THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: National Rail - How to Progress the Options

Date:	11 December 2002	**Treasury Priority:**	**High**
Security Level:	Commercial Secret	**Report No:**	T2002/1756

Action Sought

	Action Sought	**Deadline**
Minister of Finance	Attached for your signature should you agree is a paper for the Ad-hoc Ministerial Group on Rail Policy.	We understand the group will consider the paper on Tuesday 17 December 2002.

Contact for Telephone Discussion (if required)

Name	**Position**		**Telephone**	**1st Contact**

Enclosure: **Yes**

SH-8-4

Recommended Action

It is recommended that you **sign** the attached report and refer it to the Ad-hoc Ministerial Group on Rail Policy for discussion on Tuesday 17 December 2002.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Referred:

Prime Minister	Yes/No
Minister of Economic Development	Yes/No
Minister for State Owned Enterprises	Yes/No
Minister of Transport	Yes/No

Office of the Minister of Finance

16 December 2002

Prime Minister
Minister of Economic Development
Minister for State Owned Enterprises
Minister of Transport

NATIONAL RAIL POLICY – PROGRESSION OF OPTIONS

Executive summary

This report sets out options for Government to progress its national rail policy objectives and recommends a preferred approach - that Government negotiate with Tranz Rail for the acquisition of the rail infrastructure. It assumes that the Government's objectives include:

- network integrity - the ability to maintain (and extend) the integrity of the network in terms of coverage and maintenance levels;
- service coverage - the ability to either increase service levels or alter the type of services provided on the network; and
- alternative operators - the ability for alternative operators to access the network. Options range from open access to the rail infrastructure, to alternative rail operators being able to access the infrastructure at the margins.

As identified in the Government's land transport strategy, rail generally provides improved environmental benefits and gives an opportunity to reduce the impact of heavy vehicle transport on some regional arterial roads. However the overall operational scale in New Zealand is small, and the commercial environment is difficult.

Tranz Rail's financial performance deteriorated significantly during the 2002 financial year. Notwithstanding the asset sales during the 2002 financial year that reduced net debt, the company is still in a weak financial position.

It is likely that if Government wants a level of infrastructure investment, or service delivery, higher than that which is commercially viable, it will have to provide some kind of ongoing financial assistance to rail.

Major users and union groups have expressed a preference for the introduction of open access with Government owning the rail infrastructure, and any rail operator being able to access the infrastructure for an access charge. From a theoretical perspective, open access is an attractive concept. However in practical terms it is highly unlikely that an open access regime would operate effectively in New Zealand due to its small operational scale.

The four options most relevant to achieving the Government's national rail objectives are:

- **Option A: Infrastructure and service partnership** - The Crown and Tranz Rail could establish an overarching partnership, supported by a set of legal arrangements that document a set of rights and relationships.

- **Option B: Infrastructure purchase from Tranz Rail** - The Crown would acquire the track infrastructure, and all assets required for the effective management and operation of the rail infrastructure, but Tranz Rail would remain the dominant freight operator.

- **Option C: Crown purchase of company and reconfiguration** – The Crown would acquire 100% of Tranz Rail, separating out the infrastructure and divesting the “above rail” operations.

- **Option D: Infrastructure purchase as part of an arrangement with a third party** - A third party could look to acquire Tranz Rail on its own or in conjunction with the Crown.

Insert comment on REGULATION

Under all of the options above, the Government would have greater ability to influence both service levels and investment in the network. The key difference is the degree to which the Government has a preference to directly influence maintenance and investment choices through ownership of the infrastructure.

Option A: Infrastructure and services partnership, offers the least cost (in time and money) way of achieving the majority of Government’s rail objectives. However Government needs to consider whether shifting ownership to the Crown will better recognise the contribution of the rail infrastructure to the Government’s wider economic, social and environmental goals.

Of the ownership options, discussions with other rail operators have not conclusively indicated that any new operator will act in any way that is substantially different from the current, largely New Zealand based, owners of Tranz Rail.

Added to this, an infrastructure purchase from Tranz Rail avoids some of the high fiscal and process risks for Government associated either directly or indirectly with the takeover of a publicly listed company.

My preferred option is that the Crown reaches a suitable agreement with Trans Rail on a purchase of the network (Option B). However, if during negotiations it became clear that no such deal was possible, the Crown would still have the other options in this paper open to it, including purchase of the company as a whole (either Option C or D).

Treasury, reflecting the highly commercial nature of the negotiations, should lead Government negotiations with Tranz Rail. I propose to provide Cabinet with a short paper outlining the parameters of this issue and seeking full delegation to the Ad-hoc Ministerial Committee on Rail policy.

Purpose of report

1. This report sets out options for Government to progress its national rail policy objectives and recommends a preferred approach.

Background

2. Since March this year, I have tasked a team from Treasury to explore the various commercial options that might go some way to achieving the Government's national rail policy objectives. In undertaking this task, the Treasury has been guided by:

   - Government's national rail policy objectives [CAB Min (02) 6/4 refers];
   - monitoring the financial performance of Tranz Rail;
   - discussions with Tranz Rail and its major users; and
   - discussions with third parties with a potential interest in Tranz Rail.

3. With reference to these sources of information, it is clear that no single option will meet all of the Government's national rail policy objectives.

4. From discussions with my colleagues, and insights from major users, I have distilled that Government's national rail objectives are best articulated in terms of:

   - network integrity - the ability to maintain (and extend) the integrity of the network in terms of coverage and maintenance levels;
   - service coverage - the ability to either increase service levels or alter the type of services provided on the network; and
   - alternative operators - the ability for alternative operators to access the network. Options range from open access to the rail infrastructure to, alternative rail operators being able to access the infrastructure at the margins.

Rail in New Zealand

5. As identified in the Government's Land Transport Strategy, rail generally provides improved environmental benefits, and gives an opportunity to reduce the impact of heavy vehicle transport on some regional arterial roads. In order to gain an appreciation of rail economics and the commercial impediments to rail playing a greater role in our transport infrastructure, Treasury, in consultation with the Ministry of Transport, has worked with LEK Consulting (LEK).

