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greater WELLINGTON
THE REGIONAL COUNCIL

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The Future of Suburban Passenger Rail Services - The Next Steps

1. Purpose

To update the Committee on the position with respect to Tranz Metro Wellington and to consider the next steps to best secure the long term future of suburban passenger rail services in the Greater Wellington Region.

2. Public Excluded

Grounds for exclusion of the public under section 48 (1) of the Local Government Official Information and Meetings Act are:

That the public conduct of the whole or relevant part of the proceedings of the meeting would be likely to result in the disclosure of information for which good reason for withholding exists (i.e. to preserve commercial confidentiality).

3. Background

As the Committee is aware, for the past three and a half years the Council has been actively working on trying to find a robust and durable solution to the passenger rail issue in the region.

3.1 What have been the problems facing the Council?

The Council has had a long history of purchasing rail services, via a passenger rail service contract with Tranz Rail, in circumstances where a quality passenger rail service is seen as vital to the Council achieving its overall transport objectives, as detailed in the Regional Land Transport Strategy. In carrying out its purchasing role, the Council, as the public agency charged with contracting for passenger rail services and as principal funder of the services (approx 45% of Tranz Metro Wellington revenue is from Council subsidies), has experienced a range of problems including:

- Tranz Rail has controlled all the key assets (e.g. Track, signals, rolling stock) and therefore there has been a lack of contestability.

- A lack of information disclosure by Tranz Rail has meant that the Council has had increasing concerns over value for money of passenger rail services.

- Tranz Metro Wellington has been ‘for sale’ for over three years since it was earmarked by Tranz Rail in 2000 as “non-core”.

- There has been insufficient investment into key assets (e.g. refurbishment or replacement of the life expired English Electric Units and Wairarapa carriage stock), particularly since the sale announcement in 2000.

- The regulatory environment has been weak (e.g. there has been no control over how track access charges for passenger rail services should be calculated).

- The Council has been precluded from owning transport infrastructure.

In short, the Council has been tied into an unsatisfactory contracting arrangement with Tranz Rail, with no realistic alternative (i.e. no realistic prospect of competition). Understandably, this has led to a strained relationship with Tranz Rail, not helped by the precarious financial position of Tranz Rail during the past 12-18 months when the Council could be forgiven for thinking that its subsidy paid to Tranz Metro Wellington has been used in the past to help “prop up” the unprofitable elements of Tranz Rail.

Despite the difficulties in dealing with Tranz Rail, Council’s relationship with Tranz Metro Wellington has remained very good which is a great credit to all those involved on both sides of the relationship. More importantly, the passenger rail service generally remains reliable, the Tranz Metro brand is still trusted by the travelling public and, as a result, passenger rail remains a crucial contributor to meeting the Region’s transport needs.

3.2 What have been the Council’s key objectives in trying to find a solution?

The Council has been endeavouring to put in place a robust contract with a committed passenger rail operator, to enable the key objectives under the Regional Land Transport Strategy to be achieved, including the requirement for:

⇒ The operator to invest its own capital

⇒ Long term asset management planning by the operator

⇒ Tough sanctions in the event of failure by the operator to deliver the agreed services

⇒ Rate of return of the operator to be capped

⇒ Vastly improved transparency and information disclosure by the operator

The key question has always been how, in the environment outlined in section 3.1 above, can the Council best position itself to secure an improved contract with an operator committed to providing passenger rail services over the long term.

While there hasn't always been universal acceptance of how the Council should proceed, the key ingredients have largely been accepted as:

- Public sector control over key monopoly assets (e.g. track, signals, traction wires, rolling stock) to enable a realistic prospect of competition.

- Development of an improved passenger rail contract including the necessary transparency, assurance of value for money, and appropriate focus on asset management and service quality.

- Ability to test the market in search of a new passenger rail operator committed to developing the service long term (By announcing Tranz Metro was for sale Tranz Rail effectively disqualified itself from being considered to be a committed passenger rail operator, long term). Under this arrangement the chosen operator would be expected to sign-up to the Council's new contract.

These key ingredients are consistent with the environment in many places around the world including some close to home, e.g. Auckland and Melbourne.

