

**Treasury Report: National Rail - Service Performance Objectives (Updated Paper)**

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<b>Date:</b>	11 February 2003	<b>Treasury Priority:</b>	<b>High</b>
<b>Security Level:</b>	Commercial Sensitive	<b>Report No:</b>	T2003/152

**Action Sought**

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	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance	<b>Sign</b> the attached paper, and <b>Forward</b> to the Ad-hoc Ministerial Group on Rail Policy.	ASAP

**Contact for Telephone Discussion (if required)**

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<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>

**Enclosure: Yes**

11 February 2003

SH-8-4

## **Treasury Report: National Rail - Service Performance Objectives (Updated Paper)**

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### **Purpose**

1. Cabinet, on advice from the Adhoc Ministerial Group on Rail Policy, instructed Treasury to prepare a paper setting out a draft set of performance objectives for the national rail system with a view to establishing a system of performance indicators [CAB Min (03) 1/6 refers].
2. As with a draft paper provided to you previously [T2003/107 refers], the first half of the attached paper meets this objective. The second examines the capacity of various tools to deliver the Government's national rail objectives.

### **Commercial Developments**

3. The paper has also been updated to reflect recent commercial developments. As discussed with you, there are some complicated process issues that need to be considered should Government begin negotiations with Tranz Rail while at the same time being approached by third parties.
4. We are giving further consideration to these issues and will report back to you more fully in due course.
5. In the meantime, the service performance issues in this paper apply regardless what constitutes Tranz Rail's share register.

### **Previous Difference of Opinion**

6. The previous draft provided to you [T2003/107 refers] included a difference of opinion between Treasury and Transport officials about the capacity for an independent authority to mediate disputes over service quality between Tranz Rail and its customers. This issue has now been resolved. The paper now recognises:
  - where Tranz Rail fails to deliver on contracts, Tranz Rail's customers may seek remedy within the courts;
  - where Tranz Rail is perceived to be abusing a dominant market position, remedy may be sought from the Commerce Commission; and
  - where Tranz Rail fails to deliver on contractual obligations to the Government, as specified in a service level agreement, then there may be a role either for an independent authority or alternatively the Railways Infrastructure Organisation to place sanctions on the company.

## Recommended Action

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7. It is recommended that you:
- a **sign** the attached paper; and
  - b **forward** the paper to the Ad-hoc Ministerial Group on Rail Policy.

for Secretary to the Treasury

**Hon Dr Michael Cullen**  
Minister of Finance

Forward copies to:

Prime Minister	<i>yes/no</i>
Minister of Economic Development	<i>yes/no</i>
Minister of State Owned Enterprises	<i>yes/no</i>
Minister of Transport	<i>yes/no</i>

COMMERCIAL SECRET

17 March 2003

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

## **NATIONAL RAIL – SERVICE PERFORMANCE OBJECTIVES**

### **Executive Summary**

On 21 January 2003, Cabinet noted that the Ad-hoc Ministerial Committee on Rail Policy considered a paper “National Rail Implementation Path” and indicated a preference for a modified version of Option A: Purchase of Infrastructure from Tranz Rail but invited officials to complete a further paper on service performance objectives.

Since that time, other commercial parties have approached me indicating some interest in acquiring Tranz Rail and entering into an arrangement on a similar basis to that which we discussed when we considered my paper of 16 December 2002. These discussions are highly commercially sensitive.

There are some complicated process issues that need to be considered should Government begin negotiations with Tranz Rail, while at the same time being approached by third parties. I have asked Treasury officials to give consideration to these issues and to report back to me on this matter. I will keep the Ad-hoc Ministerial Committee on Rail Policy advised of these commercial developments.

In the meantime, the broad parameters to guide our discussions with Tranz Rail should act as a basis for any discussions with third parties. In particular, the service performance issues in this paper apply regardless of who constitutes Tranz Rail’s share register. However, it is possible that some of the specific service performance concerns expressed by major users may alter with a change in shareholding.

Specifying levels of performance for service delivery for rail is complex and the likelihood of success mixed. On a nationwide scale, it is difficult for Government to specify a level of service as the basic commercial relationship is between the shipper of goods and Tranz Rail. There seem to be two ways Government could establish an agreement with the company for service performance:

- a high level Strategic Alliance type agreement; or
- a detailed Service Level Agreement.