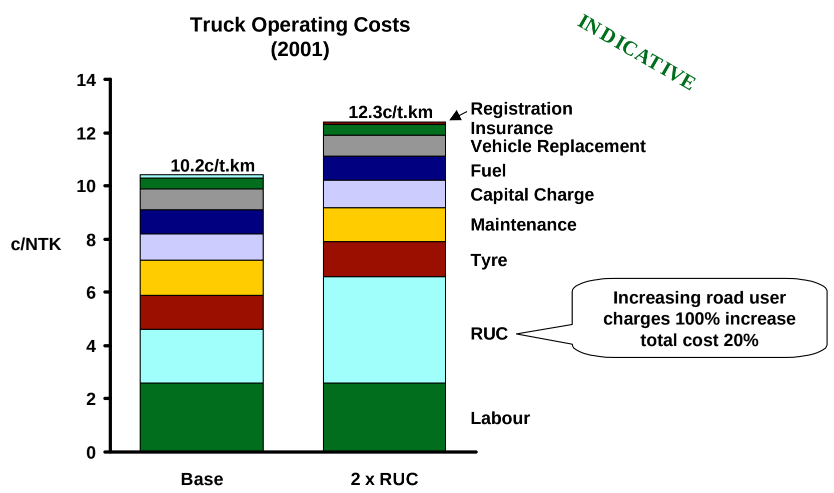
6. New Zealand is a very challenging rail market as:

   - low freight densities generate low revenues relative to track and operating costs;
   - overall railway operational scale is very small by international standards; and
   - the market is small with very little long haul and bulk freight that typically suits rail.

7. Rail infrastructure is extremely expensive to build and maintain. Track related costs are generally fixed at densities below 20 million tonnes per annum. Recovering the full life costs of the track on routes below 300,000 tonnes per annum is unlikely to be commercially viable.

8. Generally speaking, rail long haul operations are lower cost (on a per tonne kilometre basis) than road long haul operations because long haul enables rail to recover the cost of double handling implicit in most rail carriage. Road transport's competitive advantage is in pick up and delivery and rail operators must use efficiency over distance to counter this competitive advantage. Transhipment costs generally require routes above 400km if the rail operation is to be competitive with road transport (see attachment 6). LEK's view is that even increases in relative road freight charges are unlikely to have a significant impact on modal shares as highlighted below.

Diagram One: Indicative truck operating costs (source: Transit New Zealand report/industry economics)



9. This analysis by LEK suggests that even a doubling of the current road user charges is unlikely to have a impact on rail's modal share. This has implications for the road/rail parity study currently being undertaken by the Ministry of Transport. If this study does, as expected, conclude that rail is at present disadvantaged, Government may have a preference to address this issue through increased assistance to rail including alternative ownership structures for the infrastructure. The Ministry of Transport's road/rail study is due for completion in March 2003.

REFRENCE TO INVESTMENT DECISIONS in roading better investment decisions

10. Providing competitive service levels require sufficient route density to support efficient train lengths and few, if any, New Zealand routes are likely to generate sufficient volumes to support multiple operators in the long term. Work completed by LEK shows that as the overall operational scale in New Zealand is **Tasking is small????**small, the commercial options for supporting multiple rail operators are limited. In particular, train operating costs are highly dependant on reaching efficient train lengths as "train mile" and fixed costs typically account for over 80% of above rail costs. This problematic operational scale, in comparison to overseas rail systems, is highlighted in the two diagrams below.

Diagram Two: Comparative international rail freight densities (source: LEK)

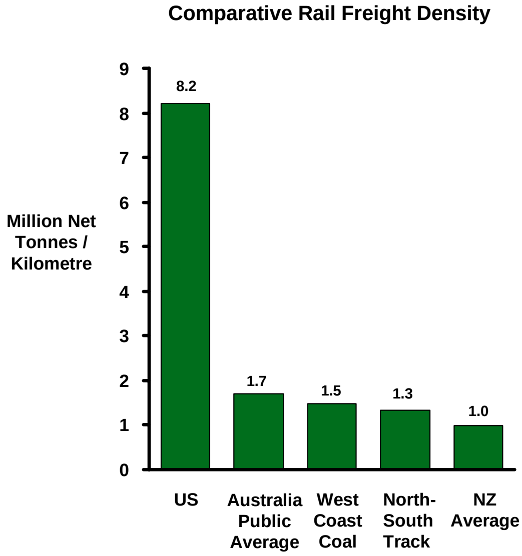
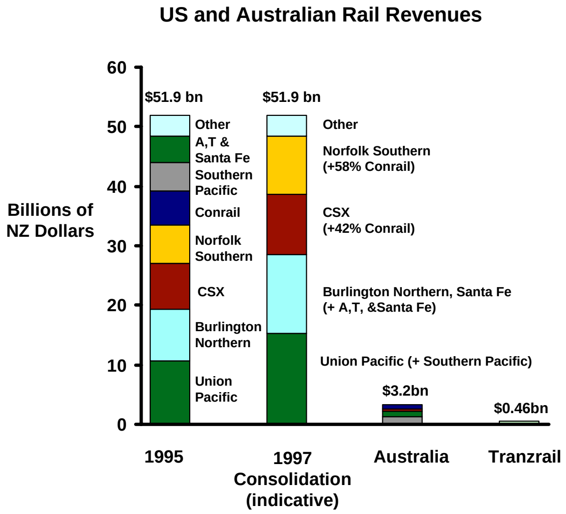


Diagram Three: Comparative international rail revenues (source: Association of American Railroads)



