
From: John Wilson
Sent: Thursday, 7 June 2007 2:01 p.m.
To: Stephanie Ward
Subject: FW: Final TAC Determination
Attachments: FINAL DETERMINATION-090207.PDF

From: Thomas Davis [mailto:Thomas.Davis@ontrack.govt.nz]
Sent: Thursday, 7 June 2007 1:13 p.m.
To: John Wilson
Subject: FW: Final TAC Determination

As requested.

Thomas Davis
Chief Financial Officer
ONTRACK

[Withheld under section 9(2)(a)]

-----Original Message-----

From: David George
Sent: 09 February 2007 12:40
To: Chris.Mackenzie@parliament.govt.nz; 'John Wilson'
Subject: Final TAC Determination

Attached for your information is a copy of the TAC determination. We are naturally pleased at the outcome.

We will consider the determination over the weekend and in the meantime, make no public comment.

Regards

David George
Chief Executive
ONTRACK
Level 4, Wellington Railway Station
PO Box 593
Wellington
NEW ZEALAND

Ph:
Fax: [Withheld under section 9(2)(a)]

NEW ZEALAND RAILWAYS CORPORATION – TOLL NZ LTD
DETERMINATION OF TRACK ACCESS CHARGE

Panel: Bill Wilson QC (Independent Auditor)
Wayne Lewis (Rail Adviser)
Phil Barry (Financial Adviser)

ONTRACK: James Palmer (Counsel)
David George (Chief Executive)
William Peat (Chief Operating Officer)
Thomas Davis (Chief Financial Officer)
David Gordon (Adviser)
David Roberts (Rail Expert Witness)
Bruce Wattie (Accounting Expert Witness)

Toll: Greg Steele (Counsel)
Ben Upton (Counsel)
David Jackson (Chief Executive)
Lloyd Major (General Manager Engineering)
Brian Fouhy (Group Financial Controller)
Rex Birdsall (Accounting Expert Witness)

Dates of hearing: 13-17 November 2006

Place of hearing: Wellington

Date of determination: 9 February 2007

Introduction

1. The New Zealand Railways Corporation owns and controls the rail network of this country. It trades under the name of ONTRACK, and I will refer to it as such in this determination.
2. Toll NZ Consolidated Ltd, to which I will refer as Toll, is by far the largest rail operator in New Zealand.
3. ONTRACK and Toll are parties to an agreement called the National Rail Access Agreement, the NRAA. Under the terms of the NRAA, to which it will be necessary to refer in detail later in this determination, Toll must pay ONTRACK a Track Access Charge, the TAC, for the right to use the network.
4. The TAC comprises cash expenses and capital components. Only the former require to be determined by me.

5. Because ONTRACK and Toll were unable to agree on the cash expenses component of the TAC for the years (ending 30 June) of 2005-06, 2006-07 and 2007-08, ONTRACK appointed me as the Independent Auditor to fix those expenses, based on forecasts of the parties.
6. ONTRACK and Toll also agreed, following proceedings in the High Court and negotiations between them, that I should be assisted by Wayne Lewis, a rail expert, and Phil Barry, a financial expert. I record my appreciation to the parties for that agreement. The experience and expertise of Mr Lewis and Mr Barry has proved invaluable to me in the conduct of the hearing and in the preparation of this determination.
7. Although the responsibility for this determination is mine, and mine alone, Mr Lewis and Mr Barry have each authorised me to say that, having read the determination in draft, they are in full agreement with it, both as to reasoning and result.

The terms of the NRAA

8. The terms of direct relevance to my determination are as follows
 - 2.2 **Mutual objective:** [ONTRACK] and [Toll] record their mutual objective of ensuring that the Rail Network is operated, maintained and renewed in an efficient and effective manner at a reasonable cost.
 - 2.3 **General principles:** The parties acknowledge that this is a long term Agreement governing complex operational and commercial inter-relationships and interdependencies, and agree that if they are to achieve their objectives throughout the Term they need to work together at all times in a co-operative and collaborative manner. In view of this, the parties agree to at all times in connection with this agreement:
 - (a) act:
 - (i) reasonably and in good faith; and
 - (ii) openly and constructively; and
 - (b) use reasonable endeavours to assist the other party to:
 - (i) perform their obligations and exercise their rights under this Agreement; and
 - (ii) achieve the objective set out in clause 2.2.
 - 4.1 **Access Rights:** [ONTRACK] grants [Toll] a licence to operate its Vehicles on the Rail Network during the Term for the purposes of operating rail services. Subject to the terms of this Agreement, this licence:
 - (a) is exclusive; and
 - (b) permits [Toll] to make unrestricted use of the Rail Network for the purposes permitted under this clause.
 - 8.1 **Development:** The parties must use their Best Endeavours to agree Service Levels and a bonus and penalty regime applicable to those Service Levels, based on the principles in Schedule 4, by 30 June 2005 or any later date agreed by the parties.