Overall the strength of the package Government is able to negotiate will depend on the terms and conditions of the access arrangement and any service level agreement (either a Strategic Alliance or a SLA). For Tranz Rail and its shareholders, the value of the overall package will be a function of three variables;

- price paid for the infrastructure and ongoing maintenance obligations for the Crown;
- service obligations placed on the company (and subsidies required to provide services); and
- access arrangements and charges payable by the company.

On balance, a high level Strategic Alliance supplemented by more detailed SLAs for specific, at risk, services (for example Napier-Gisborne), is most likely to meet the Government's objectives.

### **Purpose**

1. On 21 January 2003, Cabinet noted that the Ad-hoc Ministerial Committee on Rail Policy considered a paper "National Rail Implementation Path" and indicated a preference for a modified version of Option A: Purchase of Infrastructure from Tranz Rail in that paper. [CAB Min (03) 1/6 refers]. This option had the Government owning the rail infrastructure, Tranz Rail having dominant freight rights to that infrastructure, and some ability for alternative operators to access the infrastructure in certain circumstances.
2. Cabinet also noted that the Ad-hoc Ministerial Group instructed Treasury to prepare a paper setting out a draft set of performance objectives for the national rail system with a view to establishing a system of performance indicators [CAB Min (03) 1/6 refers]. The first half of this paper meets that instruction; the second examines the capacity for various tools to deliver on the Government's national rail objectives.
3. Since that time, other commercial parties have approached me indicating some interest in acquiring Tranz Rail and in entering into an arrangement similar to that outlined above.

4. There are some complicated process issues that need to be considered should Government begin negotiations with Tranz Rail while at the same time being approached by third parties. I have asked Treasury officials to give consideration to these issues and to report back to me. I will keep the Ad-hoc Ministerial Committee on Rail Policy advised of these commercial developments.
5. In the meantime, the broad parameters to guide our discussions with Tranz Rail should act as a basis for any discussions with third parties. In particular, the service performance issues in this paper apply regardless of who constitutes Tranz Rail's share register. However it is possible that some of the specific service performance concerns expressed by major users may alter with a change in shareholding.

### **New Zealand Transport Strategy**

6. The New Zealand Transport Strategy (NZTS) states that "By 2010, NZ will have an affordable, integrated, safe, responsive, and sustainable transport system". The Strategy is underpinned by the following key principles:
  - assisting economic development;
  - assisting safety and personal security;
  - improving access and mobility;
  - protecting and promoting public health; and
  - ensuring environmental sustainability
7. The National Rail Policy Goals and Objectives agreed by Cabinet in February 2002 support the NZTS and recognise that rail plays a crucial component in meeting these objectives, particularly providing opportunities for economic and regional development. Other rail policy goals that support the strategy include:
  - making the most effective use of the rail system to meet environmental and economic development goals, including network integration and providing high quality services;
  - maintain and develop the existing rail network infrastructure to support the move to a sustainable transport system, including preserving and improving the potential for rail and maintaining access to rail; and
  - maintain and develop sustainable access to rail services, including improving urban and regional accessibility and development.
8. Mechanisms for achieving these outcomes have already been developed to enable the transport network to meet many of the goals of the strategy and rail policy. These are outlined in Appendix 1. The most difficult of these goals to meet is providing improved rail services. Contributing to this goal forms the basis for this paper.

## Issue

9. Specifying levels of performance for service delivery for rail is complex and the likelihood of success mixed.
10. On a nationwide scale, it is difficult for Government to specify a level of service as the basic commercial relationship is between the shipper of goods and Tranz Rail. Many major users have expressed a concern to Government about Tranz Rail failing to meet service quality standards, even where those services have been specified contractually. Where Tranz Rail fails to deliver on these contracts, Tranz Rail's customers may seek remedy with in the courts. Where Tranz Rail is perceived to be abusing a dominant market position, remedy may be sought from the Commerce Commission.
11. In this environment, there seem to be two ways Government could establish an agreement with Tranz Rail for service performance:
  - a high level Strategic Alliance type agreement; or
  - a detailed Service Level Agreement (a "SLA").
12. Under either of these agreements Government would need to establish a monitoring capability either through the entity responsible for management of the rail network, or an independent authority, to ensure that Tranz Rail met its obligations to the Government under the agreements. The sanctions available to Government are discussed below.

