From: John Wilson
Sent: Friday, 16 March 2007 10:39 a.m.
To: ^MOF: Chris MacKenzie
Cc: David George; William Peet; Thomas Davis; 'David Gordon'; Ivan Kwok; Kwok, Ivan; Robert Barton
Subject: Rail: Paper on revised track access agreement with Toll
Attachments: 942917_1.DOC

Chris

Attached as promised is a revised version of the paper about the approach to a revised agreement on rail track access with Toll.

It is somewhat discursive; reflecting both the wide range of issues that flow from track access, and the linkages between them.

Treasury and Ontrack have worked constructively together on the paper. My read is that on the central issues (most obviously track access charges) Treasury and Ontrack have the same view. On some of the issues which are more peripherally linked to track acess (albeit important in themselves) we have slightly different approaches. I think Clifford Bay is probably the most obvious example. The wording attempts to encompass both views. But in the end its a Treasury paper.

I think the best approach from here would be to get some feedback from the Minister, narrowing down the range of options. A brief meeting with him would be ideal for that. Then we should boil our approach down to a brief note encompassing what the minister would put to Mark Rowsthorn in the meeting.

I'm happy to discuss any of this of course.

John Wilson

This paper sets out a draft set of proposals for agreement with Toll over access charges. It combines the provisions of the 12 February note from the Office of the Minister of Finance and the key provisions in the outline agreement that officials from Treasury and ONTRACK worked up with Toll. In a number of areas it sets out options with their implications. It is intended as a platform for establishing a fully developed proposal for you to table in the forthcoming discussion with Mark Rowsthorn of Toll.

Overview

The National Rail Access Agreement (NRAA) provides for Toll to meet the full costs of the rail network, including renewals and commercially justified track investment, once the Crown's initial $200 million contribution is used up. Discussions with Toll have taken place in the light of Toll's assertions that the NRAA formulation is not sustainable. Officials have had access to Toll NZ's commercial information and have concluded that neither Toll, nor any other rail operator, can meet the full costs of the track. Our central conclusions are:

The shortfall between the cost of operating and maintaining the rail network, and the capacity of the rail operator to pay, is around $500 million or more (depending on assumptions) over the coming 10 years. If the Crown wants a rail freight service covering the existing range it will need to meet that shortfall

The proposals and options below leave the existing freight exclusivity in place, at least in the near term, because other options appear counter-productive. The proposals attempt to strengthen the Crown's rights within an exclusive freight access regime, but the capacity for that is necessarily limited.

The proposals below include provision for capital spending on the network of up to $450 million (split freight/metro $265m/185m) as outlined by ONTRACK. Because the rail operator will not be able to make any material contribution to this, Treasury and ONTRACK do not believe this should be an important part of your discussion with Toll. You may conclude that a commitment of this nature would be a signal to Toll of the Crown's commitment to maintain the rail network in the long-term. In that case there would, however, be no sense in including the commitment in a revised agreement with Toll and thus providing Toll with a veto over the timing and content of the commitment. Such a government commitment would carry the same signalling value if it were made separate from, but set alongside, the formal agreement.

Any new agreement with Toll would be (like the NRAA) a legal contract. However the Crown's capacity to seek remedies would be limited by the fact that in many cases the Crown would not be seen as a party damaged by failure to deliver rail freight services.

For several reasons Treasury and ONTRACK expect that any agreement with Toll could last for a few years, but we do not expect it to last in the long term:

- Investment in rail rolling stock is not commercially attractive at the margin, although incentives can be structured to ensure that investment takes place in the near-term

- Looking forward, the fiscal costs are high, particularly relative to volumes of freight on some lines.

- Although rail freight volumes have grown, rail has steadily lost market share over recent decades. The investment programme outlined by ONTRACK should facilitate some freight traffic growth but more broadly it should not be expected to more than slightly slow that continued loss of market share.

- Toll (or any other rail operator) has strong incentives to seek more funding at some stage in the future if its returns become unsatisfactory. It holds a number of potential threats (cessation of specific long-distance passenger services; or freight services to Gisborne or Northland) which are of negligible commercial consequence to the rail operator but of significant import to Ministers.

