

Treasury Report: Revised TrackCo Governance Cabinet Paper

Date:	20 February 2004	Treasury Priority:	Medium
Security Level:	IN-CONFIDENCE	Report No:	T2004/240

Action Sought

	Action Sought	Deadline
Minister of Finance	Refer paper to the Ad Hoc Ministerial Committee on Rail Policy	As soon as possible

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: Yes

20 February 2004

SH-8-4-2

Treasury / Transport Report: Revised TrackCo Governance Cabinet Paper

On 17 December 2003 officials provided you and the Minister of Transport with a Cabinet paper for the Ad Hoc Ministerial group on Rail Policy [T2003/2163 refers]. The paper was subsequently approved by joint Ministers but has yet to be approved by the Ad Hoc Ministerial group.

As the paper will not be considered by Cabinet until after 28 February 2004 there is a need to revise some of the dates in the paper. This has been done in the attached paper.

For the avoidance of doubt, the revised paper has "v4" as part of the footer and is not dated.

Recommended Action

We recommend that you:

- a **sign** the attached Cabinet paper;
- b **forward** the paper to the Minister of Transport for his signature; and
- c **refer** the paper to the Ad Hoc Ministerial Committee on Rail Policy.

Agree/disagree

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Chair
Cabinet Policy Committee

CHOICE OF ENTITY TO MANAGE THE RAIL NETWORK INFRASTRUCTURE

Executive Summary

1. Following the transaction with Toll Holdings/Tranz Rail, an entity is required to manage the rail network infrastructure on behalf of the Crown. This paper seeks decisions on the functions and form of this entity, and on some implementation issues necessary to establish it.
2. In the short-term the New Zealand Railways Corporation will fulfil the rail network management role. In the medium-term legislation will be required to create an entity designed specifically for the purpose. We recommend that the entity be a Crown Agent, with mandate and funding to implement the forthcoming Rail Strategy and the rail-related parts of the New Zealand Transport Strategy.
3. Some minor legislative amendments before 30 June 2004 are necessary to enable the return of staff and land from Tranz Rail, and to allow New Zealand Railways Corporation to fulfil its role in the short term.

Proposal

4. The purpose of this paper is to seek Cabinet decisions on the governance and structure of the entity, provisionally entitled "TrackCo", required to manage the rail network infrastructure.

Comment

Establishment of TrackCo

5. Under the agreement between the Crown and Toll, which has been activated by Toll going unconditional on its offer for Tranz Rail, ownership of the rail network will transfer to the Crown. Tranz Rail will manage the track infrastructure as the Crown's agent until 30 June 2004, when responsibility for management will transfer to the Crown.
6. This will create the need for an agency, provisionally called "TrackCo", to manage the network infrastructure and associated tasks. It is proposed that TrackCo will evolve out of the New Zealand Railways Corporation (NZRC), to be operational when responsibility for management transfers on 30 June 2004.
7. New legislation will be required to establish TrackCo, some of which will be needed before the transfer of management on 30 June 2004.
8. In the interim it is proposed that NZRC's Statement of Corporate Intent (SCI) be extended so that its mandate includes TrackCo's functions and responsibilities. NZRC is able to fulfil the role of TrackCo in the short term under these proposed SCI amendments. Further detail of the legislative changes is provided later in this paper.

9. Officials are investigating the feasibility of establishing the long term structure of TrackCo through amendments to NZRC's legislation to make it more appropriate for its new role or whether it is preferable to legislate afresh. Either way NZRC is readily able to fulfil the role of TrackCo in the short term under the proposed SCI amendments.

10. Although Tranz Rail will retain management responsibility for the network until 30 June 2004, ownership of the network will transfer earlier.

11. The Auckland rail network, previously purchased by the Crown, is to be integrated into the national network. To that end, the responsibility for the 'access provider' role for Auckland is being transferred to NZRC. This role will be part of the integrated TrackCo from 1 July 2004. The Minister of Finance will retain responsibility for approving network developments until 1 July 2004. Thereafter the processes outlined later in this paper will apply.

Principal Objectives

12. The primary objective of TrackCo would be to operate an efficient and effective rail network contributing to an integrated, safe, responsive, and sustainable land transport system.

