From: John Wilson
Sent: Tuesday, 24 April 2007 4:18 p.m.
To: 'David George'; 'William Peet'; 'Thomas Davis'
Cc: Robert Barton; Stephanie Ward; 'Kwok, Ivan'
Subject: Summary of prospective Crown/Toll transaction
Attachments: 959463_1.DOC

David/William/Thomas

Attached is a document summarising the prospective transaction with Toll.

Any comments welcome. I'm out of town until Monday. I'd welcome a discussion then. Toll haven't seen this document. I'll pass it to Chris Mac as very much a work in progress, still awaiting ONTRACK input.

John Wilson

The prospective agreement with Toll: What it would and would not deliver; risks and opportunities

Basic structure of prospective deal

- The Crown purchases the rail assets from Toll NZ.
- The Crown grants Toll NZ a right to operate the rail freight and existing long-distance passenger services in NZ for a fixed term
- At the end of that term the Crown tenders the right to operate the rail freight and related services.

What assets it covers

- Rail freight and long-distance passenger rolling stock
- The rail lease and associated land interests held by Toll as part of the lease
- The Hillside and Hutt workshop assets
- Rail freight terminals

Length of term

We initially floated the idea of a 10 year term for the first franchise period. Toll has countered with a suggestion of a 15 year term with the right of renewal to be exercised at 10 years.

Toll argues that they need a long term to provide certainty for future investment. In fact, under this proposal the Crown would be doing most of the rail related investment, so this argument is not very robust. (Toll cites a new inter-modal Terminal at Penrose as an example of the type of investment that would be at risk). There is also an argument that frequent changes of freight provider will not provide the incentive to develop customer relationships.

From the Crown perspective a long term carries the basic risk that, while it locks in the Crown's obligations for the length of the term, if the rail operator runs into financial headwinds, most governments will prefer to ease the obligations on that operator rather than face a reduced rail service. So a long contract term does not produce an attractive balancing of risk from the Crown perspective.

The solution to this is perhaps a contract that runs for 15 years, with the right of renewal to be decided at 10 years, as proposed by Toll, and with a set of key parameters important to the Crown to be reviewed at 5 years also,.

Payment from Crown for rail assets

Toll NZ wrote up the value of its assets to reflect the share price that Toll Holdings paid for its Toll NZ shares. That write-up was of the order of $200 million, and was applied wholly to rail rolling stock. While the write-up was consistent with accounting standards, in officials view it does not reflect the rolling stock's next highest value use. Toll argues, as we understand it, that the book values reflect the proportion of life remaining (i.e. a proportion of replacement cost). The next best use, in the absence of government support, would be either scrap value, or sale to an overseas operator of similar rolling stock (e.g. Queensland rail). Both of those values would be much lower than the existing book value.

Toll also has values in its books for the right of way accorded by the lease, and for the revenue it expects to receive from facilitating reconfiguration of freight yards and freeing up land.

Toll is looking to get at least book value from this transaction. That would be some $480 million. In our view any credible valuation would produce a significantly smaller valuation. This is one of the most intractable issues in this prospective transaction.

One option for avoiding having to reach an unacceptable compromise about the value of the existing rolling stock would be for the Crown to agree to purchase all new rolling stock for the freight system, but to leave ownership of the existing rolling stock with Toll NZ, but take a "call option" over the existing rolling stock, so it could be purchased if necessary.

Payments from Toll for use of track and rolling stock

Under the NRAA Toll is required to pay the full costs of the track.

Under this model, Toll would be required to pay:

- Track costs
- Costs for lease of the rolling stock and rail assets.

However, if the set of charges are to be set at a level that assures the viability of the rail business, rather than of Toll NZ as a whole, it could indicatively (based on previous modelling) pay around the following

- The full capital costs of the rolling stock and other rail assets
- Around $20 million a year towards the $55 million a year operating costs of ONTRACK.
- Nothing towards either replacement of line and sleepers or new capital works on the track

If the access charge was set to make Toll NZ as a whole viable, the company could pay most of ONTRACK's $55 million a year operating costs, but not renewals or capital; i.e. there is a cross subsidy from the rest of Toll NZ to the rail business at present.