Update on Tranz Rail Holdings Limited

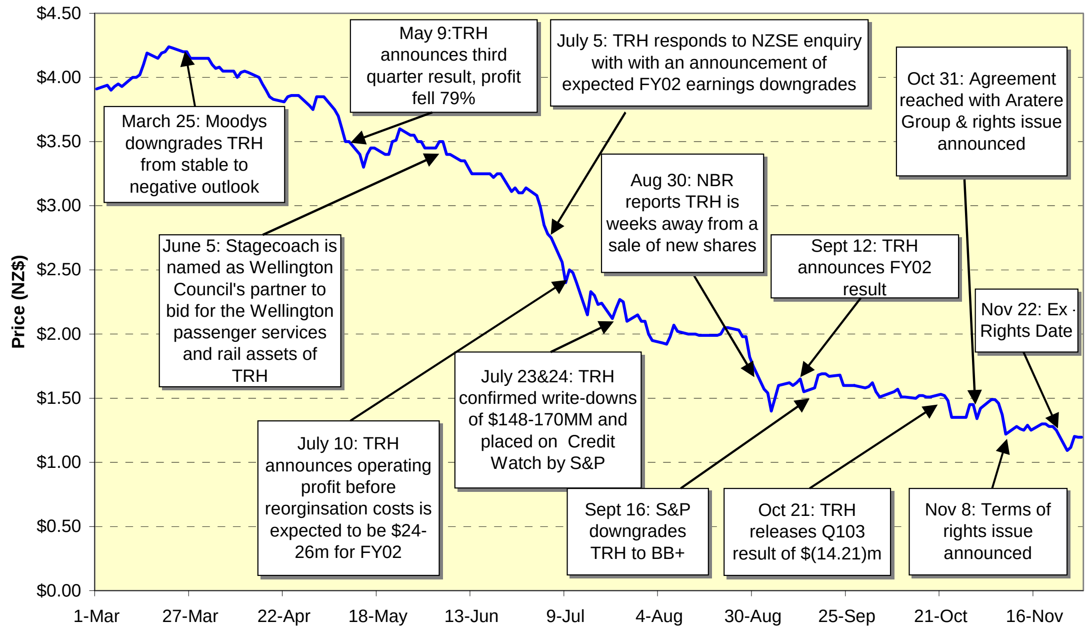
11. For the year ended 30 June 2002, Tranz Rail reported another disappointing result. While the result was widely expected by the market, it added to the sharp decline in Tranz Rail's operating performance over the last five years.

12. First NZ Capital's view is that Tranz Rail's financial performance deteriorated significantly during the 2002 financial year. Notwithstanding the asset sales during the 2002 financial year that reduced net debt, they advise that the company is still in a weak financial position. The recent rights issue is expected to resolve the company's immediate funding needs, but its future viability is critically dependent on the company achieving its operating targets.[1] In First NZ Capital's view, it remains uncertain whether Tranz Rail will be able to meet those targets.

1 A rights issue is when a listed company provides existing shareholders with the opportunity to buy more shares at a discount to the existing share price to raise equity. The rights have a value in themselves being tradable on the market. The underwriter of the issue may purchase any shares not taken up by existing shareholders.

13. As expected, Tranz Rail's poor operating performance has been reflected in the poor performance of the company's shares, which have declined by 70.3% since March 2002 when Moody's changed its outlook on Tranz Rail from stable to negative.

Table One: Tranz Rail's share price performance since March 2002 (source: First NZ Capital)



14. The completion of the rights issue will provide Tranz Rail with more financial flexibility. However, Tranz Rail's replacement debt facility matures on 30 June 2004 and if Tranz Rail's operating performance does not improve by that time, First NZ Capital advise that the company may face significant refinancing risk as the existing lenders may seek to exit or reduce their exposure to the business.

15. Tranz Rail's financial position would improve if it successfully divests its 50% interest in Tranz Scenic, the remaining part of Tranz Metro (the Wellington commuter rail business) and the company's 24% stake in Australian Transport Network.

Policy considerations

Network integrity and service levels

16. Government's concerns about network integrity and service levels can be separated into below and above rail driven issues.

17. **Below rail,** Government and major users have expressed concern about the overall integrity of the national rail network including:

- Tranz Rail's desire to close certain uncommercial lines and to target investment and maintenance to only profitable sections of the track; and [2]

[2] Tranz Rail Holdings Limited Investors Presentation, September 2002.

- the possible flow on consequences of Tranz Rail's commercial attitude to the safety of the network.

TRANZ LINK/equipment bogesy/ wagons etc

18. While Tranz Rail has clearly been under some financial pressure this year, its overall attitude to investment in the network is consistent with the commercial imperatives it faces. It is investing only in those areas where it can make a commercial return and that may not align with the Government's policy imperatives. While another commercial rail operator may be in a better financial position to make investment decisions, they would also be expected to focus investment where there is clear commercial gain.

19. **Above rail,** Government has expressed concern about the quality of services centred around Tranz Rail's decisions to reduce or alter its service delivery, including its concentration on a highly outsourced simplified rail operation with scheduled unit trains, a focus on containerisation and elimination of shunting and sidings.

20. Whether the concerns are above or below rail, it is likely that if the Government wants a level of infrastructure investment or service delivery higher than that which is commercially viable, it will have to provide some kind of financial assistance.

21. Ownership of the infrastructure, whereby the Government determines the level of investment and maintenance, is a blunt way of subsidising the rail operators. In the event that the Government did own the infrastructure, then it would be unlikely to be asked to recover all of its costs for the level of investment the Government wants. This means that a subsidy would also likely be required for the Government's Rail Infrastructure Organisation (RIO). Treasury and the Ministry of Transport have undertaken analysis as to how such an organisation would operate and be governed and have concluded that that the RIO would likely;

    - have mixed social, environmental and commercial objectives;
    - operate under amendment to the current Railways Corporation legislation;
    - have a large contract management function – on a similar basis to the operations of Transit New Zealand.

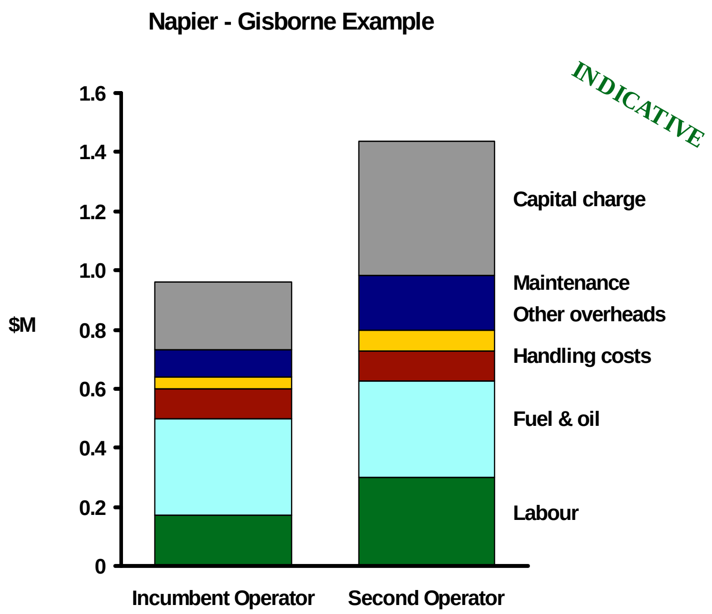
22. Irrespective of who owns the infrastructure, the Government is likely to have to provide subsidy payments to purchase non-commercial services from the rail operators. In providing such a subsidy LEK advise that the mechanism should not be prescriptive as:

    - it is unlikely that the Government can or should support all non-commercial services;
    - there is no need to expect the Government to identify all the potential subsidy candidates;
    - the regime should leave the door open for Tranz Rail, customers and potentially communities, to seek subsidies, but not create an obligation for Government to provide; however,

- a "come and talk" approach will necessarily require a disciplined evaluation processes and approval criteria.