- 9.1 **Maintenance:** [ONTRACK] must use its Best Endeavours to ensure that the Rail Network or any Line Segment is maintained to standards and conditions equal to or better than those as at the Commencement Date.
- 13.1 **Amount:** The Track Access Charges payable by [Toll] in each Annual Period shall be determined in accordance with Schedule 1.
14. **[ONTRACK] investment:**
- (a) In the period from the Commencement Date to 30 June 2008, [ONTRACK] must expeditiously invest at least \$100,000,000 plus GST on upgrading the Rail Network in order to improve its performance, efficiency, safety and reliability.
 - (b) The sum in clause 14.1(a) is in addition to the replacement capital expenditure of \$100,000.00 plus GST referred to in section 1.3(b)(i) of Schedule 1, which [ONTRACK] is obliged to expend by 30 June 2007. It is acknowledged that the capital expenditure amount paid to [Toll] pursuant to clauses 4.4(c) and 3.2(b) of the Sale Agreement and paragraph 9.2 of Schedule 10 to the Sale Agreement form part of the \$100,000,000 plus GST referred to in section 1.3(b)(i) of Schedule 1. It is also agreed that no more than \$25,000,000 plus GST of that replacement capital expenditure amount shall be capital expenditure in relation to the Midland line.

Schedule 1

1.2 Over-riding principles:

- (a) The TAC payable by [Toll] to [ONTRACK] for each Annual Period during the Term are to be set at levels which are expected to ensure that [ONTRACK] recovers:
 - (i) a return on capital and depreciation in respect of capital expenditure, to the extent provided in section 1.3; and
 - (ii) the reasonable cash expenses that an efficient access provider would be expected to incur in the operation and maintenance of the Rail Network and Network Assets and in the performance of [ONTRACK's] other obligations under this Agreement,

after deduction of net access fees received from other rail operators for the use of the Rail Network and Network Assets and income derived from arrangements transferred to [ONTRACK] under the Sale Agreement relating to bridges on the Rail Network. The parties may also agree to set-off the amount payable to [Toll] under clause 9.5(a) of the Sale Agreement in respect of the Area Networks Agreement against the TAX payable under this Schedule.
- (b) [ONTRACK] shall use its Best Endeavours to reduce operating costs through efficiency and other productivity gains. [ONTRACK] and [Toll] will seek to realise productivity gains from capital replacement and upgrade projects.
- (c) subject to any obligations of confidentiality, [ONTRACK] will provide [Toll] with open book access (subject to reasonable confidentiality terms) to all financial and operational data concerning cash expenses and capital expenditure that form part of the TAC, to enable [Toll] to assess [ONTRACK's] performance against section 1.2(b).
- (d) The TAC is payable by [Toll] throughout the Term regardless of whether or not [Toll] makes use of all or any part of the Rail Network or Network Assets (including when any part of the Rail Network is unavailable due to a Force Majeure Event or otherwise, provided that the variable component (agreed under section 1.7) of the TAC in respect of affected Line Segments will not be payable to the extent that the Line Segment is not being used by [Toll]).
- (e) GST is payable by [Toll] in addition to the TAC.

1.3 Capital expenditure:

- (a) Return on [ONTRACK's] capex: Subject to section 1.3(b), the TAC payable by [Toll] will include recovery by [ONTRACK] of a return on capital and depreciation on capital expenditure to the extent that expenditure is undertaken:
- (i) as part of the replacement of any of the Rail Network or Network Assets;
 - (ii) to enable [ONTRACK] to comply with legal or regulatory requirements (including any requirement of the LTSA or any other authority); or
 - (iii) at [Toll's] request.

[ONTRACK] will use its Best Endeavours to implement capital expenditure on the most economic basis practicable.

1.4 Other [ONTRACK] Functions: The parties record that for reasons of convenience or efficiency, if the Crown transfers this Agreement to a Crown Transferee, the Crown may also require the Crown Transferee to undertake public policy or other functions, in which case:

- (a) the Crown Transferee's accounts shall ensure that such functions are separately recorded and assume a reasonable share of corporate overheads; and
- (b) there is no expectation of cross subsidy in either direction between such additional functions and the operation and administration of the Rail Network and Network Assets.

