

## Treasury Report: Choice of Entity to Manage Rail Network Infrastructure

<b>Date:</b>	18 September 2003	<b>Treasury Priority:</b>	Medium
<b>Security Level:</b>	IN-CONFIDENCE	<b>Report No:</b>	T2003/1616

### Action Sought

	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance	<b>Sign</b> the enclosed report	19 September 2003
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Associate Minister of Finance (Hon David Cunliffe)	Note	None

### Contact for Telephone Discussion (if required)

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

**Enclosure: No**

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## Treasury Report: Choice of Entity to Manage Rail Network Infrastructure

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### Executive Summary

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An entity to manage the New Zealand rail network infrastructure, provisionally called "TrackCo", must be established by 30 June 2004. The ideal entity form for TrackCo needs to be considered, along with practical issues that may impinge on the government's ability to establish the ideal entity structure in the time available. This report provides some initial advice on these issues and seeks your views on the direction of further work.

### Entity Type

It is concluded that a non-company Crown entity is the preferred option. Of the subtypes available within this option TrackCo could be either a Crown Agent or an Autonomous Crown Entity (ACE). The choice between these largely depends on the operating model that the Government intends for TrackCo. There are two broad models that might be considered, with many variants on each. One model is to have an entity separate from TrackCo that chooses and funds rail developments. This could be done by expanding Transfunds role or developing a parallel to the Transfund/Transit structure. The second model is to establish TrackCo as an integrated rail organisation that has both purchase and provision responsibilities.

The choice between these options has implications for decisions such as the preferred entity type, ministerial responsibility, funding pathways, monitoring needs and the way TrackCo would relate to the rail operator(s).

### Implementation Issues

Creation of a new non-company Crown Entity would require new legislation. Ideally this would be passed before 30 June 2004 so TrackCo can start life in its preferred form (Option 1). However, this would not be possible unless the Government is prepared to advance the legislation urgently.

If new legislation by 30 June 2004 is not possible then there are two alternative methods of fulfilling the role in the interim, until the legislation can be passed. These interim alternatives both involve extending the mandate of the New Zealand Railways Corporation (NZRC). This could be done by:

- Option 2: amendment to NZRC's Statement of Corporate Intent (SCI) ; or
- Option 3: Staged legislation, amending the Acts that govern NZRC's structure and functions.

Amendment to NZRC's SCI has the advantage of being the simplest mechanism but does leave the NZRC as an SOE in the interim. Although the SOE entity form isn't optimal for TrackCo, it may be acceptable as an interim solution.

The other option is staged amendment, starting from the current NZRC legislation, to produce the final TrackCo configuration by mid 2005. This could be less time consuming than new legislation, but as the exact extent of the legislative changes has yet to be scoped it is difficult to determine the effort and time required.

Given that a target date of mid-2005 seems reasonable for the new legislation then any interim arrangement would only be for one year.

It is likely that the current NZRC functions would be folded into the new TrackCo as part of the new legislation.

In summary, if new legislation can be fitted into the government's programme then this would give the optimal solution. If not, a non-legislative interim solution is available. A middle path involving legislative amendments may also be a possibility, but needs further assessment.

### **Immediate needs**

While TrackCo is not required to commence operation until July 2004, some ownership responsibilities need to be managed on behalf of the Crown as soon as the assets transfer to Crown ownership. Modification of the NZRC's SCI would allow it to assume those responsibilities immediately on behalf of the Crown.

It would be appropriate to assign the Crown's responsibilities as Access Provider for Auckland rail to the NZRC at the same time.

### **Consultation**

The Ministry of Transport and the NZRC have been consulted in the preparation of this paper. The NZRC agrees with the recommendations as written. Where the Ministry of Transport has a different perspective this is noted by specific comments in the text.

## **Recommended Action**

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It is recommended that you:

- a. **note** that an entity to manage the Crown's interest in the rail network infrastructure ("TrackCo") is required by 30 June 2004.
- b. **agree** that a non-company Crown entity is the preferred form for TrackCo, noting that the specific entity type has yet to be determined.  
*Agree/disagree.*
- c. **note** that the Minister of State Services must be consulted before Cabinet considers any proposal to establish a new Crown entity.

