greater WELLINGTON
REGIONAL COUNCIL

Report	**PE06.274**
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Committee	**Policy, Finance and Strategy Committee**
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Rail Operating Contract with Toll

1. Purpose

To seek approval for the Rail Operating Contract (the Contract) between Greater Wellington Regional Council (GWRC) and Toll Consolidated NZ Ltd (Toll).

2. Significance of the decision

The matters for decision in this report do not trigger the significance policy of the Council or otherwise trigger section 76(3) (b) of the Local Government Act 2002.

3. Exclusion of the Public Confidentiality

Grounds for the exclusion of the public under Section 48(1) of the Local Government Official Information and Meetings Act of 1987 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, to preserve commercial confidentiality.

4. Background

GWRC have been negotiating a new term contract for the operation of the Wellington passenger rail system. These negotiations were largely concluded by GWRC and Toll in March 2005. At that time the Contract was passed to Land Transport NZ (LTNZ) for approval. During the last year LTNZ have employed a number of consultants to review the contract. While there have been a number of changes to the original contract they are fairly minor in nature, with the exception of the term of contract and the purchase of the Ganz Mavag.

Originally the Contract was for a minimum of 10 years with the right of extension at GWRC's option up to the maximum of 30 years. LTNZ wanted a 3 year term but have compromised on a 5 year term with a 5 year extension.

The delays caused by LTNZ in approving the Contract and difficulties between Toll and OnTrack have caused concerns for Toll. They are worried that they may not be able to recover the cost of the Ganz Mavag units through the Contract. Therefore, the Contract requires GWRC to purchase the Ganz Mavags and related assets when the Contract terminates after its ten year life.

A full copy of the Contract is available for Councillors.

5. The Contract

The Contract is between the Wellington Regional Council and Toll NZ Consolidated Ltd. It is for the provision of suburban rail services for the Wellington region. The Contract must acknowledge the objectives of the Regional Land Transport Strategy and is written on the basis of a partnership between Toll and GWRC. There is Business Plan prepared and agreed between both Toll and GWRC each year. The plan is on a rolling 10 year basis and this forms the basis for the operation of the business.

Toll must operate the Metro Business in accordance with the Business Plan and not undertake any significant activities which are not set out in the Business Plan without the approval of GWRC.

GWRC is responsible for setting the fares, timetables and providing the funding by way of subsidy payments to Toll.

Under the Contract, Toll is paid the shortfall between fares, other revenue and operating expenses, plus a fee for operating the rail services in accordance with the timetable and the minimum service standards. The fee is calculated in such a way as to provide incentives to Toll to improve and increase the business. However these incentives are capped to ensure there is a sharing of the benefit between the two parties. Toll's downside risk on the fee is limited, which is a consequence of the capping on the fee and the percentage basis upon which the fee is calculated. Further details are given under section 6.2.

The contract is expected to come into force in July 2006.

6. Contractual Terms

The main contractual terms are detailed below:

6.1 Term

The contract is for an initial term of 5 years with an extension for a further 5 years. At the end of the first 5 years the parties will meet and review the operation of the contract. Any changes must be agreed by both parties, if there is no agreement then the contract will continue for the second 5 years on the same terms and conditions.

6.2 Tolls Fee

The revenue for the Tranz Metro business comes from several sources namely;

- Fare box revenue
- Operational subsidies from GWRC (funded 60% by LTNZ, 40% GWRC)
- Other revenue such as kiosks revenue

Under the terms of the contract Toll is paid a fee (profit) for operating the business and a return on their assets employed in the business. The fee is calculated as 7.5% of deemed revenues. Deemed revenues are defined as the total of fare box revenue, operational subsidies, English Electric refurbishment grants and kiosk revenue. The subsidy paid by GWRC is adjusted to ensure Toll is paid the correct amount for their fee. As the subsidy includes Toll's fee, Toll, in effect, get paid a fee on their fee.

In respect of 2006/07 Toll's fee is forecast to be $3.6 million.

The subsidy from GWRC is increased or decreased as other factors change to ensure Toll receives the correct fee as the following examples demonstrates:

$ Million

	A	**B**	**C**
Fares	25.0	25.0	26.0
GWRC Subsidy	17.0	18.6	16.0
Other	0.7	0.7	0.7
Deemed Revenue (D)	**42.7**	**44.3**	**42.7**
Expenses	39.5	41.0	39.5
Toll's Fee (E)	**3.2**	**3.3**	**3.2**
E/D	**7.5%**	**7.5%**	**7.5%**

A Toll is paid 7.5% of $42.7 million which equates to $3.2 million

B As expenses increase to $41.0 million, the subsidy from GWRC must rise to ensure Toll receives their fee of 7.5% of deemed revenues.