1.8 Auckland costs: The parties acknowledge that:

- (a) notwithstanding that this Agreement relates to the Rail Network only, and not to the Auckland Network; and
- (b) notwithstanding any other provision of this Schedule or this Agreement,

the TAC payable by [Toll] under this Agreement shall include the costs incurred by [ONTRACK] in operating and maintaining the Auckland Network in accordance with (and performing its obligations under) the Auckland Access Agreement. Consequently, for so long as [Toll] pays the access fee under the Auckland Access Agreement, [ONTRACK] agrees to deduct that access fee payable by [Toll] under the Auckland Access Agreement from the TAC under this Agreement.

3.1 1 July 2004 to 30 June 2005 ("first Annual Period"):

- (a) The TAC payable by [Toll] for the First Annual Period is \$3,198,250 plus GST per month (equating to an annual TAC of \$38,379,000 ("Base TAC") plus GST) plus the amounts referred to in section 3.1(b). The monthly payment of that TAC shall commence from the 15th of the second month following the end of the Transitional Period (as defined in the Sale Agreement), on the basis that [Toll] is meeting the cost of operating and maintaining the Rail Network under the Sale Agreement during that Transition Period.
- (b) The Base TAC was based on budget and supporting information provided to the Crown by [Toll] ("Budget").

3.2 Subsequent Triennial Charging Periods:

- (a) At least 3 months prior to the end of the First Annual Period (and at least 6 months prior to the commencement of each subsequent triennial TAC charging period from 30 June 2008), [ONTRACK] will prepare a forecast for the expected cash expenses of [ONTRACK] for the following 3 year period ("Forecast") having regard to:

- (i) the categories and amount of costs included in the Budget; and
 - (ii) the pricing principles in section 1.2 (provided that if the Budget is in conflict with those principles, section 1.2 must be given precedence).
- (b) The purpose of the Forecast is to enable [ONTRACK] to set the TAC (before adding [ONTRACK's] return on capital and depreciation on capital expenditure in respect of which it is entitled to recover a return) for the subsequent triennial charging period. [Toll] may either agree to or dispute the Forecast.
- (c) If [Toll] disputes the costs set out in the Forecast within 30 days or receipt of the Forecast from [ONTRACK] (or 60 days in the case of the second and subsequent triennial TAC charging period), [Toll] must submit its own proposed Forecast to [ONTRACK] for consideration, with the differences from [ONTRACK's] Forecast identified. The parties must negotiate in good faith in order to resolve the matters in dispute, at all times having regard to the materiality of the matters disputed. If the parties are unable to resolve that dispute within a reasonable period of good faith negotiations, either party may refer each of their proposed Forecasts (each amended to take account of any matters agreed by the parties) to an independent third party ("Independent Auditor") to review and audit the reasonableness of the cash expenses set out in the draft Forecasts based on the pricing principles in section 1.2, 1.8, 3.1 and 4.1 and having regard to best practice.

The Independent Auditor shall produce his or her own Forecast based on those of the parties, making such changes as he or she considers reasonable having regard to best practice (to the extent consistent with those pricing principles in section 1.2). The final Forecast shall be the midpoint between the Independent Auditor's determination and the position of the party whose draft Forecast was closest to the Independent Auditor's determination (which shall be decided by the Independent Auditor). The Independent Auditor's costs shall be paid by the party whose forecast were furthest from the determination of the Auditor.

- (d) The final Forecast (either as agreed or determined by the Independent Auditor) will be used to set the TAC for the subsequent triennial TAC charging period. The TAC shall comprise the sum of the Forecast plus [ONTRACK's] return on capital and depreciation on the capital expenditure in respect of which it is entitled to recover a return for the same period as the Forecast.

9. The key points which appear to me to emerge from these provisions are:

- 9.1 The relationship between ONTRACK and Toll is intended to be in the nature of a contract of alliance or a joint venture, with each party obliged to act in their common interests.
- 9.2 There is an unavoidable tension between the interests of ONTRACK, which understandably wishes to maintain the network to a desirable standard and forecasts expenditure accordingly, and those of Toll, which as the paying party wants to avoid any expenditure which is not strictly necessary.
- 9.3 Rather than being incentivised to minimise its costs, ONTRACK's incentives are to forecast a high level of expenditure and to spend as close to its budget as possible. If it were to significantly under-spend its budget, the budget for future years would probably be reduced as a result.

