

Treasury Report: Progress report: Rail Network Transfer and Establishment of TrackCo

Date:	5 December 2003	Treasury Priority:	Medium
Security Level:	IN-CONFIDENCE	Report No:	T2003/2071

Action Sought

	Action Sought	Deadline
Minister of Finance	Agree to the recommendations and forward to Minister of State-Owned Enterprises	ASAP
Minister for State-Owned Enterprises	note	none

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: No

5 December 2003

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Executive Summary

This paper is a progress report on the Rail Network Transfer and covers the following issues:

- Latest timing for the transaction. The Completion date for the Rail Network Transfer needs to be revised due to extensions to Toll's bid for Tranz Rail and Toll's failure to reach 90% ownership, creating a need for a Tranz Rail shareholders' meeting to accept the agreement with the Crown. Change of ownership is now scheduled for mid-February, with the date for transfer of management control of the network unchanged at 1 July 2003.
- Legal issues. There are potential problems with partial surrender of the core lease and retention of GSF eligibility of Tranz Rail staff transferring to TrackCo. It is expected that some minor legislative amendments will be required to resolve these issues.
- Capital expenditure and appropriations. Some small capital expenditure projects necessary for continued safe operation of the rail network will need to be commenced before the end of the Transition period. Funds will also be required for TrackCo restructuring projects. A delegation, and minor revision of the existing rail capital appropriations, will be required to enable these projects to proceed in a timely fashion.
- Key implementation issues to be resolved before end of Transition period. The three key issues that we expect to demand particular attention during the implementation period are: Land definition and separation; Variation to the Core Lease; and Access Pricing.

Recommended Action

We recommend that you:

- a **refer** this paper to the Ad Hoc Ministerial Group on Rail Policy;

Agree/disagree.

Timing

- b **note** the latest timeline for the Rail Network Transfer;
- c **agree** that the imposition date for the \$5 million non-completion penalty for Toll Holdings be deferred to 1 March 2004;

Agree/disagree.

- d **refer** this paper to your media staff for development of responses to any questions about the timing of the rail transaction;

Agree/disagree.

Legal issues

- e **note** that to be sure of the legal status of rail land after the Rail Network Transfer it will be necessary to either clarify the relevant legislation or undertake subdivision processes under the Resource Management Act. Subdivision would be a long, complex and costly process;
- f **agree** the need for legislation before the transfer of land can be finalised;

Agreed/Decline

- g **agree** the need for legislation to maintain eligibility to the Government Superannuation Fund for Tranz Rail staff currently on the scheme who are transferring to TrackCo;

Agreed/Decline

NZRC Board

- h **direct** officials to prepare for your signature indemnities for the NZRC board to make the board duties and liabilities equivalent to those of a Crown entity board;

Agree/disagree.

Capital Expenditure and Appropriations

- i **note** that \$200 million has been allocated for TrackCo infrastructure development [Cab (03) 19/15 and Cab (03) 23/18 refer] and that this is currently appropriated in *Vote Finance D10 TrackCo Infrastructure development*;
- j **note** that some small capital expenditure projects necessary for continued safe operation of the rail network will need to be commenced before the end of the Transition period; and
- k **note** that officials will provide further advice on appropriations and the delegation necessary to ensure that time-critical projects are not delayed.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: **Progress report: Rail Network Transfer and Establishment of TrackCo**

Purpose of Report

1. This report provides information on progress with the Rail Network Transfer and the establishment of TrackCo including information on implementation issues and timing. Topics covered are:
 - Latest timing for the transaction;
 - Legal issues:
 - Partial surrender of the Core Lease;
 - Government superannuation entitlements of Tranz Rail staff transferring to TrackCo; and
 - New Zealand Railways Corporation mandate and legislation.
 - Capital expenditure and appropriations; and
 - Key implementation issues to be resolved before the end of Transition period.