### **TrackCo Model**

#### ***Either Option A***

- d. **agree in principle** that the funding and provision of rail infrastructure will be managed by different entities, using a model similar to, or expanding on, the Transfund/Transit model.

*Agree/disagree.*

**Or Option B**

- e. **agree in principle** that TrackCo will integrate both funding and provision of rail infrastructure, using a model similar to that of the Housing New Zealand Corporation.

*Agree/disagree.*

**Or Option C**

- f. **direct** officials to provide further advice on the advantages and disadvantages of different models of rail funding.

*Agree/disagree.*

**TrackCo Implementation**

- g. **note** that the creation of TrackCo as a new Crown entity would require new legislation and that if this is not possible before 30 June 2004 then, in the interim until the new entity is formed, TrackCo's functions could be managed by the NZRC.
- h. **note** that the interim management of TrackCo by NZRC could be achieved either by amendment of NZRC's Statement Of Corporate Intent, or by amendment of NZRC's existing legislation if this is possible before 30 June 2004.

**Either Option 1**

- i. **agree** that TrackCo will be established immediately by new legislation as a non-company Crown entity, **noting** that the new legislation would need to be passed by 30 June 2004;

*Agree/disagree.*

**Or Option 2**

- j. **agree** that TrackCo will initially operate as part of NZRC by an amendment to NZRC's Statement of Corporate Intent until new legislation is passed;

*Agree/disagree.*

**Or Option 3**

- k. **agree** to investigate **establishing** TrackCo as part of NZRC through amendments to NZRC's legislation;

*Agree/disagree.*

- l. **note** that the scope of legislative change required to configure the NZRC appropriately outside the SOE Act has yet to be determined.

- m. **direct** officials to **report** on the legislative amendments necessary to establish TrackCo within the NZRC but outside the SOE Act;

*Agree/disagree.*

## Transition Issues

n. **note** that a number of ownership and transition issues need to be managed between the purchase completion date (tentatively 5 December 2003) and 30 June 2004.

o. **agree** that New Zealand Railways Corporation (NZRC) be the vehicle for interim management of the ownership functions.

*Agree/disagree.*

p. **direct** officials to prepare proposals, in consultation with NZRC, for strengthening NZRC's board to a level appropriate for its additional responsibilities and eventual incorporation into TrackCo.

*Agree/disagree.*

q. **agree** that NZRC be commissioned to take responsibility for the Crown's interests in the Auckland rail infrastructure, including the role of Access Provider for rail operators in the Auckland Region.

*Agree/disagree.*

r. **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 coordinate the work, in consultation with the Minister of Finance's office, the Ministry of Transport and the State Services Commission.

*Agree/disagree.*

s. **note** that officials will agree a work programme, and the division of responsibilities for the establishment of TrackCo, with the NZRC;

t. **direct** officials to prepare a cabinet paper based on these decisions.

*Agree/disagree.*

for Secretary to the Treasury

**Hon Dr Michael Cullen**  
Minister of Finance

## Treasury Report: **Choice of Entity to Manage Rail Network Infrastructure**

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### Purpose of Report

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1. The government has initiatives underway to allow the Crown to take ownership of the rail network infrastructure and take responsibility for train control and other rail network operations. At the time of writing there is an active agreement with Toll Holdings and a back up agreement with Tranz Rail. This report assumes that the Toll offer will be successful. This would create the need for a Crown entity to manage the network infrastructure and associated tasks. The entity responsible for these functions has been provisionally entitled "TrackCo".
2. Ownership of the rail assets will transfer to the Crown on completion of either agreement but Tranz Rail will continue to manage the network on the Crown's behalf until 30 June 2004, when management control is planned to transfer to TrackCo.
3. Decisions about the objectives, structure, governance and establishment of Track Co have yet to be made. This report provides advice on:
  - objectives the government should set for TrackCo;
  - the type and structure of entity best suited to meeting these objectives;
  - practical considerations that may influence the establishment of TrackCo; and
  - management of TrackCo functions in the interim period before TrackCo can be formally established.

