From: Robert Barton
Sent: Friday, 24 August 2007 2:56 p.m.
To: ^MOF: Chris MacKenzie
Cc: John Wilson; Len Starling; Stephanie Ward; Struan Little
Subject: Two notes on rail
Attachments: Toll value.DOC; Rail Options 20_8.DOC

Hi Chris

Please find attached from John and me:

- notes/comments on ONTRACK's paper which you sent over to us yesterday; and
- a fuller note on options for rail which the Minister requested recently.

The two notes are complementary - although both can stand alone.

Either of us are happy to discuss.

Robt

24 August 2007

Notes/comments on ONTRACK's Paper "Tomorrow's Rail Freight Network"

Introduction

These notes have been written on the assumption that Ministers find ONTRACK's proposal attractive and wish to advance it, and therefore focus on practical considerations in achieving a successful acquisition.

Our overall concern with the strategy outlined by the ONTRACK board is that, in the likely event that Toll will reject the offer, there is no credible fall-back strategy for the Crown.

In summary, we think:

- Toll would reject the offer as framed by ONTRACK's paper because they would see it as being both insufficient on price and contrary to Toll's wider business strategy intentions in NZ;
- ONTRACK's proposed tactic at that point of enforcing the NRAA will not force Toll to submit as Toll NZ will still be profitable in the short term of one-to-two years;
- In the absence of an agreement, no investment in new rolling stock will occur under this strategy;
- Before entering negotiations like this, the Government should have identified where it may move to on price and/or on the nature of transaction (in the event Toll rejected the offer, as we would expect).

We outline below first why we think ONTRACK's estimate of the cost of the transaction is optimistic; and second, where we think the Government would need to consider improving the acquisition strategy.

Value

ONTRACK's note suggests that Toll NZ could be bought for a total of $659 million in capital, although as $270 million of that would be debt, only $400 million capital by way of equity injection into ONTRACK from the Crown would be required.

Some points to note:

- As the ongoing rail business will require subsidies, the Crown will carry the residual risk on its debt. Accordingly, it is cheaper for the Crown to incur the cost of that debt up front by capitalising it in ONTRACK immediately upon purchase, and that would make more sense if the rail business were to operate with a (implicit) guarantee of finance.

- Toll Holdings is currently buying out the remaining 15% minority Toll NZ shareholders at $3 per share. ONTRACK's proposed offer of $437 million for Toll's equity is around $2.08 per share. It is hard to see Toll's board agreeing to this value write-down of 15% of the equity so soon after it has acquired 100% ownership.

- As part of that buy-out, Grant Samuel produced a report on Toll NZ, which valued the equity at $607 - $698 million. While that valuation may be debated, and is built around broadly the status quo on access charges, the Toll Holdings board would have difficulty defending a sale price well below that level to its shareholders.

- At $3 per share, the company is worth $631 million. A Crown offer at that price and with the debt capitalised would cost over $900 million.

- It is unlikely that the $48 million receipt that ONTRACK has allowed for the on-sale of Toll's trucking business could be realised without the related customer contracts. Those contracts however will be critical to maintaining, let alone growing, rail's freight volumes.

- Toll NZ is currently cash-flow positive (with an EBITDA of c$110 million pa) and the business returns a very tidy profit to its shareholders <u>provided</u> no capital investment is made. (And currently, most of the capex is being met by the Crown).

- In our view, Toll will therefore place a much higher value of its New Zealand business than ONTRACK's paper indicates. There are several ways to view the value for the business:

Method	Equity Valuation (NZ$)	Comment
Book value of Assets (net)	Approx $350 million [includes a value for property, plant and equipment of $567m]	Toll's audited net assets for 2005/06 $332m, with an unaudited value of $359m for 2006/07.
Equity invested + 12.5% pa rate of return.	$437 million	ONTRACK's figure (based on what Toll has paid for its equity including the recent $3).
Share price of $3.00[1]	$631 million	$3 is the Toll offer to Third Avenue and remaining minorities
Implied Grant Samuel valuation [2]	$607 million to $698 million	
Earnings[3] X multiplier (low industry Benchmark of 8)	880 million	Toll's EBITDA for the last two years has been around $108m, but their Budget projection for 2007/08 is $125 m.
Earnings X multiplier (high industry Benchmark of 10)	1.1 billion	

Acquisition Strategy

As Toll is currently earning a comfortable cash flow from its New Zealand operations, its present strategy appears to be to retain the customers and the cash flows while avoiding having to invest capital into the business. This would explain its suggestion that the Crown buy its rolling stock and some of its other physical assets and lease them back to Toll NZ as rail operator. The risk of the capital intensive nature of the business would effectively be transferred to the Crown, while Toll could continue to have the benefit of the customer contracts.

