Options for Wellington Rail:
A Discussion Paper Issued by the TLAs

Summary

- The WRC JV proposal faces major problems overcoming a price gap between Tranz Rail expectation and what WRC is likely to be prepared to pay. The JV also increases the risk to the public sector and ratepayers, raises the difficulty of subsequent sale of the WRC share, and involves a conflict of interest.

- Waiting for the Crown to resolve the impasse is a poor option. Investment is needed now, the Crown is mainly interested in national track integrity, and sorting out a collapsed system has big problems.

- The contractual model proposed by the TLAs breaks the deadlock, gets investment going again, is likely to bring in new blood, and increases transparency.

- We believe the optimal solution can be achieved through contractual arrangements, and that Tranz Rail is amenable to this solution. It does not close off future options and may in fact facilitate them.

Introduction

This paper has been prepared as a summary document containing recommendations for change to the way the Wellington rail system is structured. It takes a practical approach to the problems facing the system, and proposes a solution that recognises the constraints and limitations of the current environment. It concludes that the best practicable solution is a "contractual model" for Wellington rail involving the negotiation by WRC of a long term (10 year) subsidy contract with the rail operator which sets out stringent performance and transparency requirements, and investment commitments.

The analysis in this paper is supported by a long version which sets out the information in more detail. The long version is available on request.

Background

The future of Wellington rail has been under discussion for over a year. During that period, 8 options for reform have been considered, ranging from an enhanced status quo to a franchise operation modeled on the Victorian rail system in Australia. These options have been discussed in various working papers considered by the group. Over time, the options have been reduced to the 2 favoured options described below.

Problems with the Status Quo

The desire for change is being driven by a number of significant problems with the current arrangements.

Apparent Desire by Tranz Rail to Exit Wellington Rail Market

Early in 2001, Tranz Rail announced its intention to sell the Wellington urban rail business.
Recent indications are that Tranz Rail has reconsidered its intention to quit the business, and subject to satisfactory resolution of some of the issues above, may be willing to remain involved in the provision of Wellington urban rail services.

Value for Money Perceptions

There is a feeling among some groups, particularly the WRC, that stakeholders are not receiving good value for subsidy dollars from the current arrangement. In particular, a lack of transparency has led to concerns that Tranz Rail may have been earning excessive profits from the Wellington rail business, and Tranz Rail have traditionally been reluctant to release commercial information. It is not clear why, if Tranz Rail has been earning excessive profits, it has been so eager to quit the business.

Lack of Control Over Strategic Assets / Integrity of the Network

Core infrastructure, stations and to a lesser extent, rolling stock are considered by many to be strategic assets as far as the Wellington region is concerned, and best vested in public ownership to protect them for the future.

Inability to Control Desired Outcomes

Under the current structure, the ability of the Crown and its agents to control outcomes such as pricing, return on investment, patronage levels, service standards and investment in new assets is exercised indirectly via the contract with Tranz Rail. There is a view that this does not provide sufficient control.

Asset Risk

The lack of long-term subsidy agreements has required WRC to directly fund capital improvements that it considers necessary. There is a view that this process has led to WRC (and therefore ratepayers) effectively taking on the risk for those assets.

Concerns over Commercial Viability of Current Operator

The current operator, Tranz Rail, has not performed well in recent years. The company’s 200 l-2002 Strategic Plan acknowledges that it has, ‘failed to please our investors, our customers and even our employees, and that’s not a healthy foundation for any business’. Tranz Rail was cash negative during the years 1996-99 and profits were down in 2001. The company’s earnings per share currently stands at 4 cent and it has a ‘no dividends’ policy

Characteristics of the Wellington Rail System

Wellington rail has a number of characteristics that make it unique and limit the options for change. It is not possible to simply apply solutions used in overseas jurisdictions for the following reasons:

- Rail assets, including core infrastructure, are owned by a private sector company which shows every sign of wishing to maximise its return on any sale. This means the Crown does not have any ability to adopt contestable solutions without purchasing or obtaining a long term lease on these assets. The Auckland rail deal shows this could be an expensive and high risk option for Wellington.

- The rail system has been operated by a private sector company for nearly 10 years and efficiency improvements will have been implemented by Tranz Rail. This contrasts with overseas examples which were operated by the public sector prior to reform and contained clear inefficiencies.

- The relatively small scale of Wellington rail compared to overseas examples limits the ability to introduce competition and 'benchmarking' on various parts of the system, by for example having different operators on different lines.

Any decision on the future of Wellington rail will need to take account of these characteristics.

