revalued its existing rolling stock from a little over $200 million to over $400 million. Toll is at this stage adamant that in any sale it would require that book value in payment. It is difficult to justify that. Toll's current view is that any long-term access charge agreement should be built round a commercial return on those asset values. In other words agreement on the value of Toll's existing assets is difficult to avoid at present if the Crown is either to purchase those assets or establish anything beyond a very short term agreement on access charges. In the event that Toll keeps the existing rolling stock, it will seek a set of access and lease charges that assure it of an adequate return on capital, using the revalued assets as a base.

- Splitting responsibilities for asset management is generally problematic as maintain/scrap/refurbish/renew decisions tend to be gamed around ownership rather than overall efficiency, so if the Crown owns the new rolling stock, and Toll owns the existing rolling stock, it is unrealistic to contemplate the more hands-on of the operating models outlined below.

- On balance Treasury concludes the Crown should restrict its spending to new rolling stock. This avoids such a large up front cash payment, and leaves open the possibility of acquiring the remaining rolling stock at a more realistic price later. ONTRACK believes the Crown should purchase all the rolling stock (on the basis that it will have to pay for it through one avenue or another).

The Crown should restrict its spending to new rolling stock. **Or**	Yes / No
The Crown should purchase all the rolling stock.	Yes / No

Q2 What role should the Crown have in management of rolling stock?

There are essentially two options for future management of Crown owned rolling stock. Either the Crown could be an arms-length financier of rolling stock to the rail operator, with the rail operator having full control of the rolling stock for the duration of the franchise term, or the Crown could have a contract for services with the rail operator under which the Crown agreed to make available rolling stock as needed by the rail operator. The issues are:

- A pure leaseback leaves the rolling stock in the hands of the rail operator, who has direct relationships with the rail customer, and leaves rolling stock deployment to be commercially driven.

- A more hands-on role for the Crown would strengthen the Crown's hand in the event the franchise relationship turned sour, and would provide the Crown with a stronger information base for re-tendering the franchise at term-end.

- The contract for services approach, which would involve a Crown agency managing and maintaining the rolling stock, could only be realistically achieved if the Crown bought all the rolling stock.

Treasury's view is that the "service contract" option is more difficult to contract for (and more prone to disputes) and by distancing the freight operator somewhat from rolling stock availability is more likely to lead to an inefficient rail freight system.

Leaseback option.	Yes / No
Service contract option.	Yes / No

Q3 What provisions should be made about the rail ferries?

The 2 rail ferries are a key part of the North-South rail link. Growth in Auckland-Christchurch inter-modal traffic would require a rail ferry service. The economics of rail ferries are such that new ferries will almost certainly only be purchased with government support. The existing rail ferries will not need replacement within the first franchise term. However, substantive growth of traffic would require additional rail ferry capacity. The choice at this stage is whether the Crown owns and manages the rail ferry capacity in the same way it owns and manages rail rolling stock capacity as part of this transaction, or simply secures a call option over the rail ferries and a set of rights that provide assurance that it may purchase and arrange independent operation of additional rail ferry capacity in the meantime should that be needed.

The issues covered under Q1and Q2 equally apply to ferries and rolling stock.

Treasury believes that a "call option" over the rail ferries, and a set of terminal rights that assure the Crown's ability to purchase and arrange independent operation of additional rail ferry capacity, is sufficient and avoids the risk to the Crown from bringing the rail ferries into what is a non-commercially motivated transaction. Moreover, there is no pressing need to address the ferry issue now, and an attempt to do so will be resisted by Toll.

ONTRACK believes that purchasing the right to manage rail ferry capacity and the Clifford Bay port development site, as part of this transaction, would remove Toll's power over a choke-point in the development of the rail system and NZ logistics. The operation of the ferries would be tendered out.

Regardless of the choices on rail ferries, it is essential that any Crown subsidy does not distort the current competitive market operating for passengers and commercial vehicles.

A "call option" over the rail ferries and a set of terminal access rights that assure the Crown's ability to purchase and arrange independent competitive operation of additional rail ferry capacity.	Yes / No
Purchase the rail ferries and the Clifford Bay development site as part of this transaction, and tender out the rights to operate the rail ferries	Yes / No

Allocation of track time slots

Q4 Should the Crown take back the right to allocate track time slots?