[1] Total shares at 210,239,000
[2] Value per share range of $2.89 to $3.32
[3] EBITDA assumed at $110 million

This suggests that Toll will be keen to retain its rail customers (as opposed to its rail assets). A Government offer to buy Toll NZ needs to take this into account. To that end, ONTRACK's proposed strategy could lead to one of four scenarios:

- Toll accepts the offer. In which case, drinks all round.
- Toll indicates that it is prepared to sell Toll NZ, but demands a much higher price than on offer.
- Toll refuses to sell Toll NZ at any realistic price (because divestment is contrary to its New Zealand and trans-Tasman business strategy)
- Toll counters with a repackaged offer to sell the Crown its rail assets whilst retaining the substance of its New Zealand business (and its cash flows).

We think that a mixture of the second and fourth responses is most likely. Ultimately, if the price on offer is high enough Toll will sell. But it will be reluctant because it is contrary to its overall strategy, and would also, we understand, represent the first time anywhere it has sold a major asset it has acquired. It is demonstrating every intention of building on its New Zealand presence – it has bought out the minority Toll NZ shareholders; in trucking it is looking to expand by purchasing more trucks and/or a competitor's business; in port facilities (it owns a Tauranga stevedoring company); and most recently, with the entry of Pacific Blue, aviation. It would however like to relieve itself of the need to invest capital in its New Zealand rail business.

ONTRACK's suggested approach of enforcing the full provisions of the NRAA and charging Toll the full TAC and WACC and depreciation on renewals is very unlikely to move Toll swiftly to sell. This is because, in the short term of the next one-to-two years, the extra amount the NRAA would cause Toll to pay would lower, but not remove, Toll NZ's profitability. The cash flows would remain positive and Toll would continue to fail to invest any new capital on rolling stock.

This assumes that Toll wishes to retain relatively good relations with the Government. It could alternatively choose to pressure Ministers by closing services on a few of its least commercial routes, without incurring any material adverse financial consequences. Whatever Toll's response, unless the government has additional negotiating positions, the impasse would last until such time that the WACC and depreciation payments really start to bite on Toll's profitability.

This means that, in approaching Toll the government needs to be clear beforehand whether and how far it is going to negotiate on price, or alternatively on the nature of the transaction.

Price

Normally a corporate acquisition like this would be built from a value argument which sets a price ceiling for the acquisition. We appreciate that, in this instance, reasons other than full commerciality are pressing Ministers' interest in pursuing this proposal. However, as with any negotiation, the purchaser should start with a firm idea of the maximum price it should pay (and be prepared to walk away once it is reached). Given this would be a non-commercial acquisition, it could be very difficult for the Crown to sustain that price discipline. Equally in rail's case, the base argument should establish which assets the Crown actually wants, which ones it definitely does not want, and which ones it might be prepared to trade away in the negotiations over purchase.

Nature of Transaction

Asset-based options other than full purchase of Toll NZ are as follows:

- The Crown could seek to buy Toll's rail business only. This effectively means separating Toll's rail and non-rail activities prior to sale (rather than after, as ONTRACK suggests). While reducing the overall cost, this approach will be fraught with the risk of the rail business losing the customers to Toll's remaining trucking operation;

- The Crown could seek to purchase Toll's rail assets (with all the attendant problems that entails in isolating them from the rest of the business, and ensuring that key customer contracts also transfer) whilst leaving the substance of the business with Toll. These assets, together with new rolling stock purchased by the Crown, would then be leased back to Toll on a franchise basis. Toll will respond positively to this concept, but will seek to retain as much of the cash flow as possible while transferring most of its business risk;

- The Crown could decide to buy new rolling stock as part of a wider deal that continues to subsidise Toll's TAC and renewals obligations. This would address the need for new investment, while ensuring Toll retains some degree of business risk.