## Strategic Alliance

13. A Strategic Alliance for rail could be a high level agreement with the company that bundles together a set of rights and relationships and could include:
  - an agreed relationship between the Crown and the company. Details of the relationship could include a requirement for parties to consult each other on substantive issues (particularly service cessation), opportunity to collaborate for investment in strategic infrastructure, and a basis for information exchange between the parties;
  - an obligation for the company to maintain specified rail service levels on a line-by-line basis. For example, a more detailed agreement could be entered into for the Napier-Gisborne line (with specific sanctions including the ability for alternative operators to provide the service in some circumstances); and
  - a negotiation/or arbitration process for the parties to follow in meeting the obligation set out above.
14. Some flexibility would be required to let the nature of the Strategic Alliance alter over time.

15. A Strategic Alliance would be similar in form to the Telecom Kiwi Share Obligation (KSO) but there would be substantial differences. The Telecom KSO was placed in the company's constitution on privatisation – this is no longer possible for rail. Under the Strategic Alliance, the Government could make a capitalised, one-off payment. Alternatively, it could be an ongoing payment or a combination thereof. The arrangement may be bound up with the purchase of the infrastructure. Any one-off payment would need to be mindful of the term of the Alliance.
16. A high level Strategic Alliance would be difficult to enforce and there would be a limited set of remedies or sanctions available to the Crown. The balance of the new relationship would rely on the development of a collaborative relationship between the company and the Government. A Strategic Alliance would have a more limited range of sanctions than a more detailed service level agreement as set out below.

### **Service Level Agreement**

17. At a more detailed level, the Government could enter into a nationwide Service Level Agreement (SLA). An SLA could specify service standards by line. For example monthly/annual tonnage; frequency of service; and quality of service (e.g., on time departures/arrivals, average delivery time). In addition, such an agreement could specify capital and maintenance targets for the Tranz Rail fleet.
18. Tranz Rail could be required to publish performance information. Performance indicators would need to be monitored by a Government agency, most likely the Rail Infrastructure Organisation (refer paper of 16 December 2002). Monthly disclosure against service standards, along with yearly information disclosure of additional information (such as financial indicators) might assist in transparency to minimise any gaming by Tranz Rail.
19. Where the rail operator fails to meet service level requirements, the agreement must have sanctions. These sanctions could be tiered and include:
  - a call in period (a period in which the operator has the ability to rectify the service failure);
  - a penalty arrangement (a set of financial penalties for service failure); or
  - in extreme circumstances, a default mechanism and the ability to allow other operators to provide the service (though this would be a significant issue for Tranz Rail in the upfront negotiation).
20. An SLA could either be time bound (i.e. renegotiated after a period - for example, 5 years), or varied on a case-by-case basis by negotiation. Some flexibility on service standards would be in the interests of both the Government and Tranz Rail. Future changes in regional growth as well as changes in transport economics would suggest a case for flexibility. Government, in negotiating these variations, could evaluate the variation in terms of its wider land transport strategy and could:
  - agree to remove the service from the agreement (i.e. curtail a service);

- negotiate a subsidy for continued provision of that service by the incumbent; or
  - where the negotiation for subsidy fails, or the incumbent does not wish to provide the service, contract with third parties for provision of that service.
21. An SLA of this magnitude would require complex negotiations. In addition, it is likely that the Government would need to develop a substantive monitoring and enforcement capability. An SLA would need to be bought from Tranz Rail.

### **National rail policy objectives and how to achieve them**

22. Within the context of these two mechanisms for specifying service performance levels, it is helpful to review the effectiveness and usefulness of other available levers to achieve Government's national rail goals and objectives.

#### ***To ensure that rail plays its full part in the total transport system***

23. The road-rail pricing study, currently being prepared for the Ministry of Transport, will add to the information base in this area. The most precise way of correcting any disparity in road-rail pricing would be to change road user charges. However, more direct support to rail is an alternative option and could be supported by Crown ownership of the rail network through variations to access charges.

#### ***To ensure that rail provides high quality services***

24. **Freight.** At a high level it would be possible to agree targets for improved delivery quality as part of a Strategic Alliance. More detailed quality standards could be established and policed as part of an SLA. Competition within the rail industry could increase the pressure on the existing rail operator to provide high quality services. However, as noted in previous papers, there is no realistic path to substantially increase competition within the rail industry in New Zealand. The rail industry already faces substantial competition from trucking across almost all of its freight operations.
25. **Urban passenger.** Long-term the quality of urban rail services will be captured through the agreements and funding arrangements via Transfund and the Auckland and Wellington regional councils. In the medium term Tranz Rail does not intend to be an urban passenger operator in either Auckland or Wellington.
26. **Long-distance passenger.** Quality of services in the long term can be assured through SLAs with the long-distance passenger operator, or through providing for some entry by new passenger operator(s) as part of a wider ranging agreement with Tranz Rail. Tranz Rail has sold a 50% share in Tranz Scenic, the long distance passenger operator, and would like to sell the remaining 50%.