3.3 What has the Council agreed to do in order to achieve these objectives?

In the past few years the Council has made some key decisions affecting the future of passenger rail services in the region, as follows:

October 2001

The Council considered a report from officers which included a review conducted by Booz Allen & Hamilton entitled "Delivery and Governance options for Wellington's Urban Railway". The Booz Allen & Hamilton report, which was addressed to all Territorial Local Authorities in the Region and the Regional Council, considered a range of options for the future of passenger rail services in the region.

However, the three options which received most attention in the Booz Allen & Hamilton report were:

- Enhanced status quo with a new operator (0% public ownership)

- Public/private joint venture with a negotiated procurement model (50% public ownership)

- Public sector ownership of key assets prior to moving to a franchise model (100% public ownership)

N.B: a franchise model is akin to contracting the service out but is often characterised by additional risk transfer objectives.

Booz Allen & Hamilton concluded that the enhanced status quo option was inferior to the other two options by stating in their report that "*even if an appropriately tailored long-term funding agreement was established, the enhanced status quo offers little leverage for WRC to ensure overall transport objectives are achieved*".

Booz Allen & Hamilton went on to note that "*Government regulation is probably the only available mechanism to mitigate the deficiencies of this option*" and "*even with a new operator in place the deficiencies of the current purchasing framework are likely to remain i.e.:*

- *lack of transparency, leading to value for money concerns*
- *WRC bears all investment risk*
- *Inadequate incentives on both sides"*

In terms of the remaining two options Booz Allen & Hamilton saw little difference between the Joint Venture (50% ownership) and public sector ownership over key assets prior to moving to a franchise model (100% ownership), with both options having their own pros and cons. When faced with the remaining options of the Joint Venture (50% ownership) or public sector ownership of key assets prior to moving to a franchise model (100% ownership), the Council decided to go with the Joint Venture option. This decision was largely based on the risks of going it alone, including:

- Due diligence price risk. The Council wanted a partner with "their money on the table" to ensure the appropriate price was paid to Tranz Rail for the assets.

- Risk of separation issues (separating Tranz Metro Wellington out from Tranz Rail). The Council saw increased risk without the involvement of the future operator in the separation process.

- Balance sheet risk. The Council saw that paying 100% of purchase price, and fully funding it by debt, could have a significant impact on the remainder of the Council's operations (in terms of both availability and cost of funding).

- Risk of 'caretaker' type phase. The Council was concerned the hiatus that may be created prior to being in a position to contract out the operation would further delay already overdue capital reinvestment.

May 2002

The Council reconsidered whether an appropriate long term solution could be found without taking an ownership interest in passenger rail and re-affirmed its intention to proceed with the joint venture option, approving Stagecoach at its JV partner.

June 2002

The Council approved an urgent refurbishment programme for the English Electric Multiple Units, subject to:

- Transfund NZ funding 30% of the cost.
- Tranz Rail accepting the conditions set by Transfund NZ <u>and</u> contributing 50% of the cost.
- Council's investment being appropriately protected.

In the event, this programme has not commenced, largely due to a lack of funding commitment from Tranz Rail. Tranz Rail's position appears to have been that as Tranz Metro Wellington was for sale, and as there was no long term funding certainty from the Council, they have been unable to commit to the required capital expenditure.

It would be expected that a purchaser of Tranz Metro Wellington would factor in future capital expenditure into any price paid for Tranz Metro (i.e. to discount it accordingly). In other words, it should be neutral to Tranz Rail as to whether they, as the seller, or the new owner of Tranz Metro Wellington, carry out the required reinvestment.

December 2002

The Council decided that it couldn't accept the conditions placed by Tranz Rail on the Tranz Metro Wellington sale process (i.e. the requirement for an indicative bid prior to due diligence, where the onus would be on the Council to justify any subsequent move away from such an indicative bid to a different price).

As a result, sale and purchase negotiations between the Joint Venture partners and Tranz Rail broke down (effectively before negotiations really started) and Tranz Rail then announced that it was going to seek competitive bids from the market. The subsequent takeover of Tranz Rail by Toll Holdings meant that no significant asset sales could proceed and today Tranz Metro Wellington remains unsold (except, indirectly of course, to Toll Holdings).

The Council's Joint Venture remains "parked in the garage".

In terms of the Council's primary role of contracting for passenger rail services, the Council also decided that it would test the market to see if it was realistic for a new operator to emerge (on the basis that Tranz Rail intended to sell Tranz Metro Wellington). A competitive pricing procedure (CPP) was duly approved by Transfund NZ and the Council has since commenced, but subsequently suspended, its search for a new operator.