1 Asset valuations

Many regimes for public/private sharing of rail costs require agreement both on the rate of return and on the value of assets. The start-up value of the Toll rail assets for calculation of acceptable returns for Toll could be either

- The asset values ($600m) as recorded in Toll NZ's accounts (i.e. including the $198m write up to the 2003 purchase price) (Toll preferred option) or
- Values reflecting their current next best alternative use in the absence of Crown support (ONTRACK and Treasury preferred option) being around $220 m
- Some agreed intermediate point, being the value as recorded in Toll's accounts, (less) a percentage of the $198m 2003 write up.

We have had long discussions with Toll on this issue. Our conclusion is that there is no prospect of moving them far from their preferred option in the near term. Moving from that option would require Toll to transparently recognise that impairment in their balance sheet. It should also be noted that Toll regards its acceptance of a 12.5% pre-tax return as essentially concessional, and would likely look for a higher rate of return in the event that it was forced to accept lower asset valuations. In a purely commercial sense Toll's asset write down would necessarily be accompanied by withdrawal of rail services and transfer of goods to road transport; i.e. the behaviours any new agreement is seeking to halt.

The ONTRACK and Treasury preferred valuation approach would require agreement between Toll and the Crown on asset values. It should also be noted that these impaired values could only realistically be applied to start-up assets. New assets subsequently acquired by the rail business would need to be valued at purchase cost.

In setting the appropriate access fee the parties will need to take a view on the asset value; however it will be up to Toll at the conclusion of negotiations to conclude whether it is required under accounting standards to recognise impairment and write down the asset value. This does not mean that you should avoid making clear to Toll that you do not accept their valuations.

2 Access charges

Toll's financial projections show the commercial viability of rail freight improving somewhat through time as volumes increase somewhat in what is a substantially fixed-cost industry.

The various options have been built round a goal of Net Present Value for Toll of zero at the 12.5% (pre-tax) return on assets, based on the Toll financial model.

Toll is asking for an access charge that is known for 10 years, on the grounds this will give them the certainty for investment. As noted below, however, major investment in the rail system will probably only happen with Crown support.

The following are the main access charge options:

Option 1 In discussion with Toll they have accepted an access charge regime that provides for a 12.5% rate of return (pre-tax). This of course leaves the asset valuation issue above to be resolved. An access charge established to provide for a 12.5% rate of return (pre-tax) in each year would rise steadily through the period, from well below the level of ONTRACK's operating costs at the start to over $93 million at the end of 10 years. ONTRACK and Treasury conclude that such a charging system, while providing Toll with a realistic rate of return would:

- Start at an unrealistically low level (under half the level set in the expert determination process for maintenance, and has Toll making no contribution to capital expenditure)
- Risk re-litigation through-out the life of the contract meaning that the higher charges at the end of the period would not be paid. (i.e. Toll gets too many benefits early and has a long time to re-negotiate)

Option 2 Alternatively, access charges could be set at a fixed level designed to return 12.5% over a ten-year term. That would mean that Toll NZ's profitability would be lower in the early part of the period, and (in the event that rail traffic grew as forecast) higher in the later years. ONTRACK and Treasury conclude that such a charging system leaves the Crown with a significant end of contract problem;

Option 3 Access charges could also be set at the level established by the outcome of the Independent Expert determination for maintenance ($56.1m a year plus escalation). In practice the start point of that charge will be very close to the 12.5% fixed level in option 2. This approach avoids debate about asset value, but offers no useful guidance for future access charge resets. It also shares the end of contract problem with Option 2.

Option 4A A blend of options 3 and 1, which starts with the access fee level determined by the independent expert, but moves to the level established by the 12.5% return in option 1 when that exceeds the level determined by the independent expert.

Option 4B Uses the same start and end points as Option 4A, but joins them using a straight line. Effectively this could be expressed as a CPI (plus) X regime.

