

COMMERCIAL SECRET

9 June 2003

MEMORANDUM FOR CABINET

TRANZ RAIL - RECAPITALISATION AND INFRASTRUCTURE PURCHASE

Proposal

1. The purpose of this paper is to confirm the decision taken on Friday 6 June by me, in consultation with the Ad Hoc Ministerial Committee on Rail Policy, with regard to the Heads of Agreement (HOA) that was signed with Tranz Rail. The paper sets out the key features of the HOA, the risks associated with it and a timetable of steps to be taken from here.

Background

2. The HOA has been negotiated by officials and Tranz Rail, in accordance with Ministers' instructions, following an approach from Tranz Rail in early May seeking solutions to the company's short-term liquidity position.

3. 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.

4. 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.

5. Shareholder approval will be sought at a special meeting to be held on 11 July 2003, or as soon after as can be arranged. Between now and then, officials have been directed to negotiate with Tranz Rail, Rail Network Transfer Agreements that would contain detailed specifications for shareholders to consider.

Summary of Package

Cash injection / Recapitalisation

6. To resolve the short-term liquidity issues the Crown will immediately provide Tranz Rail with a \$44 million cash injection by way of a short-term deposit. Upon acceptance of the deal by Tranz Rail shareholders, Tranz Rail would issue equity to the Crown at a price of \$0.67 per share giving the Crown a 35% shareholding in Tranz Rail.

7. The Crown would be able to nominate three out of the total seven directors to the board of Tranz Rail.

8. The short-term deposit will be charged at commercial rates and be second ranking, behind the banks and major leaseholders. If shareholders do not approve the deal, this will be repayable on 1 July 2004.

9. Tranz Rail's banks have still to agree that previously scheduled debt repayments would be postponed in the period up to completion of the deal, so that Crown's funds are not used to reduce the banks' exposure. No payment would be made until agreement is reached with the banks.

Purchase of Rail Network

10. The Crown would purchase the rail network and associated infrastructure for \$1. This purchase would include all the elements necessary to run the network, including track infrastructure, structures, signals, the train control centre, intellectual property and the plant and rolling stock used for track maintenance.

11. The regime would be reviewed prior to 1 July 2013 and if it is impossible for the parties to agree on any changes, then the existing arrangements would continue.

Purchase of Real Estate Rights

12. Tranz Rail's lease of the rail corridor would be partially surrendered. Lease variations would be developed to allow Tranz Rail to retain use of specific properties.

13. The Crown would purchase a variety of assets and revenue streams from Tranz Rail. These include:

- access rights to surplus land and property;
- sub-leases including income from road rail bridges and third party access fees; and
- some other infrastructure-related assets and revenue streams.

14. The value of some of these assets would be subject to verification in the due diligence process, but is currently expected to be in the order of \$50 million. The \$44 million cash injection would be a part payment of this sum. This part of the transaction should therefore be value neutral for the Crown, with the cost matching the value of the assets.

OpCo

15. An operating company ("OpCo") would be established. This would include the freight, passenger and ferry operations.

TrackCo

16. A track company ("TrackCo") would be established to manage the rail network. TrackCo would be responsible for:

- maintenance and engineering functions necessary to maintain the network;
- network control; and
- the network operating rules, certification, safety systems, and incident management and investigation.

17. It is expected that about 100 Tranz Rail staff would eventually transfer to TrackCo. Current third party contracts for network maintenance would also be assigned to TrackCo.

18. This staff transfer, together with an internal staff transfer from Tranz Rail to OpCo, is likely to throw up some issues around Government Super Fund (GSF) entitlements that may need to be addressed.

19. Details of the governance and management of TrackCo have still to be determined. The role of NZRC is central to these considerations and the working assumption is that NZRC would evolve into TrackCo. Officials will provide further advice on this matter in due course.

20. Tranz Rail would operate the network under a management contract from settlement of the transaction to 30 June 2004. The details of the management contract have yet to be determined but it will operate under strict surveillance from the Crown.

