

Treasury Report: Tranz Rail Transactions - Heads of Agreement

	5 June 2003	Treasury Priority:	Urgent
Security Level:	COMMERCIAL – SENSITIVE	Report No:	T2003/883

Action Sought

	Action Sought	Deadline
Minister of Finance	Read before considering the Tranz Rail Heads of Agreement	Thursday 5 June 2003

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: Yes

Treasury Report: Tranz Rail Transaction - Heads of Agreement

Executive Summary

This paper provides you with a Heads of Agreement (HOA) produced following the outcome of negotiations that have been carried out with Tranz Rail Holdings (Tranz Rail) over the last couple of weeks.

The key terms and conditions of the arrangements have been described in a previous report (T2003/ 863), which is attached. Key features of the agreement include:

- Crown acquisition of the rail network infrastructure from Tranz Rail Limited;
- an access agreement with Tranz Rail
- an agreed rail access charging regime;
- short-term financing for Tranz Rail;
- purchase of an equity stake in Tranz Rail; and
- an investment programme to upgrade the rail network infrastructure.

The agreement with Tranz Rail has been developed under time constraints set by Tranz Rail's unstable financial position.

The government's commitment to these arrangements would be binding once the Heads of Agreement is signed. With the exception of short-term financing, to be made in the form of a \$44 million deposit against the purchase price, the commitment from Tranz Rail is subject to shareholder approval.

Recommended Action

- a. **note** that Cabinet has delegated you Power to Act in this matter, in consultation with other members of the Ad hoc Ministerial Committee on Rail Policy (Cab Min (03) 16/14 refers). We understand you will be consulting with your colleagues later this morning;
- b. **note** that you are invited to report to Cabinet on any decisions taken under this power as soon as possible after the decisions have been taken. We will provide you with a report on Monday 9 June 2003;
- c. **note** that Officials, in accordance with your instructions have negotiated a Heads of Agreement with Tranz Rail, with the terms and conditions set out in this paper and a previous one (T2003/863) which is attached;
- d. **note** that signing the Heads of Agreement would commit the government to:
 - an immediate \$44 million cash injection;
 - the purchase of new shares in Tranz Rail giving the Crown a 35% stake;

- to the purchase of the track infrastructure for \$1.00 and the rental income and lease rights to surplus land for around \$50m;
- an on-going capital investment in the rail network valued at \$100 million over 5 years; and
- a track access fee structure which amounts to an on-going implicit subsidy to Tranz Rail Holdings Limited, expected to be around \$20 – 30 million per year.

All but the first of these would be subject to Tranz Rail shareholder agreement.

- e. **note** the risks attached to signing the HOA as described in this paper as well as T2003/863 which is attached;
- f. **decide** whether to sign the HOA with Tranz Rail;

Agree/Disagree

The following recommendations apply if you decide to sign the HOA:

- g. **sign** the attached HOA
- h. **sign** the attached letter to Tranz Rail directors inviting them to sign the HOA as it stands.
- i. **direct** officials to commence work on the Rail Network Transfer Agreements.

Financial Recommendations

- j. **approve** a secured deposit of \$44 million to Tranz Rail from Vote Finance non departmental capital contribution to other organisations, on 6 June 2003 or a later date as required;
- k. **note** the secured deposit in j above is not appropriated and will require validating legislation in the Appropriation (2002/03 Financial Review) Bill.
- l. **note** that further work in June on the agreement will result in Vote: Finance output class 9 exceeding appropriations for 2002/03. The primary cost drivers will be legal, and financial consultants, accountants and valuers;
- m. **agree** that the unappropriated departmental output costs incurred in negotiating this agreement during 2002/03 should be approved in July 2003 under section 12 of the Public Finance Act;

Agreed/declined

- n. **approve** a new departmental output class in Vote Finance, “Establishment of Track Co” in 2003/04 to set up the new company ready for operations on 1 July 2004;
- o. **approve** a new non-departmental appropriation in Vote Finance, Capital contributions to other organisations, “Track Co: Infrastructure development”, in 2003/04 and outyears for rail infrastructure development.