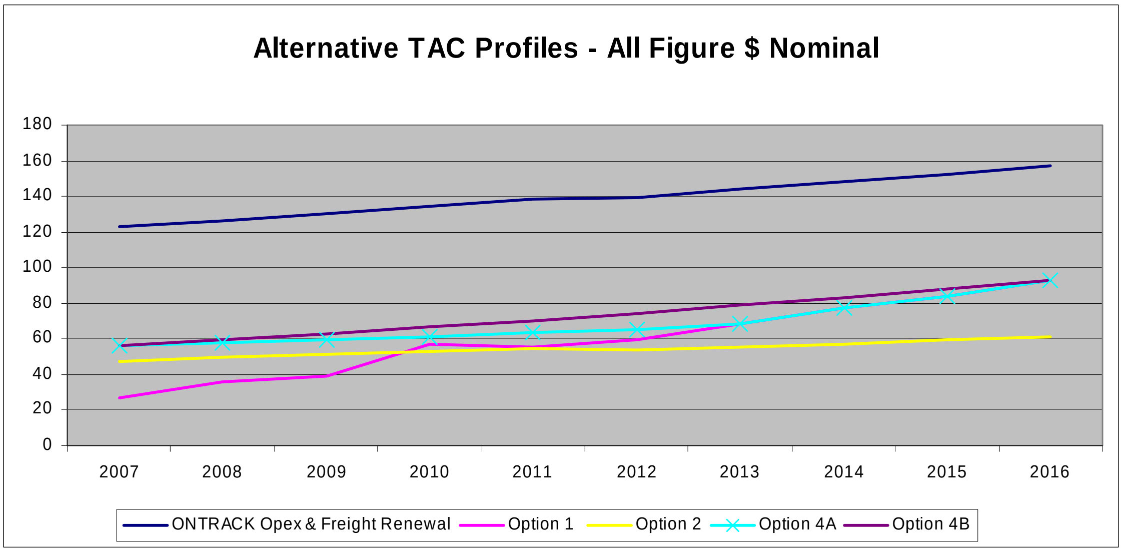
All of these charge regimes would be adjusted on the basis of an appropriate price index.

If Toll's existing book value is adopted, at 12.5% options 1 & 2 are NPV=$0 for Toll.

Because the TAC start point is higher Option 4A is NPV= ($74m) for Toll; Option 4B, which smoothes the TAC profile, is even more NPV negative for Toll ($104m). Clearly this will be resisted by Toll however it is a means by which the Crown can

- Require Toll to recognise the practical reality of the impairment – whether or not they chose to recognise it in their accounts; as it still allows for a 7.37% after tax return (11% pre tax) *or*

- Choose to provide the $75m/$104m by way of investment into locos and rolling stock



ONTRACK and Treasury believe that a TAC structured around option 4 is the most appropriate stance. At day 1 Toll pays 100% of the freight network operating costs and 9% of freight renewals. Over 10 years the 9% rises to 35%. In principle the smoothed pricing profile of 4B does provide a more predictable environment for Toll.

The $56.1m includes a $3.2m provision for incident expenses; which should be structured into an unders and overs regime so parties only meet the actual cost.

Whatever approach is used to set the TAC, we need to be clear with Toll about where the Wellington metro access costs fit into the structure:

Under the NRAA, Toll is obliged to pay the full costs of the network, including the Wellington metro section. It then charges the GWRC for track access as part of its contract.

A TAC set to ensure that Toll achieves a 12.5% pre-tax rate of return should include the Wellington metro access charge only if Toll's Wellington metro business was included in the calculations of Toll NZ's viability.

A TAC calculated to equal the $56.1 million outcome of the expert determination process, is really being set on the basis that, at the end of such a process, it is not credible for Toll NZ to pay less than the expert determination outcome. It does not of itself say anything about whether Wellington metro charges track should be part of the $56.1 million, or in addition to it. Our expectation is that Toll believes that the Wellington metro access charge is included in any of the TAC arrangements we have been discussing with them.

Action: Choose access charge option from above list to table at the Mark Rowsthorn meeting from above list

3 Terms of exclusive operating concession and Sanctions for Gross breaches of the Agreement

One way of increasing the Crown's leverage would be through a call option. The basic concept of a call option has been discussed with Toll. The following sections outline some of the issues.

Toll would transfer the rail assets into a subsidiary.

