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FINAL REPORT

Delivery and Governance Options for Wellington's Urban Railway

**Wellington Region
Territorial Local Authorities
And Wellington Regional Council**

Wellington
26th September 2001

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Introduction

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Effective and efficient rail services are an essential component of the Regional Land Transport Strategy (RLTS) for Wellington

- The Wellington Regional Council (WRC) has statutory responsibility for the provision of public transport in the Wellington Region
  - In discharging this responsibility, WRC's objective is to purchase safe, fair and reliable transport services at least cost to ratepayers
- Urban rail forms the spine of the regional public transport service, carrying a substantial proportion of daily commuter trips to Wellington
  - Rail carries about 9.9 million passengers per annum and accounts for about 15%[1] of commuters to Wellington's central area
  - Without the rail system, additional road construction would be required, although on some routes (e.g., Ngauranga Gorge, Hutt Road, The Terrace Tunnel) significant road widening is impractical
  - The alternative of an expanded bus network would be expensive to implement, would add to congestion on the urban road network and would be unsatisfactory to many public transport users
- Independent reports to WRC calculate the benefits of the regional rail system as between $120M and $170M pa[2]

(1) *Analysis of 1996 Journey to Work Census Data*
(2) *Passenger Rail Options for the Wellington Region; Discussion Document prepared by officers of WRC and various TLAs, Feb 2001*

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In mid-2000, Tranz Rail announced its intention to concentrate on freight and to sell its passenger businesses

- Wellington urban rail services were part of the integrated rail freight and passenger business sold to Tranz Rail Ltd in 1993
  - Rollingstock, stations, buildings, railway tracks and signalling equipment were sold outright
  - Corridor land was leased from the Crown for 40 years with a right of renewal for a further 40 years
- Wellington urban rail services are part of Tranz Rail's Tranz Metro business which also includes Auckland commuter services
- The railway was sold without any obligations upon the new owner to continue to operate uncommercial services
  - WRC has had to continue to provide subsidy funding to Tranz Rail to ensure retention of passenger rail services in the Wellington Region
  - The operating subsidy is currently about $16 million per annum, with fare revenue of about $21 million per annum[1]
  - 60% of the subsidy is sourced from Transfund (and raised from road users) and 40% (about $6.5 million pa) is funded through the transport levy on ratepayers in the region

(1) Total operating expenses estimated at about $30 million pa, Memo from Bruce Wattie (PWC Wellington) to Greg Schollum (CFO, WRC) 7 Feb 2001

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Tranz Rail's decision to divest Tranz Metro has created an opportunity to correct the structural deficiencies in the current arrangements

Deficiencies of Current Arrangements

- Lack of transparency leading to value for money concerns
- Short-term focus of rail operator
- Lack of incentive for operator to invest in renewal or enhancement of the rail system
- WRC bears all investment risk

Impacts

- Under-investment
  - Deteriorating asset base
  - Relatively high operations and maintenance costs
- Deteriorating service quality and reliability
- Lack of progress in improving service levels
- Reduced patronage growth

Causal Factors

- Lack of competition or contestability
  - Tranz Rail is a monopoly supplier of rail services in NZ
- Short-term funding arrangements
  - Transfund has been unwilling to consider long-term funding commitments
- No mechanism to capture the value of public investment
  - WRC prevented by law from owning transport infrastructure and operations

Failure to meet RLTS objectives

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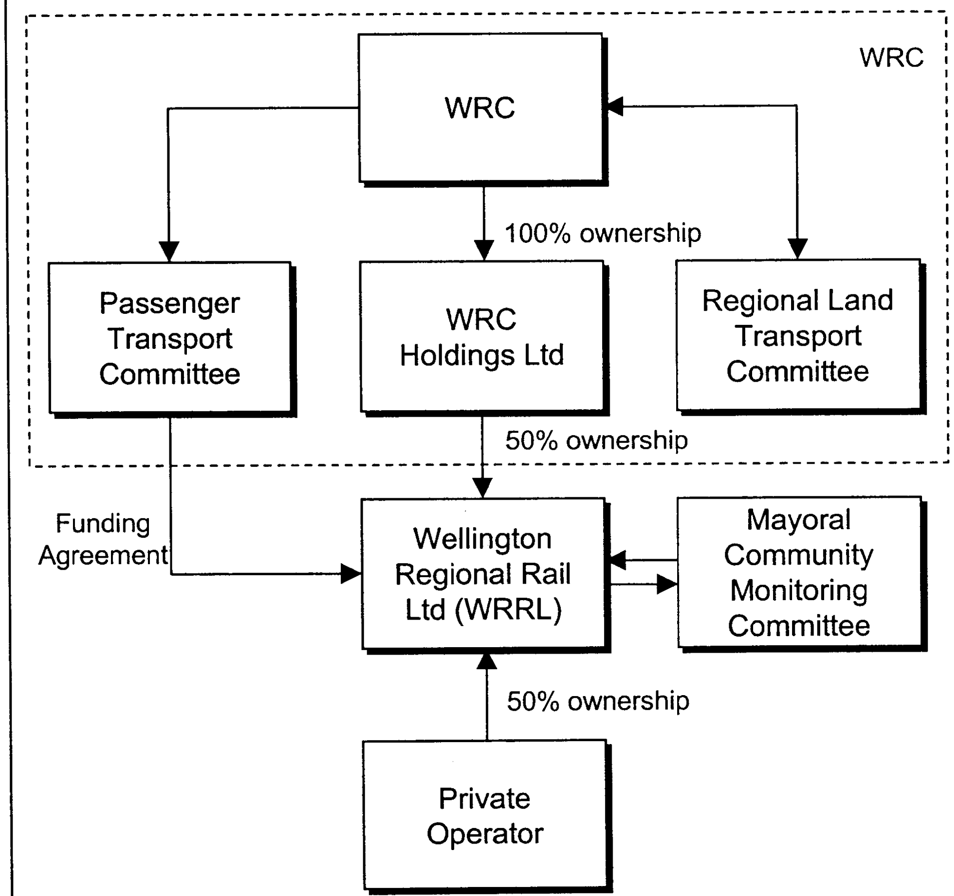
WRC has developed its preferred option which is based on a joint venture with a private operator (i.e. a "public/private partnership")