Options for Change

The WRC Joint Venture

WRC has described its JV proposal as.. . . "to secure a managed change in ownership of the Tranz Metro business with the WRC itself taking an ownership interest in the business for a period of time (this phase is called "gaining control"). The mechanism for achieving this will be:

- The establishment of a company in partnership with a private rail sector operator that will purchase the Tranz Metro (Wellington) business and operate the rail service
- The, acquisition by the Government or the (Wellington Regional) Council of the access rights to the rail corridor and associated infrastructure (e.g. track, signals, overhead wires and stations)
- The granting of access rights to the operating company (Wellington Regional Rail Limited).

The Council intends that its ownership interest in the operating company would be for a transitional period only. It will review its ownership interest with a view to selling it at the end of the transition period (5 years)."

The proposal also envisages a detailed "Funding Agreement" between the WRC and the new Public Private Partnership (JV) company for the provision of Wellington rail services. The structure is set out in Appendix 1.

We believe there are two major problems with the WRC JV model.

1. Gaining Control of Assets

The first problem is that it relies on being able to purchase the assets of the rail system (or access rights to them) at a reasonable price. The Auckland experience shows that Tranz Rail would seek to maximise its returns on the sale of rail assets, and indications from the Government are that it is not willing to support or fund a similar process in Wellington.

Even if the rail assets were obtained at a reasonable price, this would still substantially increase the risk being assumed by the public sector i.e. infrastructure and operational risk.

There are two further problems related to purchase price. Firstly, in terms of bargaining power the WRC is likely to be in a weaker position when looking to sell its 50% share in the future. The attractiveness of this parcel will be much lower than the 50% offered in partnership with the WRC on formation of the Joint Venture. Secondly, the purchase price is supported by the subsidy paid, and if the purchase price is high the rate of return will have to be supported by increased subsidy payments.

2. Conflict of Interest

The second major problem with the WRC JV is that if WRC had an ownership interest in the JV company, it would have a conflict of interest by being both purchaser and provider of Wellington rail services. The 'purchaser-provider' separation between funders and providers of public services is a fundamental principle of public sector reform, and for good reason. Under the JV model, the WRC would continually be walking a tight-rope between its duty to the Wellington ratepayers of ensuring cost-effective and efficient services through management of the funding contract, and its duty as shareholders and directors of the JV company to act in the best interests of that company. Under a worst case scenario, Wellington Regional Councillors might find themselves having to enforce contract provisions or even take legal action against a company which they partly owned. What would happen, for example, if a serious rail accident occurred? It is conceivable that WRC directors of the JV company could even be found liable.

There is an important distinction between the JV concept proposed and how it has been successfully applied overseas, and the arrangement that is envisaged for Wellington rail. Most overseas examples involve an activity previously owned and managed by the Crown being placed under a JV arrangement, thus providing a transfer of risk to the private sector. Paradoxically, the WRC JV proposal involves the buy back of assets held in private ownership, resulting in a transfer of risk back into the public sector.

The TLAs' Contractual Model

The contractual model has been designed around the constraints of the Wellington rail market and the apparent incentives and preferences of Tranz Rail as owner of the network.

It assumes, firstly, that it will not be practicable to obtain control of the rail assets at a price that the public sector will be willing to pay. It also assumes that Tranz Rail, in the absence of a deal to sell the Wellington rail infrastructure, may be attracted as a second best option by a structure that provides a long term commercial return on those assets or allows it to sell off a share of these assets as it did with Tranz Scenic.

The contractual model would be structured as follows:

Tranz Rail would be approached with the proposal that WRC would be willing to enter into a long term (10 year) subsidy contract subject to certain conditions:

- That the contract contains detailed performance requirements, including a system of performance rewards and penalties.
- That the contract be an alliance (open book) contract providing greater transparency of costs to both partners and the WRC.
- That Tranz Rail agree to undertake specified capital investments as negotiated.

Tranz Rail could also be given an option to establish a separate company to manage Wellington rail, with 50% to be owned by Tranz Rail and 50% by a company with specific expertise in the management and marketing of urban passenger services. It is envisaged that Tranz Rail would be a sleeping partner in this company (as per the Trans Scenic deal) and that WRC would be required to approve the selected partner.

The proposed structure is set out in Appendix 2.

This arrangement would provide benefits for both parties to the transaction.

For the WRC, the benefits would be:

- Establishing an investment programme for the term of the contract
- Transfering asset (residual value) and cost risk to the operator
- Transfering patronage risk to the operator through a variable scale of payments tied to passenger numbers
- Providing certainty for WRC's budgeting by removing variability of (subsidy) pricing
- Providing an ability to specify and control outputs (such as on time performance and reliability) through a system of incentives and penalties.

