

Treasury Report: TrackCo: Progress Towards Completion

Date:	14 June 2004	Treasury Priority:	Medium
Security Level:	COMMERCIAL SENSITIVE	Report No:	T2004/1012

Action Sought

	Action Sought	Deadline
Minister of Finance	Sign	None
Minister for State-Owned Enterprises	Note	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: No

14 June 2004

SH-8-4-2

Treasury Report: TrackCo: Progress Towards Completion

Executive Summary

Negotiations with Toll New Zealand Limited (Toll) are reaching a crucial stage as the intended completion date of 30 June 2004 approaches. This report outlines the issues to be resolved prior to completion, discusses risks and options, and makes some recommendations about the path ahead.

In general we expect that the government would wish Crown negotiators to be flexible about the responsibility for costs since Toll's offer went unconditional, and be flexible about minor issues, but there should be no substantive moves from the agreement in the Heads of Agreement around either exclusive access arrangements or control of spending on the network.

With the recent appointment of a new Chair-elect to the New Zealand Railways Corporation (NZRC) it is also an opportune time to consider the level of involvement of NZRC in the next round of the negotiations.

Recommended Action

It is recommended that you:

- a **note** the status of negotiations outlined in this report;
- b **note** that, in Treasury's view, completion prior to 30 June remains attainable, but the current gap between the parties is relatively large;
- c **agree** that, if necessary to achieve completion prior to 30 June, Crown negotiators should be flexible about the responsibility for costs since Toll's offer went unconditional, and should in general be flexible about minor issues, but that there should be no substantive moves from the agreement in the Heads of Agreement around either exclusive access arrangements or control of spending on the network;

Agree/ disagree

Either

- d **agree** to invite the NZRC Board to lead the negotiations on the TrackCo budget and its linkage to access charges, and the arrangements for consultation between Toll and TrackCo about future spending on the network

Agree/disagree

Or

- e **agree** that Treasury continue to lead all aspects of the negotiations while regularly consulting with, and providing information to, the TrackCo Chair-elect.

Agree/disagree.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: TrackCo: Progress Towards Completion

Analysis

1. The Crown and Toll have committed to completion of the TrackCo deal (i.e. passing the track asset to the Crown) before 30 June. The process will then involve a transition period of some two months from completion before TrackCo is fully up and running as a Crown agency.
2. This report outlines the issues to be resolved prior to completion, discusses risks and options, and makes some recommendations about the path ahead.
3. The following are the major issues to be resolved with Toll prior to completion:

Access charges

4. The Heads of Agreement (HOA) provides for access charges set to recover TrackCo's costs, and set on a per-line-segment basis, with both a fixed and per gross tonne kilometre (GTK) component to the charge. The advantage of this form of access charging regime is that it enables costs that rail operators impose on any part of the network to be passed on to them accurately. It also makes incentives for traffic growth on particular line segments more practicable. It provides some transparency and useful information for rail users and regional authorities in their contracting with rail operators. On the other hand a per-line-segment charging system is more complex than some other forms of charging.
5. As the negotiations have proceeded, both Toll and the Crown have concluded that for the first charging period the best solution will be simply to set an access charge as a lump sum to cover TrackCo's costs. A per-line-segment charging system can then be introduced as both TrackCo and Toll acquire more confidence about the data base.
6. For a lump sum access charge, the key issue to resolve is what makes up that charge. Toll has provided information as to the current costs of operating the track. Based on that information, and discussions to date with Toll, the following issues remain to be resolved:
 - Toll argue that they should only meet costs that they would have had to meet had TrackCo not been established. They therefore argue that they should not meet the costs of the TrackCo Board/CEO/CFO, or any serious corporate function for TrackCo.
 - There are other areas where we believe Toll's assessment of its own track costs is unrealistically low. Our preliminary assessment is that while the Toll proposed access charge is some \$41 million per annum, adding all the essentials into it takes that up to \$50 million per annum.
 - The main cost for TrackCo is the Transfield contract. Toll would like (with Crown endorsement) to restructure the Transfield contract both to reduce Transfield's margins and
 - . They would want to set their proposed negotiation goal as the maximum level of their reimbursement to TrackCo for Transfield's work.