Transaction Timing

2. The Crown's July agreement with Toll Holdings anticipated that ownership of the rail network assets would transfer to the Crown in late November 2003 (the "Completion" date). Subsequently Toll's takeover offer for Tranz Rail was extended several times. In addition, Toll has been unsuccessful in reaching its 90% share ownership target, creating the need for it to obtain Tranz Rail shareholder approval for the transaction with the Crown. These events meant that a November Completion date was not practical and that the Completion date needs to be revised.
3. Toll intends to hold a Tranz Rail shareholders meeting in late January-early February 2004, with a view to executing the Completion documentation by mid-February. Officials consider that this timeline is reasonable and would not unduly hinder the Crown's ability to achieve its objectives for the rail infrastructure. The consequences of the delay are minor.
4. Although the change of ownership is delayed other implementation activities are relatively unaffected. Officials and Toll are still working to the 1 July 2004 date for hand-over of the management control of TrackCo. Tranz Rail is already working on the partition of TrackCo from OpCo. NZRC is identifying a recruitment agency for the Chief Executive search and has started preliminary planning for the establishment of its side of the structure, in preparation for the hand-over at the end of the Transition period.
5. The change in timing would have negative consequences if it resulted in delays to urgent capital works. A proposal to mitigate this risk is described below.
6. The Crown's Agreement with Toll provided for Toll to pay the Crown a \$5 million penalty if settlement did not occur by 30 November 2003. However, as Toll is still

advancing the transaction diligently and in good faith we recommend that Ministers agree to extend the penalty date to 1 March 2004.

7. We have prepared some Questions and Answers that may be useful if media questions arise about the delay to Completion of the Rail Network Transfer. These are attached as Annex 1.

Issues that may have Legislative Consequences

Partial Surrender of the Core Lease

8. The legal form of the surrender of rail land by Tranz Rail is problematic and a legislative solution may be required. The Heads of Agreement provides that Tranz Rail will partially surrender the Core Lease, allowing the majority of rail land to revert to the Crown. Partial surrender of the lease constitutes a subdivision in terms of the Resource Management Act 1991.
9. The question therefore arises as to whether RMA subdivision processes must be applied to the partial surrender of the core lease. The *New Zealand Railways Corporation Restructuring Act 1990* provides that the subdivision requirements of the RMA do not apply to the *granting* of a lease to a railway operator. (The relevant sections of the legislation are reproduced in Annex 2.)
10. The NZRC has been given legal advice to the effect that this provision can be read to allow for partial surrender of the lease. The NZRC has acted on this advice in the Wellington Railway Station transaction and a large number of other smaller transactions.
11. Legal advice given to Treasury is that “granting of a lease” cannot necessarily be read to include partial surrender of a lease. Treasury followed the advice it was given in the Auckland rail transaction and initiated a subdivision process. At the time of writing, a year and a half later, this work is still not complete. Costs of \$0.25 million have been incurred to date. Extrapolating this experience to the Rail Network Transfer suggests that using the RMA subdivision process would cost several million dollars and take several years.
12. In light of the different legal opinions, and the time and cost involved, officials sought a Crown Law opinion. Crown Law’s opinion is that there is a difference between the literal reading and the purposive effect of the law, and it suggests difficulty predicting how a court would interpret the relevant provisions.
13. Given this ambiguity, and the cost of the subdivision process, we recommend a legislative remedy to facilitate the Rail Network Transfer and to regularise the status of previous transactions run by the NZRC.

Government Superannuation Fund

14. A number of Tranz Rail employees who are Government Superannuation Fund (GSF) members are expected to transfer into TrackCo at the end of the Transition period (currently scheduled for 1 July 2004).
15. Tranz Rail has employees who are members of the GSF by virtue of Section 16 of the *New Zealand Railways Corporation Restructuring Act 1990*. This allowed NZRC employees who were transferred to Tranz Rail during the privatisation process to

maintain their GSF eligibility. These staff were deemed to be employed in the government service for the purposes of the *Government Superannuation Fund Act 1956*. However, this provision lasts only so long as that person continues in the service of Tranz Rail. Under current law transfer to another entity (even one that is Crown-owned) would terminate this entitlement.