13. It would be required to apply sound commercial frameworks and practices in its day-to-day operations, protect the value of its assets and perform well financially. This requirement would include determining the most cost effective way to maintain and operate the existing network in compliance with Land Transport Safety Authority (LTSA) approved safety standards. Standard public sector objectives (for example, to be a good employer, to exhibit a sense of environmental responsibility, etc.) would also apply.

TrackCo Core Functions

14. TrackCo will be required to carry out a number of functions related to the operation and maintenance of the rail network infrastructure. These include:

- Management of the rail network infrastructure;
- Train control at national and local levels;
- Maintenance planning and contracting;
- Developing proposals for capital works on the rail network; and
- Rail safety system management.

15. TrackCo will also inherit a large property portfolio and would be tasked with managing that property.

Policy Background

16. In December 2002, Cabinet approved the release of the government's New Zealand Transport Strategy (NZTS) with the Vision that: "By 2010 New Zealand will have an affordable, integrated, safe, responsive, and sustainable transport system". The NZTS seeks to encourage the transport of products by rail, wherever feasible. It is anticipated that TrackCo will have a significant role in achieving this goal, directly and indirectly.

17. The National Rail Strategy (NRS), currently under development by the Ministry of Transport, will form a subset of the NZTS. The National Rail Strategy will focus on enhancing and developing commuter rail services in urban centres to reduce road congestion, and also seek to increase the share of heavy freight carried by rail.

18. These two documents will form the foundation for public policy in rail and would be reflected in TrackCo's SOI and other accountability documents.

TrackCo Funding

19. The intention is to establish TrackCo with a structure broadly in parallel with the structure of Housing New Zealand Corporation. TrackCo will receive income from the following sources:

- rail operators by way of track access fees;
- leases and land sales; and
- the Crown, to achieve certain public policy objectives.

Of these sources, access fees from Toll/Tranz Rail will predominate.

20. Under the agreement with Toll, TrackCo is to recover costs from Toll/Tranz Rail for capital expenditure that would provide commercial benefits to Toll/Tranz Rail. TrackCo's financial structure would need to have the flexibility to enable it to finance large, commercially-justified projects that a rail operator has agreed to pay for through access fees. TrackCo would also directly receive the Crown's agreed investment of \$200 million over 5 years (as set out in the agreement with Toll Holdings) for upgrading the rail network to improve its performance, efficiency, safety and reliability.

Crown Funding

21. For those proposals where there is no commercial benefit to operators but which are justified on public policy grounds, there would be provision for direct funding from the Crown. In practice, many such proposals are likely to have both a commercial and public policy element and so the funding split would be subject to negotiation between TrackCo and users.

22. The Ministry of Transport would be the primary source of advice to Ministers on funding proposals seeking approval of major rail developments justified on public policy grounds (such as new infrastructure). Other agencies (MED, Treasury, etc.) would be involved in the development of this advice.. Approved funding would then pass to Transfund as a defined funding envelope to be passed on to TrackCo.

23. As an example of the above, where government provides funding directly to major rail infrastructure projects, such as the electrification of Auckland rail (either separately or in conjunction with the proposed Auckland Regional Transport Authority). Cabinet will consider a policy and funding paper prepared by the Ministry of Transport. If Ministers approve the project, Crown funding will be appropriated in Vote Transport and administered by Transfund, which will not be able to revisit Ministers' decisions. TrackCo will manage and deliver the project in light of its Performance Agreement.

24. In the case of more modest developments (such as the expenditure to keep an existing branch line open) TrackCo would have sufficient autonomy to allow it to make such public policy decisions. TrackCo would have a bulk-funded appropriation passed through Transfund to assist in the funding of such developments. This bulk appropriation would be sought from Ministers on advice from the Ministry of Transport. The appropriation should be passed to TrackCo on a basis that preserves TrackCo's autonomy.

25. It is proposed that such payments would be channelled through Vote Transport to Transfund via a new output class. Provision for this exists within the Land Transport Management Act 2003.

26. Transfund's role would be to channel appropriations to TrackCo, and to confirm TrackCo's expenditure has been used as intended. TrackCo would have to account to Transfund for the expenditure of funds received from Transfund. Transfund would have no role in the allocation of new funding, beyond what it already administers through the Alternatives to Roothing and Passenger Transport output classes.

27. The existing Alternatives to Roothing (ATR) and Passenger Transport funding through Transfund would continue. Transfund would continue to allocate this funding according to criteria established in the recently passed Land Transport Management Act 2003.