### What will TrackCo do?

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4. The appropriate entity structure for TrackCo depends on its objectives and functions. The following discussion assumes that TrackCo can be created from scratch by new legislation. Alternatives if this is not possible are discussed later in the paper.

### TrackCo Objectives

5. The principle objective of TrackCo would be to operate a safe and effective rail network. Secondary objectives would include commercial and public policy elements.
6. TrackCo would be required to apply sound commercial frameworks and practices in its day-to-day operations. Exact wording of this objective has yet to be defined but is likely to include requirements to protect the value of its assets and perform well financially. Wording such as "operate in a business-like manner", or "be financially viable" may be used. This requirement would include determining the most cost effective way to maintain and operate the existing network in compliance with safety standards set by the LTSA.
7. 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

8. From 1 July 2004 TrackCo would be required to carry out a number of functions related to 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;
  - Track and structures engineering;
  - Contract and project management;
  - Rail safety system management;
  - Rail Incident management control; and
  - Incident investigations.
9. TrackCo would also inherit a large property portfolio and would be tasked with developing that property, ensuring that developments were consistent with the NZTS.
10. TrackCo will receive income from track access fees, leases and land sales. It may also receive an operating subsidy from the Crown. Some capital expenditure will be Crown-funded. Detailed operating and capital expenditure budgets for TrackCo have yet to be developed. However, it is clear that TrackCo would be responsible for assets with a replacement cost of several billion dollars. It is likely to have an operating budget in excess of \$70 million per annum and a capital expenditure budget of \$200 million over five years. It would be the direct employer of more than 120 staff and be responsible for maintenance contracts worth around \$50 million per annum.

### Preferred Entity Type

11. Given the nature of TrackCo's objectives and its core functions it appears that the most appropriate entity form would be a non-company Crown entity.
12. The use of a non-company Crown Entity would enable Ministers to:
  - access the management skills and experience of a governance board;
  - ensure that TrackCo contributes positively to achieving the vision and objectives of the NZTS;
  - set public policy and semi-commercial objectives;
  - give TrackCo a mandate to reinvest in rail infrastructure or services; and
  - influence the direction of the entity while maintaining some distance from its day-to-day operations.

13. The preference for a non-company Crown entity can most easily be shown by elimination of the other possibilities. The main alternatives are:
  - A State-owned Enterprise (SOE);
  - A Crown-owned Company (CrOC); or
  - A Government Department (Department).
14. The SOE model is not favoured as, although having some commercial objectives, return-on-investment is not the primary objective of TrackCo. Although it will receive significant amounts of third party revenue, TrackCo would not be purely commercially driven. In the case of the Toll Heads of Agreement, most of TrackCo's revenue would be regulated under the terms of the access charging regime. This regime includes a fixed rate of return on capital. TrackCo will have little ability to generate additional third-party revenue, except at the margins.
15. A Crown-owned company could be in keeping with the mixed policy and commercial objectives of TrackCo and the company structure would be useful for establishing the required governance and monitoring regimes. However, there appears to be little justification for the shield of limited liability. The relatively onerous directors' obligations stemming from the Companies Act could also be a problem.
16. The creation of a "Department of Tracks" is not favoured. A Departmental structure is warranted when the entity has objectives that are complex, fluid or difficult to define, and is therefore likely to require a high level of Ministerial oversight. In contrast TrackCo's objectives are straightforward and unlikely to change much in the foreseeable future. The Departmental structure would also make it difficult to gain the additional expertise and oversight that would be available from a governance board.
17. In summary, we consider that a non-company Crown entity is the most appropriate organisational form for TrackCo.
18. The proposed Crown Entity Bill defines three variants within the non-company Crown Entity category. Of these it appears that TrackCo could be either a Crown Agent or Autonomous Crown Entity (ACE). The choice between these is heavily influenced by the extent that TrackCo is required to undertake other "non-core" or optional functions. These are functions that will be required by government, but do not necessarily have to be placed in TrackCo.