The process remains suspended largely due to uncertainty over the future control of key assets and the future pricing for the use of such assets (e.g. track access pricing).

3.4 Summary

The Council's key objective throughout this long drawn out saga has been to reach a position whereby there is sufficient public sector control (not necessarily Council control) over the key monopoly assets, to ensure that we can fully discharge our accountabilities over the use of public money in relation to our contracting role.

In short, we have been looking to put in place the "right" contract with the "right" operator.

Unfortunately, the future of the region's rail services remain 'on hold' and the concerns with deteriorating rolling stock are becoming more real as each month passes.

4. Assessment of the current situation

On the face of it the Council has been able to make little headway over the past three and a half years in terms of securing the future of the region's passenger rail services. However, it is important to acknowledge that there have been some major shifts in the overall environment which mean the Council is now better placed to achieve its overall objectives.

These major changes include:

- Toll Holdings is now in control of Tranz Rail.
- Track Co is being established to control the national rail infrastructure.
- Transfund NZ appears to have become far more focussed on solutions rather than process issues.
- The legislation to enable regional council ownership of transport services and infrastructure has been passed.

Looking at each of these key changes in turn:

- Toll Holdings is now in control of Tranz Rail

  Our contact to date with Toll Holdings suggests that they are in no hurry to sell Tranz Metro Wellington. In fact they appear to be comfortable with retaining the business, but equally they are prepared to discuss a possible sale of the business or the key assets associated with the business (e.g. rolling stock, stations, track access).

Importantly, they have indicated a willingness to sit down and transparently talk about the various options available to both parties.

Also of significance is the relationship between the Crown and Toll Holdings which is important for both parties as they set about establishing Track Co and transferring various assets back to the Crown, pursuant to the Heads of Agreement between the parties. Toll Holdings appear to want to do the right thing for Wellington and for New Zealand by ensuring if they do choose to exit the Tranz Metro Wellington business that there is a smooth transition of Tranz Metro Wellington into new ownership. This attitude is understandable given their close working relationship with the Government.

Irrespective of whether the Council ultimately decides to take an ownership interest in Tranz Metro Wellington going forward, the Council faces a key risk if Toll Holdings chooses to sell the Tranz Metro Wellington business, the risk that the business will transfer to a new owner for the ‘wrong’ price based on an over optimistic view of the future level of Council subsidy. If this occurs it could effectively ‘lock in’ a situation whereby the Council’s future subsidy will be expected based on that ‘wrong’ price.

This must be avoided if at all possible, which is why we have been at pains to point out to both Toll Holdings and to potential purchasers that Council’s current level of subsidy should not be assumed to continue in the future. This is because we can’t be assured that the subsidy is currently a fair price for the public sector to pay.

We have reinforced this message in recent correspondence with Toll Holdings (refer **Attachment 1**), where we have suggested the provision of a range of key information as a means of breaking the ‘circularity’ between Council’s subsidy and the value of the Tranz Metro Wellington business. We have done so in the hope of achieving a win/win outcome for both Toll Holdings and the Council.

Without access to the appropriate information, officers continue to have a very low level of confidence that the Council’s subsidy is appropriate, which only serves to heighten historical concerns about value for money.

I have yet to receive a reply to my 23 October 2003 letter.

- Track Co is being established to control the national rail infrastructure

Several months ago the Crown and Toll Holdings entered into a Heads of Agreement covering the transfer of certain assets from Tranz Rail back to the Crown and the establishment of Track Co to own and manage the national rail infrastructure. More recently the Government has purchased the Wellington Railway Station.

On the face of it these are welcome initiatives by the Government to reassume control over the track and associated infrastructure (e.g. tunnels/bridges and the major commuter station) and the future obligations that are implicit in that.

However, under the agreement, I understand that Tranz Rail/Toll Holdings will retain exclusive access rights to run Tranz Metro passenger rail services, subject to 'use it or lose it' provisions in terms of the level of services provided. As service levels would need to drop to approximately half the current level for the 'use it or lose it' provisions to apply the exclusive track access rights are expected to remain with Toll Holdings unless they choose to sell them (presumably as part of any sale of Tranz Metro Wellington). In other words, the establishment of Track Co is not expected to remove any of the monopoly power from Toll Holdings/Tranz Rail in terms of determining who can run passenger trains. It therefore remains a key asset which Toll Holdings is free to use or sell. If the Council is not the purchaser of these track access rights such rights will transfer to the new owner of Tranz Metro Wellington. This situation is obviously a major impediment to the Council achieving its objectives for passenger rail in the future and is therefore a major area of disappointment arising from the agreement between Toll Holdings and the Crown.

