From: John Wilson
Sent: Friday, 15 December 2006 10:05 a.m.
To: ^MOF: Chris MacKenzie
Cc: William Peet; Kwok, Ivan; Robert Barton
Subject: Briefing Note for rail meeting with MoF
Attachments: 924119_1.DOC

Chris

Attached is a briefing note as background for any meeting we get with the MoF on rail isseus.

The note:

- Summarises where we have got to in discussions with Toll
- Canvasses some of the related policy issues
- Makes some recommendations on next steps.

The note is from Treasury. Ontrack have been informally consulted, but they may have some additional perspectives.

John Wilson

Rail: where we're at; possible paths forward

Discussions with Toll

Discussions with Toll on "Option 2" have reached the following point:

Toll argued strongly that it did not need Crown finance to purchase new locomotives and rolling stock; and that it did not want anyone else owning the locos and rolling stock it used. We therefore explored a version of Option 2 with Toll purchasing its own new rolling stock and locomotives. As developed this has the following features:

- Track Access Charge (TAC) is set to provide Toll NZ a 12.5% pre-tax return on assets.
- The base values for calculating this return include Toll's asset values that were written up to its purchase price.
- The agreement would be for two successive 5 year terms
- The purchase of new locomotives and rolling stock is assured by a bond to the value of the new locomotives and rolling stock, backed by a financial institution, that can be cashed by the Minister of Finance in the event the locos/rolling stock are not delivered and commissioned within a reasonable timeframe.
- Nationwide freight service is assured by
    - Contractual agreements for service (as part of the agreed subsidy) for the Napier –Gisborne; Northland and Hokitika lines
    - A use it or lose it arrangement for the rest of the network that consolidates track segments into large groups and links one commercially strong segment with one weaker one of similar scale; loss of exclusivity on one would trigger loss of the other.
- For long distance passenger, Ministers would have the choice of either:
    - Open access immediately for all services other than the TranzCoastal and the TranzAlpine. Or
    - A Crown agreement with Toll to operate the 3 existing services in the interim; Crown purchase of rebuilt rolling stock; tendering for a hook and pull operation and for management of the long distance passenger system.
- General acceptance that any new operator legitimately allowed onto the track (e.g. as a result of loss of exclusivity) should be able to carry freight to/from its final destination,
- A better arrangement for fair pricing for freight forwarders (e.g. Mainfreight)
- There are some unresolved issues around the RFR over services on new links. Toll raised the concern that loss of this RFR would potentially raise the potential of inadvertent open access. Officials view has been that if Ministers want open access we would seek that openly.
- Wellington metro access rights would revert to the Crown immediately, with the existing agreement with the GWRC being protected through its 10 year term.
- A general tightening of land provisions; Toll would lose its place on the ONTRACK board.
- A level of separation between the rail and non-rail businesses inside Toll though this is by no means resolved

In discussions with Toll, Officials have indicated that Ministers concerns about the above are likely to centre on two issues

- A strong reluctance on the Crown's part to fund Toll's written up valuations of its rail assets.
- The fact Ministers were strongly attracted to the "Crown ownership of locos and rolling stock" element of the original Option 2.

Options

Going forward there are 3 options

- Implement an agreement with Toll broadly along the above lines
- Agree a substantially amended approach with Toll
- Abandon attempts to establish a revised agreement with Toll and pursue another option (eg purchase of the company)

Costs

There are three defining cost parameters.

- An agreement which accepts Toll's valuations alongside its proposed 12.5% pre-tax rate of return (e.g. along the above lines) would cost an NPV of $500 to $650 million. This subsidy would be the same whether the agreement is along the lines above, or involves substantial Crown purchase of assets.

- An agreement built round the pre-purchase rail values, but retaining Toll's projected 12.5% pre-tax rate of return, would require a subsidy with an NPV of $280 to $420 million. This subsidy would be the same whether the agreement is along the lines above, or involves substantial Crown purchase of assets. The only way to get Toll to this view of value would be through a prolonged period of withdrawal of support for rail and acrimonious dispute with Toll.

- Leaving rail to find its own commercial base would require no new subsidies.

Any large scale upgrades to the track (ONTRACK has identified some $400 million outside Auckland which is desirable) and capital expenditure on long distance passenger rolling stock (estimated cost of replacing existing passenger rolling stock $40 million) would be substantially non-recoverable from rail users and in addition to the above subsidies.

Rail policy brief summary

- The public want a strong freight railway and are prepared to pay through the tax system for it

- About a third of the rail freight services (by line length) are commercially viable and the remainder have little prospect of becoming so. The cost of keeping freight services on minor lines operating is small compared to the subsidy required to keep the Auckland-Christchurch rail freight route operating.

- In an environment of rising concern about climate change, closure of substantive parts of the rail freight system is not a realistic option.

- The level of subsidy required to keep rail freight in operation would mean that rail was covering substantively less of its costs than road freight covers. i.e. we would be well beyond road/rail balance.