23. However, such a mechanism should also have the threat of introducing a new entrant to limit Tranz Rail's pricing power and potential for gaming – the Government should retain the ability to strike a deal with someone else if they cannot with Tranz Rail. The overall issue is whether the cost and complexity of this "threat of entry" warrants a contestable regime. LEK's view is that the costs to the new operators would likely be significantly higher than the incumbent, and overall a second operator would likely require significant support. In LEK's view, national scale rail operators are unlikely to be attracted by such subsidy arrangements. However small local operators may be attracted to operate a niche line segment. To illustrate, an indicative assessment of entry onto the Napier Gisborne line is presented below.

Diagram Four: Indicative costs of entry onto the Napier-Gisborne line (source: LEK consulting)



24. One of the benefits of Government ownership of infrastructure is that it simplifies the assessment and verification of the amount of subsidy to be paid to any operator because any subsidy on commercial lines would only be for the provision of above rail services. Even if the Government did not seek any access charges on an uncommercial line there may be a need to provide a subsidy to ensure continued rail services. Without detailed cost information from Tranz Rail, it is difficult to gauge the order of magnitude of any likely subsidy. However LEK Consulting have produced the following indicative analysis for the Napier-Gisborne line.

Diagram five: Comparative inter-modal analysis Napier-Gisborne line

Napier - Gisborne Example

Comparative Intermodal Costs

INDICATIVE

Rail Cost	($000)	
Operations		
Labour	172	
Fuel & oil	326	
Handling cost	103	
Other overheads	40	
Maintenance	92	
Capital charge	229	
Total		962
Access charge		
Maintenance		2,120
Total Rail Cost		3,082
Line Revenue*		697
Subsidy Required		
Including Track Costs		(2,385)
Excluding Track Costs		(265)

Life cycle costs

For this route it appears that even with zero access charges, a below rail subsidy would be required

Open access and alternative operators

25. Major users and union groups have expressed a preference for the introduction of open access with Government owning the rail infrastructure, and any rail operator being able to access the infrastructure for an access charge.

26. From a theoretical perspective, open access, whereby rail operators compete in the market placing some pressure on price and quality standards, is an attractive concept. However in practical terms it is highly unlikely that an open access regime would operate effectively in New Zealand.

27. LEK's view is that the prospects of attracting a second general freight operator are limited. A number of potential international entrants have had limited success in entering other markets, and the New Zealand rail market is not an attractive prospect.

28. Even if another operator did enter the market, the natural commercial response of both Tranz Rail, and any other operator, would likely be to concentrate resources on the more profitable parts of the rail business, in particular, the main trunk and the bulk commodity lines. This works against the Government's objectives to maintain the integrity of the network and coverage of services. This issue has also been revealed in discussions with third parties interested in the New Zealand freight market (explored later in this paper).

29. Some major users have an appreciation of the issues impacting on the viability of open access, others simply see the Government's interest in national rail issues as an opportunity to lower their transport costs (particularly as some are in contract negotiations with Tranz Rail). Given the view that open access is unlikely to either be

practical or affordable it is likely that the expectations of major users will need to be managed.

30. Within this overall context the Treasury has been exploring a broad range of options. In assessing these options the following has become clear:

- network integrity can be maintained without ownership of the network but ownership of the network does offer opportunities to minimise risks of gaming for subsidies;

- service coverage is most assuredly achieved by allowing a single operator to retain some monopoly rights and cross subsidise non-commercial operations from profitable operations; and

- open access is highly unlikely to be achieved without purchase of the entire company, and even in the case where the Crown is a party to a consortium purchase, it will most likely be very difficult to secure.

31. The four options most relevant to achieving the Government's national rail objectives are:

- **Option A: Infrastructure and service partnership -** The Crown and Tranz Rail could establish an overarching partnership, supported by a set of legal arrangements that document a set of rights and relationships. At the high level, a partnership between the Crown and Tranz Rail could include a requirement for parties to consult each other on specified substantive issues (such as investments, divestments, and changes to service levels), the opportunity to jointly invest in strategic infrastructure, an agreed basis for the Crown to ensure services on uncommercial lines, and a basis for information exchange between the parties.

  This option would meet the Government's policy objectives of network integrity and service levels. It would leave Tranz Rail as the dominant freight operator and provide access for alternative operators under certain circumstances, e.g. where service levels dropped below specified levels.

- **Option B: Infrastructure purchase from Tranz Rail -** The Crown would acquire the track infrastructure, and all assets required for the effective management and operation of the rail infrastructure. Tranz Rail would retain rail operations including its freight operator rights. The Crown would negotiate a minimum service level component into any access arrangement with Tranz Rail. Where service levels dropped below those specified in an agreement, the Crown would retain the ability to introduce alternative freight operators onto the network.

  This option would meet the Government's policy objectives of network integrity and service levels. It would leave Tranz Rail as the dominant freight operator with alternative operators being given access to the infrastructure under certain circumstances i.e. where service levels dropped below certain levels.

  Tranz Rail is displaying reluctance to contemplate a transaction that involves purchase of the infrastructure with open access. They argue that given this transaction would likely require shareholder approval, and that it would be difficult to argue it was in the company's interest, it would be likely to evolve into a purchase of the company as a whole.

- **Option C: Crown purchase of company and reconfiguration -** This option would have the Crown acquiring 100% of Tranz Rail, separating out the infrastructure and divesting the above rail operations.

  This option would meet the Government's policy objectives of network integrity and service levels.

  This is likely to be the only way that open access can be obtained as the Crown controls reconfiguration of the company even where reconfiguration may not be in the company's interest.

  Given the LEK economic analysis in this environment it may be difficult to attract alternative operators andthere may be a requirement for the Crown to retain all assets but provide for open access under this option.