28. It is recommended that Treasury and the Ministry of Transport report back to Ad-hoc Ministers by 14 May 2004 on:

- Options for channelling funding to TrackCo;
- How best to coordinate TrackCo ("bulk") funding and the Alternatives to Roothing funding; and
- Monitoring of TrackCo financial and operational performance.

Entity Type

29. There are four main options for the governance form of TrackCo:

- A State-Owned Enterprise (SOE)
- A Crown-owned company (CrOC); or
- A non-company Crown entity
- A Government Department

30. Because TrackCo's objectives are relatively straight forward, easy to define and unlikely to change much in the foreseeable future, a "Department of Tracks" is not favoured. A Government Department would also rule out the additional expertise and oversight available from a governance board – a key feature of the other options.

31. The SOE model is not favoured. Although TrackCo will have some commercial objectives, return on investment will not be its primary one. Under the Heads of Agreement, most of TrackCo's revenue would be regulated with a fixed rate of return on capital. TrackCo will have little ability to generate additional third party revenue, except at the margins.

32. Given the nature of TrackCo's objectives and its core functions, the most appropriate entity form would be a non-company Crown entity. Under the Public Finance (State Sector Management) Bill, a non-company Crown entity can be further categorised as an Independent Crown Entity, an Autonomous Crown Entity, or a Crown Agent, depending on the level of Ministerial involvement envisaged.

33. Under the proposed model, TrackCo would be required to give effect to Government policy, specifically the NZTS and NRS. Therefore it should be a Crown Agent. This entity type allows the Government to set the direction of the entity while maintaining some distance from its day to day operations.

34. There would be some merits in the Crown Company model. For example, it would send a stronger signal to Toll that TrackCo is expected to take a commercial approach and not to subsidise Toll's business. However, as the entity responsible for giving effect to government policy in the area, a Crown Agent is the more appropriate form.

35. Given TrackCo's intended role the company structure has several disadvantages relative to a Crown Agent form. These include: a lesser ability for Ministers to set direction; an inappropriately high level of personal liability of directors; and a greater degree of financial flexibility than is required for TrackCo's intended functions.

36. Directors' duties and conflict of interest rules for Crown entities are being regularised in the Public Finance (State Sector Management) Bill. Any other desired features from the Companies Act (1993) could be replicated in TrackCo's legislation, which would be tailor-made to achieve the Government's goals.

Responsible Ministers

37. The Minister of Finance and the Minister of State-owned Enterprises will remain the responsible Ministers for the expanded New Zealand Railways Corporation. It is recommended that the Ministry of Transport in consultation with Treasury should advise the Ministers on transport policy-related TrackCo issues.

38. A Board appointed by the Responsible Ministers will govern TrackCo.

39. The Responsible Ministers will have powers broadly in line with ministerial powers in relation to other Crown Agents, as per the Public Finance (State Sector Management) Bill. These would include the powers to request information, extract capital, etc. and to formally direct the Board of TrackCo.

40. Annual accountability documents will be agreed between the board and Responsible Ministers. These will include an SOI, Business Plan and Asset Plan, each with a multi-year outlook. They should incorporate details and full costs of capital investment and policy initiatives including reflecting the aims and objectives of the NZTS and NRS.

41. The Minister of Transport would be responsible for transport policy in the context of the New Zealand Transport Strategy and the proposed Rail Strategy, and would continue to be responsible for Transfund and the Land Transport Safety Authority.

Financial Features of TrackCo

Capital structure

42. The Toll Heads of Agreement allows for access charges to recover TrackCo's Weighted Average Cost of Capital (WACC). Free cash should be returned to the Crown for Government reallocation rather than being available by default to the board. This would also provide an incentive on TrackCo to perform.

43. A means of managing TrackCo's free cash needs to be implemented whereby the right incentives are provided to TrackCo to help TrackCo resist pressure for this money to be automatically reinvested to Toll's benefit. Options range from a capital charge to a debt-equity structure with dividend payment.

44. The capital structure to be chosen should ensure that TrackCo factors the cost of capital into decisions, and faces commercial pressures to perform. The Treasury, in consultation with NZRC and the Ministry of Transport, will report back to the committee on the best way to achieve this.

45. TrackCo may also be required to pay the Crown any surplus capital and any net surplus available at the end of the financial year, following consultation between the Board and the Responsible Ministers.

46. TrackCo's mixed objectives mean it could only borrow on the basis of a guarantee from government. That means that there is little purpose in it borrowing directly from the private sector.