27. **Infrastructure.** Crown ownership of the rail infrastructure would provide government with more direct capacity to control the quality of the rail infrastructure through maintenance. That capacity would be determined by both the nature of the Rail Infrastructure Organisation arrangements with the maintenance contractor, and the extent to which the Rail Infrastructure Organisation had detailed track maintenance expertise.

***To preserve the option of using rail; to maintain access to rail; to promote regional development***

28. **Network.** Crown ownership of the rail network would provide Government with the direct capacity to ensure the continued existence of the existing rail network. The same outcome could be secured through an agreement with Tranz Rail. Neither approach of itself will secure services on the network.
29. **Services.** Transfund's Alternatives to Roothing output provides funding that can support services that are in the public interest but not of themselves commercially viable to the operators. An overarching agreement with Tranz Rail could provide support for this funding. Arrangements with passenger operators would need to be established separately.

***To improve the potential for rail***

30. Funding to build new rail lines (e.g. Marsden Point) could be provided through Transfund's Alternatives to Roothing program. Crown ownership of the existing network would simplify any issues around ownership of the new lines, but alternative arrangements could be established if the network remained in Tranz Rail ownership.

**Path forward**

31. Overall the strength of the package Government is able to negotiate will depend on the terms and conditions of the access arrangement and any agreement on services (either a Strategic Alliance or an SLA). For Tranz Rail and its shareholders the value of the overall package will be a function of three variables;
- price paid for the infrastructure and ongoing maintenance obligations for the Crown;
  - service obligations placed on the company (and subsidies required to provide services); and
  - access arrangements and charges payable by the company.
32. Existing mechanisms (including Transfund's Alternatives to Roothing program) give Government some levers to improve service levels. Additional mechanisms such as a Strategic Alliance type agreement or a more detailed SLA could assist if Government wanted a more comprehensive level of service specified. Government track ownership also provides a lever to indirectly subsidise service levels (through subsidised track access) but will not in itself meet the Government's expressed service level objectives.

33. On balance, a high level Strategic Alliance supplemented by more detailed SLAs for specific, at risk, services (for example Napier-Gisborne), is most likely to meet the Government's objectives.

### Consultation

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

### Recommendations

35. 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 for service performance:
    - a high level Strategic Alliance type agreement; or
    - a detailed SLA;
  - c **agree-in-principle** that a high level Strategic Alliance 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. 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;
  - e **direct** Treasury to begin discussions with Tranz Rail on Option A: Purchase of Infrastructure from Tranz Rail in National Rail: Implementation Path, of 16 December 2002 paper, under which:
    - 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 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
- f **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;
- g **note** that Government has been approached by some third parties showing preliminary interest in Tranz Rail; and
- h **agree** that any discussions with third parties be on the same basis as discussions with Tranz Rail as outlined above in (e); and
- l **note** that Treasury is preparing advice on any issues that may arise from undertaking discussions with Tranz Rail in light of (g) and (h) above.

Hon Dr Michael Cullen  
Minister of Finance

## **Appendix 1: Rail Policy Objectives and Implementation**

### **Introduction**

The New Zealand Transport Strategy (NZTS) states that “By 2010, NZ will have an affordable, integrated, safe, responsive, and sustainable transport system”. The Strategy is focused around five objectives which correlate with the National Rail Policy Goals and Objectives agreed by Cabinet in February 2002, and the rail objectives resulting from the Land Transport Management work.

The links between these strategic decisions is shown below, together with the mechanisms for achieving these outcomes that are already underway. Note that some rail policy goals relate to more than one NZTS objective.

### **Strategic Linkages and Outcomes**

#### ***NZTS Objective 1: Assisting economic development***

##### *National Rail Policy Goals*

- To make the most effective use of the rail system to meet environmental and economic development goals, and therefore:
  - to integrate rail transport into the total transport system; and
  - to ensure that rail provides high quality services.
- To maintain and develop the existing rail network infrastructure to support the move to a sustainable transport system, and therefore:
  - to preserve the option of using rail;
  - to maintain access to rail; and
  - to ensure that, wherever appropriate, incentives work to encourage more heavy freight to be carried by rail.