- **Option D: Infrastructure purchase as part of an arrangement with a third party -** A third party could look to acquire Tranz Rail on its own or in conjunction with the Crown. Separately, the Crown would agree to acquire the rail infrastructure for a specified amount on a basis similar to that set out above as Option B. This option would meet the Government's policy objectives of network integrity and service levels. From discussions with possible third parties so far, it is highly likely that any agreement with a third party would require that third party to retain dominant freight operator rights. That is, in practical terms this option is unlikely to deliver open access.

32. Under all of the options above Government would have greater ability to influence both service levels and investment in the network. The key difference is the degree to which the Government wishes to directly influence maintenance and investment choices through ownership.

33. Government ownership of the infrastructure would entail separation of the above rail operations from the below rail management of the network (vertical separation). Vertical separation has been undertaken internationally to varying levels of success. Some of the challenges vertical separation may present include:

- the relationship between the track operator and the rail operator could be fraught, litigation may be required to resolve disputes;
- duplication of cost, high administration costs and the loss of some economies of size and scope;
- difficulties recovering costs and determining access charges;
- confusion over roles and responsibility of the separated entities (including safety considerations);
- a tendency for an engineering bias which may lead to a higher level of maintenance than is necessary;
- a lack of coordination between separated rail entities may result in inappropriate investment decisions; and
- greater regulatory intervention – interconnection agreements in other New Zealand network industries have been difficult.

Implementation considerations

34. Treasury has undertaken work in consultation with First NZ Capital and Buddle Findlay to assess the steps required to implement each of the options. These steps are set out in the attached gant charts and are indicative only. The gant charts, set out for each of the options, represent an optimistic rather than worst case indication of timing. The key timetable drivers are highlighted by colour reference.

Table Three: Key to Gant Charts

Timing controlled by Government	(red)
Timing controlled by third parties	(blue)
Timing controlled by the Takeover Code	(green)

Non-ownership options

Option A: Infrastructure and services partnership

35. Implementation of the Option A could be achieved in the shortest time with minimal risks.

36. Given that administrative mechanisms through Transfund New Zealand could be used, implementation of this option would substantially be taken up by negotiation with the Tranz Rail. It should be noted that the Land Transport Management Bill precludes the ability for Transfund to apply National Roads Account Funding directly to Tranz Rail – an additional mechanism would be required.

37. Treasury's assessment is that such an arrangement could be agreed with the company within 2-3 months as set out in detail in Attachment 1.

Ownership options

Option B: Infrastructure purchase from Tranz Rail

38. Of the ownership options, Option B would contain the least implementation risk.

39. Discussions to date with Tranz Rail indicate that the company would be willing to sell the infrastructure to the Crown on the broad basis of the proposal set out under Option B.

40. Fundamental to the company's value is its core monopoly freight right. The company would be motivated in any transaction to protect those commercial parts of the network over which it had this right. As noted previously, the company is not prepared to sell the infrastructure with open access.

41. In early discussions with the company they had expressed some resistance to selling the infrastructure and indicated that if it did, it would be at a price close to the current book value of the assets of around $400 million. Since those early discussions, a change in the financial position of the company, and in the senior management team, has placed the Government in a stronger negotiating position.

42. The company now appears to show good faith in the potential to negotiate a mutually beneficial arrangement over the infrastructure. The price paid for the network would depend very much on the access arrangements, and on access fees charged.

43. Negotiation with Tranz Rail would be expected to take a period of 4-5 months. The key stages of this negotiation are set out in Attachment 2.

Company Acquisition Options

44. In the possible company acquisition options, our rough estimate is that it would take 8 months to acquire the company under Option D, a third party approach, and approximately 6 months under a Crown takeover of the company (Option C). A large proportion of the former is in the pre-acquisition phase.

45. Both options are a means to acquire the infrastructure and need to be assessed in terms of meeting the Government's objectives. The prospect of finding it difficult to dispose of the residual part of the company and having to hold the company intact for some duration is quite real under the Crown takeover path. Under the third party option, the Crown is beholden to a third party.

46. All things being equal, if the Government wishes to pursue ownership of the infrastructure, and does not want or is unable to conclude a direct deal with Tranz Rail, the potentially cheaper but slower third-party option has merits.

47. If the Government wishes to act sooner, and wants to leave its options open with regard to reconfiguration and the potential for the introduction of open access, then the more expensive Crown takeover option could be considered.

48. Under either of the acquisition options the Government's motivations for acquiring the company, or acting in a consortium to acquire the company, will be closely scrutinised by the financial markets. There is limited international precedent for Government's to make on-market bid's for publicly listed companies. Unclear objectives or poor communication of objectives to the markets may induce financial market scepticism. The Government would also be vulnerable to "insider" legal risks, under the Securities Amendment Act 1988, arising from its particular set of communications risks.

Option C: Crown Purchase of Company and Reconfiguration

49. In order for the Crown to successfully launch a full 100% takeover of Tranz Rail there are a number of implementation issues that would need to be resolved.[3] The most substantive of these include:

- a more detailed understanding of principles to guide reconfiguration of the company on acquisition;
- a well developed pricing strategy including a credible exit strategy should the takeover prove too difficult or too expensive to complete; and
- a communication strategy to support the takeover bid.

50. Timing would be critical and the management of a takeover bid within the policy process would be complex. To avoid giving investors conflicting or incorrect signals, it would be essential that there is a single person who is authorised to speak on behalf of the Crown. No other person in the Government should make any public comment on the offer. This would form the basis of the communications strategy mentioned above.

[3] It is considered that a full takeover of the company would be required to successfully reconfigure the business as reconfiguration would require shareholder approval which may be difficult to obtain unless the Crown has 100% control of the company.

51. Under the Takeover Code, an offer cannot be made conditional on the bidders due diligence. First NZ Capital advise that the risk of leakage, and the detrimental effect it would cause (on price) far outweigh the benefits to the Crown of undertaking due diligence, particularly since the Crown would be making a takeover offer for public policy rather than investment reasons. On the other hand, particularly given recent high profile corporate failures where inadequate due diligence appears to have been a crucial factor, Ministers may well prefer to commission due diligence.

52. Because the Crown would be perceived as having no financial constraint and a need to acquire Tranz Rail for public policy reasons, there would be a serious risk that Tranz Rail's shareholders hold out for a higher offer price, irrespective of what the Crown said about its price.

