THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: National Rail – Potential Third Party Approach

Date:	19 September 2002	**Treasury Priority:**	**High**
Security Level:	Commercial Sensitive	**Report No:**	T2002/1241

Action Sought

	Action Sought	Deadline
Minister of Finance	Agree Treasury, in consultation with advisors, evaluate any third party proposal on its merits. Agree Treasury commence contractual negotiations for advice. Note Treasury would report back prior to entering into contracts.	ASAP

Contact for Telephone Discussion (if required)

Name	Position		Telephone	1st Contact

Enclosure: **No**

19 September 2002 SH-8-4

Treasury Report: National Rail – Potential Third Party Approach

Executive Summary

This report outlines some broad issues Government would need to consider in evaluating a third party approach to meet the Government's national rail objectives.

Government has agreed a set of national rail objectives (CAB Min (02) 6/4). Over the last few months, Treasury has prepared advice on a number of options to meet these objectives.

Over the course of this period, Tranz Rail's share price has come under substantial pressure and major users have expressed continued dissatisfaction with the level and quality of services they have been receiving from the company. Since the exit of the major strategic shareholders in February 2002 the change in Tranz Rail shareholders has been toward more passive investors - predominately institutions.

With the recent decline in the Tranz Rail's share price there has been rumoured interest in the company by established overseas rail operators and other investors. First NZ Capital have previously advised that it would be highly unlikely for third parties to take a strategic interest in the company without first talking to the Government about its rail policy objectives and its expressed preference to own the rail infrastructure to achieve those objectives (CAB Min (02) 6/4 refers).

It is appropriate that Government consider issues that may arise in considering any potential approach from a third party in the context of Government's wider land transport objectives. This paper sets out issues and relevant fiscal and process risks related to:

- The price, terms and conditions of vertical separation;
- The entry of alternative operators onto the network; and
- The ability to influence service levels.

If a third party makes a formal approach to the Government, this would likely lead to discussion around what the third party intends and how this may or may not align with the Government's objectives.

This paper also seeks agreement that Treasury commence contract negotiations for necessary legal, financial and technical expertise but notes that further appropriations for any additional expenditure would be sought before advisory contracts were finalised.

Recommendation

It is recommended that you:

a **note** that this paper offers guidance for evaluating the pros and cons of any third party arrangement in which a third party takes over Tranz Rail and the Crown enters into a pre-acquisition agreement to acquire the rail infrastructure;

b **agree** that Treasury, in consultation with advisors from the offices of the Prime Minister, and Ministers of Finance, Transport and Economic Development evaluate any third party proposal on its merits;

agreed/declined

c **agree** that Treasury commence contract negotiations for necessary legal, financial and technical advice; and

agreed/declined

d **note** that Treasury would report back to you prior to entering into any contracts.

Hon Dr Michael Cullen
Minister of Finance

Purpose

1. This report sets out some broad issues Government would need to consider should it have a formal approach from a third party interested in the acquisition of Tranz Rail. It sets out a process that Government may want to follow to consider such approaches in the context of wider land transport policy objectives.

Background

2. Government has agreed a set of national rail objectives (CAB Min (02) 6/4). Over the last few months, we have given you advice on a broad range of potential options to meet these objectives ranging from the use of explicit subsidies to a Crown acquisition of Tranz Rail.

3. On 9 September 2002, Cabinet also agreed that a small group of Ministers be given Power to Act with respect to national rail issues (CAB Min (02) 23/8 refers)

4. Over the course of this period, Tranz Rail's share price has come under substantial pressure and some major users have expressed continued dissatisfaction with the level and quality of services they have been receiving from the company (though recent evidence suggests some major users have progressed contract negotiations with the company).

5. With the recent decline in the company's share price there has been rumoured interest in the company by established overseas rail operators and other investors. First NZ Capital has previously advised that it would be highly unlikely for third parties to take a strategic interest in the company without first talking to the Government about its rail policy objectives and its expressed preference to own the rail infrastructure to achieve these objectives (CAB Min (02) 6/4 refers).

6. Given this, it is appropriate that Government consider the issues that may arise if it is approached by a third party in the context of its wider land transport objectives.

Issues for Government

Ability to meet the Government's objectives

7. In any discussion with the third party Government would need to be clear about its policy objectives and any desire to maintain or enhance service levels on certain lines in addition to negotiating for the infrastructure.

8. Under a third party option, the Government has limited ability to directly influence the outcomes post acquisition and would therefore need to negotiate its policy objectives into any pre-acquisition arrangement. Such a pre-acquisition arrangement would need to include:

   The price, terms and conditions of vertical separation

9. A third party would be looking to acquire either 100% or a strategic interest in Tranz Rail. Separately, the Crown would agree to acquire the rail infrastructure for a specified amount. Any discussion would need to include preliminary understanding on

rights of access, charging and maintenance arrangements. One of the key issues for Government is the extent to which access charges reflect full cost recovery for maintenance and capital investment.