The Crown would have a call option over that subsidiary. That option could be exercised by the Crown after 10 years, or in the event of a serious material breach of the agreement. In the event the call option was exercised at the 10 year period Toll would retain its exclusive operating rights for a further 10 years, after which freight operating rights would be subject to open tender. If the option was exercised in the event of material breach, Toll's exclusive operating rights end. This option would raise the following issues:

- It would almost inevitably also imply a parallel put option for Toll.
- Any attempt to set a valuation for the rail assets up to 10 years hence is difficult. There's a risk of creating an insurance policy for Toll. The alternative is to set a "fair value" process.
- There's a question of how widely the rail assets should be defined (should it include the ferries, and the Tranzlink truck business)
- Customer contracts are central to the viability of the rail system. If Toll passed the rail assets to the Crown, but kept the major customer contracts, (and continued to service them through its trucking business) the viability of the rail business would be seriously threatened
- There is an awkward interface with the bond outlined in para 6 below. In the event that "serious breach of the contract" included failure to buy new locomotives and rolling stock, and the rail assets passed to the Crown, the Crown would be cashing the bond against itself.
- Toll will be relatively relaxed about a put/call option over rail assets, where the outcome is simply a Crown finance lease of those assets back to Toll. Toll will resist options that imply Crown control and direction of the rail business, particularly in the short-term.

- Because the call option is a relatively draconian remedy, it could only be exercised in the event of a serious material breach of the agreement. While that might encompass a one-off implementation of Plan B, it would probably not encompass a failure to buy new locomotives and rolling stock, where services were generally being maintained.

It is Treasury's and ONTRACK's view that if a call option is to be included in the agreement, then it should be structured to cover Toll's rail business (ie assets and customer contracts). A call option limited to rail rolling stock would risk the Crown simply providing Toll with cheap finance.

Action: Decide whether to proceed with a Call option, and if so how broadly it should be defined and what breaches of the agreement it should encompass

4 Keeping the subsidy in rail/fair treatment for freight forwarders

The following are the levers to ensure that the subsidy flowing from the above access charges stays in the rail industry and does not end up being a subsidy for other parts of Toll's business at the expense of its competitors.

Any structural separation of the rail business (as foreshadowed in the broader ranging call options in para 3 above) would help ensure transparent contracting between the rail business and the rest of the Toll business. (Toll believes that no such structural separation is necessary.)

The proposed land provisions (see para 11 below) are also relevant.

Toll is implementing a new system of charging for freight forwarders. It will limit volume rebates. It will make the relevant schedule public. The Crown's concerns with this proposal relate to timing (how quickly it will be implemented) and whether its structure will disadvantage particular freight forwarders. Toll notes that this will require a reliable network of weigh bridges, which will require ONTRACK capital investment.

5 Crown Capital Investment, and Toll NZ's financial contribution.

In future the Crown should expect to spend around $65 million a year on renewals of freight network line and sleepers;

Any programme of freight network improvements will be in addition to that. The ONTRACK document "A Convenient Solution" outlines such a programme of up to $265 million over 5 years on freight network improvements, broadly along the lines of (along with a further sum in the metro passenger networks) .

The access charge regime above will generate only a very modest (if any) amount beyond ONTRACK's current operating costs for core rail activities. On the assumption that small amount is applied first to renewals, that would mean that Toll NZ as the dominant operator would pay:

- Ontrack's operating costs where those costs are a legitimate charge to Toll NZ.

- Incident expenses
- A small proportion of the cost of replacement line and sleepers
- Nothing towards any overall programme of network improvements
- Possibly (small) contributions to specific track improvements which enable Toll to serve particular major customers better (eg Clandeboye connection)

Where Toll requests additional track work over and above what the Crown chooses to fund, then an additional charge could be added to the TAC. ONTRACK and Treasury believe that any capital payments from Toll should in future be on a paygo basis, so as to avoid the risk that commitments are made but not ultimately paid for.

6 Rolling Stock Investment

In future, a reliable freight rail system almost certainly requires replacement rolling stock and locomotives. Given that the rolling stock investment does not appear (at the margin) to be hugely commercially attractive to Toll, the Crown has sought additional confidence that the investment will in fact take place.