Notwithstanding that Toll Holdings/Tranz Rail has retained exclusive track access rights, it is expected that the establishment of Track Co will limit the ability of Toll Holdings/Tranz Rail to use its monopoly position to extract a subsidy based on unreasonable access charges. Although the track access pricing regime has yet to be finalised our discussions with Government officials suggest that Track Co will operate within a cost recovery mandate and that pricing will be based on a purchase price of the network of $1, rather than based on the sunk cost of the network. This is very significant and should result in a relatively low track access charge when compared with charges which incorporate a commercial return on capital based on the sunk cost of the network. However, this could remain an area of concern if Toll Holdings/Tranz Rail are responsible for allocating track access charges between passenger and freight services.

We intend to continue to liaise closely with Treasury officials to ensure as far as possible that the Council's interests are protected.

We are also working with Government officials on a Common Access Agreement to try to protect the interests of passenger services vs freight in terms of the allocation of track access slots. This is crucial if we hope to achieve continued growth in passenger rail services in future.

- Transfund NZ appears to have become far more focussed on solutions rather than process issues

In recent months Transfund NZ has become far more proactive in terms of communicating with officers about the passenger rail issue, and more importantly, such communication appears to be very focussed on helping the Council to try to find a robust long-term solution for the region. Such discussions have focussed on the desirability of public sector control over the key assets as a crucial component of any robust long-term solution and Transfund's ability and willingness to contribute capital funding towards achieving that.

In response, we have been working closely with Transfund officials to determine how we can best access their offer of capital funding to assist with securing control over the key Tranz Metro assets and then putting in place an urgent refurbishment programme.

During November 2003, a submission was lodged by officers seeking Transfund NZ funding assistance (refer **Attachment 2**) on the basis that the formal backing of a Transfund NZ Board resolution might well be important to the Council as it considers how it wishes to proceed with the rail issue.

On 27 November 2003 the Transfund NZ Board resolved to support a capital funding contribution to the GWRC for the development of Wellington passenger rail services and referred the matter to a Transfund Committee for further liaison with GWRC. It is understood that the Committee will comprise of two Transfund Board members. The Transfund Board also resolved to retain the Transfund officers' submission (refer **Attachment 3**) "in Committee" until any negotiations regarding Tranz Metro have been completed.

Effectively the Transfund NZ Board appear to be saying to the Council:

- We support the general concept of providing funding assistance to help secure the key assets in public ownership

- Go and start talking to Toll Holdings about whether a sensible deal can be reached.

Page 3 of **Attachment 2** sets out the likely timeline which clearly shows that the Council has yet to formally decide whether or not it wishes to proceed down this path. That is a potential outcome arising from the Council's consideration of this report.

The timeline on page 3 of **Attachment 2** also sets out the process going forward should the Council decide on a path which would see it negotiating with Toll Holdings for the sale/purchase of the key assets necessary to run the Tranz Metro Wellington business, or the Tranz Metro Wellington business itself.

I appreciate that the funding application to Transfund NZ may read as though the Council has in effect already decided to proceed down the path of securing control over the key assets (including track access) necessary to run the service. However, officers were mindful of the need to secure some level of capital funding commitment from Transfund prior to consideration of this report by the Committee.

It is now for the Council to determine, based on the support offered by Transfund NZ, whether it wishes to proceed further to explore the option of purchasing the key assets from Toll Holdings.

- The legislation to enable Regional Council ownership of transport services/infrastructure has been passed

During October 2003 the Land Transport Management Act was passed which enables regional councils to own both transport services and transport infrastructure.

This removes a legal impediment, that has long obstructed the Council in carrying out its transport responsibilities. This should avoid the requirement for any convoluted structures in future to circumvent the legal restrictions, such as the establishment of ARTNL in Auckland. In my view such structures only serve to confuse accountability and complicate governance arrangements which can seriously undermine the efficiency and effectiveness of the expenditure of public money.

Now that the Land Transport Management Act has been passed the Council is free to pursue the purchase of transport services and/or transport infrastructure should that be the wish of the Council, subject of course to meeting the requirements of the Local Government Act 2002.