Access agreement

21. The Crown would grant access rights to Tranz Rail. The initial rights would be for exclusive access for freight services, moderated by an enhanced "use it or lose it" principle. The "lose it" threshold would be raised substantially from the level in the existing NZRC lease for most lines to 60% of current traffic volumes.

22. There would be a set of agreements with Tranz Rail about its performance, including safety and customer satisfaction. Performance on these dimensions would be linked to a set of financial incentives and penalties.

23. The government also agrees to give rights of first refusal to Tranz Rail for any new line and any new subsidy for a line or a freight service.

24. There would be provision to protect the rights of existing and currently planned non-Tranz Rail operators (Auckland metro), heritage operators and Tranz Scenic.

25. The HOA would advance, but not of itself fulfil, the Crown's objectives relating to long distance passenger services. In the HOA Tranz Rail agrees to assist the government in achieving its objectives with respect to long distance passenger services. Tranz Rail has sold its rights to nationwide long-distance passenger services to Tranz Scenic. It may therefore be necessary jointly to buy out the other Tranz Scenic partners to achieve access for other parties.

Access Charging

26 The proposed access-charging regime has two components. One that would set the total quantum of access charges and the other that would determine how the quantum would be allocated among the different rail users and services.

Total access charges

27 The total quantum of charges would be set based on the following parameters:

- The overall Track Access Charge (TAC) to be set at a level that enables Tranz Rail to be financially viable;
- The TAC to be reviewed every three years based on an “open book” appraisal of Tranz Rail’s historical and forecast performance.
- Any increase in the TAC of more than 10% following review to be phased in over three years; and
- The price and terms of third party access to be reviewed in the seventh year.

28 The TAC would be fixed for the nine months to June 2004, and capped for the three subsequent years. Specifically it would be fixed at 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.

29 It should be noted that these terms are independent of the costs of TrackCo. Current modelling of Tranz Rail’s expected financial performance under the new arrangements suggests that in the first three years TrackCo would recover only 50-70% of its costs. This amounts to a subsidy to Tranz Rail of around \$20 million per annum.

Charge allocation

30 The TAC would be collected using a two-part tariff with flagfall and variable components split by line segment. It would be based on the following parameters:

- The variable unit charge to reflect usage of the track, i.e. actual tonnage and distance of the traffic, and to be charged on a gross tonne kilometre basis.
- The flagfall unit charge will reflect the density of traffic that the particular line is capable of handling. Specifically, it will represent access rights to certain train paths for a time period irrespective of the number of train paths actually utilised.
- Unit charges to be indexed yearly by an agreed index. The unit charge mechanism will be fully developed in the nine months to 30 June 2004.
- The charges to be structured and balanced to provide an incentive to move additional freight on rail.

31 This charging system would commence on 1 July 2004. For the nine months to 30 June 2004 there would be a fixed dollar charge (9/12 of TAC).

Network Investment Programme

32 The Crown would commit to investing \$100 million to refurbish and improve the network. The specific projects have yet to be agreed but are likely to include some safety and compliance projects and some improvement to access and the network itself.

33 While the make-up of the investment program is yet to be determined, some of the new investment is likely to assist Tranz Rail increase profits and would thus be partially recovered by TrackCo.

Timetable

34 *Between now and Tranz Rail's special meeting* - Rail Network Transfer Agreements containing detailed specifications of transactions are to be negotiated.

35 *11 July 2003 or as soon after as can be arranged* - Tranz Rail will hold a special meeting where Shareholder approval will be sought. Upon shareholder approval, the shares in Tranz Rail will be issued to the Crown and the Crown's three appointees will be appointed to the board.

36 *30 September 2003* - ownership of rail network will be transferred to the Crown. Tranz Rail will continue to operate it under a management contract until 30 June 2004.

37 *31 June 2004* - employees will transfer to the Crown.

38 The new Crown entity, expected to evolve out of New Zealand Railways Corporation, will be established.

Risks

Shareholder Approval

39 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.

40 While Toll Holding's takeover offer may be seen as an attractive alternative to some shareholders, in fact the Crown transaction is fully compatible with a new owner investing in the Tranz Rail operating company.

Open Access

41 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

42 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.

