

## Treasury Report: National Rail - Third Parties and Process Issues

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| <b>Date:</b>           | 13 February 2003     | <b>Treasury Priority:</b> | <b>High</b> |
| <b>Security Level:</b> | Commercial Sensitive | <b>Report No:</b>         | T2003/163   |

### Action Sought

|                     | <b>Action Sought</b> | <b>Deadline</b>   |
|---------------------|----------------------|---|
| Minister of Finance | Note                 | Prior to the next meeting of the Ad hoc Ministerial Committee on Rail Policy. |

### Contact for Telephone Discussion (if required)

| <b>Name</b> | <b>Position</b> | <b>Telephone</b> | <b>1<sup>st</sup> Contact</b> |
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**Enclosure: No**

13 February 2003

SH-8-4

## Treasury Report: **National Rail - Third Parties and Process Issues**

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### Purpose of Report

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1. You have sought advice from us on how to manage a process whereby the Government is presented with two options:
  - enter into negotiations with Tranz Rail to purchase all of the national rail infrastructure; and
  - at the same time, undertake discussions with third parties who are preparing a takeover offer for Tranz Rail under the takeover code and are interested in on-selling the infrastructure to the Government.
2. This report meets that request. It canvasses the risks of the parallel paths and concludes that entering into without-prejudice discussions with Tranz Rail, to test to the degree to which it may be able to deliver a solution that meets the Government's objectives, does not materially disadvantage or preclude the Government from having discussions with third parties.

### Analysis

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#### Discussions with Tranz Rail

3. Treasury officials have yet to substantively re-engage in discussions with Tranz Rail since the Christmas period. The discussions are likely to resume shortly if the Ad-hoc Ministerial Committee endorses the recommendations in the *National Rail – Service Performance Objectives* paper [T2003/152 refers]. That paper seeks approval to begin without prejudice discussions with the company for the Crown to purchase the infrastructure.

#### *Update on Tranz Rail's financial position*

4. Tranz Rail's second quarter results announced an operating profit from trading (EBIT) of \$18.4 million for the three months to 31 December 2002. The operating profit, although slightly behind the original forecast of \$19.4 million for the quarter, was consistent with the revised forecast included in the prospectus for the rights issue.
5. While the rights issue has resolved the company's immediate funding needs, the company's viability remains highly dependent on its ability to meet its operating targets. In addition, the company remains highly dependent on the support of its bankers. Its high debt position combined with the prospect of its debt facility maturing on 30 June 2004, means that existing lenders may be seeking to exit or reduce their exposure.
6. In the short term, any assistance for the support of services on marginal lines, such as the bid currently before the Transfund Board, is unlikely to have a material difference on the company's overall financial position.
7. While Tranz Rail's share price has increased by 25% since the beginning of the year and institutions are increasingly interested in exiting the company, the current share price is still significantly below the levels at which they bought in at (\$3.60 per share).

*Implications of financial position for Government*

8. While institutions are increasingly interested in exiting the company, this does not mean that they would necessarily support a sale of the infrastructure (the support of institutions would be required because a sale of the infrastructure would constitute a major transaction, requiring the approval of an ordinary resolution of the company). A sale of the infrastructure would not necessarily be in the shareholders' interests and would not necessarily facilitate their exit from the company (the proceeds could be used to retire debt rather than returned to shareholders via a special dividend). For these reasons, the Government should be aware that Tranz Rail's shareholders could block a sale of the infrastructure to the Government.

**Approaches by Third Parties**

9. Government is in the difficult position of engaging in discussions with Tranz Rail on the future of rail, while at the same time being approached by third parties interested in acquiring the company. There may be a risk that Government is not able to achieve its rail objectives through successful negotiations with Tranz Rail. A decision to pursue discussions with a third party may give rise to criticism about process and allegation of bias.
10. As outlined to you in previous discussions, one of the disadvantages of any third party options is that those parties control timing. Government would have limited ability to influence process and may have difficulty marrying the third party commercial drivers and imperatives on timing, with "normal" public policy making processes.
11. To try and manage these process risks it will be important to ensure that the broad principles of any arrangement discussed with Tranz Rail are the same as the broad principles discussed with a third party. To this end, the preference of the Ad Hoc Ministerial Committee on Rail Policy for purchase of the rail infrastructure with Tranz Rail retaining its dominant freight operator rights, subject to meeting agreed performance indicators, will act as guidance [CAB Min (03) 1/6 refers].
12. Government, as a matter of course, should also:
  - maintain, as far as is commercially practicable, fair and transparent processes – in particular when evaluating the benefit to Government of different arrangements with third parties; and
  - carefully manage all communication about the Government's relationship with Tranz Rail and any third parties – all discussions should be treated as commercially secret. The legal risks arising from speculation about Government's relationship have been set out to you previously.
13. There is also a potential sequencing risk. Prior to entering into formal negotiations, Tranz Rail will most likely require the Crown to enter into a confidentiality agreement the terms of which may restrict the Crown's ability to make a takeover bid or be a party to a bid. To manage this risk Government should, in the first instance, attempt to progress discussions with Tranz Rail as far as practicable without entering into formal negotiations that require the disclosure of price sensitive information, and thus a confidentiality agreement.
14. Crown acquisition of the infrastructure from Tranz Rail under its current shareholders would not preclude a third party subsequently coming in and taking over the company. Similarly, any service level agreement negotiated with Tranz Rail would not preclude a change in shareholding of the company. Negotiation with Tranz Rail for the

infrastructure, where that negotiation has a confidentiality agreement as set out above, is likely to preclude the Crown being a party to a arrangement with a third party only while the Crown is negotiating with Tranz Rail.

15. Ministers will need to weigh up the risks set out above before signing any confidentiality agreement with Tranz Rail. At such key decision points it will be important that Government does not unnecessarily constrain its options.

## Process from here

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16. Entering into without-prejudice discussions with Tranz Rail to test the degree to which it may be able to deliver a solution that meets the Government's objectives does not materially disadvantage the Government in any discussions with third parties. Government should attempt to progress discussions as far as practicable without entering into formal negotiations that require the disclosure of price sensitive information, and thus a confidentiality agreement.
17. Discussions with third parties need to be as fair and transparent as possible, and it is important that Government consider options with third parties that are no-less favourable than the options it explores with Tranz Rail under its current shareholding.
18. These commercial discussions are going to be difficult to manage within the normal policy making process. It will be important to achieve consistency of message throughout.

## Recommendation

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19. It is recommended that you **note** this report.

for Secretary to the Treasury

**Hon Dr Michael Cullen**  
Minister of Finance