The entry of alternative operators onto the network

10. Given the size of the New Zealand freight market it would be necessary to gauge any third party's views on open access and alternative operators entering the market. The existing access arrangements would have to be kept in place (Tranz Scenic and the heritage operators). Provision would also have to be made for access to the Auckland and Wellington corridors and any new owners of Tranz Metro. There may be some scope for horizontal separation (e.g. separating out coal lines). From a first best position, Government would prefer entry of alternative operators onto the network provided by the Government's rail infrastructure entity – this would likely be an area of extensive discussion. The establishment of an infrastructure entity in itself would be a significant area of work.

Ability to specify service levels

11. A condition of any third party arrangement would need to include the Government's ability to influence service levels on certain lines.

12. It would also be important to establish the third party's intentions for any reconfiguration, particularly service coverage, the ferries, passenger transport. Once they have entered the market, a third party would likely to want to reconfigure the business in such as way as to maximise profit. This may mean a reduction or change in focus of current rail services

Fiscal risks

13. Treasury has yet to engage financial advisors on the detail of any third party proposition – and to an extent it would be highly dependent on the views of the third party. A third party arrangement whereby a third party took over the company and the Crown entered into an agreement to acquire the infrastructure avoids some upward price risk. Disclosure of the Crown's involvement could produce some upward pressure but this could be offset if the market understood the third party to be in control of the exit strategy. At this stage there would likely be two broad options for the pricing of the purchase of the infrastructure:

- A price formula – a pre-agreed arrangement taking into account the average cost to acquire the company; or

- A fixed price for the infrastructure.

14. A fixed price for the infrastructure is likely to minimise upward price risk and provide a more plausible exit strategy for the Government.

15. The price the Crown would pay for the infrastructure would be dependent on:

- Access arrangements (including whether the acquirer has monopoly rights over the network and the extent new operators were introduced);
- Access charges;
- Maintenance and investment arrangements; and
- Any other terms and conditions the Government placed on the third party including service coverage obligations.

16. The greater the service obligations the Government wants placed on the third party, the more the infrastructure is likely to cost.

17. The decision on whether or not to conduct due diligence on the company would belong to the third party. The Government would then need to consider whether it wanted to conduct due diligence, or provide for due diligence, on the infrastructure in any pre-acquisition arrangement.

Process risks

18. The success of a third party arrangement would depend completely on the interests of that party and the degree to which they align, or have the potential to align (at a price) with the Government's objectives. A clear contractual arrangement would be needed otherwise Government would be in a very weak negotiating position and may achieve nothing.

19. If the Crown could not agree terms and conditions initially, it could have a lesser formal involvement based around a set of principles (in a heads of agreement) with formal negotiation beginning post acquisition. Clearly, thought would need to be given to what would happen if the Crown were not able to complete negotiations successfully.

20. The current presumption is that any arrangement between the Crown and a third party acquirer would be disclosed at the time any offer was made. This disclosure may not be legally required (depending on the nature of the arrangement) but would be recommended given the unique position the Crown would be in as a direct or indirect party to a takeover. While disclosure would create some upward price pressure, non-disclosure to avoid this pressure would likely draw significant criticism when at a later date, the Crown's relationship with the third party was revealed.

Process from here

21. Government needs to be in a position to respond to any formal approach from a third party on its merits. This paper and Government's previous decisions provide a basis for initially considering any approach.

22. If a third party makes an approach to the Government, this would likely lead to discussion around what the third party intends and how this may or may not align with the Government's objectives. Treasury officials could be delegated the authority to enter into such discussions on behalf of Government, reporting to yourself and other "Power to Act" Ministers. This would include meeting with any potential third parties on

behalf of the Crown. These discussions would need to be carefully managed, for risk of leakage, and would be undertaken in consultation with staff from your office.

Project Budget

23. To date, National Rail Project costs have been met within Treasury baselines as it was agreed, as part of the 2001/02 Technical Adjustments process that Treasury retain $0.720 million (GST inclusive) to meet potential costs. Of that money, approximately $0.500 million (GST exclusive) has been transferred into 2002/03 financial year for the project.

24. While the current budget is sufficient to cover normal advisory work, a further appropriation would need to be sought if negotiations with a third party commenced. It would be helpful, in the interest of time, if Treasury were permitted to enter into contract negotiations for this advice in the meantime.

25. Overall, it is difficult to estimate a potential budget for this project but a rough order assessment means that the project costs associated with any potential transaction could be in the vicinity of:

Potential Project Costs		**($ million)**	
		(GST exclusive)	
Transaction phase	Financial Advisors	$	1.5
	Legal Advisors	$	1.0
	Technical Advisors	$	1.5
	Contingency	$	0.5
Total Potential Project Costs		$	4.5

26. Treasury would report back to you prior to entering any contracts.