There are a number of ways of structuring a set of charges:

- It could be set at the start of the agreement, and then fixed, aside from index-based adjustments, for the term of the agreement. In theory that would provide Toll with a strong incentive to grow rail freight traffic, so as to secure rising profits. Experience suggests, however, that if the rail operator ran into financial headwinds, rather than facing the consequences and perhaps cutting services, it would approach the government for a reduction in charges

- The charge could be reviewed annually on the basis of the rail business's financial performance. It would essentially insulate the rail operator from financial risk, which would raise some questions about what the rail operator was actually adding to the industry.

Both of these options would require some quite detailed Crown oversight of the rail business, and clear corporate separation of the rail business from the rest of Toll NZ. There are also some questions around whether the Crown subsidy should be spread across all components of the costs, or concentrated in one area. For example, the Crown could provide track capital and renewals essentially free to the operator, and charge the full costs of the rolling stock. That would, however, most likely lead to over-provision of track relative to rolling stock.

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Rail freight contracts

At present both some major freight contracts (e.g. the Fonterra contract) and a lot of the freight customer relationships that are not governed by long-term contracts are contracted through Toll Tranzlink, Toll NZ's trucking arm. Toll envisages that such contracting relationships will continue. While, in the event of a new franchisee taking over the rail business, that franchisee would be free to contract directly with customers, freight customers seeking a comprehensive freight service are likely to continue to buy their rail freight services through Toll Tranzlink or another freight forwarder. This applies particularly to the inter-modal area of rail freight, which is the most prospective area for traffic growth.

It is therefore critical that, at the time of the award of the rail freight franchise to another franchisee, the contracts between Toll Tranzlink and the rail business are transparent and arms-length commercial contracts that can readily be transferred to the new rail operator. One factor in this will be ensuring corporate separation of the Toll NZ rail business from the rest of Toll NZ's business. Toll is confident the contracts are (or can be made) sufficiently transparent, and is comfortable with corporate separation.

Rolling stock

After the prospective transaction, the Crown would own the rolling stock. The lease agreement with Toll NZ would give Toll NZ full rights to deploy the rolling stock within NZ as it chose.

The Crown would not have the power to direct Toll NZ to move rolling stock from one part of its business to another.

In the event that a freight customer was arguing that Toll NZ was failing to provide rolling stock, the following options would be open.

- The freight customer could purchase its own dedicated rolling stock.
- If the Crown concluded there was a shortage of rolling stock, it could purchase more, and negotiate an appropriate arrangement with Toll for payment.

The rail operator would be responsible for maintaining the rolling stock. The Crown would be responsible for purchase and for major refurbishments. Decisions about purchase and major refurbishment would need to be taken jointly. In summary the key principles for rolling stock purchase would be:

- The rail operator needs to determine the amount of rolling stock, and to be confident that the rolling stock meets its customer's needs.
- The Crown needs to be sure that the rolling stock will have value beyond the life of the existing operator's franchise.

Metro and long distance passenger

The prospective agreement would have the following impacts for metro and long – distance passenger services.

For Auckland metro, Toll NZ's current relatively small role would be part of the franchise, and would thus be able to pass in due course to any new rail operator.

In Wellington, the current arrangements under which GWRC is buying new rolling stock, and has a call option over existing rolling stock, would not be affected. (ie unless GWRC exercises the call option, Toll will continue to own the existing Wellington metro rolling stock) Toll's access rights over Wellington would terminate as part of this transaction, but the existing 10-year agreement with GWRC would be protected.