- 9.4 Toll has incentives to argue for a low level of expenditure and to seek to shift costs to the Crown (e.g. by seeking to have items classified as public policy and, to some extent, as capital expenditure rather than as maintenance).
- 9.5 Where (as here) the parties' forecasts diverge, the procedure for resolution is a draconian one. It is colloquially known as a *Russian Roulette* provision, and specifies (clause 3.2(d) in Schedule 1) that the amount payable is to be not my forecast but the midpoint between that figure and the forecast which is closer to it.
10. It is I think also significant that (clause 3.1(a)) the initial TAC was described as *the Base TAC*. It seems to me to follow that that TAC is the starting point for my determination of the subsequent TACs, recognising of course that the parties went on in clause 3.1(b) to record that the Base TAC was based on budget and supporting information provided to the Crown by [Toll]. (Toll was responsible for the network for the 10 months to 1 September 2004.)
11. Some support for the proposition that the Base TAC is to be the starting point is to be found in the observations of two members of the Court of Appeal in *Dimond Manufacturing Co Ltd v Hamilton* [1969] NZLR 609. In considering a provision that a contract for the purchase of shares was based on a balance sheet, Justice McCarthy said that
- ... I have little doubt what was intended by the parties. By stating that the accounts were the basis of the contract, they show their intention to bring the accuracy of the accounts into the very heart of the arrangement.
- (page 624, lines 11 to 14)
- and Justice North, the President of the Court, that
- To this end, all the parties to the deed acknowledged that the contract was based on a balance sheet ... In my opinion this acknowledgement constituted a fundamental condition of the contract so that if nothing more had been said an action could have been maintained by the appellants against the old shareholders if the balance sheet had been shown to be incorrect.
- (page 642 lines 13 to 19)
12. While I accept that the Crown, in agreeing to the Base TAC, relied on information provided by Toll, it could have conducted due diligence if it so wished and did apparently have sufficient knowledge of the network to agree to provide \$200 million of additional funding.
13. In practical terms, there is I think an onus on ONTRACK (albeit not a heavy one) to justify the increase of some 32 percent from the 2004-05 agreed TAC to the figure which it now puts forward.

The positions of the parties

14. In summary:

- 14.1 ONTRACK's 2005-06 forecast for the purposes of the *Russian Roulette* determination is \$57.96 million.
- 14.2 There is a dispute as to what is the corresponding figure of Toll; Toll claims that it is \$44.72 million, whereas ONTRACK contends that it is \$42.48 million. The documentation placed before me shows quite clearly that the actual figure put forward by Toll to ONTRACK was \$42.48 million.
- 14.3 At the hearing, both parties took a position more favourable to themselves than their *Russian Roulette* forecasts.
- 14.4 Conversely, both ONTRACK and Toll were at the hearing prepared to compromise on some small items.
- 14.5 In the event, the parties are now in agreement, or within \$100,000 of agreement, on all but the following 22 items (with the figures expressed as thousands of dollars and to the closest thousand dollars)

	ONTRACK	less Toll	(\$'000)
- level of net contribution of Auckland	-3,627	-3,994	367
- project revenue	-246	-541	295
- sale of scrap materials	-612	-1,224	612
- miscellaneous revenue	-253	-76	-177
- wages	11,332	9,594	1,737
- transfer of wages to capital expenditure	-1,490	-2,120	630
- transfer of wages to commercial property	0	-161	161
- reallocation of wages to public policy	-267	-725	458
- board/director fees	180	70	110
- legal costs	308	100	208
- other professional fees	577	280	297
- renegotiation of access agreement	615	0	615
- contract services	952	745	207
- pricing and initial business plan	205	0	205
- new contractor and start-up costs	479	0	479
- Transfield (maintenance) charge	35,859	28,339	7,520
- domestic travel	498	320	178
- training costs	183	64	119
- transfer of corporate overhead to capital expenditure	0	-807	807
- reallocation of corporate overhead to public policy and commercial property	-314	-1,011	697

- forecast efficiency gains	-323	0	-323
- incident costs (net)	3,194	2,500	694

14.6 The total of the differences listed above is \$15.897 million, which represents 98 percent of the total sum in dispute of \$16.3 million.

14.7 The figure of \$16.3 million is greater than the difference between the *Russian Roulette* numbers, whichever number is adopted for Toll, because (as I noted in para 14.3) both parties did at the hearing advance positions more favourable to themselves than their respective *Russian Roulette* numbers, and the consequent divergence of their positions was only offset to a small degree by the modest compromises noted in para 14.4.

