

COMMERCIAL SENSITIVE

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

## **NATIONAL RAIL – OVERVIEW AND UPDATE OF RECENT ISSUES**

### **Introduction**

The Ad-Hoc Ministerial Group on Rail Policy is meeting on Tuesday 18 March 2003. It last met in December 2002 where it considered a paper, National Rail - Implementation Path which discussed options for progressing Government rail policy. The attached paper, National Rail - Service Performance Objectives, provides follow up information as requested at that meeting.

The purpose of this brief paper is to provide an overview of the two papers and to update you on the basis of the very latest information. It should be read in conjunction with the two papers. The recommendations in this brief paper supersede those in the other two papers.

### **Objectives**

The Government's vision for rail is set out in the New Zealand Transport Strategy as summarised in the paper, National Rail - Service Performance Objectives. In brief, Government wants a strong rail system with the ability to encourage heavy freight in particular to move from road to rail. The Government's objectives can be summarised as:

- network integrity - the ability to maintain (and extend) the integrity and capacity 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.

### **Background**

In December, the Ad-Hoc Ministerial Group on Rail Policy considered a paper, National Rail Implementation Path, which sets out three options most relevant to achieving the Government's preference to own the infrastructure. These were:

- **Option A: Infrastructure purchase from Tranz Rail** - The Crown would acquire the track infrastructure (including tracks, tunnels, signals, train control etc), and all assets required for the effective management and operation of the rail infrastructure, with Tranz Rail remaining the dominant freight operator;
- **Option B: Crown purchase of company and reconfiguration** - The Crown would acquire 100% of Tranz Rail, separate out the infrastructure and divest the “above rail” operations; and
- **Option C: Infrastructure purchase as part of an arrangement with a third party** - A third party would acquire Tranz Rail on its own or in conjunction with the Crown and on-sell the infrastructure to the Crown.

Ministers expressed a preference for a modified version of Option A. The Government would own the rail infrastructure, Tranz Rail would have dominant freight rights to that infrastructure, and there would be some ability for alternative operators to access the network in certain circumstances.

Ministers asked for more work on how a quality rail service could be ensured under this option. [Cab Min (03) 1/6 refers].

That work is contained in the paper, “National Rail - Service Performance Objectives.” It provides background on how Government’s detailed objectives in rail could be met - with or without ownership of the network. The principles in that paper apply irrespective of which option is taken to obtain infrastructure ownership, or who owns Tranz Rail.

### **Proposed Model**

The model proposed to achieve the Government’s goals is described in more detail in the two longer papers. In summary it is as follows.

#### ***Establishment of a Rail Infrastructure Organisation***

The Crown would own the track infrastructure and all assets required for the effective management and operation of the rail infrastructure (including land, tracks, tunnels, bridges, signalling, train control etc). These would be placed in a Crown entity (the Rail Infrastructure Organisation).

The rail operator would retain Tranz Rail’s existing rail operations including its freight operator rights but access to the track would be contestable where the operator fails to meet specific performance indicators; for long distance passenger transport where no service is provided at present; and for all existing non-Tranz Rail types of operator (eg heritage).

#### ***Establishment of a Strategic Alliance with the rail operator***

A high level agreement with the operator would be established (a Strategic Alliance) which bundles together a set of rights and relationships whereby;

- the Crown and rail operator are required to consult each other on substantive issues (particularly service cessation), have an opportunity to collaborate for investment in strategic infrastructure, and agree a basis for information exchange between the parties;

- the company is required to maintain specified rail service levels on a line-by-line basis. For example, a more detailed service level agreement (see below) could be entered into for non-commercial services on the Napier-Gisborne line; and
- where the rail operator fails to maintain specified rail services, there is an ability for alternative operators to access relevant parts of the rail infrastructure - this may be enforced by the Rail Infrastructure Organisation or an independent authority;

### ***Establish Service Level Agreements (SLA) for specific lines and types of service***

More detailed and closely specified service level agreements for particular lines or services would be purchased covering for example:

- frequency/volume of service/ service quality etc (these would be updated from time to time to reflect changing economics and market trends);
- Provisions for penalties/incentives; default mechanism include contestability; Provisions to cope with changing economics and rail viability
- Publication of performance information by rail operator.
- SLAs would cover certain at-risk lines and services such as:
  - Services on marginal/uneconomic lines
  - Services to smaller centres/regional plants
  - Services where Tranz Rail cannot supply specific use wagons e.g. (fertiliser/timber/meat).