5. Options for moving forward

5.1 Short term 'rescue' strategy

Clearly, the most pressing concern of the Council, Transfund NZ, the Government and all other key stakeholders is the deteriorating condition of much of the rolling stock used by Tranz Metro Wellington.

The key question is can we put in place a refurbishment programme under the current ownership structure which appropriately protects the public sector investment in such rolling stock?

As noted in section 3.3, Tranz Rail had been reluctant to invest any capital in a refurbishment programme while Tranz Metro Wellington was for sale and while there was no long-term funding agreement in place with the Council. It remains to be seen what the attitude of Toll Holdings will be to this much needed investment.

In an attempt to find an alternative solution the Council Chairperson wrote to the Ministers of Finance and Transport in July 2003 seeking Government help in respect of the ageing rolling stock (refer to **Attachment 4**). To date no formal response has been received from the Government although Government advisors have indicated a response is currently being worked on.

The lack of response to date would indicate that the Government has been unable to reach any agreement with Toll Holdings over the sale/purchase of ageing rolling stock.

Therefore, it would appear that there is a low likelihood of the Council being able to urgently implement a short-term rescue strategy in respect of ageing rolling stock which is separate from the longer term strategy of securing an improved contract with an operator, committed to the long-term future of passenger rail in the region.

This only serves to reinforce the importance of the Council revisiting its long-term strategy for securing passenger rail services in the region, a strategy which needs to deliver the appropriate level of transparency to provide the Council with the necessary comfort around value for money.

5.2 Long-term strategy

The options for securing public sector control over the key assets (e.g. track access) and putting in place the 'right' contract with the 'right' operator are essentially the same as previously identified by Booz Allen & Hamilton:

Option 1: 0% ownership option

Take a "hands off" approach and try to negotiate an improved contract with the owner of Tranz Metro Wellington. Depending on whether Toll Holdings decides to sell this could well mean the Council renegotiating a new contract with Toll Holdings (after following the normal CPP process of course).

Option 2: 50% ownership option

Reactivate the Joint Venture proposal which is currently "parked in the garage" and commence negotiations with Toll Holdings for the sale/purchase of Tranz Metro Wellington.

Option 3: 100% ownership

Reconsider the risks associated with buying 100% of the key assets associated with the Tranz Metro Wellington business (or the Tranz Metro Wellington business itself) given the changes to the environment detailed in section 4 of this report.

Looking further at the pros and cons of these options:

Option 1: 0% ownership interest by the Council

Pros

- There is a fresh set of relationships involved and initial indications are that Toll Holdings want to pursue a win/win relationship with the Council.
- The Council would not need to put in any upfront capital to acquire the key assets of Tranz Metro Wellington (or the Tranz Metro Wellington business).
- The much needed reinvestment can commence sooner, assuming suitable arrangements can be agreed between the Council and either Toll Holdings,

if they choose to hold Tranz Metro Wellington, or a new owner should Toll Holdings choose to sell.

Cons

- The current monopoly position would continue, as either Toll Holdings or the new owner, would have exclusive track access rights and control over the key assets.

- Toll Holdings, if they choose to sell Tranz Metro Wellington, would in effect determine who the next passenger rail operator would be, as this new operator would be the only party that could realistically respond in future to the Council's request for tender.

- The Council would in all probability still have minimal leverage negotiating a new contract and the Council is likely therefore to still have concerns over value for money.

Option 2: 50% ownership interest by the Council

Pros

- The risks (excluding those associated with the track, tunnels, bridges, signals etc) would be shared between the public and private sectors.

  N.B: the establishment of Track Co and the transfer back to the Crown of ownership of the track, tunnels, bridges, signals etc has significantly reduced the due diligence risk faced by a potential purchaser.

- The Council could rely on the rail expertise of its JV partner during both the acquisition and operation of Tranz Metro Wellington.

- Some savings in net subsidy would be expected compared with 100% private ownership due to different cost of financing and different tax positions.

- The Council would secure the track access rights to enable the Council to select a new operator in future. (This was an agreed component of the JV arrangements with Stagecoach).

- There is strong public support for a level of public ownership in Tranz Metro Wellington.

Cons

- There is some external 'political baggage' still surrounding the JV.

- Some concerns remain at political level over how the JV would work in practice (e.g. how effective would the buy back provisions be in practice should the Council wish to engage a new operator?).