Transfield contract

7. As noted above, the Transfield contract will be the largest component of TrackCo's costs. The contract is one of the "material contracts" that will become TrackCo's responsibility once it is established. However, Toll wishes to renegotiate the contract prior to completion and has asked for Crown endorsement to do this. Toll's objective is to reduce Transfield's margins and to fix the operational expenditure at \$25 million per annum. Issues around this are as follows:
- Given Transfield's expected reluctance to engage in this discussion, and the prospect of the asset transferring to the Crown by 30 June, there must be a great deal of doubt about whether Toll could achieve its goal.
 -
8. At this stage we have told Toll that they can proceed to renegotiate the contract, provided that such a renegotiation does not delay completion, and subject to TrackCo Board approval of any final agreement. If the negotiation with Transfield is likely to extend beyond 30 June, there will need to be an agreement between Toll and the Crown about how to proceed. Refusing Toll's request would have allowed Toll to argue that the Crown had not configured TrackCo efficiently and therefore that the track access fee should be reduced below the actual cost. The conditional approval of Toll's request will allow a test of Toll's assertions that the Transfield contract can be improved, without exposing the Crown to undue risk.

Control and Direction of Capital Spending

9. The Heads of Agreement provides for a set of provisions for consultation between Toll and TrackCo about capital spending on the track (both the \$100 million committed in the HOA and also the ongoing commitment to capital spending on the track).
10. Toll is now arguing that those provisions do not give it enough influence over capital spending and that Toll's approval should be required for capital spending which is funded either from the Crown's initial capital contribution or from Toll's access charges.
11. In discussion Toll has also informally argued that none of the \$100 million capex from the Crown should be spent on the West Coast line. Their argument appears to be that Solid Energy's cost-plus approach to coal-freight charges would preclude Toll from making a return on such investment. We have told Toll that Ministers would expect a material proportion of the \$100 million to be spent on the coal route.

Access Regime

12. The Heads of Agreement provides for Toll to have exclusive access to the network, subject to the use-it-or-lose-it provisions, and to protection of existing operators. Toll is arguing that such operators (Taieri Gorge and Heritage/charter operators) should gain access through the Toll access agreement. In our view that is not what the Heads of Agreement provides.

Responsibility for Transition Cost

13. The HOA provides for the Crown to refund Toll's costs in organising the transition. Toll has been arguing that this obligation stands irrespective of whether completion actually takes place. Our view is that the obligation only crystallises on completion.
14. Capital expenditure since Toll's bid went unconditional. Toll has been arguing that the Crown should reimburse it for all its capital spending on the network since its bid went unconditional last October. While the Crown would have incurred some of this expense if it had ownership it has not enjoyed the benefits of ownership and therefore, in our view, has no legal or moral obligation. Toll's prolonged responsibility for capex has derived from its continued delays in passing ownership of the network to the Crown. Toll says that to date its capital commitment has been of the order of \$11 million.

Path to Completion

15. As can be seen above, there are a number of major issues to be resolved before completion (passing of track ownership to the Crown). Some of the issues to be resolved are financial while others (control and direction of capex; access regime) concern the future control of TrackCo.
16. The Crown has two reasons to complete this transaction as quickly as possible:
 - The transaction has dragged on for long enough already, and government wants to get on and set the TrackCo agenda
 - Government does not want to facilitate any tax advantages Toll may gain by slipping the transaction past 30 June.
17. Toll has a number of incentives:
 - The relationship with the NZ government will deteriorate if the transaction is pushed past 30 June. On the other hand Toll will gain tax advantages from such a slippage.
 - Toll wants to secure for itself as many financial gains and as much control as it can over the rail system as a whole.
 - Toll probably does not believe that the government would legislate in a situation like this. They may see talk of legislation as simply a reflection of government determination to complete the deal by 30 June, and thus they are testing how much government is prepared to concede to achieve that.
 - If the transaction slips past 30 June Toll's incentives change. Having secured the tax advantages, Toll would have fewer incentives for delay. On the other hand, Toll would have an incentive to secure as soon as possible the value that will accrue to it from the Crown's contribution of non-recoverable capital to the rail network.
18. A 30 June completion remains attainable. However there is a high risk that to achieve that date the Crown would need to concede a great deal either in financial terms or in terms of control of the network in the future. The Crown team may therefore need to revert to Ministers for further judgements over the coming days.