16. In the circumstances, loss of a GSF entitlement would be a breach of natural justice and would have an unreasonable adverse impact on the staff involved. Legislation is therefore required to avoid loss of GSF entitlements. It is recommended that the government commission the drafting of this legislation and have it enacted before 1 July 2004.
17. We have previously provided advice on the continuity of GSF contribution rights relating to employees of Tranz Rail, other SOEs and privatised companies [T2003/839]. When SOEs were privatised, employees who were contributors to the GSF, were permitted to continue to contribute to the GSF by various statutory deeming provisions. The deeming provisions provided for a once-only, time bound window to retain status for GSF provisions.
18. In principle, we favour a continuation of the present limits in the GSF Act with regard to contribution rights. This is because the Crown is ultimately the underwriter of the GSF schemes. However, the current situation differs from those previous scenarios in that the employees concerned are moving back into the employ of the core public service.

NZRC legislation

19. There are several elements of legislation applying to NZRC that constitute a suboptimal legislative base for TrackCo. These include NZRC's:
 - Status as an SOE;
 - Tax status; and
 - Statutory functions.

SOE Status

20. The NZRC is currently both a statutory corporation and an SOE. As previously reported (TR 2003/1616), although the SOE platform is not ideal for TrackCo it appears to be workable in the short term. Removing the SOE status immediately would create a number of problems, particularly with governance and reporting mechanisms.
21. One issue that does arise from the SOE status is the level of personal responsibility accepted by directors of SOEs. This is more onerous than the equivalent provisions for board members of Crown entities. Given personal liability, current and potential board members of NZRC may be reluctant to take control of the rail network without a full engineering due diligence process, which would be expensive, time-consuming and a duplication of existing Tranz Rail/ LTSA processes.

22. In the circumstances it would be appropriate to indemnify the board to a level of responsibility equivalent to that of a Crown-entity. This is the level that will ultimately apply anyway when the full TrackCo legislation is passed. Providing the indemnity now should avoid board recruitment and retention issues, and remove an anomaly that would otherwise apply in the interim period. We recommend that you direct officials to prepare the appropriate indemnities for your signature.

Tax status

23. Officials recommend that TrackCo be a taxable entity. The July HOA with Toll assumes TrackCo is taxable and the HOA includes agreement that TrackCo will take advantage of available tax deductions to the extent permitted by law.
24. Making TrackCo a tax paying entity would also help to protect the tax base. From time to time TrackCo will need to enter joint venture arrangements with taxable entities in the private sector. If TrackCo were tax exempt it may allow taxable private sector entities to avoid tax through income splitting arrangements.
25. The NZRC is currently tax exempt. A legislative change is therefore required to change NZRC's tax status before it assumes the responsibility for running TrackCo on 1 July 2004.

Statutory functions

26. The NZRC's functions are specified in Section 12 of the *Railways Corporation Act 1981* (RCA). The drafting of s12 reflects NZRC's 1981 role as owner and operator of rail, ferry and road passenger and freight services. The NZRC has expressed a desire to have some amendments to these clauses to ensure it has clarity in the legislation base for its role as TrackCo. However, if this legislation was opened for amendment it would be difficult to determine where to stop, and a much larger Bill could result.
27. While we agree that these functions don't map exactly to the mandate now being given to NZRC, we consider that there are sufficient tools available to deal with this issue without legislation. Section 30 (2) of NZRC Restructuring Act 1990 says that the NZRC has no obligation to perform the functions in s12 of the RCA, and Ministers are able to provide NZRC with a specific mandate for the roles now intended through the Shareholding Ministers Expectations and Statement of Corporate Intent processes. We therefore recommend against other amendments to the RCA at this time.

Capital Expenditure and Appropriations

28. Some small capital expenditure projects are now becoming necessary for the continued safe operation of the rail network. These will need to be commenced before the end of the Transition period. Examples of such projects include:
- Track de-stressing;
 - New signs for conditional stop protection (safe working system for track workers);
 - Rectification of minor faults to reduce speed restrictions on key lines; and
 - Replacement of some train control communication equipment.