- p. **approve** a new non-departmental appropriation in Vote Finance, Capital contributions to other organisations, "Track Co: Annual maintenance", in 2003/04 and outyears for rail infrastructure maintenance.
- q. **approve** a new non-departmental appropriation in Vote Finance, Capital contributions to other organisations, "Track Co: Working capital", in 2003/04 for the capitalisation of a Crown entity to manage the rail infrastructure.
- r. **approve** a new non-departmental appropriation in Vote Finance, Capital contributions to other organisations, "Tranz Rail", in 2003/04 for the purchase of a 35% equity stake in Tranz Rail.
- s. **approve** the following changes to appropriations to allow for additional work on rail policy options, and capital contributions to Track Co and Tranz Rail, with a corresponding impact on the operating balance and debt:

Vote Finance	\$000 – increase/(decrease)					GST
	2002/03	2003/04	2004/05	2005/06	2006/07	
<i>Departmental Output Classes:</i>						
D10 Establishment of Track Co (funded by Revenue Crown)	-	5,000	-	-	-	Incl.
<i>Capital contributions to other organisations:</i>						
Track Co: Infrastructure development	-	25,000	25,000	25,000	25,000	N/A
Track Co: Annual maintenance (subsidy)	-	20,000	20,000	20,000	20,000	N/A
Track Co: Working capital	-	15,000	-	-	-	N/A
Tranz Rail	-	75,000	-	-	-	N/A
Total	-	135,000	45,000	45,000	45,000	

- t **note** that amounts sought are only approximate, and will be reviewed at the October Baseline Update 2003;
- u **agree** that the changes to the 2003/04 and outyear baselines be incorporated into the 2003/04 Supplementary Estimates; and
- Agreed/declined*
- v **agree** that until the 2003/04 Supplementary Estimates are enacted, the changes to appropriations in 2003/04 be met from Imprest Supply.

Agreed/declined

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Tranz Rail Transaction - Heads of Agreement

Purpose of Report

- 1 The purpose of this report is to provide you with a Heads of Agreement (HOA) resulting from negotiations with Tranz Rail Holdings Limited (Tranz Rail) and to alert you to the issues and risks implicit in signing it.

Analysis

- 2 Over the last two weeks, in accordance with your instructions, we have negotiated a deal with Tranz Rail whereby the Crown would:
 - Take back the rail network infrastructure;
 - Provide a short-term advance to enable Tranz Rail to address its liquidity position; and
 - Recapitalise the company so that the Crown ends up with a 35% ownership stake.
- 3 On 31 May 2003, we provided you with a report (T2003/863) that describes the deal negotiated and the Heads of Agreement that has been drafted. That report is attached.
- 4 In that report we reported that the negotiations had reached a point where we had agreement with Tranz Rail on everything except two significant issues:
 - The equity price - the Crown's position is \$0.67 per share against Tranz Rail's asking price of \$0.85 per share
 - The Tranz Rail board's request for more certainty around the access charge.
- 5 Since that time we have come to the view that the Crown should not move any further on the equity price.
- 6 With regard to the access charges, the Board requested a \$50m access charge per annum for the first 5 years. In recognition of the board's concern to give shareholders some greater level of certainty about the value of the Crown transaction, while at the same time protecting the integrity of the access pricing structure developed in the HOA, we have proposed the access fee be fixed for the nine months to June 2004, and capped for the three subsequent years. Specifically it would be fixed at an annual rate of 9/12 of \$55 million in the initial year. In the second year it would be capped at \$60 million; \$65 million in the third; and \$70 million in the fourth year.
- 7 The rest of the deal described in the 31 May report remains intact.

Toll Holdings

- 8 Since the 31 May report, Toll Holdings' has confirmed it intends to make a take-over offer for Tranz Rail of \$0.75 per share. This has added new

dimensions to the decision-making process. The Toll offer was formally made on Wednesday 6 June. It is considerably more conditional than had been expected.

- 9 While some may see the proposed Crown transaction and the Toll offer as alternatives, in fact the Crown transaction is fully compatible with a new owner investing in the operating company.
- 10 We do not consider it is possible to come to an agreement with Toll prior to their offer being successful. This is because Toll has a relatively optimistic view of the viability of rail in New Zealand and negotiation would be constrained by a lack of access to Tranz Rail's financial information by both parties.
- 11 After a successful offer by Toll, there would be no certainty of the company facilitating a sale of the network.
- 12 Therefore if ownership of the infrastructure is a key objective for Government, agreeing to the Heads of agreement is the surest way of securing the network.

Next Steps

- 13 If Ministers want to pursue this deal, it is recommended that the attached HOA be signed and Tranz Rail directors be invited to sign.
- 14 Once the HOA is signed, by both Ministers and the Tranz Rail board, the deal would need to be approved by Tranz Rail's shareholders at a special meeting – which would be expected to be held on 11 July. Transfer of ownership would then occur on 30 September 2003.
- 15 If directors accept the Crown offer, it is proposed that an announcement would be made on the morning of Friday 6 June. The table below summarises the steps that should be taken.