Suggested Approach

19. The following outlines a proposed approach to negotiations over the coming weeks.
20. The Crown takes the HOA very seriously and is not expecting any move away from the general balance of the HOA. We expect Toll to abide by what it agreed to in the HOA. Toll has chosen a slower path to completion than that outlined in the HOA. Toll should be prepared to accept all the financial and other consequences from that path.
21. On specific issues to be resolved:
 - **Access charges;** the budget for TrackCo to establish access charges must be realistic; Toll must meet reasonable corporate costs of TrackCo (CEO/CFO/Board etc). The Crown may choose to do things on the network which are not recoverable from Toll.
 - **Transfield Contract.** The Crown is comfortable with Toll attempting to reduce the return to Transfield from its contract. However, any such renegotiation must not delay completion and any final outcome must be subject to NZRC/TrackCo Board approval.
 - **Control of capital spending in future:** The Heads of Agreement sets out arrangements for consultation between Toll and TrackCo about future capital spending on the network. Those arrangements should be adhered to.
 - **Access regime:** Access for non-Toll operators whose rights are protected under the HOA will be directly with TrackCo, not through Toll.
 - **Transition costs:** The Crown will only meet Toll's costs in arranging for the transaction once the transaction is completed.
 - **Capital spending since Toll's bid went unconditional:** The HoA does not suggest this is the Crown's responsibility. However, a contribution to pre-completion capital expenditure could be offered if, and only if, it was clear that conceding it was the final step necessary to get to completion.
22. While all of the above points appear reasonable in themselves, in sum they still represent a position a good way from Toll's current position. Therefore, if the Crown takes the approach outlined above, it is not particularly likely that Toll will concede enough ground by 30 June for the transaction to take place. A 30 June completion is therefore likely to require more concessions, either in terms of the financial arrangements or in terms of control of the network.

Negotiation Process

23. We are expecting to enter detailed negotiations with Toll this week on draft legal agreements, which will raise all the above issues. To set the expectations for that negotiation we are planning to send Toll a message that we are open to discussing issues such as responsibility for capex since Toll's bid went unconditional, and the legal framework around responsibility for transition costs. We have already agreed with them an approach to the Transfield contract.
24. On access charges we agree that TrackCo should have unnecessary costs pared out of it, but Toll should expect to bear all the legitimate costs of TrackCo. On issues such as access for third-party operators, and Toll's rights over capital spending, the broad balance established in the HoA was debated at length at the time and should remain.

One issue on which we may encounter resistance will be an attempt to have the use-it-or-lose-it principles clearly extend to long distance passenger rights.

Government Objectives

25. In moving forward we are working from the following understanding of government objectives:
- Ministers place a high priority on securing public ownership of the rail network.
 - Ministers expect TrackCo to make its own decisions on capital and maintenance spending, albeit within the provisions for consultation with Toll set out in the Heads of Agreement.
 - Toll should pay all the costs it imposes on the track system, except for a return on the agreed \$200 million of initial capital spending and specific projects which TrackCo may commit to for public policy reasons and without any expectation of a return from Toll.
 - Toll has exclusive access to the network, with protection for existing (categories of) operators, but that exclusive access is lost if not used.

Managing the negotiation going forward

26. Treasury has managed the negotiations with Toll and Tranz Rail to date. The NZRC Board has consistently argued for a bigger role in the negotiation. Now that a TrackCo chair-elect has been chosen, and given that TrackCo will take responsibility for implementing much of the agreement, there is a case for inviting the NZRC Board to participate in the negotiations on areas which TrackCo will need to implement in future. Major such areas are the TrackCo budget and its linkage to access charges, and the arrangements for consultation between Toll and TrackCo about future spending on the network.
27. Although the NZRC Board has been kept briefed on the progress of the negotiations, there is obviously a trade-off in bringing the Board into a more central role. On the one hand such a move would ensure that the incoming board was comfortable with the arrangements it must implement. On the other hand bringing a new lead into part of the negotiation runs a risk of slowing the process down. This could be mitigated by making sure that the Board understands the importance Ministers place on completion before 30 June.