Cash Injection / Short Term Deposit

43 In the event that the transaction does not proceed because shareholders approval is not given there is a risk that the Crown's immediate \$44 million deposit would not be recoverable. The Crown will have a second charge but the banks and Aratere lenders have the first priority.

44 In addition, delays in the transaction could result in a need for further support for Tranz Rail's cash flow. The initial investment deals with immediate needs but does not address cash flow beyond August. Tranz Rail's revenue receipts are usually lowest in the spring season so its liquidity problems do not cease in August. Projections received from Tranz Rail indicate that, in the absence of asset sales, its cash position would continue to deteriorate until early November. Given Tranz Rail's improved outlook following the HOA, its banks may be prepared to provide this liquidity, but the possibility of a further call on the Crown (e.g. by way of a rights issue) cannot be excluded.

Due Diligence

45 The Heads of Agreement is binding and although some 'due diligence' is planned, the HOA is not subject to the results. The Crown is therefore exposed to risks including:

- Tranz Rail's current financial position could be even worse than its current forecasts;
- The cost of running Track Co may be underestimated;
- The cost of imposing the safety and reliability of the track may be substantially more than the \$100 million committed.

Transition

46 The HOA restricts Tranz Rail from deliberate actions that might impact negatively on the Crown's position. However, once the HOA is signed the Crown is exposed to a number of risks. These include:

- possible public perception that the Crown is already in control of the track;
- action from the banks or the Aratere and GATX lease holders. Although the HOA has been negotiated with the banks encouragement and cooperation, they are not a party to it. Their legal position and security is unchanged.

47 The transition period would also bring certain costs to implement the changes. Implementation would involve investment bankers, lawyers and other consultants. Tranz Rail would also have internal costs that are unlikely to be included in their budgets to date. These costs have yet to be quantified.

Safety and Compliance

48 It is possible that capital investment, additional to that forecast, would be required to meet current and future safety and compliance requirements. Tranz Rail asserts that it meets all current requirements. However, in the circumstances it is not feasible to obtain any warranty or retention of liability.

49 It is also possible that safety and compliance spending would increase due to:

- higher public expectations for assets in Crown ownership; and
- government's lesser appetite for risk compared with a private owner;

Financial Implications

50 The decisions have committed the government to:

- an immediate \$44 million cash injection to Tranz Rail;
- \$76 million for the purchase of new shares in Tranz Rail
- \$1.00 for the purchase of the track infrastructure and around \$50m for the rental income and lease rights to surplus land;
- \$100 million over 5 years for on-going capital investment in the rail network; and
- a track access fee structure which amounts to an on-going implicit subsidy to Tranz Rail, expected to be around \$20 – 30 million per year.

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

51 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

Legislative Implications

52 The secured deposit of \$44 million to Tranz Rail from Vote Finance non-departmental capital contribution to other organisations is not appropriated and will require validating legislation in the Appropriation (2002/03 Financial Review) Bill.

Consultation

53 Members of the Ad Hoc Ministerial Committee on Rail Policy have been consulted.

Recommendations

54 I recommend that Cabinet:

- a **confirm** the decisions, set out below, taken on Friday 6 June 2003 under Power to Act from Cabinet on 12 May 2003 (Cab Min (03) 16/14 refers) with regard to the Heads of Agreement signed with Tranz Rail.

Decisions as referred to in a) above are:

- b **note** that Cabinet has delegated the Minister of Finance Power to Act on national rail policy issues, in consultation with other members of the Ad hoc Ministerial Committee on Rail Policy (Cab Min (03) 16/14 refers), and invited him to report back on any decisions taken under this power as soon as possible after the decisions have been taken.

- c **note** that Officials, in accordance with my instructions have negotiated a Heads of Agreement with Tranz Rail, with the terms and conditions set out in this paper;
- d **note** that on Friday 6 June 2003, the Minister of Finance signed a Heads of Agreement with Tranz Rail committing the government to:
- providing Tranz Rail with an immediate \$44 million cash injection;
 - purchase of new shares in Tranz Rail giving the Crown a 35% stake;
 - the purchase of the track infrastructure for \$1.00 and the rental income and lease rights to surplus land for around \$50m;
 - 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, 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 the HOA and the timetable from here as set out in this paper;
- f **note** that officials have been directed to commence work on the Rail Network Transfer Agreements.