Time / Sequence	Event
8.30am	Tranz Rail issues a suspension of trading notice to the NZSE
Am	Tranz Rail Board meeting
Am	Tranz Rail's announcement to NZSE
11.00am (or earlier - immediately following announcement to the NZSE)	Minister's media release announcing deal and calling press conference
12.00	Minister's press conference Further detail on deal provided here

- 16 If directors do not accept the Crown deal, it is likely that they will have a continuous disclosure requirement to disclose the nature of it.

Risks

Shareholder Approval

- 17 The deal is subject to shareholder approval. Given the current disconnect between shareholders' views on the value of the company and our own

views, there is a risk that shareholders would take the view that the Crown was being offered equity too cheaply and vote against the whole deal. This would then leave the Crown exposed as a lender to the company, and not having resolved the core issues.

Fiscal Cost

18 This deal would deliver to the Crown the infrastructure, and 35% of the equity in Tranz Rail. There would be a commitment to under recover annual track expenditure which amounts to an on-going implicit subsidy to Tranz Rail, expected to be around \$20 – 30 million per year.

19 A summary of the fiscal costs of the deal is provided in the table below.

Summary of Costs	\$m
On signing HOA: Short –term deposit (repayable but ranks behind banks and Aratere lenders)	44
On shareholder approval 35% shareholding Purchase of track, surplus land, sub-leases	76 est 50
Commitment to upgrading Crown-owned track over five years	100
Present Value estimate of implicit subsidy through access fee regime (\$20-30m per annum)	\$200-\$300

20 The economics of rail in New Zealand are such that for the Government to secure a viable rail system, significant fiscal costs are required. As well, this deal could well be seen as Government underwriting a private sector company although the Crown’s 35% equity stake will partly mitigate this. The access pricing system also to some extent blunts the incentives on Tranz Rail to grow through better service but the service level agreements and KPI regime mitigate that partly.

21 Government’s decision to proceed will hinge on how much ownership of the infrastructure in itself is a key objective. A deal with Tranz Rail at this time, along the lines of the HOA, is the surest way of securing the network.

Open Access

22 While the transaction provides a strengthened “use it or lose it” regime, it does not deliver open access. There may be a public expectation that the network transaction would result in an open access regime. Open access is unlikely to be effective in New Zealand because of the market’s small scale.

Road Rail Policy

23 The access charge regime and rail subsidy methodology established in the HOA represents a significant shift in the balance of road/rail pricing in favour of rail. As yet we have not fed the HOA access pricing structure into the Surface Transport Costs and Charges study currently being developed. However, it is clear that the HOA pricing structure, by making such a rebalancing towards rail, would at least mitigate any likely recommendation for further rebalancing towards rail arising out of the Surface Transport Costs and Charges study.

Appropriation Issues

- 24 The agreement with Tranz Rail has been developed under tight time constraints and conditions of commercial sensitivity. Accordingly, there is no appropriation for the \$44 million secured deposit to Tranz Rail. Similarly departmental costs incurred in the current year in negotiating this agreement are likely to exceed existing appropriations and will require S12 approval. Neither has it been possible to estimate legal and consultant costs associated with setting up the new regime for next year.
- 25 Annual appropriations in Vote Finance in 2002/03 total \$1,105.133 million, and approval of unappropriated expenditure up to 1% of this, or \$11.051 million can be performed under section 12 of the Public Finance Act. The additional departmental expenditure incurred in negotiating this agreement fall within this amount. However, the \$44 million secured deposit will need validating legislation.
- 26 Requests for section 12 approvals and for validating legislation for over-expenditure during 2002/03, are due with you by 23 July 2003. We will prepare a separate report seeking the relevant approvals in July 2003 following completion of the 2002/03 accounts.
- 27 The balance of the funding required falls in the 2003/04 financial year and can be included within the 2003/04 Supplementary Estimates.

Wayne Walden
Chairman
Tranz Rail Limited
Private Bag 92 138
AUCKLAND

Dear Wayne

Please find attached a signed copy of the Heads of Agreement that my officials have been negotiating with your staff.

I believe the proposed deal addresses Tranz Rail's short-term liquidity position, as raised in Michael Beard's letter of 7 May, as well as the Government's public policy objectives of having an economically viable rail network that serves the public interest.

I hope you can commend it to your shareholders as being in the best long term interests of the company.

I would like to take this opportunity to thank your staff for the effort put into negotiations over the last couple of weeks. I appreciate the tight time frames they have been forced to work under.

It would be in both our interests to make an announcement tomorrow, on Friday 6 June. This would provide some certainty and minimise the impact of the inevitable speculation and rumour that has arisen in recent days.

I will have my officials make contact with your staff to ensure that arrangements are in place for this and that our public statements are aligned.

Yours sincerely

Hon Dr Michael Cullen
Minister of Finance