53. A credible exit strategy and financial bottom line would be crucial. Under this takeover option the Government must be prepared to walk away should the price become too high. There are significant fiscal risks of paying too much for the company and failure could be damaging to the Crown's reputation in financial markets. The cost to the Crown of an offer, and the ultimate success or otherwise of that offer, would depend in part on the Crown's ability to convince investors of the Crown's position on the offer price and the alternatives available to the Crown.

54. A takeover offer could also likely to attract opportunistic buying in Tranz Rail shares by other parties. The objective of these parties would be to acquire at least 10% of Tranz Rail to block the Crown's ability to reach the 90% threshold required for compulsory acquisition. There is also potential for existing shareholders to exercise a blocking stake. Both groups could hold out for a higher price from the Crown.

Option D: Infrastructure Purchase as part of an arrangement with a third party

55. An alternative is that the Government could await entry of a third party to acquire Tranz Rail and enter into a prior agreement with that party for the Crown to acquire the rail infrastructure post acquisition.

56. The prior agreement would be a substantive Heads of Agreement, with only minor details to be finalised after the takeover was successful.

57. The third party would make an offer under the Takeovers code for either 100% or a strategic interest in the company. The Crown and the third party could make the takeover offer jointly. Another option is the Crown would not be a party to the takeover although the existence of the pre-acquisition agreement would be disclosed in the takeover offer.

58. The Crown would have an input into the pricing and exit strategy for the offer. The Crown would purchase the track infrastructure from the third party at the predetermined price (subject to the outcome of due diligence) and in conjunction with the other terms and conditions negotiated in the Heads of Agreement.

59. First NZ Capital, on contract to the Treasury, have undertaken no-prejudice preliminary talks with Rail America and Toll Holdings, two experienced rail freight operators who have previously expressed some interest in Tranz Rail. These discussions, and this summary – are strictly commercially secret.

60. Both parties expressed interest in the proposal. RailAmerica has previously undertaken a detailed due diligence evaluation of Tranz Rail, so was better placed than Toll to respond in detail to the proposal. Toll advised that it was in the midst of a major acquisition and could not devote significant resource to the proposal until early in the

New Year. It was willing to attend meetings in New Zealand prior to then to progress the proposal.

61. RailAmerica view was that it would make a takeover offer for Tranz Rail after first entering into an agreement with the Crown for the Crown to acquire the rail infrastructure if the offer was successful. The indicative financial parameters mentioned implied that the amount to be paid by the Crown would fund the bulk of the takeover consideration payable by RailAmerica.

62. RailAmerica proposed that it would enter into a long-term lease of the infrastructure from the Crown for no consideration. In return, RailAmerica would pay for infrastructure maintenance, and capital expenditure. RailAmerica made it clear that it would want to control the infrastructure and rail operations and did not support open access. It considers that open access would result in “cherry picking” of Tranz Rail’s most profitable routes and services by other operators, and weaken the company’s ability to retain its current network.

63. Toll stated that it is comfortable with the principle of open access, which it is familiar with in Australia. However, in First NZ Capital’s view, Toll is much less knowledgeable about Tranz Rail and New Zealand transport economics than RailAmerica. It is possible that Toll may be less comfortable with open access once it is more familiar with these matters. Because of the exploratory nature of the discussions, the issue of open access was not more fully discussed with either party.

Relationship to Auckland and Wellington Rail Issues

64. Under all of the ownership options, ownership of the infrastructure in the Auckland context would remain with the Crown and brought into the Rail Infrastructure Organisation. In the Wellington region, the WRC Consortium would still be required to negotiate with Tranz Rail for the above rail operations. If the negotiations to acquire Tranz Metro were successful, the Crown would then provide access to Tranz Metro. If Government preferred Option A – the Infrastructure and Services Partnership, then ownership of the Auckland corridor rights would likely transfer to Auckland Regional Transport Licensing Trust (ARTNL).

Fiscal Considerations

65. There will be upfront and ongoing fiscal costs associated with all the options.

Cost of Acquisition under Ownership Options

66. Upfront costs under all of the ownership options include the cost of acquiring the network and potentially some one-off investment in the infrastructure.

67. If Ministers concluded that a one off upgrade of the network was desirable, or wished to add new non-commercial rail links there would be extra costs.

68. Acquisition costs will be driven by the option chosen. Post acquisition capital expenditure will be the same for each of the ownership options, and will be driven by bringing the infrastructure up to a desired standard. While the latter is independent of which path is taken to acquire the infrastructure, acquisition costs may depend on which of the options is chosen.

69. The cost of purchase of infrastructure from Tranz Rail (Option B) would depend on access arrangements, charges, and how much the Crown was committed to improving the network. The purchase price of the network would increase as

access for alternative operators increased. A deal could be structured so that a low capital payment is made for the infrastructure with accompanying low access charges and vice versa.

70. Under Option C, a full Crown takeover, Tranz Rail shareholders are likely to be receptive to an offer because of increasing concerns about the company's financial viability. Nevertheless, they would attempt to extract the best possible price and would perceive the Government to be willing and able to pay more than fair value for Tranz Rail to achieve its policy objectives.

71. Investor pressure for the Crown to raise its offer price would be tempered by investors' desire for the offer to succeed, so they can exit a poorly performing investment. Precedents in New Zealand and Australia show that a premium to the pre-offer market price of the order of 30% is generally required for a 100% takeover to succeed.

72. Because of the special features of the Government as the offeror ("deep pockets"), the Government may have to offer substantially more. Based on Tranz Rail's recent share price of $0.95-1.00 and assuming completion of the rights issue, First NZ Capital assess that the Government would need to offer around $1.50 per share (about $317 million) for an offer to be successful.

73. Sale of non-infrastructural assets, once the company is acquired, may take some years. Proceeds would be used to repay company debt so there would not be any payment to the Crown as shareholder. Furthermore the Crown would take responsibility for the company's liabilities.

74. Option D, an approach in conjunction with a third party, avoids some of the upward price risk attached to a Crown takeover as the third party making the takeover would be seen as acquiring the company for commercial reasons. Disclosure of the Crown's involvement could produce some upward pressure but this could be offset if the market understands the third party to be in control of the exit strategy. This removal of upward price risk has a corresponding reduction in the Crown's ability to directly control the process and less certainty over the outcome.

75. Whether this will enable the Crown to obtain the infrastructure any more cheaply than under a full Crown takeover is doubtful. It will depend on the financial relationship between the third party and the Crown, and how enthusiastic the third party is to acquire Tranz Rail.