## **TrackCo Optional Functions**

### **Purchasing**

19. The Government is seeking ownership of the rail network infrastructure to help it achieve certain public policy objectives. Continuing funding will be needed to achieve these objectives, specifically operating subsidies for particular lines and capital for developments that may not be justified on a purely commercial basis. This creates the need for an agency to be given responsibility for assessing rail public policy proposals and to channel the funding for approved projects.
20. One option to achieve this would be to integrate the responsibility for funding decisions within TrackCo ("large" TrackCo). This would parallel the structure of Housing New Zealand Corporation (HNZC) and, to an extent, the District Health Boards.

21. Combining responsibility for purchase decisions and delivery within one organisation should lead to better integration of advice and increase the likelihood that funding decisions are well informed by practical considerations. It would also simplify the reallocation of TrackCo property revenue to other rail uses, if that were desired.
22. Under this sort of structure TrackCo would need to have the capability to assess projects and provide advice about funding requirements. A direct reporting line to Ministers, similar to that used by HNZC, might also be required.
23. Disadvantages of this model include the possibility that TrackCo advice may become “engineering-driven”. TrackCo may also face pressure from rail operators to expend public funds for private gain. To avoid public perceptions of undue influence a transparent investment decision mechanism would be necessary.
24. The most obvious alternative to this model would be to restrict TrackCo to a narrower, more delivery-focused role (“small” TrackCo) and have a separate agency to assess and fund public policy spending. This would parallel the Transfund/Transit structure.
25. This model would be more compatible with explicit and transparent assessment of projects and, if Transfund were the funder, would allow for better integration of advice between different land transport modes. Small TrackCo could be more commercially focused, providing all services under contract either to the rail operators or the Crown funding agency. As a more commercial organisation small TrackCo would be better placed to manage its business interface with rail operators. Pressures on TrackCo to spend public funds for private benefit would be reduced.
26. We note that both options have disadvantages and that variants of each are possible. There are a number of factors that Ministers may wish to take into account in deciding between the two models. These include:
  - the relative importance of integration within the rail sector compared with consistency across the transport sector;
  - the differences in transparency between the options;
  - the way that the structures and decision-making processes may be viewed by other sectors in the transport industry;
  - government’s future intentions for the *Alternatives to Roading* funding mechanism;
  - whether the presence of a Toll director on the TrackCo board has any influence the functions that TrackCo is given; and
  - experience with similar structures in other sectors.
27. The Ministry of Transport has advised Treasury that it favours the small TrackCo (Transfund/Transit) model. The key factors leading it to this conclusion are the importance of integration of advice between different land transport modes and the need to avoid “engineer-dominated” advice.
28. More detailed comparative analysis of these options is available if required. Once the choice between the two major options has been made officials can begin work on advice about the specific configuration.

### ***Property***

29. We expect that the government will wish to avoid the administrative complexity of unnecessary Crown entities. The preferred alternative is therefore likely to be to incorporate the current NZRC functions into the new TrackCo as part of the new legislation. However, the option to retain the existing NZRC once the new TrackCo is established cannot be completely discounted at this stage.
30. Retaining the NZRC would avoid the transfer of residual liabilities to TrackCo and would also allow the separation of property management from rail operations. This might be desirable if the objective was to keep TrackCo as commercially-focused as possible. Officials will provide further advice on this issue before final decisions are made.

### **Implications for Form**

#### ***Entity type***

31. If the large TrackCo model is chosen then the Crown Agent form would be favoured as TrackCo would be required to “give effect to” the government’s policies. On the other hand, if the small TrackCo model were chosen then the ACE form would probably be favoured as TrackCo would have a minimal public policy role and would only need to “have regard to” the policy of the day. Under the small TrackCo model the separate purchasing agency would be the entity expected to give effect to government policies.