29. In addition some expenditure is required for restructuring projects associated with the split of TrackCo from OpCo, for example IT set up and restructuring costs associated with the formation and operation of TrackCo.
30. Toll/Tranz Rail has proposed that during the Transition period, for agreed projects, it will make immediate payments for the work and subsequently claim from the Crown.
31. \$200 million has been appropriated for TrackCo Infrastructure Development [Cab (03) 19/15 and Cab (03) 23/18 refer] and is available to fund rail infrastructure projects. In addition \$5 million has been appropriated for Establishment of TrackCo. Both appropriations are currently in Vote Finance. From 1 July 2003 similar projects would become the responsibility of the TrackCo board and would be funded by appropriation through Vote Transport.
32. The existing appropriations were established before decisions were made about where TrackCo would be located and which balance sheet the assets would sit on. Recent decisions, and the need to start committing funding, mean that some rearrangement of the appropriations will be necessary. Officials will provide advice on these matters in the New Year.
33. A responsive approval process will be required to allow rapid authorisation of minor projects during the Transition period. Officials will also provide advice about an appropriate delegation to allow this.

Policy Issues

34. There are three key issues that we expect to demand particular attention during the implementation period:
 - Land definition and separation
 - Variation to the Core Lease; and
 - Access Pricing.
35. These issues are described briefly below. Officials will provide further advice on these as the options to resolve them are developed.

Land Definition & Separation

36. It appears that resolution of all land issues involved in the Rail Network Transfer will take some time. Complicating factors include:
 - the size of the land definition task;
 - the proposed Core lease variation;
 - RMA subdivision issues;
 - retention of flexibility to enable released land to be used again by rail in future; and
 - the potential for Treaty claims.

37. It appears that it would be desirable to have a process that allows the Rail Network Transfer to occur before final resolution of all the land issues.

Variation to the Core lease

38. We understand that the NZRC has sent you a letter outlining the current negotiated position with respect to the variation to the Core Lease. We agree with NZRC that some of the previously agreed lease variations are no longer valid and the Core lease needs to be reviewed again in the light of the July HOA. However it may be difficult to re-open this issue without conceding further value to Toll or delaying the Completion date.

Access pricing

39. We anticipate some difficulties determining the optimal access pricing regime and agreeing this with Toll/Tranz Rail. There are considerable difficulties determining the relative costs imposed on the network by passenger and freight services and the appropriate allocation of access charges between main trunk and regional lines. The position is somewhat easier while Wellington Metro and Tranz Scenic receive access rights through Tranz Rail.

Annex 1: Questions and Answers

Why has the Completion date been delayed?

The change of completion date to mid-February 2004 was necessary because Toll made a number of extensions to its takeover of Tranz Rail and because Toll has been unable to secure 90% of Tranz Rail shares. The Heads of Agreement is conditional on gaining Tranz Rail shareholder approval. As it doesn't have complete control Toll is required to hold a shareholders meeting to vote on the transaction. In light of these factors the Crown has agreed to Toll's request to put back the Completion date.

Will this change the date that the Crown starts to run the rail network?

No. The planned date for transfer of management control remains at 1 July 2004.

Will this hold up the Crown's investment in rail?

No. Although the full investment programme has yet to be agreed, some smaller projects have been scheduled already. Tranz Rail and subcontractors will be working on some Crown-funded projects between now and the end of the Transition period.

What is the Completion date?

This is the date when the Crown takes ownership of the rail network infrastructure.

What is the Transition period?

This is a period following Completion when Tranz Rail will manage the rail network on the Crown's behalf. At the end of the Transition period management control of the network will be handed to the Crown agency tentatively entitled TrackCo.