The outline agreement between Toll NZ and the Crown therefore includes a proposal that a performance bond stands behind and guarantees Toll's purchase of new locomotives and rolling stock. The bond or set of bonds would be structured as follows:

- The bond would be backed by a financial institution
- It would be in the name of Toll Holdings or Toll NZ
- The value of the bond at the start would be equal to the expected costs of new locomotives and rolling stock.
- The value of the bond would decline, exactly in line with the originally projected costs, as the new locomotives and rolling stock were delivered/commissioned. Once all the originally planned locomotives and rolling stock were delivered/commissioned, the bonds would be worthless
- The documentation would establish both an expected programme of locomotive/rolling stock investment, and an allowable period around that to account for reasonable delays.
- If the locomotives and rolling stock have not been purchased by the end of the allowable period, or at agreed milestone dates throughout the period the Minister of Finance would be entitled without seeking any further approval to cash the bond to the expected value of the locomotives and rolling stock.

In the event that the preferred access charge option was one of the Options 4 which are NPV negative to Toll, that option could be made more attractive to Toll NZ, and more confidence provided about rolling stock investment, by adding in a subsidy for purchase of new rolling stock and locomotives in the early years as suggested in section 2 (Access Charges).

Action: Agree above approach.

7 Use it or lose it mechanism.

The agreement will retain the requirement on Toll to run a nationwide freight service. There are 3 options for ensuring that freight service continues on the commercially non-viable lines.

Option 1 A use-it–or-lose-it regime that pairs each commercially marginal line with a commercially important line (so that for example loss of exclusivity on the Napier-Gisborne line would also trigger loss of exclusivity on a commercially important line). The 'use-it-or-lose-it segments would be aggregated to 10 line groups, and the reference years would change to 03-06 (the issue of whether the range starts at 02 or 04 has yet to be resolved). This would:

- Provide a more robust threat than the current system of small use-it-or-lose-it line segments.
- Conversely, because the threat is more draconian, ensure that it is less likely to be used.

Option 2 A system of contracts with specific payments for performance, to keep freight services operating on the most commercially marginal lines (primarily Napier-Gisborne, Northland and Hokitika). This would

- Provide the most secure assurance that freight services on the least commercially viable lines will be kept operating
- Make transparent the costs of keeping services operating on individual lines.

In discussions with Toll, Treasury and ONTRACK had reached agreement on a mix of Options 1 and 2

Option 3 A use it or lose it system based on the "city pairs" between which trains actually run. (ie between city pairs rather than restricted to a particular line segment) with service thresholds and an exclusivity regime operating between those city pairs. This would

- Limit Toll's exclusivity to those freight services it currently operates (in parallel with the current long-distance passenger exclusivity).
- Toll would likely resist this change and the apparent loss of exclusivity across large parts of the network.
- ONTRACK and Treasury believe that it would be very difficult to make this work for freight, primarily because it would be very difficult to define city pairs.

In each case

- The "use-it –or-lose-it" mechanism would be structured so that if Toll lost freight exclusivity on a particular line section, a new operator would be able to carry that freight to its destination. (But not pick up freight at intermediate points)
- The rail ferry would be treated as part of the "use-it-or-lose-it" regime. In the event of loss of exclusivity on the rail ferries, Toll will enable any new operator to have all necessary port and traffic rights. The Wellington/Picton route will be defined as a line segment and will be subject to the same volume targets and KPIs as other rail line segments.
- Toll NZ would have the right to sub-contract another operator on a line segment, without loss of exclusivity.
- It would be made clear that exclusivity on lines not currently served at all (Castlecliff, Rotorua etc) has been lost.
- Use-it-or-lose-it thresholds would increase through time.

Action: Choose Use-it-or-Lose-it approach from above options.

8 New line segments and Subsidies

Under the NRAA, Toll has a right of first refusal to operate services on new line segments, and to operate any subsidised service. The suggested approach to remove concerns in this area is:

Remove Toll's right of first refusal for subsidies, where the subsidy covers a part of the track where they have lost exclusivity. But retain it for new line segments. Agree a set of principles for establishing freight rates on new line segments consistent with broader freight rates for like commodities.

Action: Agree to this approach

9 Long distance passenger Services

The outline agreement with Toll provides for Ministers to have a choice between:

1. Open access immediately for all services other than the TranzCoastal and the TranzAlpine. (We could also modify this option so that the present 12-month stand-down period after Toll ceases a service is abolished)

- This would preserve the option for new entrants into long-distance passenger operation, but Treasury and ONTRACK believe that, without substantive Crown financial support such entry is very unlikely.

or

2. A Crown agreement with Toll to operate the 3 existing services in the interim. The Crown could then choose to build new or refurbished rolling stock, and tender for a hook and pull operation, and for management of the long –distance passenger system.

