From: John Wilson
Sent: Monday, 4 December 2006 5:13 p.m.
To: David George; 'William Peet'; Thomas Davis; David Gordon
Cc: Robert Barton
Subject: Rail:ownership issues
Attachments: 920399_1.DOC

David/William/Thomas/David

Attached is the piece of text as discussed. The numbers need checking or even inputting. More broadly all comments welcome.

John Wilson

Rail ownership issues

In the light of some recent discussion about potential ownership changes to the rail operating company, the purpose of this note is to

- Set out the expected flows of finance from government to the rail system to support freight and long-distance passenger over the coming years
- Indicate to what extent those flows would change in the event that the Crown owned the rail operator as well as the track
- Indicate the likely commercial parameters around any purchase of the rail operator
- Indicate possible corporate structures in the event that the Crown owned the rail operator, and their implications, in particular around the likelihood of continuing financial disputes.

The note does not canvas in any depth issues around the different incentives on, and thus behaviour of various ownership models. Nor does it attempt in any depth to assess any other potential costs or savings flowing from particular ownership structures.

The note focuses on financing of the nationwide freight system, and the long-distance passenger system. It assumes that urban passenger rail systems in Auckland and Wellington are funded separately.

Likely flows of finance to the rail system

If Ministers want to maintain a nationwide freight system, the following costs are likely to fall to the Crown regardless of ownership:

Subsidy of access charges to the track. Nationwide rail freight operation in New Zealand is not capable of paying all its financial costs, including the full costs of the track. If the government wishes to sustain a nationwide freight service, concessional access to the track will be necessary. The amount required, based on the proposition about Track costs put to the expert by ONTRACK, is around $70 million a year. This covers the difference between the total costs of the track (track staff, maintenance costs, signalling etc, renewals such as replacement of worn-out line and sleepers) and the rail operator's capacity to pay. Key parameters in establishing the rail operator's capacity to pay are:

- The efficiency of both the track and rail operators
- Growth in rail freight (rail is a high fixed cost business). Growth is partly determined by the state of the economy and partly by rail's competitiveness in terms of price and quality with other modes.
- Rail's capacity to increase prices (this will be determined by the quality of service rail delivers in terms of reliability and timeliness, and by price competition from other modes)
- The rate of return on assets targeted by the rail operator. (In its latest modelling, which has led to the $70 million a year figure, Toll is targeting a rate of return of 12.5% a year before tax. That does not appear to be a high rate of return for the business)

- The valuation of the rail operator's assets. Toll wrote up the valuation of its NZ rail assets to match the $1.15 per share price it paid for the business. Officials believe that the business is worth more like 60c a share. That difference in valuation contributes around $xx million to the rail funding gap. Over time this issue would disappear as Toll replaced the assets with new ones and the replacement costs of those assets appeared in the accounts.

Track Upgrades: ONTRACK has identified around $450 million of upgrades to the track (including Wellington but not Auckland) that could be done over the next 5 years or so. These range from improving tunnel clearances to enable large containers to transit; connecting large industrial sites to the track; general improvements to speed and reliability. The working assumption should be that little or none of this can be recovered from rail users.

New rolling stock: Toll NZ has identified around $450 million of new freight rolling stock that is desirable. Toll is arguing that if it gets a sufficiently attractive agreement on TAC it will commit to investment in new rolling stock. Officials have very significant doubts that, even with a highly concessional access charge, the return at the margin for Toll from this rolling stock investment would be sufficient to ensure that the investment takes place. Similarly, investment in a replacement rail ferry (around $120 million) (as opposed to a general roll-on roll-off ferry) looks commercially marginal. A rail ferry is an integral part of the Auckland-Christchurch rail link.

In the case of the long-distance passenger rail services, at present they do not generate sufficient income to fund their own capital replacement, so if eventually there is to be replacement rolling stock for the long distance passenger services, officials believe that the Crown will need to fund most of that capital, and that there would be negligible return on that spending. Toll has identified around $40 million of potential passenger rolling stock replacement.

How would a change of ownership affect the funding flows?

If the Crown owned the rail operator, the fiscal flows would change as follows:

Track Upgrades: no change

New rolling stock and rail ferry: An SOE would have exactly the same problems as Toll in investing in new rolling stock and rail ferry capacity, and would likely require the same level of Crown funding.

Subsidy of access charges for the track: Assuming that Toll and a Crown-owned rail operator are equally efficient, Crown ownership would have only one impact on the required subsidy for track access. The Crown would not be wedded to Toll's purchase valuations as valuations of the rail assets. This would reduce the level of subsidy required.

This reduction in subsidy would, however, need to be set against any excess over valuation that the Crown needed to pay to secure the business.

Commercial parameters around purchase

This section summarises how we think the owners of Toll NZ would deal with an approach from the Crown to buy the company.

There are two major shareholders of Toll NZ.