- Over the last 25 years freight rates have substantially decreased. Over the same period rail has lost market share, particularly in the intermodal area. The major improvement in roading transit times and the effect of greater blue-water shipping competition are the primary causes of that erosion. Rail is in a very difficult competitive market focused on price, timeliness and reliability. Timeliness is increasingly important.

- A large one-off investment in rail should not be expected to turn round rail's long-term decline.

- Well-directed network and rolling stock investment will make rail more competitive than it would otherwise be.

- There's strong desire to limit the number and scale of acrimonious disputes between the rail operator and the Crown.

- Ministers want decisions around pricing, operations, engineering and employment issues to be taken at arms length, but want some level of Ministerial influence over major investment decisions.

- The Crown does not want to fund generous returns on rail operator investment.

- The Crown does not want to subsidise non-rail investments when subsidising rail, particularly when that favours Toll's trucking or shipping operations against competitors.

Corporate Form

As long as the above web of objectives and constraints holds, the following parameters round organisation design will hold:

A commercial rail operator (privately owned or SOE/Crown Company)

- Will tend to under invest compared to what the public want.

- Will be engaged in continuing disputes with the Crown over public policy funding.

- Will have strong incentives to deliver for customers and stem the loss of market share.

- Will have strong incentives to pursue cost reductions and implement capital projects efficiently.

- Will provide Ministers only constrained capacity to influence its investments.

A public policy driven rail operator (Dept or Crown Entity)

- Will invest as per funding provided by Ministers
- Will seek increased investment and public policy funding from Ministers
- Will probably be more focused on what Ministers want than what customers want and is likely therefore to accelerate the loss of market share.
- Will probably be more focused on process compliance than efficiency.

It is probably more realistic to think of Ministers succeeding in layering (albeit imperfectly) a set of public policy concerns over a commercial operator, than the reverse.

Given the scale of the subsidy required to keep rail freight in operation, Ministers desire to specify the detail of some investments, and the fact that Ministers objectives for rail have some inherent conflicts that will appear in quite detailed and specific form, and can only be realistically be resolved at the Ministerial level, it is probably unrealistic to imagine rail returning to corporate form appropriate to a 100% commercial operation (eg an integrated SOE). The more realistic options are either an integrated Crown entity or a continuation of the present part-commercial (operator) part crown entity (track) trajectory.

Process issues

Officials believe they could finalise an agreement with Toll along the lines set out above.

If Ministers wanted to amend the outline to include Crown-owned locos and rolling stock, we do not know precisely what sort of package could be agreed with Toll. Ultimately we expect Toll would not allow an issue of locomotive/rolling stock ownership to stop an agreement being reached. Our impression is that they are relatively open about locomotive and rolling stock financing, but that they would resist any attempts by the Crown to gain leverage through locomotive and rolling stock ownership and they would strongly resist any suggestion of ONTRACK deployment of the locos and rolling stock. There is a risk, therefore, of achieving little more than opening up a new area for subsidy to Toll.

It is not at all clear that at this stage the company could be bought for a realistic price, in a useful structure, in a timely manner and without highly acrimonious dispute.

If Ministers do not want to pay Toll's uprated valuations for rail, Officials believe the only way to change Toll's expectations about the future viability of its business would be to substantively reduce financial support to rail for the short-medium term. Officials assume that is unrealistic.

Toll's restructuring

Toll has announced a planned restructuring that separates its operations into two companies; one based round port and rail assets with lower risk and return and higher debt levels; and the continuing Toll Holdings, with relatively few assets, built round the logistics business, and with lower debt to provide scope for further acquisitions. The plan is that the shareholding in Toll NZ will be part of the continuing Toll Holdings. The implications appear to be:

- Officials expect that Toll's preference would be to have the Toll NZ shareholding in the infrastructure operation, but that without a firm long-term agreement with the Crown over access fees it cannot use Toll NZ to back debt. The restructuring thus increases the Crown's leverage somewhat, but will also increase the pressure on the Crown to settle quickly on a basis Toll likes.

- Toll intends to use the restructuring to abandon its commitment to sell 50% of Pacific National. Alongside their continued holding of the shares in Virgin Blue it confirms they are not generally enthusiastic sellers of their businesses.

- The general approach of the ongoing Toll Holdings (which hold the Toll NZ shares) would be to hold contracts and cash flows rather than assets. It would be consistent with others owning rail assets, but not with others having substantive economic control over those assets.

- Paul Little will be CE of the ongoing Toll Holdings. It is not yet clear who will replace Mark Rowsthorn as chair of Toll NZ.

Next steps

Our view of the next steps is:

1. You should invite Mark Rowsthorn as chair of Toll NZ to a meeting.

2. At the meeting you should canvas:

    - The outline agreement above and whether you believe it represents a path forward either as it stands or with substantive amendment.

    - Toll's long-term view of its NZ business in the light of the restructuring it has announced and the constraints the NZ business faces.