##### *Implementation*

Transfund NZ has already committed \$30 million for Alternatives to Roothing which includes applications for the construction of new rail links (e.g. Marsden Point and Clandeboye), improved infrastructure (e.g. Cobden Bridge near Greymouth), and service provision (e.g. services on the Napier-Gisborne line).

Regional development funding from Transfund could also be used to develop local rail systems.

If Government purchases the rail infrastructure from Tranz Rail, additional funding could be provided from the National Land Transport Fund to maintain the national infrastructure to a specified level of quality, following passage of the Land Transport Management Bill.

The Surface Transport Costs and Charges study is looking at the relationship between overall road and rail costs. Results are expected in the near future. Similar studies by NZIER and the Ministry of Transport's Land Transport Pricing Study have previously indicated that road pricing is too low when compared with rail.

### ***NZTS Objective 2: Assisting safety and personal security***

The NZTS commits the Government to developing a long-term safety strategy for rail.

#### *Implementation*

The draft Railways Bill updates the rail regulatory environment to account for a multi-operator network; implements the recommendations of recent investigations into rail safety in New Zealand, including the Wilson and Halliburton reports; provides for a higher degree of regulatory oversight of rail; and increases penalties for non-compliance. The Bill is expected to be introduced in early 2003.

The current review of Transport Accident and Incident Investigation will propose an amended structure for accident and incident investigation in New Zealand across all transport modes.

A multi-year Rail Safety Strategy is under development to provide clear safety goals for rail.

Amendments to the Health and Safety in Employment Act 1992 will set new standards of workplace safety and health for all transport modes.

### ***NZTS Objective 3: Improving access and mobility***

#### *National Rail Policy Goals*

- To maintain and develop the existing rail network infrastructure to support the move to a sustainable transport system, and therefore:
  - to preserve the option of using rail;
  - to maintain access to rail; and
  - to improve the potential for rail.
  
- To maintain and develop sustainable access to rail services, and therefore:
  - to promote regional accessibility and development; and
  - to maintain and develop rail services as part of improving urban accessibility.

#### *Implementation*

The funding mechanisms outlined for Objective 1 above also apply to this objective to maintain the extent and quality of the rail network and to fund non-commercial services.

The outcome of the *Surface Transport Costs and Charges* study will provide the basis for the Government to refocus land transport charges to promote sustainable use of the rail network.

Transfund and the Regional Councils are already funding and promoting expanded urban passenger rail services in Auckland and Wellington, with plans for further network and service expansion under development (e.g. Auckland Regional Growth Strategy).

#### ***NZTS Objective 4: Protecting and promoting public health***

##### *National Rail Policy Goals*

- To make the most effective use of the rail system to meet environmental and economic development goals, and therefore:
  - to ensure that rail provides high quality services.
  - to integrate transport into the total transport system.

##### *Implementation*

The funding mechanisms outlined for Objective 1 above also apply to this objective to maintain the extent and quality of the rail network and to fund services. With the passage of the Land Transport Management Bill, Transfund will be required to allocate funding to take account of sustainability goals, including health impact issues.

The outcome of the Surface Transport Costs and Charges study will provide the basis for the Government to refocus land transport charges to promote lower health impacts from the rail network.

The Ministry of Transport has commissioned a National Noise Impacts Analysis Model for assessing the impact of noise from land transport; has evaluated emissions from rail, and is working on issues related to water runoff from land transport. Proposals for regulatory management of all of these issues for both road and rail are under development, taking into account the lower environmental impacts of rail compared to road transport.

#### ***NZTS Objective 5: Ensuring environmental sustainability***

##### *National Rail Policy Goals*

- To make the most effective use of the rail system to meet environmental and economic development goals, and therefore:
  - to integrate rail into the total transport system.
  - to ensure that rail provides high quality services.
- To maintain and develop the existing rail network infrastructure to support the move to a sustainable transport system, and therefore:
  - to preserve the option of using rail.

- to maintain access to rail.
- to improve the potential for rail.
- To maintain and develop sustainable access to rail services, and therefore:
  - to maintain and develop rail services as part of improving urban accessibility.

#### *Implementation*

The funding mechanisms outlined above also apply to this objective to maintain the extent and quality of the rail network and to fund non-commercial services.

The outcome of the *Surface Transport Costs and Charges* study will provide the basis for the Government to refocus land transport charges to promote sustainable use of the rail network.

The development of environmental regulation noted in Objective 4 above will also promote rail as part of a sustainable land transport system.