- A variation of this last approach would be for the Crown to underwrite Toll's purchase of new rolling stock by agreeing to it having a put option to the Crown over it.

We have reported separately in more detail to you on these options.

Timetable and Process

ONTRACK's paper proposes a 6 week timetable to present an offer to Toll, although is silent on how long the process would then take to complete. The duration of the timetable however depends on the type of process chosen. The following are key issues that need to be considered:

- There are two ways the deal can be viewed:

    - As a corporate takeover by one company of another. In this case, having obtained the necessary shareholder backing, ONTRACK would manage the process (with appropriate reference back to Ministers as the negotiations progressed);

    - As the Crown buying out Toll. In this case, Ministers would be directly involved and presumably advised by Treasury and ONTRACK.

- The key timing constraint would be how long it took the Crown and Toll Holdings to agree on the basis and extent of a transaction.

- Regardless of the approach adopted, we would advise that expert external financial and legal assistance be engaged to advise and assist with the process.

- Prudence would suggest a thorough due diligence be carried out over the company and its assets.

- All this suggests that there can be no assurance that a transaction could be completed in calendar 2007.

- Beyond the immediate questions of the acquisition process, further consideration would need to be given to whether ONTRACK's suggested post-acquisition corporate structure is optimal. (Which we have not yet considered).

24 August 2007

Rail Freight Options

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. This note attempts to set out the public policy issues relating to rail freight and long-distance passenger services. It sets out 5 options for dealing with these issues.

The problem

The 2003 agreement between the Crown and Toll provided that, once the Crown had spent $200 million refurbishing the rail track, Toll would pay the full costs of the rail track. That was to be through a recovery of ONTRACK's operating costs, and a recovery of capital costs and depreciation of ONTRACK's new capital investment. (All investment in rail track assets prior to 2003 was written off).

In the event it has become clear that the rail freight business cannot earn enough to pay the costs of the track. Toll NZ is currently paying a track access fee of $54 million a year. This covers around 50% of ONTRACK's cash costs. The Crown is meeting around the same amount (most of the Crown contribution is funding renewal of line and sleepers).

The Crown contribution of $50 million a year means that rail users are paying a significantly smaller share of the total costs they impose (including externalities) than truck operators. Moving to more balanced road/rail pricing now would disadvantage rail. Equally any sort of integrated funding mechanism that treated road and rail equally would disadvantage rail compared to the present.

The economic rationale for increased Crown support for the rail freight system is therefore:

- A view that in the long run some of the (particularly) environmental externalities will become much more significant than they are at present, and thus that (the option value of) an operating rail freight system is high.

- The prospect that (especially for specific heavily trafficked routes) the costs of road enhancement to cope with current rail traffic if it were diverted onto the roads would be higher than the costs of long-term support to the rail system.

Crown objective

In the light of the above, Treasury officials have concluded that Crown objectives are as follows

- To ensure that a viable robust nationwide rail freight system continues

- To enable growth of rail freight traffic, where that can be achieved at reasonable fiscal cost.

- To ensure, as part of the goal of growing rail freight traffic, that rail freight continues to offer an efficient and responsive service to customers.

- To ensure that new locomotives and rolling stock are purchased as soon as possible.

- To resolve any difficult issues that need to be resolved with Toll NZ by the end of calendar 2007

Present Situation

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 therefore be no near-term threat to rail freight services, but in the longer term the quality of the rail freight service will erode as the quality of the rolling stock erodes.

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 ONTRACK has written to you reflecting a preference for the Crown to purchase the rail assets and then operate them as an integrated business with the rail track. (The “purchase option”)

Negotiating and implementing any of these approaches satisfactorily, and at a realistic cost, will take some time. Later sections of this paper set out some of the challenges with either of these approaches.

1: A minimal approach to securing rolling stock

The simplest way to secure new locomotives and rolling stock would be to offer Toll NZ a 10 year “put option” for any new locomotives and rolling stock it wants to purchase. This would cover off Toll’s concern that the current uncertainty over the future access regime makes it very difficult for its board to approve new investments. A put option would largely remove that risk by underpinning the investment in new rolling stock with a guaranteed exit. It would allow Toll NZ to pass the newly purchased rolling stock and locomotives to the Crown for their depreciated value at any time during that 10 year period.