- Transfund NZ has indicated that its support for 60% capital funding is linked with the assets remaining under public sector control. As the JV is 50/50 public/private it is likely that Transfund capital funding would not be available under a JV model.

Also, there is no allowance within the Council's LTCCP for the acquisition of the key assets of Tranz Metro Wellington, or the Tranz Metro Wellington business. Therefore, an amended LTCCP would need to be issued should the Council wish to pursue this option.

Option 3: 100% ownership interest by the Council

Pros

- Transfund NZ has indicated that it is prepared to provide 60% capital funding support to assist the Council to secure ownership of the key assets. This significantly reduces the potential impact of any acquisition on the Council's debt.

- 100% public ownership of key assets is expected to have the most positive impact on the Council's net subsidy due to different cost of financing and different tax positions.

- The Council would secure the exclusive track access rights along with control over the key assets necessary to run the service.

- It would position the Council to contract out the operation of the service on our terms.

- There is strong public support for a level of public ownership in Tranz Metro Wellington.

Cons

- There is increased risk for the Council in going it alone in terms of negotiating an appropriate deal with Toll Holdings. However, this is mitigated to some extent by the expected involvement of other Government agencies (e.g. Treasury).

- If Toll Holdings was only prepared to sell Tranz Metro Wellington as a business (i.e. not prepared to sell the key assets as distinct from the remainder of the business) the Council would be the owner of the operation for a transition period. This would bring with it increased risk e.g. responsibility for safety although the Council could seek to negotiate a contract with Toll Holdings for the management and operation of Tranz Metro Wellington during a transition period.

Also, there is no allowance within the Council's LTCCP for the acquisition of key assets of Tranz Metro Wellington or the Tranz Metro Wellington business. Therefore, an amended LTCCP would need to be issued should the Council wish to pursue this option.

Summary of Long-term Options

As noted above, there are pros and cons associated with each of the options and in my view the options can be summarised as follows:

Option 1: 0% ownership interest

The success of this option would largely depend on matters outside the control of the Council, including:

⇒ The attitude of Toll Holdings to selling Tranz Metro Wellington.

⇒ the nature of the deal struck between Toll Holdings and the new owner of Tranz Metro Wellington, assuming Toll Holdings do move to sell.

⇒ the attitude of Toll Holdings or a new owner of Tranz Metro Wellington in terms of negotiating a new contract with the Council and their willingness to operate the business on an open book basis.

However, at the end of the day, as noted by Booz Allen & Hamilton in their assessment of options in 2001, the problems inherent in the current arrangement would be largely unchanged if the Council chose to pursue Option 1 i.e. the Council would be in a contractual relationship with a monopoly provider.

As a result, while we should be able to improve our position compared with our historical contractual relationship with Tranz Rail, we remain somewhat captive in a monopoly situation.

Option 2: 50% ownership

The Joint Venture option was originally chosen by the Council as its preferred option owing to the nature of the risk sharing arrangements. However, as noted within this report the environment has changed which has resulted in a lower risk profile:

- Track Co has resumed ownership of track, signals, tunnels, bridges etc, and the associated maintenance obligations that go with ownership.

- Track Co is expected to determine the nature of shared access arrangements between passengers and freight and to set track access charges based on a transparent charging regime.

- Transfund NZ has indicated its support for providing 60% funding assistance associated with any purchase.

Option 3: 100% ownership interest in key assets

Subject to agreeing a sensible price the option of the Council pursuing the purchase of key assets necessary to run Tranz Metro (including track access rights) is now looking more attractive than was the case in 2001, due largely to:

- The establishment of Track Co and the transfer back under Crown ownership of the track and associated infrastructure which mean that the due diligence risks associated with the purchase of key Tranz Metro Wellington assets are reduced.

- The offer of capital funding from Transfund (at a rate of 60%) significantly reduces the risks to the Council's balance sheet (and credit rating) which mean that the residual borrowing required by the Council to fund the remaining 40% should be much more manageable.

- The takeover of Tranz Rail by Toll Holdings has introduced a new set of relationships, the early indications of which are positive about the future relationship between the Council and the passenger rail operator.

The key issue as I see it in terms of Option 3 is ensuring that the Council does not, and is not seen to, get too closely associated with the day-to-day operation of Tranz Metro Wellington, even during the transition period.