C As fares rise the subsidy from GWRC decreases to ensure Toll is paid no more than their fee of 7.5% of deemed revenues.

Any additional revenue from fare increases will reduce the subsidy paid by GWRC to ensure Toll's fee remains at 7.5% of deemed revenue. Alternatively, any increase in operating costs will increase the GWRC subsidy.

The fee is set at the start of the year by reference to the Business Plan which is agreed by Toll and GWRC. At the end of the financial year and based on the audited financial statements of the business there is a reconciliation between the Business Plan and actual amounts. If Toll has received more than their entitlement (based on the audited accounts) then this excess is shared 50/50 between Toll and GWRC.

If Toll has received less than their entitlement then they will bear some of the downside up to a maximum of $300,000. Any amount over and above this shortfall is to the account of GWRC. In either case the Business Plan for the following year is reset to take into account any excess's or short falls in Toll's fee.

6.3 Business Plan

Each year a Business Plan for the following 10 years is agreed between GWRC and Toll. This plan includes the following:

- Description of the business
- Asset Management Plan
- Asset Employed
- Issues and risks
- Financial forecast including Capital Expenditure programmes.
- Major assumptions
- Key Performance indicators
- Business Strategies

The Business Plan is the basis upon which payments are made to Toll by GWRC during the year. At the end of the year and based on the audited financial statements there is a wash up between the estimated and actual results.

6.4 Open Book

The contract is an open book basis. It is defined in the Contract as;

"Open Book means the disclosure of full and accurate information, both operational and financial, and all related management information of the Metro Business. Where costs, revenue and any assets are shared with other sectors of Toll's business, disclosure shall include data which supports the allocation methodology adopted."

GWRC receives this information on a monthly, quarterly and yearly basis, with the year end financial statements being audited. During the year Toll is paid on the basis of the Business Plan. This is then reconciled to the audited financial statements at year end and any excesses or shortfalls are accounted for under the terms of the contract as noted in section 6.2.

GWRC is entitled to appoint their own auditor to review any financial or operational information.

6.5 Fares and Timetables

GWRC has the right to set the fares and change the timetables (subject to consulting with Toll). GWRC also has the right to alter the level of rail services. In practice GWRC could (after consulting with Toll) stop running trains on a particular line.

6.6 Livery

Toll will adopt and apply any livery or brand required by GWRC at the cost of GWRC.

6.7 Quality of Rail Services

Toll must provide the rail services in a safe, reliable, punctual and cost effective manner. The services must comply with the minimum service standards, in accordance with the Business Plan. The funding paid by GWRC will be reduced if Toll does not meet certain specified minimum service standards, regarding scheduled timetables and maintenance.

6.8 Funding of Assets paid for by GWRC

The Contract contemplates GWRC purchasing assets (such as the new electrical multiple units) for use by Toll in the provision of rail services. Where this occurs Toll will not be permitted to charge depreciation on that portion of the assets which have been funded by GWRC. These assets will be leased to Toll under a separate lease agreement. Over time it is expected that GWRC will own the majority of the assets used in the Metro business.

6.9 Purchase of the Ganz Mavags and Other Assets

The Contact requires GWRC to purchase the Ganz Mavag units and other Toll assets necessary to provide the rail services upon termination of the Contract. This is on the basis that Toll does not obtain a further contract for the provision of the rail services. GWRC is not obliged to purchase these assets if the Contract is terminated due to a breach by Toll.

The purchase price of the Ganz Mavags and other assets will be set at the time of purchase by agreement or arbitration. This is to ensure that Toll keeps the units in reasonable condition prior to the purchase by GWRC.

GWRC is proposing to purchase and refurbish the Ganz Mavags once the new electrical units are in service. However no contractual commitment, apart from the one noted above, has been given by GWRC.

This clause was not included in the original contract given to LTNZ in March 2005. However the delays, changes requested by LTNZ (especially regarding the term of the contract) and Toll's negotiation with OnTrack have caused serious concerns for Toll. They do not want to have the Contact terminated and to be left with assets not depreciated and with no use.

While the purchase of these assets is contemplated by LTNZ in their Procurement Procedure there is no firm commitment by them at this stage to provide funding.

6.10 Termination

The Contract will terminate after 10 years or prior to that if there is a material breach by Toll. In addition GWRC can terminate the Contract at the next year end if their funding from LTNZ ceases or substantially reduces.