Joint ventures and subsidiaries

47. TrackCo would be able to form subsidiaries and joint ventures subject to certain conditions and with approval from the Minister of Finance. Subsidiary companies would be subject to parent entity legislation and the JV's powers would be no greater than the parent's.

Tax status

48. It is recommended that TrackCo be subject to tax. From time to time it 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. The HoA with Toll assumes TrackCo is taxable.

49. Currently NZRC is exempt from income tax. There is therefore an issue around TrackCo's status in the interim period prior to its legislation being passed. One option is early legislation to amend NZRC's status.

Issues to resolve

Resource Management Act and Surrender of Core Lease

50. A question has arisen as to whether Tranz Rail's partial surrender of the Core Lease of rail land will require the Crown to go through a sub-division process under the Resource Management Act 1991 (RMA). Crown Law has advised that there is a difference between the purposive effect of the law, which would not require subdivision, and the literal reading, which might. Crown Law suggests risks in relying on a court to judge in favour of the purposive effect. It appears that minor amendment to the New Zealand Railways Corporation Restructuring Act will be necessary to remove the ambiguity and avoid an expensive and time consuming subdivision exercise. It should be noted that while land can't actually be surrendered until this is resolved, the land to be surrendered can still be agreed between parties.

Government Super Fund

51. There is an issue around those employees of Tranz Rail who are to transfer to TrackCo who are members of the Government Super Fund (GSF). Under the Government Superannuation Fund Act 1956, bringing them back into a Crown Entity or Crown Company means they will lose their entitlement to the GSF. Legislation is likely to be required to remedy this.

Next Steps

52. It is proposed that the Minister of Finance will continue leading the implementation process, in consultation with the Ad Hoc Ministerial Group on Rail Policy. At the officials' level Treasury will lead the transaction work, while the Ministry of Transport will lead the transport policy work. Both will operate in consultation with each other and with the Minister of Finance's office, the New Zealand Railways Corporation and the State Services Commission.

Consultation

53. The Treasury and the Ministry of Transport jointly drafted this report. The NZRC has been consulted.

Financial Implications

54. An appropriation of \$2.138 million has been allocated to *Vote Finance Output Class D9* for external advice on the Rail project. While most of this funding will be required to complete the sale and purchase, some is earmarked to assist with implementation work.

55. This report has no new financial implications.

Legislative Implications

56. To provide the necessary legislative framework for the transfer and management of TrackCo, a two-stage legislative process is proposed:

(a) A short Bill to be introduced and passed before 30 June 2004 to address

- Preservation of existing staff members entitlements to GSF;
- The subdivision provisions of the Resource Management Act as they link to the core lease surrender; and
- The tax status of NZRC.

(b) A longer Bill to establish the long term structure of TrackCo, government funding and related management procedures, consistent with the NZ Transport Strategy and this paper.

57. It is recommended that the Ministry of Transport and Treasury, in consultation with NZRC, be asked to report back to ad-hoc Ministers by 14 May 2004 with a summary of the prospective contents of the long-term legislation.

58. Legislative priority 2 has been obtained for the short Bill and legislative priority 3 has been obtained for the longer Bill, both in the 2004 Legislative Programme. Cabinet approval is sought to issue drafting instructions, subject to detailed final policy matters being approved by the Ad Hoc Ministers Committee on Rail. Both Bills will need to be approved by Cabinet before final introduction.

Human Rights Act

59. This paper has no Human Rights Act implications.

Regulatory Impact Statement

60. This paper contains high-level policy statements and does not introduce any new regulation therefore a Regulatory Impact Statement is not required. Further papers documenting policy proposals for the long bill will contain Regulatory Impact Statements as appropriate.

Publicity

61. No publicity on the contents of this paper is proposed.

Recommendations

62. It is recommended that the Ad-hoc Ministerial Group on Rail Policy:

Establishment of TrackCo

1. Note that under the agreement the Crown has with Toll, ownership of the rail assets transfers to the Crown and that Tranz Rail will manage the track infrastructure under a management contract until 30 June 2004.

2. Note that on 1 July 2004, when management of the track has transferred to the Crown, an entity to manage the Crown's interest in the rail network infrastructure ("TrackCo") is required.