Financial Recommendations

- g **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;
- h **note** the secured deposit in j above is not appropriated and will require validating legislation in the Appropriation (2002/03 Financial Review) Bill.
- i **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;
- j **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;
- k **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;
- l **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.
- m **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.
- n **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.

- o **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.
- p **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)					
	2002/03	2003/04	2004/05	2005/06	2006/07	GST
<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	-	140,000	45,000	45,000	45,000	

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

Hon Dr Michael Cullen
Minister of Finance

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department

<p>Departments consulted: The attached submission has implications for the following departments whose views have been sought and are accurately reflected in the submission:</p> <p>.....</p> <p>.....</p>		
<p>Departments informed: In addition, the following departments have an interest in the submission and have been informed:</p> <p>.....</p>		
<p>Others consulted: Other interested groups have been consulted as follows:</p> <p>.....</p>		
Signature	Name, Title, Department	Date / /

CERTIFICATION BY MINISTER

<p>Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee. The attached submission:</p>		
Consultation at Ministerial level	<input type="checkbox"/> did not need consultation with other Ministers <input type="checkbox"/> has been the subject of consultation with the Minister of Finance <i>[required for all submissions seeking new funding]</i> <input type="checkbox"/> has been the subject of consultation with the following Minister(s)	
Consultation with Government MPs	<input type="checkbox"/> does not need consultation with the government caucuses <input type="checkbox"/> has been or will be <i>[specify which]</i> the subject of consultation with the following government caucuses: <input type="checkbox"/> Labour caucus <input type="checkbox"/> Progressive Coalition caucus	
Consultation at Parliamentary level	<input type="checkbox"/> does not need consultation at parliamentary level <input type="checkbox"/> has been or will be <i>[specify which]</i> the subject of consultation with the following other parties represented in Parliament:	
Signature	Portfolio	Date / /

Most submissions to Cabinet and Cabinet committees are relevant to departments other than the initiating department. It is important for the quality of decision making that all interested departments are involved in developing a submission. Departments should consider the schedule of interests of all departments in chapter 11 of the Cabinet Office *Step by Step Guide* for **every** submission for which they are responsible. Particular attention should be paid to the need to consult the departments listed below, which have a broad “horizontal responsibility”.

The Cabinet Office will **reject submissions** if the necessary consultation does not appear to have taken place.

Department	Issues on which they must be consulted
Crown Law Office	Proposals having legal implications for the Crown
Ministry of Consumer Affairs	All policy proposals likely to affect the economic welfare of consumers
Ministry of Foreign Affairs and Trade	All proposals having implications for New Zealand's external relations, trade policy and international legal obligations
Ministry for the Environment	All proposals having significant environmental implications
Ministry of Maori Development (Te Puni Kokiri)	All proposals with implications for Maori, as individuals, communities or tribal groupings, with particular focus on reducing inequalities, and Treaty of Waitangi issues
Ministry of Pacific Island Affairs	All proposals with implications for Pacific peoples as individuals and communities with particular focus on closing the gaps issues
Parliamentary Counsel Office	Proposals for legislation or amendments to legislation
Department of Prime Minister & Cabinet	All policy proposals which are likely to have implications for the government as a whole, or for the coordination of the activities of two or more departments
Ministry of Research, Science and Technology	All proposals having implications for science policy or funding, or which might be significantly influenced by scientific or technological input
Senior Citizens Unit, Ministry of Social Policy	All matters relating to the well-being of older people
State Services Commission	All proposals with an impact on organisational structures, Chief Executive accountability or departmental performance specification and industrial relations in the state services
The Treasury	All proposals having economic, financial or fiscal (expenditure or revenue) implications
Ministry of Women's Affairs	All proposals that relate to the economic and social status of women, especially Maori women
Ministry of Youth Affairs	All proposals dealing with issues of concern to 12-25 year olds