GWRC has the power to appoint a party in the event of a material unremedied breach by Toll, to undertake Toll's obligations. However this will depend on being able to do this under Toll's access agreement with OnTrack.

6.11 Assignment

Toll can not assign its rights and obligations under this Contract without the permission of GWRC.

6.12 Disputes

Any disputes that cannot be resolved can go to compulsory arbitration if required by one party.

7. Other Matters

7.1 OnTrack

Toll has signed a contract with OnTrack which gives them exclusive access rights to the track for 67 years. In return Toll must pay the costs of maintaining and renewing the track. Access fees for the entire network are forecast to be $58 million for 2006/7, an increase of $10 million on the previous year.

The Wellington Metro's share of this $58 million is forecast to be $6.2 million, an increase over the current year of $1.2 million.

OnTrack will not provide to either Toll or GWRC a breakdown of how the $58 million is made up, in particular, how the $58 million is allocated to each line segment. Neither of us can review and negotiate the level and allocation of the expenditure with OnTrack. OnTrack's response is that they are not obliged to disclose this information; it is their responsibility to ensure the track is safe. Toll must simply pay the amount demanded by OnTrack.

The access fees simply cover the maintenance of the rail network but do not include any replacement of assets or improvements. Replacement of life expired assets in the system are termed renewals. OnTrack will be spending $60 million on renewals in respect of 2006/7. This amount is forecast to be spent each year in the foreseeable future.

OnTrack charge a return on these renewal assets plus depreciation. In respect of the Wellington Metro network, OnTrack will be spending approximately $6 million each year. The charge for this renewal expenditure increases rapidly each year. For example if $6 million is spent each year for ten years on the system then by year ten the charge for renewals to will be $5.7 million. This does not include the cost of access fees, which as noted above, are forecast at $6.2 million for 2006/7.

Toll cannot incur this level of expenditure in its business without making substantial losses. They have been negotiating with the Crown and OnTrack for the past two years to find a solution to this problem without success to date. Toll wants the Crown to subsidise some of the OnTrack costs to allow Toll to run a viable rail freight business.

The access fees are forecast to increase by between 3-4% per year over the next 10 years. By 2016 Wellington Metro's share of the access fees will be $8.2 million. Together with our share of the renewal expenditure Wellington Metro's total costs for access fees and renewals 2016 will be $13.9 million. GWRC has made no allowance for any renewal expenditure in its 2006-16 LTCCP. However, due to the small dollar effect of renewals in 2006/7 the forecast access fees of $6.2 million will cover GWRC's obligations for both amounts. From 2008 onwards GWRC does not have any amounts to cover the renewal expenditure. These amounts represent 100% of the costs, LTNZ will fund 60% of these amounts

GWRC by signing the Rail Operating Contract will be obliged to pay their share of both the access fees and renewals, regardless of the amount.

OnTrack do acknowledge that this level of investment over the next few years will produce an outcome which cannot be sustained economically. However, while there have been intense negotiations between Toll, OnTrack and the Crown regarding the Crown subsiding some of OnTrack's costs nothing has been finalised at this stage.

GWRC has few options in this matter, they must keep the urban passenger rail network running. They must contract with Toll as they have the exclusive access rights to the track. In turn OnTrack, under their agreement with Toll, can charge the costs of maintaining the rail network regardless of the amount. Approximately 11 million passengers use the rail system per annum, the prospect of those passengers being transported by road is something which GWRC may not want to contemplate.

GWRC will be relying heavily on Toll to broker an acceptable deal with OnTrack/the Crown regarding these costs. Toll pays over 80% of these costs and is therefore incentivised to reach a satisfactory outcome. GWRC will also lobby Government to ensure their interests are protected. However it is unlikely that any of these matters will be resolved in the next few weeks. Therefore, if GWRC approves this Contract then they are agreeing to a somewhat unknown future in respect of this matter.

Management have considered a shorter term contract but this does not solve the problem as OnTrack's costs will be the same regardless of whether it is a one year, five year or ten year contract. In addition any shorter term contract will bring financial consequences from Toll, in particular they may require the purchase of the Ganz Mavag's up front.

GWRC may have to increase rail fares at a faster rate than currently forecast to offset these increases.

LTNZ pay 60% of the subsidy paid to Toll by GWRC. If costs increase faster than the growth in fare revenue then the subsidy payment will increase, including LTNZ's share. Under the terms of contract GWRC may terminate the Contract if its funding from LTNZ ceases or substantially reduces. Therefore GWRC does have some protection from increasing costs if they become unacceptable to LTNZ.