My approach to the determination

15. I heard detailed evidence and extensive submissions to support the precise estimates of both ONTRACK and Toll of the costs in each category. It is however important to remember, in my view, that forecasts are by their very nature subjective and not capable of assessment with mathematical precision. I propose therefore

- to *split the difference* between the parties where the gap between them is less than \$100,000 (as noted in para 14.6, these items collectively represent only two percent of the sum in dispute)
- in assessing the remaining categories of cost, to work from the approximated figures in para 14.5 (in any event, it is likely that the differences which arise from working to the nearest thousand dollars will largely balance out as between ONTRACK and Toll).

16. The effect of this approach is that the sum of \$197,776 (50 percent of the difference between the figures in para 14.6) will be added to the total of the sums which I allow in the 22 categories listed in para 14.5 in order to determine my Forecast for 2005-06.

17. I intend to consider these 22 items in turn and, in doing so, to have regard to

- the base TAC of \$38 million for the 2004-05 year, which was supplemented by a Crown subsidy of \$7 million
- the *over-riding principles* set out in clause 1.2 of Schedule 1 to the NRAA
- the other relevant provisions in the NRAA
- the evidence and submissions which I heard.

18. I will generally follow the sequence as it appears in para 14.5 but will group some items and in view of the difficulty and complexity of the issues raised by the *Transfield charge* and the

magnitude of the amount in dispute under that head, propose to defer my discussion of it to the end.

19. Before doing so, I remind myself that I am not acting as an arbitrator but as an *Independent Auditor* and am required by section 3.2(c) to produce my own Forecast, based on those of the parties but making such changes as I consider reasonable having regard to best practice and consistent with the pricing principles in sections 1.2, 1.8, 3.1 and 4.1.

Auckland

20. Although Toll uses the rail network in the Auckland metropolitan area for its freight services, passenger services in that area are operated by another company called Veolia. ONTRACK claims that the fees paid by Veolia for the use of the network are fixed by its contract with Veolia and are reasonable and appropriate.
21. Toll submits that ONTRACK has misapplied clause 1.2(a) of Schedule 1 to the NRAA because only the fees received from operators on the *Rail Network* should be deducted and, because the *Rail Network* excludes the Auckland network, Veolia revenue is not a relevant *net access fee* for the purposes of clause 1.2.
22. Looking at the NRAA as a whole, it seems to me that it would be an affront to commercial commonsense to exclude the revenue from Veolia and that cannot therefore have been the intention of the parties.
23. I also accept that the quantum of the access fee negotiated between ONTRACK and an independent party in Veolia provides the best evidence of the reasonableness of that fee.
24. On this issue, I therefore uphold ONTRACK's position.
25. I add however that I do so on the basis that there was a *bona fide* negotiation between ONTRACK and Veolia. If this were not the position, it would be necessary for the reasonableness of the Veolia fee to be determined independently.

Project revenue

26. In dispute here is the question of whether there should (as Toll claims) be an offset against the cost of consultants employed by ONTRACK to reflect income from third parties to whom the consultants provide service.
27. I agree with Toll, and see no reason why it should not receive credit for the payments which ONTRACK receives.

Sale of scrap material

28. At issue here are first whether Toll should receive credit for ONTRACK-projected revenue from scrap, principally rail and sleepers, and, if it should, the appropriate quantum.
29. I see no reason in principle why Toll should not receive credit for the return from scrap when it is meeting, directly or indirectly, the cost of replacement.
30. ONTRACK provided detailed calculations to support its claim under this head. Toll responded with calculations indicating that substantially higher revenue should be obtained from the disposal of scrap.
31. I think that there is merit in both positions, but greater merit in that of ONTRACK. More particularly, it appears to me that Toll has given insufficient weight to factors which are likely to reduce the recovery such as the costs of transporting rail and sleepers from the location where they are removed (possibly in a remote area) to the point where their disposition can take place.
32. I therefore allow ONTRACK 75% of the difference between the parties.

Miscellaneous revenue

33. This item represents revenue received by ONTRACK from third parties in relation to such matters as giving consents for access to property.
34. Toll submits that any activities associated with generation of this revenue are not obligations under the NRAA and accordingly neither the revenue nor the costs incurred in achieving it should pass to Toll. For its part, ONTRACK submits that the costs are properly incurred under the provisions of the NRAA.
35. I accept the submission for Toll and therefore disallow this item.