Annex 2: Relevant Legislation

Resource Management Act 1991

11. Restrictions on subdivision of land—

- (1) No person may subdivide land, within the meaning of section 218, unless the subdivision is—
 - (a) Expressly allowed by a rule in a district plan [and in any relevant proposed district plan] or a resource consent, and a survey plan relating to the subdivision has in accordance with Part 10—
 - (i) Been deposited by a District Land Registrar or a Registrar of Deeds; or
 - (ii) In the case of a subdivision by or on behalf of a Minister of the Crown, been approved by the Chief Surveyor for the purposes of section 228; or
 - (b) Effected by the acquisition, taking, transfer, or disposal of part of an allotment under the Public Works Act 1981 (except that, in the case of the disposition of land under the Public Works Act 1981, each existing separate parcel of land shall, unless otherwise provided by that Act, be disposed of without further division of that parcel of land); or
 - (c) Effected by the establishment, change, or cancellation of a reserve under [section 338 of the Maori Land Act 1993]

218. Meaning of "subdivision of land"—

- (1) In this Act, the term "subdivision of land" means—
 - (a) The division of an allotment—
 - (i) By an application to a District Land Registrar for the issue of a separate certificate of title for any part of the allotment; or
 - (ii) By the disposition by way of sale or offer for sale of the fee simple to part of the allotment; or
 - [(iii) by a lease of part of the allotment which, including renewals, is or could be for a term of more than 35 years; or]
 - (iv) By the grant of a company lease or cross lease in respect of any part of the allotment; or
 - (v) By [the deposit of a unit plan, or] an application to a District Land Registrar for the issue of a separate certificate of title for any part of a unit on a unit plan

New Zealand Railways Corporation Act 1981

Section 12 - Functions of Corporation

- (1) The functions of the Corporation shall be—
 - (a) To establish, maintain, and operate, or otherwise arrange for, safe and efficient rail freight and passenger transport services within New Zealand:
 - (b) To establish, maintain, and operate, or otherwise arrange for, safe and efficient road passenger and freight transport services within New Zealand:
 - (c) To establish, maintain, and operate, or otherwise arrange for, a safe and efficient ferry service for freight, including the carriage of passengers and vehicles between the North and South Islands:
 - (d) To provide or otherwise arrange for those ancillary services which, in the opinion of the Corporation, are necessary for it to efficiently carry out its functions:

- (e) To endeavour to carry on the operations of the Corporation in such a way that revenue exceeds costs, including interest and depreciation; and to provide for a return on capital that may be specified from time to time by the Minister of Finance.
- (2) The Corporation shall also have such other functions, powers, and duties in relation to the Corporation's activities as are conferred or imposed on the Corporation by this or any other enactment.

New Zealand Railways Corporation Restructuring Act 1990

16. Contributors to Government Superannuation Fund—

- (1) Any person employed by a transferee company who, immediately before the transfer day, was employed by the Corporation or another transferee company and was a contributor to the Government Superannuation Fund under the Government Superannuation Fund Act 1956 shall be deemed to be, for the purposes of the Government Superannuation Fund Act 1956, employed in the Government service so long as that person continues in the service of the company and the Government Superannuation Fund Act 1956 shall apply to that person in all respects as if the service with the transferee company were Government service.
- (2) Subject to the Government Superannuation Fund Act 1956, nothing in subsection (1) of this section shall entitle any such person to become a contributor to the Government Superannuation Fund after that person has once ceased to be a contributor.
- (3) For the purposes of applying the Government Superannuation Fund Act 1956, in accordance with subsection (1) of this section, to a person who is in the service of a transferee company and is a contributor to the Government Superannuation Fund the term "controlling authority", in relation to that person, means that company.

30. Conflict with New Zealand Railways Corporation Act 1981—

- (1) Nothing in the New Zealand Railways Corporation Act 1981 shall be construed as limiting or derogating from any provision contained in this Act and the powers conferred by this Act, and in particular the power to vest railways assets and railways liabilities conferred by section 6 of this Act, may be exercised notwithstanding anything contained in that Act.
- (2) Without limiting subsection (1) of this section, nothing in section 12 of the New Zealand Railways Corporation Act 1981 shall be construed as imposing an obligation on the Corporation to perform the functions specified in that section.