### **Recent Developments**

Since the last meeting of the Ad-Hoc Ministerial Group, two third parties expressing an interest in buying Tranz Rail have approached me. Both of these third parties have now indicated that prior to their making any bid they wish to enter into formal discussions with the Crown with a view to producing a Heads of Agreement setting out a post-acquisition arrangement.

The agreements suggested by both parties would cover ownership of the rail network and the basis on which it passed to the Crown; commitments from the Crown to refurbishing the network; and access charges. In informal discussions with both these parties, officials have suggested that the Crown would envisage taking over the network at no charge, and committing to a significant amount of refurbishment.

Both of the parties have indicated that they would not bid for Tranz Rail at current share prices, so any transaction would only take place if the share price drops. This may in the end be a stumbling block to such a transaction occurring. One of the parties has indicated that it would only want to commit to an intense negotiation with the Crown if it knew that it was in an exclusive position. This would mean a choice of direction would have to be made before the heads of agreement negotiating stage is entered into.

Since the last meeting of the Ad-Hoc Ministers, Tranz Rail has also written to me requesting talks be resumed as soon as possible. It is increasingly apparent that the company is under financial pressure and management is keen to demonstrate to shareholders some progress in talks with the Government.

Entering into without-prejudice discussions with Tranz Rail, testing whether a deal may be reached that meets the Government's objectives, would not preclude the

Government from having discussions with third parties providing Tranz Rail does not disclose any price sensitive information.

We are at the point however where Tranz Rail is likely to want to provide the Crown with commercial information to bolster its arguments. Possession of that information could prevent the Crown from dealing with parties wishing to mount a take-over bid for Tranz Rail.

In addition, an announcement that the Crown is in negotiations with Tranz Rail over the rail network (which Tranz Rail would be obliged to make under NZSE rules) is likely to raise some expectations that the Crown would be prepared to pay more than the network is worth (officials assess the network probably has negative value) and thus push up the Tranz Rail share price. Such a share price increase would make any third party takeover bid for Tranz Rail less likely.

Declining Tranz Rail's request to advance formal discussions or to consider commercial information would place Tranz Rail under further financial market pressure, and make the relationship with the company very difficult.

Even though the company is under financial pressure, Tranz Rail's shareholders would not necessarily support a sale of the infrastructure. (Shareholder support would be required because a sale of the infrastructure would constitute a major transaction, requiring the approval of an ordinary resolution of the company.) Major shareholders are increasingly interested in exiting the company totally and a sale of the infrastructure would not necessarily be in their best interests (especially at a negligible or modest price). It is possible that Tranz Rail's shareholders would block a sale of the infrastructure to the Government and hold out for a takeover.

### **Proposed Path Forward**

To acquire the infrastructure, the Government is presented with a choice of pursuing negotiations with either Tranz Rail or one of two third parties. There is no guarantee that any of these routes will be successful at modest price levels. The two third parties, while seriously interested, have placed share price conditions on any takeover bid. They may therefore attempt to encourage the Crown to pay generously for the network to bridge any gap. In the case of Tranz Rail there is a real possibility that its shareholders will not accept a sale of the infrastructure at a realistic value and would want to hold out until the company is taken over.

If the Crown were to pursue discussions with either of the two third parties alone, the time taken to agree a heads of agreement and the potential time taken to wait for the share price to fall would risk provoking Tranz Rail. If the Crown were to enter into negotiations with Tranz Rail, receipt of confidential commercial information would preclude pursuing an arrangement with the other two parties.

While the Crown must be very careful in continuing parallel discussions with all three parties, in the immediate term continuing without-prejudice discussions, testing the degree to which a deal can be reached, appears the best path forward.

In response to Tranz Rail's request that the Crown engage more formally, it is proposed that we be upfront and say Ministers have yet to make a final decision on the nature of Crown's involvement in rail.