For other passenger services:

- As part of the transaction, Toll would agree to continue the existing 3 services.
- The remainder of the track would be open to new entrants (although no serious new entrants can be expected without substantial Crown financial support.)
- The existing long-distance passenger rolling stock would pass to the Crown. If the Crown wanted to buy new or substantively refurbished rolling stock for the existing 3 services, lease payments would be subject to negotiation with the rail operator. (In officials view any such lease payments would be minimal)

Ferries

The 2 existing rail ferries (Aratere and Arahura) provide a key link in the Auckland-Christchurch rail freight service. Without the rail ferries that service would become substantively less competitive. For various reasons, including the fact that rail is not a space-efficient way of loading a ship, rail ferries are becoming relatively less common globally. Replacement general ferries can be readily leased (e.g. Kaitaki) and can be readily disposed of. A replacement rail ferry, however, would need to be purpose built. Toll claim the existing 2 ferries will, with some refurbishment, last beyond the first 15 years.

The prospective agreement provides the Crown with a call option over the rail ferries, so that if the Crown needed to buy them at the end of the first franchise term to secure the rail ferry service it could. Officials believe that, on present economics, the rail ferries will only be replaced at the end of their life if the Crown funds a substantial part of the capital costs. The call option is intended to ensure that intermodal rail freight service from Auckland to Christchurch can continue beyond the end of the franchise term.

Governance

The prospective transaction will throw up two new tasks for the Crown:

- Purchasing rolling stock and leasing it back to the rail operator.
- Managing a relationship with the rail operator that would cover a broader field than the present track and minimum-service threshold based

We have not yet considered in detail which Crown agency should carry out these roles.

Toll place a good deal of store in having an over-arching consultative body, including senior representative from the relevant Crown agencies. They see it as in some senses a replacement for their place on the ONTRACK board.

Place of Toll, ONTRACK and the rail asset holding entity in NZ transport under this deal.

If this deal went ahead, for the first term,

ONTRACK would continue to operate the track, and receive funds from both Toll NZ and the Crown to do that.

A Crown agency (to be determined) would own all freight and long-distance passenger rolling stock, freight terminals, Hutt and Hillside workshops, and lease them to Toll NZ.

Toll NZ would operate:

- Rail freight services
- The 3 existing long-distance passenger services
- Wellington metro
- The Hutt and Hillside workshops

Toll NZ would own and operate:

- Toll Tranzlink (which in turn would sub-contract substantial rail freight)
- The Interislander ferry system

(The latter 2 through a separate company)

Place of Toll and new rail operator in NZ transport if the franchise went to somebody else

If at the end of the term, the rail franchise was awarded to another rail operator,

ONTRACK would continue to operate the track, and receive funds from both the new rail operator and the Crown to do that.

A Crown agency (to be determined) would own all freight and long-distance passenger rolling stock, freight terminals, Hutt and Hillside workshops, and lease them to the new rail operator.

The new rail operator would operate:

- Rail freight services
- The 3 existing long-distance passenger services
- The Hutt and Hillside workshops

Toll NZ would own and operate

- Toll Tranzlink (which in turn would sub-contract substantial rail freight)
- The Interislander ferry system

Operation of Wellington metro at the end of the existing contract term would be a decision for GWRC.

Legal Agreements

The prospective agreement would replace the National Rail Access Agreement (NRAA) and the rail lease.

There are likely to be two substantive new legal documents:

- A sale and purchase agreement
- A franchise agreement setting out the rights and obligations of each party.

Options to secure more operational control and Risks

If Ministers wished a Crown agency to have more day-to-day control over deployment of the rolling stock:

- Officials doubt that any major moves down that road are in Toll's thinking. Indeed Toll floated the idea of the Crown franchising back to the rail operator the track as well as the rolling stock. (We told them that in the light of Ministers' most recent experience with private control of the track that option would not be acceptable) Toll is firmly of the view that it is much more focused on keeping costs down in the rail system than is ONTRACK.

- An increased Crown role in deployment of rolling stock would of necessity move that deployment further away from paying freight customers, and put it in the hands of an agency with less commercial focus and much broader goals than serving those paying customers. Given Toll (and other freight forwarders) have a choice between road and rail for their inter-modal service the relative efficiency of services is important. The risk is that a badly designed transaction would in fact make rail less competitive with other transport modes.