2: Purchase and leaseback of rolling stock

The Crown could buy some new locomotives and rolling stock and lease 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 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. For the lease option, 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 the Crown 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 make notably more difficult, any of the broader options for the future of rail freight outlined below. 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 rail assets.

3: Broader Transaction I: the "franchise option"

Under the "franchise option":

- The Crown would purchase the rail assets (principally locomotives, rolling stock, the rail lease, land rights and workshops and depots)
- The Crown would grant Toll NZ a franchise to operate the freight system for 10 years

- At the end of that 10 year period, the Crown would be free to choose a franchisee to operate the rail system.

Implementing 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 provide some long-term flexibility around choice of rail freight operator. It would put an end to the rail lease, bring rail land back to the Crown, and end Toll’s exclusive access rights (including for Wellington metro). It would leave operation of the commercial aspects of the railway with Toll NZ for the first term. During that term, it would not provide the Crown with materially more control over what services the rail operator delivers than it has at present.

4: Broader Transaction II: the “purchase of rail assets option”

- Under the “purchase of rail assets option” the Crown would purchase the rail assets (principally locomotives, rolling stock, the rail lease, land rights and workshops and depots) and operate them as a Crown owned rail business.

The “purchase of rail assets 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 could 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:

    - o 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.

    - o 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 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.

5: Broader transaction III: Purchase of Toll NZ

Under this option the Crown would buy the entire Toll NZ business, (i.e. rail, ferry and trucking components), sell off any parts it did not want, and operate the remainder as a Crown-owned business.

Toll has given no indications of a desire to sell its entire NZ business. On the contrary, it has given every indication that it sees its New Zealand business as a strategic acquisition, as witnessed by its current proposal to buy out the remaining minority shareholders. Moreover the parent company, Toll Holdings, has a track record of having never sold major assets it has acquired as it has grown its business over the years.

Toll Holdings has recently agreed to buy out the minority shareholders in Toll NZ for $3 a share. As part of the transaction Grant Samuel produced a report valuing the Toll NZ shares at around that level. It would thus be difficult for Toll Holdings to explain to its shareholders a sale of Toll NZ at any lower price than $3 a share (or approximately $630 million). Indeed Toll Holdings might conclude that given Ministers enthusiasm to control the rail system, and the scale of the Crown balance sheet, it could secure a good deal more. Over and above the equity, Toll NZ also has some $270 million of debt which would be part of the acquisition. If the Crown were able to buy Toll NZ for $3 a share 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

Any of the broader transactions (options 3 to 5 above) would take some time to negotiate and agree. In Treasury's view none of them can be confidently agreed this calendar year. 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.

	Achievability	Durability	Implications
1. Present situation	Easy	Stable in short term; but won't last long into 2008; increased pressure for TAC subsidy continuing.	No new rolling stock
2. Toll buys new rolling stock with put option	Easy	ditto	New rolling stock, purchased by Toll. This is at best only an interim solution – but should hold for 1-2 years. No need for govt to make any institutional changes.
3. Crown buys new rolling stock and leases to Toll	Relatively easy	Durable over short-to-medium term;	New rolling stock Operational risks remain with Toll Need for changes/new Crown institutions
4. Crown buys existing assets and franchises back	Relatively easy (because essentially Toll's proposal), but could trip up over valuation and other details.	Durable over medium-to-long term because govt owns all assets and Toll faces little risk from its business.	Govt buys new rolling stock Most of business risk transfers to Crown Franchise re-tendered after 10 years Need for changes/new Crown institutions
5. Crown buys Toll's rail business	Very difficult because Toll not a willing seller.	Very durable over long term because Govt has complete control and carries all risk	Govt achieves full control over assets, but not necessarily the customer contracts Full business risk rest with govt New state rail company required; Ongoing, rising subsidies likely.
6. Crown buys Toll NZ	Very difficult (even at a premium price)	Very durable over long term because Govt has complete control and carries all risk	Govt achieves full control over business and risk New state rail company required Difficult transition in breaking out Toll's non-rail activities (eg Tranzlink) Ongoing, rising subsidies likely.