- Toll Holdings of Australia owns 83.5% of the business. Toll Holdings bought the business, we conclude, as part of an attempt to secure a central role in NZ as an integrated transport and logistics provider. Although Toll will have concluded that commercially rail in New Zealand is less attractive than it hoped, it will believe that it can secure funding from the Crown to ensure the financial health of the rail business. That confidence will be based on Ministers' expressed desire to have freight move from road to rail, widespread public support for rail as expressed at the time of the Overlander issue, and Toll's success at securing such funding from Australian state and federal governments. Toll will also believe that, as a major Australasian transport operator, it has much to offer the NZ government. (Eg as the majority owner of Virgin Blue airlines)

- Third Avenue Capital of the US owns 10.4 % of the shares. Third Avenue Capital appears to be a somewhat independent-minded US funds manager. (Its lead fund manager, with many years experience in the industry, is 81 years old). We surmise that Third Avenue Capital bought its shares in order to extract leverage (and thus financial return) from Toll when Toll attempted to take 100% control of the business.

Given what the Crown would most likely want to do with the business, and the fact that would not necessarily conform to the interests of the company itself, the Crown as purchaser would ideally target 100% ownership, which would involve dealing both with Toll Holdings and with Third Avenue. It might be possible to simply buy Toll Holdings out, and to slowly get Third Avenue to accept a similar payment for its shares.

Buying both Toll Holdings and Third Avenue's shares at the same time would be a complex process. Both have blocking stakes. An agreement with one to pay a higher price would automatically reflect in the price to be paid to the other.

Pricing issues

Officials conclude that the company is currently worth around 60c a share. (ie around $120 million)

The share price is currently $2.80. This is based on trades among the small group of shares not held by Toll and Third Avenue. To the extent that these people are well-informed, they are backing a combination of the Crown and Toll to sustain the value of their investments. At $2.80 a share, the company would be worth $590 million.

In a commercial transaction, Toll might be prepared to accept a price for its Toll NZ shareholding that gave it a demonstrable return on its original investment. Say $1.65 a share or around $330 million.

However, Toll's current view is that the Crown will provide adequate funding to secure the financial viability of its rail business. That expectation is likely to be built into Toll's view of the businesses value. The risk for the Crown is that it could pay the rail operating subsidies twice (once in the purchase price to Toll, and then again to the Crown-owned rail operator).

Beyond that:

If they were sophisticated sellers Toll (and Third Avenue) would conclude;

The Crown was not buying for commercial reasons, so the price the Crown is prepared to pay could be much higher than that indicated by commercial parameters.

The Crown's balance sheet is strong enough to pay for example a price equal to (or indeed a multiple of) the current share price.

Once Ministers had publicly committed to a purchase as their rail policy solution, it would be very difficult for Ministers to reverse tack over a difference of a few hundred million dollars.

All of this says the purchase price would be extremely unpredictable.

What should be the Crown's price limit.

On a commercial basis, the Crown should not be prepared to pay more than the commercial value of the business (ie around $140 million) plus the savings that would accrue from no longer needing to meet the returns on Toll's uprated asset valuation. Officials guess that, as long as Toll believes that the Crown will subsidise rail extensively rather than let it fail, there is little prospect of it accepting that sort of price.

Issues around Crown ownership

2 issues suggest that the returns from a Crown-owned rail operator would be lower than those earned by the current operator.

- Stakeholders (customers; employee organisations) would recognise that the Crown was buying into rail for other than commercial reasons, and would pressure the Crown-owned rail operator and Ministers to see that their own organisational rail objectives also coincided with the public interest and should be funded.

- There would be a large risk in any such transaction, if Toll were in any sense an unwilling party, of Toll taking some of the major customers with it with long-term contracts. (Precisely how the ferries and the trucking businesses were dealt with would impact on this).

On the other hand Crown ownership of the rail operator would reduce some of the costs inherent in having multiple entities in the rail business.

Possible Crown ownership structures

The current structure is a private rail operator, with a Crown–owned track operator, currently an SOE, but intended to become a Crown entity. That structure has led to a continuing set of disputes between two (largely) commercially oriented organisations with essentially monopoly positions.

Other possible options (if the Crown owned the rail operator) are

- Single track and operations SOE. This would be a return to the 1986-93 model. But the SOE would not now be viable on a stand alone basis and would require significant funding for non-commercial purposes. There would be continuing disputes between the SOE and Ministers about funding. TVNZ is perhaps the nearest current parallel.

- Single track and operations Crown entity. This would remove the commercial focus from the operation and bring it more closely under Ministerial control. The nearest historic parallel would be rail pre-1980. The Crown Entity would require significant annual funding. There would be continuing disputes between the Crown Entity and Ministers about funding.

- Separate SOES for track and operations. If the 2 SOES behaved commercially, this would largely replicate the current set of disputes between Toll and Ontrack.