6. If the Council wished to pursue an ownership interest what would be the impact?

6.1 What would be purchased?

On the assumption that Toll Holdings is prepared to sell either the key Tranz Metro Wellington assets (e.g. Rolling stock, stations, track access rights) or the Tranz Metro Wellington business, to the Council, it is important to have a clear understanding at the outset how this scenario might play out.

In my view there are two main ways that this might occur:

1. Toll Holdings may be prepared to sell just the key assets (e.g. Rolling stock, stations and track access rights).

   This has some advantages for the following reasons:

   - Transfund NZ has indicated its support for providing funding assistance towards the purchase of assets. If only assets are acquired the level of Transfund NZ funding assistance will be clear cut.

   - The change of ownership of key assets to the Council, coupled with agreement by Toll Holdings to continue to be the operator for a transition period, would position the Council to seek competitive bids from the market to run Tranz Metro Wellington services in future.

     This sort of process would mean the Council would never get its name on the rail safety licence as it would transfer directly from Toll Holdings/Tranz Rail to the new operator.

   - It would position the Council publicly as the owner of key assets but never the operator and avoid all the concern about the Regional Council running trains. More importantly perhaps, it would mean unreasonable expectations would not be created by other parties e.g. Tranz Metro Wellington staff feeling they are returning to the Government sector.

However, it may create complications for Toll Holdings and ourselves in terms of valuing the remainder of the business without the key assets. This matter needs to be further explored.

2. Toll Holdings may only be prepared to sell the Tranz Metro Wellington business as a total package.

   This would mean the Council would acquire the business and take over all obligations associated with staff etc, in addition of course to the safety obligations noted above, although onerous obligations could be left behind, with a consequential price impact.

   While this creates increased risks for the Council, such risks could also be managed though the entry into a management contract with Toll Holdings for a transition period.

   I believe that the Council would need to ensure that its risk management procedures were sufficiently robust to pursue this course of action, should Toll Holdings be only prepared to sell Tranz Metro Wellington as a going concern business.

Unless and until negotiations start with Toll Holdings we are just second guessing what their attitude might be to selling Tranz Metro Wellington.

6.2 What impact would a purchase of either key Tranz Metro Wellington assets or the Tranz Metro Wellington business have on the Council's subsidy?

In a sense this is the $64,000 question!

The difficulty with any such analysis is that we do not have a solid basis on which to compare because we have no confidence with the current level of subsidy. If we did we could look at various scenarios and provide guidance on whether the Council's subsidy should go up or down from the current level. We also know that in recent years there has been insufficient capital reinvestment meaning there is an increasing backlog of work creating upward pressure on subsidy.

In the current climate of lack of financial information and potential changes with the establishment of Track Co and the new track access charging regime, any predictions about future subsidy are fraught with danger.

Therefore any potential impacts on the Council's future level of subsidy need to be heavily caveated.

Notwithstanding the need to caveat any projected impacts on Council's subsidy it is important to try and identify the key factors which should drive the level of subsidy in future.

• Operating Costs (e.g. salaries, wages)	Once the information is provided by Toll Holdings/Tranz Rail there is expected to be a high level of precision around these figures.
• Track Access Charges	Track Co will determine track access charges in future and as such these charges should be externally verifiable. This will remain problematic if Toll/Tranz Rail are responsible for the allocation of charges between passenger and freight.
• Charges for use of other assets (e.g. rolling stock)	Currently this is represented by depreciation and maintenance expenditures. In future if the Council can secure ownership of the key assets, arrangements will need to be entered into with the new operator for use of these assets, which will attract an asset usage charge (e.g. lease fee) designed to recover Council's costs.
• Return on capital	The operator is entitled to earn a reasonable return on capital employed.

In terms of return on capital it is useful to explore the differences between public and private ownership of the key assets.

If the Council decides to pursue Option 1, either Toll Holdings will continue as owner or a new private sector owner of Tranz Metro Wellington will emerge, and it is expected that they will be seeking to achieve a return on capital after tax, of up to 10%. This equates to a pre-tax return on capital of 15%.

In other words, under a continuation of the status quo, it is reasonable to assume that part of the Council's subsidy goes towards providing a return on capital of up to 15% (pre tax).

If the Council decided to pursue an ownership interest, the Council's borrowing costs would be less than the required rate of return on capital invested in Tranz Metro Wellington, and this difference could be used to help reduce the subsidy paid by the Council.

