

Wednesday, 18 July 2001

Mr Dave Watson
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WELLINGTON

Dear Dave

TRANZ METRO WELLINGTON: RAIL CONTRACT

Thank you for your letter of 19 June 2001, outlining your thoughts on the issues facing the Council and Tranz Metro. I agree that the existing situation is not an easy one for either party. I have given the matter considerable thought and believe we need to take a positive approach to resolve the issues. My thoughts on this are outlined below. Your comments would be appreciated.

Situation

Currently services operated by Tranz Metro and funded by Council are being provided without a formal contract.

The business is operating close to capacity in terms of the use of peak trains.

Investment is needed to upgrade services, infrastructure and rolling stock.

We are well advanced towards implementing major service changes over the next month.

Funding is available for these service changes and other initiatives. However impetus has stalled due to the impending sale of Tranz Metro.

As a solution to this situation you have proposed that the Tranz Metro sale be concluded as soon as possible. This would allow Council to directly negotiate a long-term contract with the new owner and hopefully resolve the difficulties that have faced us over the years. I fully support Council in this approach but see a number of practical difficulties.

Firstly, we are still awaiting the outcome of negotiations between Tranz Rail and Government over the Auckland Regional Council's desire to purchase local corridors for commuter services. This outcome could have a major impact on the value of Tranz Rail including the metro businesses. Secondly, there is the lead-time required for the sale process. The relatively straightforward sale of Tranz Scenic suggests this lead-time will be around

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twelve months. Therefore we may have to operate in the current environment for longer than we would both prefer.

I believe the key question facing us is how do we manage a dynamic business between the decision to sell and the final settlement? What do we do about planned service changes? How do we fund them? What should we do about rolling stock and infrastructure issues that are facing us now? How can the parties to the sale be confident that their interests are being addressed in an equitable manner?

Approach

Simplistically, there are three approaches we can adopt to address the above issues.

Firstly, we can rollover the current contract but do nothing else. All initiatives would be put on hold until the business has been sold. No use would be made of funding available from Transfund, Council and Tranz Metro. The commuter rail network would continue to operate as at present; however, with both parties taking such a short-term focus patronage may suffer.

Secondly, we can do nothing and “manufacture” a crisis. This would certainly result in some action. For example the Council could stop funding Tranz Metro. Tranz Metro would be forced to either quit the business or significantly put up fares. Either way the impact on passengers and the business would be substantial. Such a crisis could force the sale situation to be resolved quickly through political pressure. However history has not always shown this approach to be effective. The deregulation of the 1990s led to a situation similar to that of today in terms of the future of Tranz Metro. That deregulation almost resulted in the destruction of the metro business as the process failed to address the peculiarities of the rail in terms of long life assets and fixed infrastructure. The resulting crisis did nothing to politically resolve the issue: In the first months of deregulation Tranz Metro lost over 25% of its passengers and associated revenues due to a loss in confidence by customers. The situation could have been much worse and it was only through the efforts of interested parties in Tranz Rail and Council that a catastrophe was avoided. Those efforts allowed Tranz Metro to survive and grow but it was a close call.

Thirdly, we can elect to develop processes to work through each issue in a positive manner. This will not be easy given the position of the parties. Clear objectives, performance indicators and processes are needed for each party to be comfortable with this approach. This will be challenging, as there is no simple package we can pickup and use to resolve these issues.

The first approach has the benefit of business as usual but that is really an illusion. None of the major issues facing Tranz Metro and Council will be addressed. It is likely that we will have the same discussion in twelve months time or when the business is sold. It also means all initiatives will cease with

investment limited to maintaining the business. That has not been the case in recent years and it would be sad to return to this type of management.

The second approach will certainly bring Tranz Metro, Council and the sale process into the public and political arena. Whether the result will be what the parties expect is open to doubt. A somewhat similar process has taken place in Auckland over the last eight years with Tranz Rail, Transfund, Infrastructure Auckland, territorial authorities, regional councils and national government all involved. The cost has been substantial, progress has been minimal and the customer is no better off in terms of service provided.

The third approach is hard. It can however bring results where parties are prepared to work together in good faith to achieve their objectives. The approach avoids the taking of positions and puts the focus on objectives, processes and results. To a large extent this is how Council has worked with operators to develop public transport in Wellington.

My preference is for the third approach, as I would prefer to see a healthy Tranz Metro move through to sale. In my opinion the other approaches rely on either apathy or crisis for results that historically have been doubtful in terms of value to stakeholders and customers.

Ground Rules

For the third approach to work I believe some ground rules are needed. I believe the following provide a firm basis on which to proceed.

- Funding of existing services to continue in terms of a rollover as per previous years.
- No service changes without consultation
- If agreement cannot be obtained on one issue, park it and move onto the next.
- Any investment in the business to be neutral to both parties in terms of the sale price of Tranz Metro.
- All new initiatives to be capable of measurement in terms of value to customers, Council and Tranz Metro.
- Negotiations to be conducted between parties and not via the media

I have given considerable thought to how this approach will work with all the issues facing us. However for brevity this letter will only address two of the outstanding issues.

Contract

In order to maintain existing services we need to confirm the rollover of the contract. I have kept services operating on the assumption this will be urgently dealt with. Any rollover should be in terms of the 2000/01 contract with the usual inflationary adjustments. The continuation of the Ganz Mavag programme also needs to be addressed in terms of our earlier discussions.