Under the NRAA, Toll has the right to allocate time slots 3-6 months ahead for use of the track ("pathing"). ONTRACK manages the time slots on a day-to-day basis. The logic of that was that Toll is the exclusive freight operator (and the Wellington metro operator), and so is in a better position than anyone else to prioritise track use. In contrast, while a little untidy in the mechanics, in the Auckland metro area each party (Toll, Veolia, ONTRACK on behalf of heritage operators and ONTRACK as maintainer and developer) submits a desired timetable and slots to ONTRACK about 3-6 months in advance. ONTRACK then identifies conflicts and seeks to unlock additional capacity or move slots around to optimise the network.

The issue is whether as part of this transaction, the Crown should take back the right to allocate track time slots as per Auckland, or whether the right to prioritise should be left with the rail freight operator. In other jurisdictions the track operator normally has this right, but that is in an environment where other major rail users are at the least being enabled.

In the medium term Toll remains the only freight operator, and the operator for Wellington metro.

The Crown having control of the track time slots would give the Crown some more leverage in the event that the franchise relationship went sour mid-term. In Treasury's view this gain is minimal.

On the other hand giving the Crown control of track slots would move that control away from the freight operator, and would run the risk of focusing track priorities on track improvement per se and on relatively marginal operators rather than on the freight service itself.

Treasury's view is that, provided provision can be made for a future non-Toll Wellington metro operator, leaving the path allocation with the freight operator is the best option.

Rail freight operator retaining allocation of track time slots	Yes / No
Crown taking back this right. (ONTRACK preference)	Yes / No

Workshops

Q5 How should the rail workshops be treated?

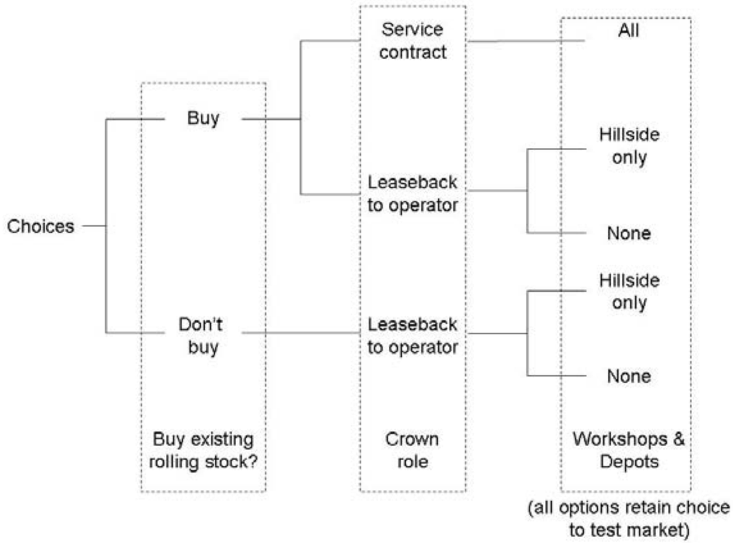
At present Toll operates its Hillside workshops, and contracts out management of its Hutt workshops. There are also a set of depots that carry out more routine maintenance and component change out. In the world post the proposed transaction, the Crown would be a major customer for the outputs of the Hutt and Hillside workshops (ie they would be either building or refurbishing rolling stock for the Crown as owner or for substantively Crown-funded metro operations). The workshop operator does not have enormous pricing power for new rolling stock builds or major refurbishments, since for many of these tasks there is finely priced international competition. Purchase of the workshops and depots is an option rather than a requirement, and there are some integration issues at the margin. The options are to:

- o Purchase the workshops and depots, and lease them to the rail operator (Toll in the first instance) to manage as they do today.
- o Purchase the workshops and depots and run a tender process to determine whether it is efficient to outsource the functions (where it has not already been contracted out).
- o Purchase the workshops and operate through a government agency
- o Not offer to purchase the workshops and depots at this stage. (noting that, once again, Toll will be seeking book value for these assets, which we expect will be in excess of realistic commercial value)

Treasury's view is that we should not offer to purchase the workshops and depots at this stage.

Interaction between Asset decisions

While the various asset decisions are independent, there is a logical set of links between the various issues as outlined below.



Conclusion

None of the options is particularly stable in the medium.

A full transfer of rail assets at book value would be a very high price to pay for some increased leverage over the rail business, and the possibility of a longer lasting agreement.

A simpler option would be to reach a pragmatic agreement on the TAC, and to agree to buy and leaseback new locomotives and rolling stock. This is unlikely to be a long-run solution. But a clear message from the Crown that it cannot pay Toll's book value for the rail assets might (eventually) encourage Toll to look at the value and structure of any transaction in a different light.