- This would enable Ministers to preserve specific long-distance services, but on the basis that the Crown contributes all the capital without any realistic prospect of recovery.

Action: Agree that revised agreement with Toll should preserve Ministers capacity to make the choice outlined above.

10 Wellington metro

The outline agreement with Toll provides that the Wellington metro access rights would revert to the Crown immediately, with the existing Toll agreement with Wellington Regional Council being protected through its 10 year term. That would mean that GWRC is free to tender operators at the end of the contract term.

Toll will concurrently need to surrender land (such as station parking etc) and other assets related to the metro operation.

Action: Agree above approach.

11 Land

The outline agreement with Toll provides that Toll will surrender all tracks/network assets on retained land, marshalling yards and adjacent land to ONTRACK.

Toll and the Crown will share land release proceeds 50/50. (Including a Toll concession on Wellington land which is currently 100/0 in Toll's favour). This is intended to ensure both parties seek to maximise proceeds.

Toll will pay market rate for land not used for basic (as opposed to wider) rail purposes. This mainly relates to Toll Tranzlink paying market rent of around $6 million pa (If the TAC is set to assure the Toll NZ Group's rate of return, this is value neutral to Toll.)

The consequences of this would be

- A reduction in Toll's land holdings under the core lease
- Some redrafting of the core lease to reflect the changed circumstances
- A new commercial lease for the non-core land with appropriate review clauses to fit in with the tenure of the access agreement.

Action: agree above approach

12 Clifford Bay

The outline agreement with Toll says Clifford Bay will not form part of the agreement with the exception that any pre-existing agreements that could be used to assist a future development of Clifford Bay would be made available to the Crown. The intention of that proposal is that Toll (who own land and a set of rights relating to any potential Clifford Bay development), should not be able to frustrate any such development in future. In general the various parties' commercial incentives are such that if a Clifford Bay development is really financially attractive it is likely to happen. If you wanted as part of any agreement with Toll to seek other assets beyond the pre-existing agreements, (Toll's Clifford Bay land is the most obvious example) so as to give added confidence that Toll could not frustrate a development, such a request should not be allowed to stand in the way of achieving a rail access agreement with Toll.

13 ONTRACK status and Legislative Framework

ONTRACK will remain an SOE, with the Crown making an explicit contribution to its funding.

There will need to be some changes to accommodate SOE status with the revised track valuation. We will be reporting separately on this.

ONTRACK will be set a target reduction for corporate overheads.

The Railways Act 2005 and historic industrial agreements (outside of the current collective agreements) be rewritten to remove unnecessary restrictive or outdated practices and align with general health and safety legislation

That the current draft of the Rail Network bill be revised (among other things to retain ONTRACK's SOE status). And that consideration be given to merging it with the Railways Act 2005.

14 Crown/Toll broader commercial relationships

Toll's ONTRACK directorship would terminate.

Toll will commit to provide and operate equipment over the total network, and will make a "best endeavours" commitment to grow the market share of rail in bulk and intermodal traffic.

The Crown and Toll would establish new mechanisms to provide

- o Productive collaboration between ONTRACK and Toll NZ where those mechanisms do not exist and
- o Capacity for Toll NZ to challenge ONTRACK's costs, to the extent Toll is exposed to the risk of them increasing.

Toll places some value on a commitment from the Crown side to a regular communication forum.

There would be a re-draft of the NRAA to reflect the new arrangements and the Government's increased network rights as a result of its substantial financial contribution.

15 ONTRACK/Toll operating relationships

ONTRACK and Toll will be incentivised to work as "joint equal partners" to develop rail. (If this is to be implemented we need to flesh out what we mean by "joint equal partners" and what incentives we have in mind)

The matters to be addressed include, but are not limited to

- A general tidy up and consolidation of the NRAA and rationalisation of CAT and the equivalent documents for Toll's freight rights in the Auckland region
- A commitment to collectively reviewing Codes & Standards and Operating Rules to improve productivity and remove demarcation issues
- A commitment to review working practices to improve productivity
- A review of financial and operational risk management arrangements including incident costs