Wages

36. This subject represents a substantial sum in dispute. It arises from disagreement first as to whether certain positions are required within ONTRACK, and secondly the level of remuneration which is appropriate.
37. Having heard and considered very extensive submissions on these questions, I am unable to say whether there is greater merit to the ONTRACK position taken overall or the Toll position.
38. I therefore think that it is appropriate to take a position midway between that of the parties.

Transfer of wages

39. Under this topic, three separate categories may be conveniently considered together
- transfer of wages to capital expenditure
 - transfer of wages to corporate property
 - reallocation of wages to public policy.
40. In addition to the wages required to maintain the network, some part of the wages paid by ONTRACK must obviously be allocated to capital expenditure (dealt with separately under the NRAA and not at present in issue), the management of ONTRACK's extensive commercial property portfolio and what is termed *public policy* (matters such as level crossing safety, for which ONTRACK is funded by the Government).
41. The appropriate allocation of wages between the operation and maintenance of the network and these other matters resulted in a divergence of opinion between Mr Wattie of Pricewaterhouse Coopers (ONTRACK's financial adviser) and Mr Birdsall, formerly of KPMG and now with Stimpson & Co (Toll's adviser). In summary, as I understood their evidence, Mr Wattie was of the view that wages should be allocated to the other areas only where it could be established that the wages were being incurred exclusively for those purposes. Mr Birdsall took a different approach, contending for an apportionment which reflected in a realistic and pragmatic way work which was being undertaken by the employees concerned.
42. In the context of the NRAA, which as I have already noted I see as a contract in the nature of an alliance contract or joint venture, it seems to me that the issue is best addressed by an assessment of commercial reality, rather than accounting theory. That is not however the end of the matter because, on balance, I think that even on the criterion of commercial reality the amounts which should be apportioned are significantly less than those proposed by Toll.
43. Taking all these matters into consideration, I think that it would be just and reasonable to allocate wages in accordance with expenditure, including the approximate two to one ratio of capital to current expenditure for ONTRACK, and therefore adopt ONTRACK's figures.

Directors' fees

44. Unsurprisingly, ONTRACK submits that the fees being paid to the members of its Board are appropriate. Toll contends however that they are excessive, having regard to the responsibilities of the Board to manage an access provider rather than a vertically-integrated company which both provides the network and operates it.

45. Whatever may be the relative responsibilities of the ONTRACK Board and a notional Board which was also responsible for the operation of the network, it seems to me that the fees being paid to the Board cannot be said to be unreasonably high. I therefore allow this item in full.

Legal costs and other professional fees

46. Although itemised separately, these categories of claim can I think be sensibly dealt with together.
47. Particularly with legal costs, this category appears to me to illustrate very clearly the difficulties inherent in the process enshrined in the NRAA for the determination of the TAC. Matters such as serious accidents, which by their very nature are unforeseeable, are likely to be a major driver of the necessity to incur external legal costs. It is only to be expected that, for the purposes of the determination of the TAC, ONTRACK will err on the side of caution and assume the worst possible realistic scenario in quantifying the costs sought in the forecast.
48. To a lesser degree, I think that the same type of reasoning will and does also influence the ONTRACK assessment of likely other professional fees.
49. Having regard however to the substantial commitment of ONTRACK to Land Transport New Zealand, I allow the sum of \$400,000 under this head.

Renegotiation of access agreement

50. ONTRACK claims a substantial amount for professional fees incurred in relation to the anticipated renegotiation of the NRAA at the end of the current triennium. Toll opposes this claim on the basis that no part of the cost will be incurred in the 2005/06 year and, in any event, they should in principle not be included.
51. I see no justification for including these costs for the year to June 2006 when, by their nature, they will not be incurred in that year.
52. I will address the question of whether the costs should be included in either or both of the subsequent years later in this determination.

Contract services

53. This category includes a number of disparate activities, such as the updating of codes and standards and the daily microfilming of train control graphs against the possibility of their being required in subsequent investigations.
54. This is another area where the submissions advanced as to whether separate allowances should be made for these matters, or whether they should be subsumed into other categories,

appear to me to be approximately evenly balanced. I therefore take a position midway between that of the parties.

Pricing and initial business plan

55. This is again a comparatively small item, with the amount in dispute approximately \$205,000.
56. Toll submits that business planning and budgeting are a normal activity for any business or enterprise and that ONTRACK is or should be sufficiently resourced to undertake these activities.
57. I agree with Toll's submissions, and therefore disallow this claim.