76. Option D, a consortium approach, does minimise some of the holding risks and costs that the Crown would have to bear under a Crown takeover alternative.

Ongoing costs

77. Under the ownership options, ongoing costs will include the costs of maintenance of the infrastructure, at least on the commercially viable core rail network, and running the Crown entity to manage it. Access fees should offset this but it is unlikely that this new entity will be able to recover its cost of capital.

78. Based on Tranz Rail's existing Transfield contract the continuing cost of maintenance is likely to exceed $50 million per annum.

79. Under the non-ownership option, the Option A, there will be ongoing payments to Tranz Rail to maintain minimum service levels and to maintain the track at a certain standard.

80. Ongoing payments to Tranz Rail or any other above rail operator to maintain minimum service levels will be a feature of the ownership options. The cost of this would obviously depend on the level of services desired. As an indication of cost, keeping the Napier Gisborne line operating with regular services is expected to cost $2.6million per annum.

Preferred option

81. Within these wider policy and implementation considerations, Option A: Infrastructure and services partnership, offers the least cost (in time and money) way of achieving the majority of Government's rail objectives. However Government needs to consider whether shifting ownership to the Crown will better recognise the contribution of the rail infrastructure to the Government's wider economic, social and environmental goals.

82. My view is that it should be possible to reach a suitable agreement with Trans Rail on a purchase of the network. However, if during negotiations it became clear that no such deal was possible, the Crown would still have the other options open to it, including purchase of the company as a whole.

83. Of the ownership options, discussions with other rail operators have not conclusively indicated that any new operator will act in any way that is substantially different from the current, largely New Zealand based, owners of Tranz Rail.

84. Added to this, an infrastructure purchase from Tranz Rail avoids some of the high fiscal and process risks for Government associated either directly or indirectly with the takeover of a publicly listed company.

85. In this context, a negotiation with Tranz Rail on the acquisition of the national rail infrastructure is the option most likely to align with all of the Government's national rail objectives.

Implications for the road/rail study

86. This preferred option would have the effect of shifting the road/rail pricing balance in favour of rail, particularly if there were any major upfront spending. The interaction between any moves to further rebalance road/rail pricing, and a transaction with Tranz Rail presents some difficulties. Any major increase in assistance toward rail would provide a windfall gain the company. It is important that the Crown is transparent about its intentions in this area to avoid any suggestions of inappropriate actions.

Process from here

87. Treasury, reflecting the highly commercial nature of the negotiations, should lead Government negotiations with Tranz Rail. I propose to provide Cabinet with a short paper outlining the parameters of this issue and seeking full delegation to the Ad-hoc Ministerial Committee on Rail policy. The steps subsequent to this decision are set out in more detail in Attachment 2.

Legal risks and communication strategy

88. Tranz Rail's current weak operating performance and share price make it vulnerable to speculation about its relationship with the Crown. Throughout the discussions with the company, the Crown will be privy to information that is materially price sensitive information that the public does not have. This could potentially make the Crown an "insider" in relation to Tranz Rail.

89. All inside information held by officials, departments, and Ministers is likely to be imputed to the Crown. It seems unlikely that all inside information of the Crown could be imputed to Ministers in any private capacity under the insider trading laws. However it may be inferred that information know by Ministers' offices is also know by the Minister.

90. As is the case with Air New Zealand, collective responsibility precludes complete separation of ministerial responsibilities. However, there is a strong set of legal and communication considerations that mean that the Government should have a single spokesperson on this issue. Given the commercial nature of the discussions I propose to act as this spokesperson. In the meantime, all Ministers should avoid publicly discussing:

- the detail of any proposal;
- what they think of any proposal;
- any materially price sensitive information; and
- any confidential information relating to Tranz Rail;
- the value of Tranz Rail's shares;
- the value or prospects of Tranz Rail;
- whether someone should buy or sell Tranz Rail shares (and of course Ministers should not buy or sell Tranz Rail shares themselves, or recommend that their friends or family or others do so).

91. As is the case with Air New Zealand, the reason why Ministers should avoid discussing these matters is that there are particular constraints on disclosure arising under the rules to prevent insider trading.

92. The rules against insider trading have been identified in various Cabinet papers on this subject over the past few months. The Crown will be an insider in relation to Tranz Rail if it receives information which is not publicly available and which is likely to affect materially the price of Tranz Rail securities were it publicly available. This insider information may come from the company to the Crown either through its negotiations or through its regulatory interest in the company.

93. The Crown must avoid liability for insider trading and for "tipping". Under s 9(1) of the Securities Amendment Act 1988 an insider of a public issuer who has inside information and who "advises or encourages any person to buy or sell securities of the public issuer" is liable to the persons listed in s 9(2). Therefore, Ministers must avoid making any public statements that might be construed as advising or encouraging the purchase or sale of Tranz Rail shares.

94. In order to assist in managing these communication and legal risks, staff in our respective offices and departments should be provided with information on an as required basis and distribution of papers kept to a minimum. I have asked Treasury to assist in management of these processes and work with my office in the development of a communications strategy.

Financial Implications

95. Implementation of Option B will require significant financial, technical and legal expertise. Treasury have prepared a budget to cover these costs and this is outlined in attachment 5. The Treasury will require an addition $2.7 million in 2002/03 to meet project related costs. I propose that this funding be provided to the Treasury and that any unused funding be returned to Government.

Recommendations

96. I recommend that the Ad-hoc Ministerial Group on Rail Policy:

a) **agree** that Government's national rail objectives are best articulated in terms of:

i network integrity - the ability to maintain (and extend) the integrity of the network in terms of coverage and maintenance levels.

ii service coverage - the ability to influence levels of services either to increase service levels or alter the type of services provided on the network.

iii alternative operators - the ability for alternative operators to access the network in certain circumstances.

b) **note** that advice from Treasury and LEK Consulting is that in practical terms it is highly unlikely that an open access regime would operate effectively in New Zealand.

c) **agree** that a purchase of the national rail infrastructure from Tranz Rail can achieve the Government's national rail objectives and meets Government's preference to own the network to directly influence maintenance and investment levels.