While this issue with OnTrack has serious consequences for GWRC management have concluded that GWRC has little option but to proceed in signing this Contract with Toll.

7.2 Land Transport

LTNZ has reviewed the Contract extensively over the last year. They are now at a stage where they can approve the Contract subject to them ensuring that the Business Plan is in accordance with the intent of the original Rail Business Case. The Business Case was prepared by Warwick Walbran in 2004. No major issues at this stage are expected from LTNZ on the Contract or Business Plan.

However there is still one matter outstanding between LTNZ and GWRC concerning the payment terms to Toll. LTNZ have been concerned with the formula used to pay Toll i.e. 7.5% of deemed revenues. They are of the view that this will encourage Toll to increase their costs artificially, which would result in an increase in their fee. GWRC contend that the open book and audit provisions in the Contract will prevent this. In addition any cost blowouts in the Tranz Metro business will also impact on Toll's rail freight business.

However, despite this LTNZ remain unconvinced and they are only willing to pay their share (60%) of Toll's fee based on their own formula. This formula would involve 100% reimbursement of Toll's costs (after deducting fare revenue etc). Toll's fee would then be inflated each year based on an inflation based index agreed between LTNZ and GWRC.

GWRC is permitted by LTNZ to pay Toll under the agreed formula in the Contract, 7.5% of deemed revenues (as discussed in section 6.2). Any difference (both positive and negative) between the two calculations will be for the account of GWRC.

GWRC has modelled the difference between these two formulas under a variety of scenarios. Assuming the starting point for Toll's fee is the same under both methods then the difference over ten years is not great. A summary of these calculations are included in **Attachment 1.**

LTNZ initially chose a starting point for Toll's fee of $3.2 million, which is based on financial forecasts prepared by Toll over 18 months ago. Since that time there has been a number of changes to the assumptions in respect of 2006/7:

- Patronage was originally forecast to be 10.4 million passengers in 2006/7, the current patronage forecast is 11.1 million passengers.

- Access fees were forecast at $4.2 million, they are now forecast to be $6.2 million.

- There have been substantial increases in diesel, electricity and wages.

- There will be a 15% fare increase in 2006 which was not originally forecast.

The effect of the above is to increase Toll's fee for 2006/7 from $3.2 million to $3.6 million. It is interesting to note that Toll is expecting to make a profit of $4.7 million for 2005/6. They will be taking a reduction in profit of $1.1 million for 2006/7.

GWRC has requested that LTNZ uses the current starting point for Toll's fee rather than one that has been superseded.

We have now received informal advice that LTNZ will use $3.6 million as the starting point. This will be confirmed prior to the meeting.

7.3 Legal

GWRC solicitors have reviewed the Contract and their letter is included as **Attachment 2 (to come).**

8. Timing

Subject to the Council approving this Contract it is expected that it will be signed in early July to take effect from 1 July. If there are any delays beyond this then it is intended to exchange letters between GWRC and Toll to allow the commercial terms of the Contract to take effect from 1 July.

9. Conclusions

The entering into the Contract is a major milestone for GWRC. It changes GWRC role from simply funding a service to one where there is partnership between the two parties. GWRC will be responsible for setting fares, standards and the level of rail services. It will, over time, become the major owner of the rail rolling stock worth in excess of $200 million.

The Contract is not without risk for GWRC. There are issues with OnTrack costs, purchase of the Ganz Marvags, shortfall in funding from LTNZ in respect of Toll's fee and changes in Government policy.

However, the benefits arising from this Contract outweigh the potential downsides as these risks exist regardless of whether or not a new contract is entered into. Therefore on balance management is of the firm view that GWRC should enter into this Contract.

10. Communication

A media release has been prepared and agreed with Toll.

11. Recommendations

That the Committee recommends that Council:

1. ***Receives** the report.*

2. ***Notes** the content of the report.*

3. ***Approves** entering into a 10 year Rail Operating Contract with Toll NZ Consolidated Ltd on the terms and conditions noted in Section 6 above.*

4. ***Authorises** the Chief Executive Officer and Chief Financial Officer to sign the Contract on the Council's behalf*

Report prepared by:	Report approved by:	Report approved by:
Barry Turfrey Chief Financial Officer	**Wayne Hastie** Divisional Manager, Public Transport	**David Benham** Chief Executive Officer

Attachment 1: Difference between GWRC and LTNZ payment methods

Attachment 2: Phillips Fox letter (to come)