New contractor and start-up costs

58. These are one-off transition costs incurred in in-sourcing maintenance from Transfield to ONTRACK.
59. ONTRACK claims its actual costs, but Toll disputes its liability for them on the basis that it should not have to incur the cost associated with the transfer from Transfield to an in-house operation and makes the point that any such costs should be offset through the appointment of a more efficient service provider.
60. In the context of the NRAA, it seems to me unreasonable that Toll should be required to meet these costs. I therefore disallow them.

Domestic travel

61. This is again a subjective assessment, where it would be unsurprising if ONTRACK erred on the high side.
62. Having said that, and even allowing for the benefits of video and telephone conferencing, it seems to me that the amount claimed by ONTRACK cannot be said to be unreasonable when regard is had to the possibility, of and indeed the likelihood, of executives being required to travel to different parts of the country to attend to matters arising, possibly incidents requiring urgent attention.
63. I would also not want to discourage travel by ONTRACK executives to enable face to face meetings with their Toll counterparts. During the hearing I noted not only the expertise and experience of the executives of both parties but also their compatibility at a personal level. This makes the apparent absence of constructive discussion prior to the hearing, particularly at the Chief Executive level, all the more regrettable.
64. I therefore allow in full this claim by ONTRACK.

Training costs

65. This is another modest claim, where the difference between the parties is approximately \$119,000. It appears to me to be another item where the competing arguments are evenly balanced, and I therefore take a position midway between that of the parties.

Transfer of corporate overhead

66. As with the transfer of wages, this issue requires an assessment of the extent to which the corporate overheads of ONTRACK should be apportioned first to capital expenditure, secondly to commercial property and thirdly to public policy.
67. Very much the same considerations arise as in the allocation of wages. Again I accept Mr Wattie's evidence that, as a matter of accounting theory, the ONTRACK position is correct, or even unduly unfavourable to Toll. But again, as with allocation of wages, the test in terms of the NRAA should I think be commercial reality rather than accounting theory.
68. Applying this test, it seems to me that, for the purposes of the transfer of corporate overhead to capital expenditure, it would (as with the transfer of wages) be appropriate to follow the two to one ratio of capital to current expenditure and so determine a figure of negative \$538,000.
69. As to the reallocation of corporate overhead to public policy and commercial property, the arguments appear to me to be evenly balanced and I therefore allow a figure of negative \$663,000 (50% of the difference between the parties).

Forecast efficiency gains

70. While it is common ground that efficiency gains must be taken into account in the setting of the TAC, the quantification of such gains is a difficult and subjective subject.
71. Having reviewed the evidence and the submissions, I believe that this is another claim where the competing arguments are approximately equal. I therefore adopt a figure halfway between the positions of the parties.

Incident costs

72. Under the terms of the NRAA, ONTRACK can recover the costs involved in investigating or remedying any events which impair or compromise the safety or operational integrity of the Rail Network.

73. As ONTRACK acknowledged, correctly in my view, the amount in the Forecast for this item is effectively a provisional sum because, by their very nature, the number and severity of incidents will vary from year to year.
74. I address this item further in the next section of this Determination, which discusses maintenance charges.

Transfield charge (maintenance)

75. The cost of maintenance is referred to as the *Transfield* charge because maintenance was previously out-sourced to that company.
76. To listen to the evidence and submissions for the two parties, one may well have thought that two different Rail Networks were being described. ONTRACK painted a picture of a rundown network, close to collapse, which required substantially more maintenance than should have been necessary, at least until the capital works which were necessary to bring the network up to standard had been incurred. In contrast, Toll described a network which, while requiring a certain amount of additional capital expenditure, was operating reasonably well and did not require substantial additional maintenance to be carried out pending the completion of the required capital works.
77. Allied to this gulf between the parties, was a wide divergence between them as to what fell into the category of maintenance and what capital work. To take a simple example by way of illustration, if a ditch beside the track has fallen in, it is likely to be a question of degree whether the restoration of that ditch to a good condition requires the clearing of the existing ditch (maintenance) or the construction of a new ditch (capital work).
78. I accept Toll's point that it should not be required to pay more for maintenance than it would as part of a vertically-integrated business, and that consequently the maintenance charge should not be increased through ONTRACK adopting a role as *guardian* of the network. Commerciality should prevail.
79. It is I think unfortunate that the parties have not agreed on the Service Levels and bonus and penalty regime contemplated by clause 8.1 of the NRAA. Had they done so, the present dispute may well have been averted.
80. This is not I think a part of the case which is susceptible to precise judgment and quantification. Rather, I am required to stand back and look at the evidence as a whole before deciding what if any part of the very substantial sum in dispute should be allowed.