## Negotiating Strategy

Irrespective of whether negotiations are with Tranz Rail or with the other parties, the following are key parameters/milestones:

- Negotiators should first establish with the other party what is broadly feasible and report back to ad-hoc Ministers. Only if Ministers are comfortable with the outline agreement should a more detailed agreement be pursued
- The Crown should commit to a sensible outcome, but should not commit to any particular outcome (eg network ownership) regardless of cost.

Officials at this stage assess that the rail network has negative value. That is to say that by taking it from Tranz Rail at no cost, the Crown would be improving Tranz Rail's financial position since Tranz Rail would retain all its access rights, would pay no more than the costs of maintenance for the network in future, and the Crown would commit to refurbishing the network (without payment from Tranz Rail, and to the benefit of Tranz Rail in terms of better service to its customers)

The passage of time has strengthened the Crown's negotiating position and will probably continue to do so. The Crown has a number of strengths to its position. In discussions with Tranz Rail (or other parties) the option of regulatory intervention to secure public policy goals should not be ruled out.

## Consultation

Treasury has prepared this paper. The Ministry of Transport was consulted.

## Recommendations

It is recommended that the Ad Hoc Ministerial Committee on Rail Policy;

- a **note** that Government has set out its goals for rail in the New Zealand Transport Strategy and the National Rail Goals and Objectives;
- b **note** that specifying levels of performance for service delivery for rail is complex and that there are two ways Government could contract with a rail operator for service performance:
  - a high level Strategic Alliance type agreement; or
  - a detailed SLA;
- c **agree-in-principle** that a high level Strategic Alliance with the rail operator is likely to best meet the Government's objectives whereby;
  - the parties are required to consult each other on substantive issues (particularly service cessation), have an opportunity to collaborate for investment in strategic infrastructure, and agree a basis for information exchange between the parties;
  - the company is required to maintain specified rail service levels on a line-by-line basis, updated from time to time. For example, a more detailed service level agreement could be entered into for non-commercial services on the Napier-Gisborne line; and

- where Tranz Rail fails to maintain specified rail services, there is an ability for alternative operators to access relevant parts of the rail infrastructure - this may be enforced by the Rail Infrastructure Organisation or an independent authority;
- d **note** that existing mechanisms (including Transfund's ATR program) give Government some levers to improve service levels and that track ownership does not in itself meet the Government's expressed service level objectives in terms of the strategic direction of the rail system;
- e either
- i **direct** Treasury to begin discussions with Tranz Rail on Option A: Purchase of Infrastructure from Tranz Rail in the paper National Rail: Implementation Path, of 16 December 2002.
- or
- ii **direct** Treasury to begin discussions with the two third parties, and to report back to Ministers with advice on the type of deal attainable with each, and the parameters for choosing between them.
- or
- iii **direct** Treasury to explore further, on a without prejudice basis, with both Tranz Rail and the other parties, what can be agreed with each of them, and to report back to the Ad Hoc committee.
- f **note** that in any approach which does not involve final negotiation with Tranz Rail, the expectations of Tranz Rail and its shareholders will need to be managed carefully.
- g **agree** that the broad structure of a rail deal would be:
- the Crown would acquire from Tranz Rail the track infrastructure and all assets required for the effective management and operation of the rail infrastructure (including land, tracks, tunnels, bridges, signalling, train control etc);
  - Tranz Rail would retain rail operations including its freight operator rights, subject to meeting agreed performance indicators;
  - access to the track would be contestable where Tranz Rail is unable to meet the performance indicators in (b) above; where negotiated with Tranz Rail directly; where Government offered a service subsidy; for long distance passenger transport where no equivalent service is provided at present; and for heritage operators; and
- h **direct** Treasury to report back to the Ad-hoc Ministerial Group on Rail Policy on the outcome of the discussions outlined in (e) above prior to entering into any formal negotiations;

- i **agree** that in discussions with Tranz Rail (or other parties) the option of regulatory intervention to secure public policy goals should not be ruled out.

Hon Dr Michael Cullen  
Minister of Finance