#### ***Substructure***

32. If the large TrackCo model is chosen it may be desirable to establish some substructure within TrackCo to mitigate some accounting and governance issues.
33. Accounting issues arise because TrackCo will need to distinguish between the operating expenses recoverable from rail operators and those to be paid for by public funds, and account for the capital costs of new rail assets separately depending on whether they were created for commercial or public policy reasons. These issues would exist to some extent in a small TrackCo, but the problem is more substantial with a large TrackCo, because of its policy arm and pool of public-policy funding.
34. With respect to governance, the Heads of Agreement with Toll includes provision for Toll to have a director on the TrackCo board. This is likely to be helpful in encouraging efficiency in the “core” TrackCo functions. However, it could be problematic in terms of the public policy and property roles of the large TrackCo. A transparent mechanism would be required to negate any suggestion of private company influence, and self interest, in advice given to Ministers. At minimum it would mean the Toll director absenting him/herself from large parts of the board’s deliberations.
35. The accounting and governance issues would be reduced if TrackCo had its ‘core’ functions located in a subsidiary with its own accounts and board, with the Toll director sitting only on the subsidiary board. If the large TrackCo model is preferred then officials can provide more advice on alternative substructures.

## Other Features of TrackCo

36. Once the basic structural form of TrackCo is decided the specific features and powers of TrackCo need to be determined. These include:
- Tax status;
  - Capital structure & access to debt;
  - Dividend/capital charge policies;
  - Use of financial instruments;
  - Accounting policies;
  - Appropriations & Funding mechanism; and
  - Crown immunity.
37. Officials will provide advice on these matters once the basic form of TrackCo has been determined.

## Implementation Options

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38. As described above, it is recommended that TrackCo be a non-company Crown entity. Creation of this entity would require new legislation. Ideally the legislation would be passed before 30 June 2004 ("Option 1"). However, there may be practical difficulties passing new legislation in the time available.
39. The new Crown Entities legislation may have a bearing on the best timing for the TrackCo legislation. Drafting of the TrackCo Bill would be much simpler if the new framework established by the proposed Crown Entities legislation were available. Although some entity-specific clauses would be required, most of the framework for TrackCo would be established by the generic legislation. In the absence of that legislation the TrackCo Bill would need to be more substantial.
40. If new legislation by 30 June 2004 is not possible then there are two alternative methods of fulfilling the role in the interim, until the legislation can be passed. These interim alternatives both involve extending the mandate of the New Zealand Railways Corporation (NZRC). This could be done by:
- Option 2: amendment to NZRC's Statement of Corporate Intent (SCI) ; or
  - Option 3: Staged legislation, amending the Acts that govern NZRC's structure and functions.
41. Incorporation of a new limited liability company without legislative backing is also a theoretical possibility. However, incorporation of a new company has little to recommend it. This possibility is not considered further.
42. Options 2 and 3 are both interim solutions, aimed at creating an acceptable holding situation until the new legislation can be passed. For the purposes of this paper we assume that the new legislation would be passed by mid-2005, giving any interim solution a life of one year.

## New Zealand Railways Corporation

43. The NZRC is a State Owned Enterprise (SOE) and is also a statutory corporation with its own legislation. There are currently three Acts that have a substantive impact on the NZRC's structure and functions. These are the *New Zealand Railways Corporation Act 1981*, the *State-Owned Enterprises Act 1986* and the *New Zealand Railways Corporation Restructuring Act 1990*. The *Railway Safety and Corridor Management Act 1992* would also have a substantive impact if NZRC were given responsibility for the network infrastructure. (The *Railway Safety and Corridor Management Act* is currently being replaced as part of the *Railways Bill*.)
44. The NZRC currently holds the lease over the rail land and manages residual liabilities dating from prior to rail privatisation. It is an executive arm of the Crown, except for the purposes of the Resource Management Act. It has a board, which the Minister is able to direct if required. Its reporting mechanism is that of an SOE. Before the privatisation of Tranz Rail the NZRC owned and operated the rail network.
45. Under its establishing legislation, NZRC has the power to "establish, maintain and operate or otherwise arrange for safe and efficient rail freight and passenger services, as well as road and ferry services for freight and passenger services". In the NZRC Restructuring Act it was also given the power to grant a railway operator "rights of any kind in respect of railway assets". The Restructuring Act also frees the NZRC from the obligation to perform any of the functions described in the 1981 Act.
46. Given its existing powers NZRC could readily act as the agent for the Crown's ownership interest in TrackCo, in the short-term.