- The prospect of attracting a new operator who has a fresh approach to the provision of rail services and none of the 'baggage' of WRC's current relationship with Tranz Rail.

For Tranz Rail and the rail operating company, the benefits would be:

- Providing certainty for planning and investment by guaranteeing subsidy levels
- Providing a bankable contract to build the business upon
- Providing a framework and standards for the provision of urban rail services

Key Differences Between the Models

The JV and contractual models have a number of similarities and some crucial differences:

- Both models rely on WRC completing a successful, commercial negotiation with Tranz Rail to obtain agreement to the proposals.

- Both models rely on a detailed, performance-based long term contract (10 years) to ensure that the operator provides the quality and quantity of services required by WRC as funder.

- Both models incorporate the concept of greater transparency in the contract between the rail operator and the WRC as funder.

- Both models require a similar level of complexity in the contractual relationships between the major parties, and therefore require the careful drafting and management of contracts.

The crucial differences between the models are as follows:

- The JV model is dependent on WRC or the Crown gaining control of (purchasing or obtaining long term access rights to) the core infrastructure and assets required to operate Wellington rail at a price that they are willing to pay.

- The, contractual model recognises that it will not be practicable to obtain control of the rail assets at a reasonable price. However, it provides an incentive for Tranz Rail to enter the agreement by allowing it to cash up part of its assets, and obtain a secure income stream from the remainder.

- The JV model enshrines a major conflict of interest between WRC as funder and operator of the business that could compromise its ability to discharge either role effectively.

- The contractual model maintains a clear separation between the roles of funder and operator, such that WRC is able to concentrate on its core business of negotiating and managing the long term funding contract without compromise, and the operator is able to concentrate on the business of operating Wellington rail in accordance with that contract.

How Successful are the Models in Dealing with Perceived Problems?

Conflict with Business Objectives of Current Operator

Until recently, it seemed that Tranz Rail's preference was to sell the assets in Wellington rail outright, and this may still be the case. However, there is agreement among the TLAs and WRC that the Crown is unlikely to be prepared to obtain control of those assets at a price acceptable to Tranz Rail or at all. Moreover, Regional Councils are not permitted to own transport infrastructure. These issues appear to rule out the JV model as a viable option.

The contractual option, on the other hand, is very similar in terms of its business structures to the Tranz Scenic sale recently agreed by Tranz Rail. It therefore seems likely to be acceptable to Tranz Rail, at least in principle, as a commercial proposition. To the extent that it does not require taxpayer funding for purchase of rail assets, it should also be much more acceptable to the Crown.

Value for Money Perceptions

Both models incorporate contractual provisions requiring greater transparency from the rail operator about the costs of providing the contracted services, and therefore both should give greater assurance of value for money.

The JV model provides the opportunity for WRC as part-owner to hold seats on the board of the operator company. This will certainly result in WRC obtaining better information regarding the costs which are known to the operator company. However, it will not necessarily provide any insights into the costs of any services which continue to be provided by Tranz Rail, such as track access.

On the other hand, if the rail assets were to be purchased outright at an inflated cost, obtaining even a reasonable rate of return on excessive asset values will result in poor value for money. Moreover, WRC representatives could be placed in the invidious position of attempting to obtain a commercial return on assets with their director's hats on at the same time as trying to limit subsidy payments with their WRC hats on.

Lack of Control Over Strategic Assets / integrity of the Network

The JV model attempts to provide control over the integrity of the network through purchase or long term lease of the infrastructure assets, and in the process requires the Crown to assume most or all the risks of ownership. This will require a law change, the contractual model does not.

The contractual model is based on the assumption that rather than controlling the integrity of the network (whatever that may be), WRC is more interested in controlling the quality and quantity of services available to Wellington rail commuters. This is achieved through the funding contract.

Inability to Control Desired Outcomes

Both models should provide an enhanced ability to control desired outcomes through the provisions of their funding contracts. The potential introduction of a new private sector partner for operating the rail services is likely to deliver better outcomes in terms of service quality.

Asset Risk

While the asset risk assumed by the WRC under the current arrangements is a cause for concern, under the JV this risk would be greatly increased, with the Crown / WRC assuming a greater responsibility for risk associated with rail assets. The contractual model will place the majority of asset risk with the rail operator, consistent with principles adopted in overseas jurisdictions

Concerns over Commercial Viability of Current Operator

If the WRC were successful in buying into the Wellington rail business via the JV model, it may reduce the risk of the rail operator becoming insolvent. However, the cost would be to substantially increase the risk assumed by ratepayers and taxpayers.