d) **direct** Treasury to begin negotiations with Tranz Rail on the basis that:

i the Crown would acquire the track infrastructure and all assets required for the effective management and operation of the rail infrastructure;

ii Tranz Rail would retain rail operations including its freight operator rights;

iii the Crown would negotiate a minimum service level component into any access arrangement with Tranz Rail, in return for an access fee to cover relevant costs;

iv where service levels dropped below that specified in an agreement, the Crown would retain the ability to introduce alternative freight operators onto the network; and

v access to the track would be contestable for long distance passenger transport where no service is provided at present; where freight dropped below specified levels; where Government offered a service subsidy; and for heritage operators).

e) **note** that Treasury report back to the Minister of Finance on a regular basis to update on the progress of discussions;

f) **note** the proposed process is set out in Attachment 2 to this paper

g) **agree** I should report back to the Ad-hoc Ministerial Group on Rail Policy prior to any heads of agreement phase

h) **agree** that Treasury receive an increase of $2.7 million in 02/03 and that this funding be sought from Cabinet at the nearest possible opportunity;

i) **agree** that the broad parameters of this paper be reported to Cabinet and that Cabinet provided the Ad-hoc Ministerial Group with Power to Act on National Rail issues, including full financial delegation;

j) **note** the legal risks arising from the Crown being an “insider” under the Securities Amendment Act 1988;

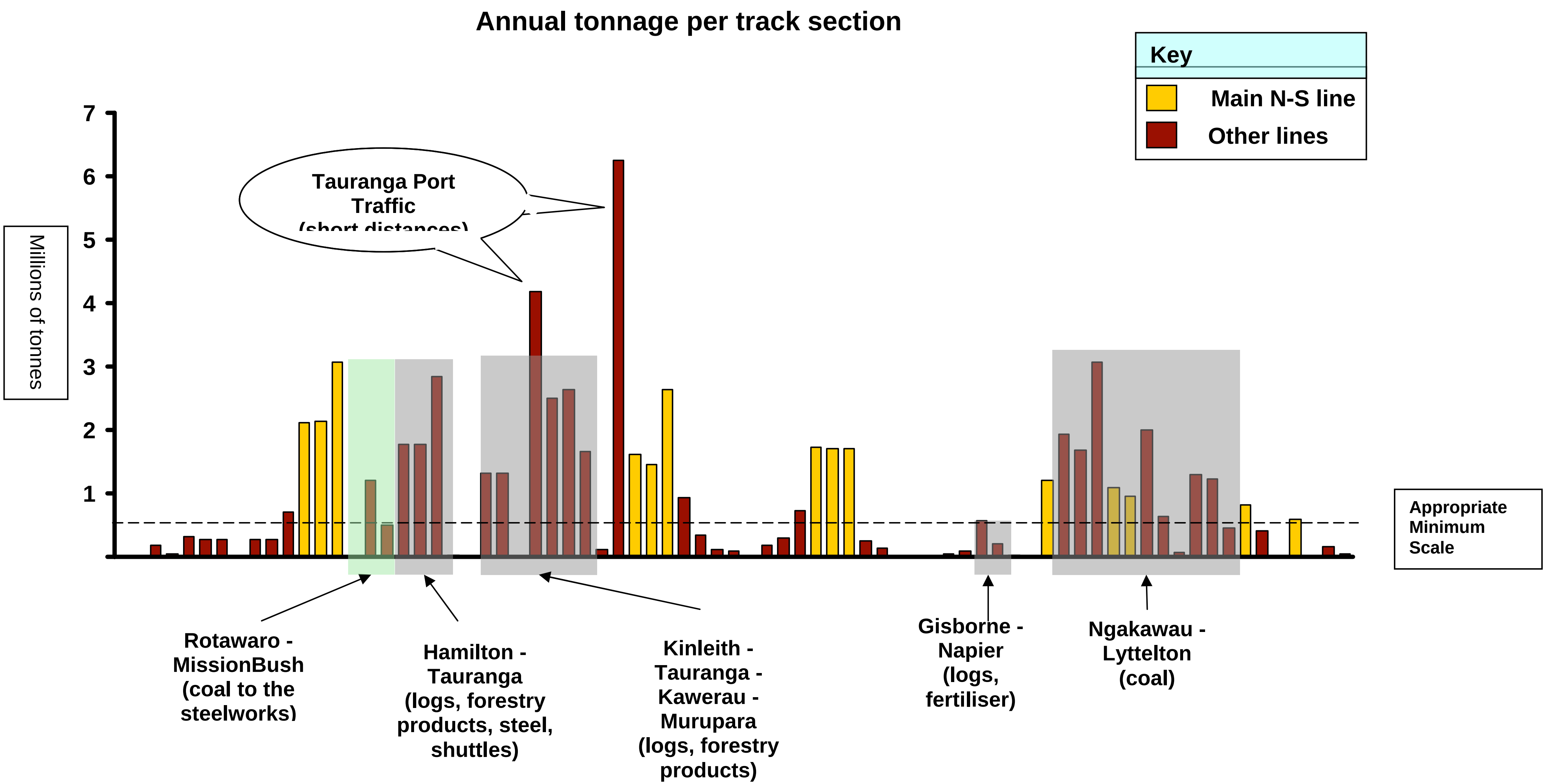
k) **agree** that the Minister of Finance be spokesperson for the Government on all national rail issues.

Hon Dr Michael Cullen
Minister of Finance

Attachment 5

Indicative Budget for Option B: Purchase of Infrastructure from Tranz Rail

Skills	Nature of advice	$
Financial and investment banking skills	Financial and Investment bank support	$495,000
	Disbursements (negotiation phase)	$74,250
Technical rail expertise	Technical expertise of rail business including pricing strategy/governance (negotiation phase)	$300,000
	Disbursements (negotiation phase)	$75,000
	Technical expertise (technical due diligence)	$300,000
	Disbursements	$45,000
Legal expertise	Legal Advice (as per Buddle Findlay letter)	$750,000
	Disbursements	$150,000
Treasury expenses	Treasury direct costs (excluding labour)	$50,000
Subtotal		$2,239,250
Contingency		$447,850
Total		$2,687,100


Annual tonnage per track section
Key
Main N-S line
Other lines
Millions of tonnes
7
6
5
4
3
2
1
Tauranga Port Traffic (short distances)
Appropriate Minimum Scale
Rotawaro - MissionBush (coal to the steelworks)
Hamilton - Tauranga (logs, forestry products, steel, shuttles)
Kinleith - Tauranga - Kawerau - Murupara (logs, forestry products)
Gisborne - Napier (logs, fertiliser)
Ngakawau - Lyttelton (coal)