### ***Modification to Statement of Corporate Intent***

47. The simplest method to give NZRC responsibility for TrackCo would be to amend NZRC's Statement of Corporate Intent, extending its mandate to include TrackCo's functions. This would leave NZRC operating under all of its existing legislation. NZRC's 2003/04 SCI has been delayed pending developments in the sector.
48. If you wish to pursue this option officials will draft the appropriate letter for you to send to the NZRC board.

### ***Modification to NZRC's legislation***

49. The third option (Option 3) would be a phased modification of NZRC's existing legislation to make it more appropriate for its new role. This could include removal of the NZRC from the schedule of SOEs. Some strengthening of the remaining legislation would be required to incorporate aspects of the SOE legislation that need to be retained in the new mandate.
50. This option may be preferable if the legislative changes are minor but becomes less favoured if more substantive changes are required. Analysis of the necessary legislative amendments has started but more specialist advice would be needed to complete it. If the government wishes to pursue this option we recommend that officials be directed to report back on the scope of legislative changes that would be necessary.

## Choice of Implementation Options

51. In summary, if new legislation can be given urgent priority in the government's legislative programme then this would give the optimal solution. If not, a non-legislative interim solution is available until the legislation can be passed. A middle path involving phased legislative amendments may also be a possibility, but needs further assessment. Overall it appears that the creation of TrackCo from modification of NZRC's SCI, while not ideal, is workable and is likely to be the fastest option. Using this mechanism NZRC could be given TrackCo responsibilities until a new entity can be created.

## Implementation

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52. Once Tranz Rail shareholders accept a HOA a number of activities will be required to implement the TrackCo-OpCo split and establish TrackCo. There are agreed mechanisms and structures for those activities requiring cooperative work between the Crown and Tranz Rail/Toll. However there are also a number of implementation activities that do not encroach on Tranz Rail/Toll or where the Crown's position needs to be developed before discussion with other parties. These activities include:
- policy development on access charging and performance indicators;
  - advice on strengthening the NZRC board;
  - determining conditions for transfer of TrackCo staff from Tranz Rail, including employment conditions and GSF status;
  - developing safety and licensing systems; and
  - treatment of NZRC staff.
53. We understand that the Minister of Finance will continue leading the implementation process, in consultation with the Ad Hoc Ministerial group. At the officials' level Treasury will coordinate the work, in consultation with the Minister of Finance's office, the Ministry of Transport, the State Services Commission and the NZRC.
54. We note that 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.

## Managing Interim Ownership Responsibilities

55. The Crown currently has responsibilities for ownership and as the Access Provider for the Auckland rail infrastructure. On completion of either HOA the Crown will also gain ownership responsibilities for the national rail assets. At the time of writing it appears this transfer of responsibility will be in December 2003, seven months before TrackCo is required to be operational.
56. Although many of the ownership responsibilities, such as network control and maintenance, will be contracted out, the Crown cannot contract out of some liabilities under the Health and Safety in Employment Act and the Resource Management Act. This creates the need for an interim holding arrangement for the assets.

57. The Crown could hold the assets directly, as currently done for Auckland rail. However, it would be preferable to have an entity that was directly tasked with managing the risks involved. The NZRC is the obvious candidate for this role. We therefore recommend that the NZRC SCI be amended immediately to allow it to take up this role.

## Next Steps

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58. The next steps to set-up TrackCo and implement the rail Network Sale & Purchase Agreement include:
- Consult with the Minister of State Services. (The Minister of State Services must be consulted before Cabinet considers any proposal to establish a trust, or any non-departmental, non-SOE entity that could be within the Crown financial reporting entity" [CAB (00) M 19/11 (1) refers].)
  - Prepare more detailed advice on TrackCo features and powers;
  - Write to the NZRC identifying additional responsibilities and requesting it submit its SCI on this basis;
  - Commission the NZRC, in consultation with SSC, to begin preparations for the CE appointment process; and
  - Treasury and the NZRC agree a work programme and division of responsibilities for the other tasks necessary to establish TrackCo.