81. Applying these principles, I think that the *Transfield charge* can be broken down and assessed as set out in the following table (again working to the nearest thousand dollars)

	Proposed by ONTRACK	Assessed	Comment
Base Transfield Charge	28,339	28,339	
Track Geometry Decline	1,828	914	- allow 50 percent, in recognition of substantial decline
Structures and Works Orders Decline	1,400	700	- known at time of Base TAC and in part capital expenditure (allow 50 percent)
Side Drains and Culverts	985	492	- known at time of Base TAC (allow 50 percent)
WEA Traction	144	144	- accept as appropriate
Access Road	25	25	- accept as appropriate
Vegetation – Off Track	189	189	- accept as appropriate
Training (25 people)	514	257	- Transfield had a training programme but some additional staff (allow 50 percent)
Coal Route Maintenance	312	156	- recognises that there is some deferred maintenance and an aging asset, but considerable expenditure has occurred in the last three years towards upgrading of the asset (allow 50 percent)
ECMT Maintenance	306	306	- recognise increase as consequence of increase in traffic
Interest on inventory purchases	477	0	- reject as not properly included in charge
Tunnel cleaning	326	81	- allow 25 percent because should have been known
	34,845	31,603	
Total above base Transfield Charge	6,506	3,264	

Conclusion as to my Forecast for 2005/06

82. Bringing together my conclusions on the different parts of the claim, I think that the TAC cash expense for the year to 30 June 2006 should be assessed at \$50.325 million, arrived at as

follows (extending the table in para 14.5 to include my findings and the sums not in dispute or modest in amount)

	ONTRACK	Toll	Independent Forecast
- agreed cost items	10,811	10,811	10,811
- agreed revenue items	-1,515	-1,515	-1,515
- fifty percent of items of less than \$100,000	1,867	1,472	1,670
- level of net contribution of Auckland	-3,627	-3,994	-3,627
- project revenue	-246	-541	-541
- sale of scrap materials	-612	-1,224	-765
- miscellaneous revenue	-253	-76	0
- wages	11,332	9,594	10,463
- transfer of wages to capital expenditure	-1,490	-2,120	-1,490
- transfer of wages to commercial property	0	-161	0
- reallocation of wages to public policy	-267	-725	-267
- board/director fees	180	70	180
- legal costs	308	100	100
- other professional fees	577	280	400
- renegotiation of access agreement	615	0	0
- contract services	952	745	849
- pricing and initial business plan	205	0	0
- new contractor and start-up costs	479	0	0
- Transfield (maintenance) charge	34,845	28,339	31,603
- domestic travel	498	320	498
- training costs	183	64	124
- transfer of corporate overhead to capital expenditure	0	-807	-538
- reallocation of corporate overhead to public policy and commercial property	-314	-1,011	-663
- forecast efficiency gains	-323	0	-161
- incident costs (net)	3,194	2,500	3,194
	57,399	42,121	50,325

83. It follows that the sum as forecast by me is closer to the *Russian Roulette* figure of ONTRACK, (para 14.2), albeit marginally, and the final TAC cash expense for 2005-06 must therefore be at the mid-point between my forecast and the forecast of ONTRACK.

84. The NRAA requires that, given this conclusion, Toll must pay the costs of this determination.

85. As I have already noted (para 9.5), the process is a draconian one. It was however agreed upon by two commercially-sophisticated and well-advised parties and must take effect according to its terms. Having said that, I was told at the hearing that wider discussions are taking place between the parties. I would suggest that, in the context of those discussions and in the interests of attempting to develop a good commercial relationship going forward, the parties may wish to discuss ways for improving the incentives on each party to act in a commercially constructive manner and whether strict effect should be given to the outcome of the *Russian Roulette* determination.

Subsequent years

86. At the hearing, the parties sensibly agreed that the TAC for the 2006-07 and 2007-08 years should be the 2005-06 TAC, adjusted for inflation as measured by the Consumer Price Index.
87. That leaves the question of whether an allowance should be added in either or both of those years for ONTRACK's costs in relation to the determination of the TAC for subsequent years. It does seem to me that, again emphasising the context of the NRAA, it would be reasonable for ONTRACK to carry those costs itself in the same way that Toll will have to carry its costs, because it is unlikely to be able to pass them on to its customers in the competitive environment in which it operates.
88. I also accept the submission of Toll that, when the forecast efficiency gains for 2005-06 have been halved (para 71), the same logic should be applied to the second and third years of the Forecast period to reflect increasing gains.



W M Wilson QC
Independent Auditor