3. Note that the creation of TrackCo as a new Crown agency would require new legislation.

4. Agree that TrackCo will evolve out of New Zealand Railways Corporation (NZRC).

5. Agree that the interim management of TrackCo by NZRC be achieved by short-term amendment of NZRC's Statement of Corporate Intent, and a short Bill (to be passed by 30 June 2004), to avoid Tranz Rail employees transferring to TrackCo who are members of the GSF losing their entitlement, and provide such other modest legislative amendments as may be necessary.

6. Agree that the long term structure of TrackCo and its management arrangements be legislated for in a longer Bill to give certainty for the development of the rail network consistent with the Government's goals.

7. Note that the short bill has been given priority 2 in the 2004 Legislative Programme.

8. Agree that:

- The Ad-hoc Ministerial Committee be given power to decide detailed policy issues relating to the above bills prior to further Cabinet consideration.
- appropriate drafting instructions be issued for the first bill without delay.

9. Instruct the Ministry of Transport and Treasury, in consultation with NZRC, to report back to the Committee by 14 May 2004 with a summary of the prospective contents of the longer-term legislation and any detailed policy issues in accordance with paragraph 7 above.

10. Note that the Ministry of Transport has placed a bid and obtained a priority 3 for the longer bill.

Objectives and Functions

11. Note that TrackCo would be required to carry out a number of functions related to operation and maintenance of the rail network infrastructure most of which will be dealt with in accountability documents rather than legislation.

12. Agree the primary objective of TrackCo should be to operate the national rail network in a way that contributes to an integrated, safe, responsive, and sustainable land transport system.

Funding

13. Note that TrackCo will receive funding directly from rail operators in the form of access fees and charges, income from land management, and the agreed \$200 million injection from the Crown to upgrade the network.

14. Agree that Ministers should determine the level and direction of appropriation to TrackCo for major rail projects that are justified on public policy grounds.

15. Agree that TrackCo should receive an appropriation for funding of minor rail investments, to be spent at the discretion of the TrackCo board.

16. Direct officials to prepare advice on the quantum of the minor rail investments appropriation and the conditions that should be placed around its use.

17. Direct Treasury and the Ministry of Transport, in consultation with the NZRC, to provide further advice by 14 May 2004 on:

- Options for channelling funding to TrackCo
- How best to coordinate TrackCo (“bulk”) funding and the Alternatives to Roothing funding;
- Monitoring of TrackCo financial and operational performance.

18. Note that the existing Alternatives to Roothing (ATR) and Passenger Transport funding through Transfund will continue.

Entity Type

19. Note the advantages and disadvantages of each entity type described in this paper.

20. **Agree** that TrackCo take the form of a non-company Crown entity with some features of the Companies Act (1993) replicated in its legislation.
21. **Agree** that TrackCo should be a Crown Agent with Ministers having the ability to direct TrackCo to give effect to Government policy.

Responsible Ministers

22. **Note** that the Minister of Finance and the Minister of State-owned Enterprises are currently responsible for the NZRC;
23. **Agree** that the Ministers' of Finance and State-owned Enterprises continue to be the Responsible Ministers for NZRC pending the establishment of TrackCo and that the Ministry of Transport in consultation with Treasury provide advice to the Ministers;
24. **Invite** the Minister of Transport to report to the Cabinet Policy Committee with a draft of the National Rail Strategy, with a view to having the Strategy in place by 30 June 2004.

TrackCo Features

25. **Direct** Treasury, in consultation with NZRC and the Ministry of Transport, to report back with a recommended capital structure for TrackCo designed to place commercial pressures on TrackCo's cash flows and use of capital.
26. **Agree** that TrackCo would be able to form subsidiaries and joint ventures subject to certain conditions and with approval from the Minister of Finance.
27. **Agree** that TrackCo will be subject to tax.

Government Super Fund

28. **Note** that in order to prevent Tranz Rail employees who are members of the Government Super Fund (GSF) and who are to transfer to TrackCo from losing their entitlement to the GSF minor legislative amendments will need to be introduced.

Next Steps

29. **Agree** that the Minister of Finance will continue leading the implementation process, in consultation with the Ad Hoc Ministerial group and that at the officials' level Treasury will continue to lead the transaction work, while the Ministry of Transport will lead the transport policy work, both to operate in consultation each other and with the Minister of Finance's office, the NZRC and the State Services Commission.

Hon Dr Michael Cullen
Minister of Finance

Hon Paul Swain
Minister of Transport