Such a rollover meets the ground rule requirements outlined above. It maintains an existing operation under a known contract with financial adjustments independently set. Regular performance reports are already provided to Council.

New Services

Council and Tranz Metro have been working to upgrade Paraparaumu, Hutt, and Johnsonville timetables. These service proposals are ready to be implemented. Timetable details and costings have been provided to Council.

Council has requested a detailed breakdown of that costing before the project can be progressed. On the face of it this appears to be a reasonable request. Unfortunately as you must be aware it would be inappropriate for Tranz Rail to provide such detail as the Council has a declared interest in purchasing Tranz Metro. Such information could only be made available if Tranz Metro and Council operated within a suitable long-term contract.

Before such a contract could be agreed many issues would need to be worked through. For example how would Council assess costs as to their effectiveness and efficiency? What costs would be included and what would be left out? Who would make that decision? How would Council value the asset base? Would Council allow for asset replacement? Would profit levels and fares be set by Council? Who would take the patronage risk? Would the contract be set after open tender to ensure contestability, as was the case with the original contract? Unfortunately we do not have a contract which addresses any of these issues.

If the business was not for sale, the Council was not an interested party and we were considering a long-term contract then issues such as these could be explored. In the context of the current timeframe it is difficult to deal with all these issues.

Your request has therefore placed Tranz Metro in a difficult position. We have developed timetables, negotiated extensively with service organisations, redesigned train schedules, improved unit servicing, employed staff, set up training programmes and printed timetables. We planned to commence services 5 August 2001, a date set by Council. We have this week posted staff rosters.

I am aware that the financial agreement between Tranz Metro and Council should have been confirmed earlier. However I had already provided

indicative costs to Council at an earlier date and had not been given any indication that detailed costs would be required. Council must have been aware that Tranz Rail could not meet that requirement given the impending sale and Councils involvement in that sale. Council must also have been aware that such an approach could result in the service changes being delayed. If this was to be the situation we could have pursued other funding approaches that could have provided Council with the “substance” it requires.

So how can we resolve this issue? It is likely to be typical of the type of problem we will encounter over the next year and is a good example to start with. There are a number of options.

Firstly, we can cancel or postpone the service changes. This is in effect adopting a do nothing or “create a crisis” approach.

Secondly, we can address the “substance” of the costing by alternative means. For example the new services represent a 13% increase in carriage kilometres provided. This can be independently assessed. Last years contract provided a \$17.4m grant of which \$15.9m relates to the operating grant. A 13% increase in carriage kilometres represents a \$2.1 m net contract cost on a pro rata basis. The net contract quote for the new services is \$1.46m, which is a significant reduction.

Thirdly, the net contract quote can be assessed independently to establish its effectiveness. The key performance indicator for public transport services is passenger trips and passenger kilometres generated. Council is funded on this basis for passenger growth. The Council could therefore assess any net contract costing for services using Transfund and Council rates developed for new passengers. A great deal of effort was spent in setting up those rates so they must reflect to a significant degree acceptable payment levels for new passengers. To allow this assessment of performance I have provided details of forecast passenger outputs.

output	Peak	Off-peak	Total
New passenger journeys 000	109	234	343
New passenger kilometres 000			8,722
Net contract cost \$000			1,460
New fare revenue \$000			724

An elasticity of 0.3 was used to establish the new patronage. The above detail should allow an independent assessment of the value of the net contract costing.

Fourthly, we could discuss direct funding of service improvements in terms of output funding using Transfund and Council rates. This would be in line the desire of Transfund to move to this funding basis for Councils and operators. On the downside for Tranz Metro there is likely to be cash-flow implications as a result of this approach but the option should be explored.

Fifthly, an assessment of funding could be made on our public charter rates. These rates are the lowest we provide to wholesalers, etc for charters and are based on market based fares. The rates are based on the provision of off-peak Tranz Scenic services recovering all costs except replacement of rolling stock. I have used the lowest rate available as they differ by line and have deducted fare revenue to arrive at a net contract cost. The fare revenue for the new metro services is of course substantially lower than that normally obtained from Tranz Scenic services. A discounted rate could be considered if the charter is long term.

Fare revenue \$000	724
cost \$000	3,929
Grant requirement \$000	3,205

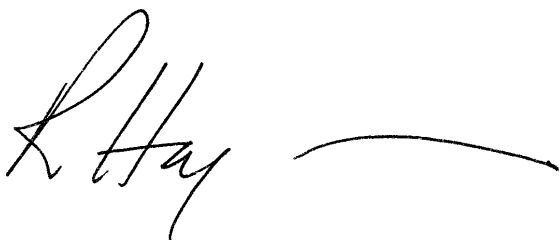
I offer the above options as potential solutions to your problem in assessing the substance of our net contract costing. There may be issues of timeframes due to the sale but that can be dealt with under the existing contract.

In conclusion I do not believe that a detailed breakdown of costs is needed to assess the value of the net contract costing. The key issue is really whether the passengers generated are value for money in terms of the net contract payment. I believe there is a process for Council to independently assess that value.

A limited timeframe and lack of a formal agreement on funding has placed us in difficult position in terms of introducing the new services. However in line with my belief that we should take a positive approach to resolving these issues I intend to continue plans to introduce new services on 5 August 2001.

I am sufficiently encouraged by the work put in by Tranz Metro, Council and other parties to believe that these service improvements are a major benefit for customers and stakeholders. These improvements should not be put aside because the impending sale. I believe the funding issues can be resolved and will work with you to achieve this.

Yours sincerely



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