Also, as the Council is not a taxpayer, it does not need to fund the tax impost that a private sector operator would be expected to pay. This provides a further advantage to the Council, but is separate from the cost of financing advantage outlined above.

A further matter to consider is the level annual subsidy to be received from Transfund should the Council acquire the Tranz Metro Wellington assets. Transfund's contribution to the total amount needed to purchase the assets (60% of the purchase price) will be akin to a grant. Transfund will not require a return on the money provided but the quid pro quo will possibly be a reduction in their future contribution to the Tranz Metro Wellington subsidy. This reduction will reflect that having funded 60% of the purchase price of the assets, there is no longer a need to fund an annual return on 60% of the business' assets.

All other things being equal, these advantages should have a positive impact on the future level of Council subsidy as you move from full private sector ownership towards public sector ownership.

7. Where to from here?

Irrespective of whether the Council wishes to pursue taking an ownership interest in the key assets of Tranz Metro Wellington (e.g. Rolling stock, stations, track access rights) there are several important areas of focus for the Council over the coming months.

- **Track Access Arrangements**

  Ensuring that Tranz Metro Wellington has access to appropriate slots to run trains and has the flexibility to increase, or otherwise change, its requirements for access slots is crucial to the long-term future of passenger rail in the region. Officers have started discussions with Government officials and with Tranz Metro Wellington management about these issues and we are currently working on a draft Common Access Agreement for Wellington which looks to protect the interests of passenger services vs freight.

  Associated with this is the need to ensure not only access to appropriate slots but that such slots are fairly and transparently priced, as track access charges are expected to have a large indirect impact on the future level of Council subsidy. Discussions have commenced with Government officials over this aspect and these are expected to continue throughout the first half of 2004.

- **Discussions with Toll Holdings over the disclosure of key financial and operational information**

  As noted in section 4 we have requested certain information from Toll Holdings in an attempt to increase our comfort level over the current level of subsidy.

  The provision of such information is seen as a prerequisite to the establishment of any new long-term contract with Toll Holdings (notwithstanding that the Council is likely to firstly need to go through a market search for a new operator via an approved CPP process).

The Council now needs to decide if it wishes officers to further explore with Toll Holdings the possibility of Council taking an ownership interest in Tranz Metro Wellington e.g. purchasing the key assets such as rolling stock, stations and track access.

If it does, the Council needs to determine if such discussions are with a view to the Council taking a 100% ownership interest or a 50% ownership interest (JV).

8. Communications

The Chief Executive and the Council Chairperson have recently been discussing the broad options available to the Council with a range of key stakeholders.

However, formal consideration of this report is expected to generate a degree of public interest and it is therefore appropriate that formal and informal communication around the rail issue is once again increased. A communications plan has been developed to help facilitate the process.

9. Recommendations

That the Committee recommend to Council that it:

1. *Receive the report and note its contents.*

2. *Endorse the action taken by officers in suspending the Council's search for a new passenger rail operator, while the future ownership of key assets necessary to run the service, and the pricing of such use, remains uncertain.*

3. *Request officers to engage in further discussions with Government officials over the future track access arrangements for passenger rail services in the region, with a view to protecting, as far as possible, the Council's interests.*

4. *Request officers to engage in further discussions with Toll Holdings covering both Council's contractual relationship with Toll Holdings for passenger rail services, and the potential for the Council to take an ownership interest in the key assets of Tranz Metro Wellington, including rolling stock, stations and track access rights.*

5. *Request officers to continue to liaise with Transfund NZ officials and/or the Transfund Committee established to further investigate the development of passenger rail services in the region.*

6. *Request that officers report back to the Committee as soon as practicable in 2004, once discussions with Toll Holdings have reached a stage where the Council can consider the next steps with respect to passenger rail in the region, including consulting fully with the regional community.*

Report prepared by:

Greg Schollum
Chief Financial Officer

Attachment 1: Letter to Paul Little, Managing Director Toll Holdings Ltd, dated 23 October 2003

Attachment 2: GWRC Submission to Transfund NZ for Funding Assistance to Purchase, Refurbish and Renew the Rolling Stock and other key Urban Rail Infrastructure Assets of Tranz Metro Wellington dated November 2003

Attachment 3: Submission to the Transfund Board from Transfund officers - Application for Capital Funding for Wellington Passenger Rail

Attachment 4: Letter to the Ministers of Finance and Transport dated 29 July 2003