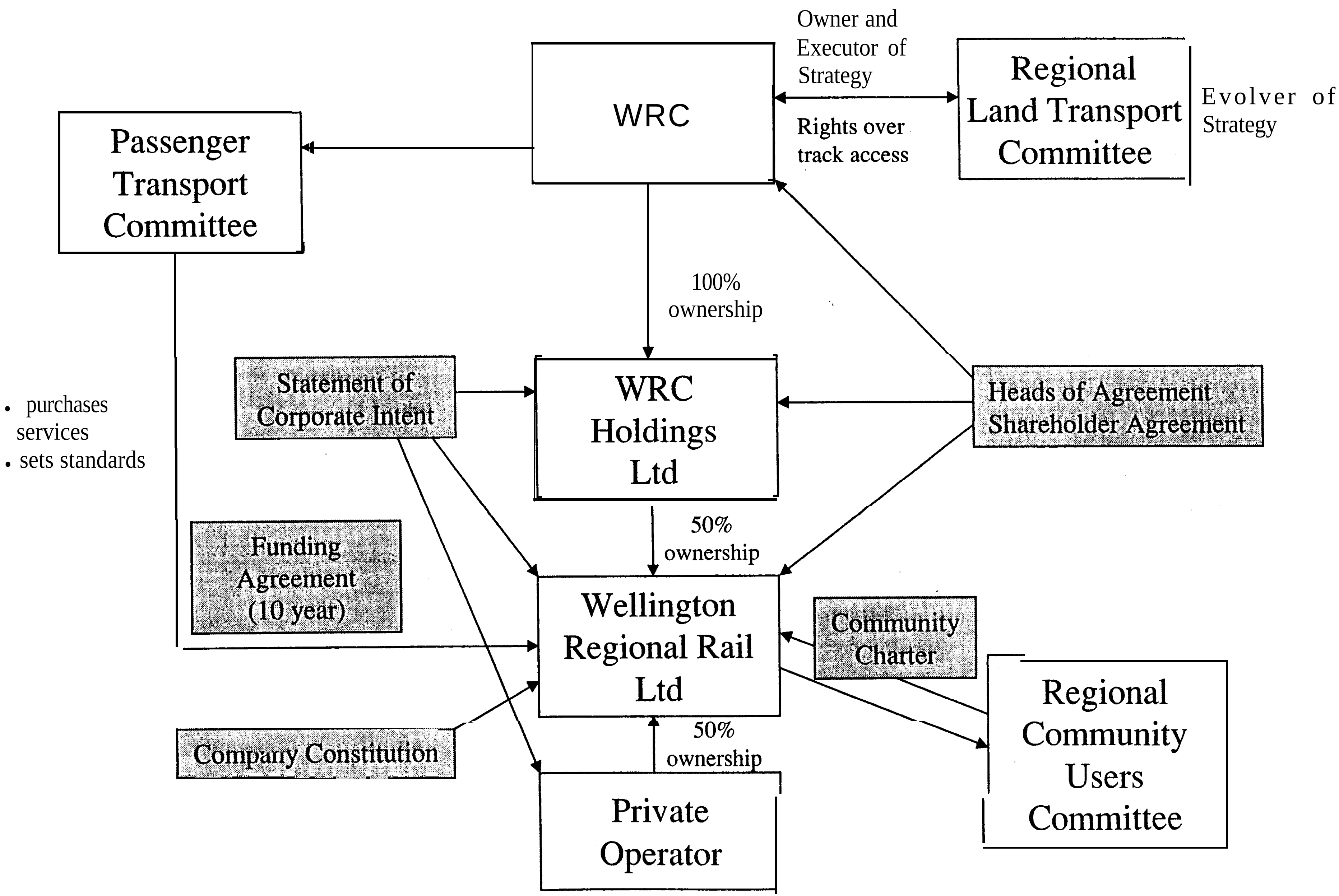
The proposal to establish the rail operator as a stand alone business with a new private sector partner, a stable, long-term contract and improved transparency via the "open book" provisions would substantially reduce concerns about an unforeseen insolvency.

Conclusion

There are many similarities between the JV and contractual models. However, a close analysis of the two options shows the contractual model is a better option for obtaining the outcomes for Wellington rail commuters without incurring the additional risks which would result under the JV option.

APPENDIX 1

Overview of WRC's Public Private Partnership Approach



APPENDIX 2

CONTRACTUAL MODEL DIAGRAM