Key Features

- WRC would form a JV with a private operator following a contestable process
  - The operator would be selected based on, inter alia, their preparedness to sign up to the guiding principles of the JV
- The JV would negotiate with Tranz Rail to purchase Tranz Metro Wellington as a going concern with each partner providing 50% of the required capital
  - WRC would retain contingent control in the event that the two partners cannot agree ('C' share)
- A rail service contract between the WRC and WRRL would be established
  - This would include rigorous requirements for long-term asset management and information disclosure and would be a significant enhancement on the existing contract with Tranz Rail
- A Mayoral Community Monitoring Committee would also monitor the performance of WRRL from a user perspective
- The WRC would review its continuing ownership in WRRL after 5 years with a possibility of selling out, with the private operator having first option

Governance Framework for Wellington Urban Rail Services



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Booz·Allen & Hamilton was retained by the Tranz Rail Steering Committee(1) to provide a view on the robustness of the WRC proposal and other workable alternatives

Terms of Reference

- Booz·Allen is to produce a report which provides:
  - A view on the robustness of the WRC proposal
  - Views on other workable proposals (options)
  - Comment on governance issues
  - A conclusion on the best option, having regard to current circumstances and the identified evaluation criteria
- The engagement commenced on 10 September with a Draft Final Report due 21st September

Report Structure

- Introduction
- Option Development to Date
- Refinement of Options and Key Features
- Initial Assessment
- Discussion of Alternatives
- Conclusions

(1) Comprises representatives from Wellington Region TLAs and WRC

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Option Development to Date

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A number of ownership options were identified by the Region's TLAs and the WRC

Ownership Options

Options [1]	Key Features
1. A new private operator	▸ A private operator buys and operates Tranz Metro ▸ Likely to negotiate long-term access arrangements and pay a fee to Tranz Rail for use of track and other fixed infrastructure ▸ Effective continuation of the status quo in terms of governance and subsidy framework
2. A LATE owned by TLAs	▸ Shareholding by TLAs based on a formula ▸ Operational funding from WRC ▸ Similarities to initial Auckland proposal[2] ▸ Operation likely to be contracted to the private sector
3. A joint venture between WRC and a private rail operator	▸ 50/50 joint venture company (LATE) ▸ WRC partner selected on competitive basis ▸ Public sector has long term lease or owns outright the corridor infrastructure ▸ Conduct of the JV governed by Shareholders Agreement and company constitution which dictates, inter alia, long term commitment to rail, full transparency of finances ▸ Initial 10 year funding agreement specifies service levels, funding and investment and rate of return constraints
4. Full ownership by WRC	▸ 100% WRC ownership ▸ Contract out operation and maintenance
5. Full ownership by Central Government	▸ Central government acquisition of Tranz Metro Wellington ▸ Operation may be contracted to the private sector
6. Central Government owns corridor	▸ Central government owner of all infrastructure (tracks, signals, bridges, tunnels) ▸ Separate ownership of Tranz Metro operations

(1) Passenger Rail Options for the Wellington Region – No. 2; Discussion Document prepared by officers of WRC and various territorial authorities, 20 April 2001

(2) It is unclear whether the Central Government will retain any ownership in the final Auckland agreement

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Only two options were analysed in detail

Ownership Options Dismissed

Options	Reason for Elimination[1]
1. A new private operator	✓
2. A LATE owned by TLAs	▸ Uncertainty about the political support for the capital funding and governance commitment required ▸ The desirability of a direct shareholder relationship to link to urban management objectives is seen as less pressing than Auckland
3. A joint venture between WRC and a private rail operator	✓
4. Full Ownership by WRC	▸ The Regional Council does not feel it has sufficient expertise in the management of a passenger rail operation, and sees the option as too risky
5. Central government ownership	▸ A perceived reluctance of central government to "get back into the railways business" and operate trains
6. Central government owns corridor	▸ Evaluation of this option is not feasible (or appropriate) until its parameters (and likelihood) become clear

(1) Passenger Rail Options for the Wellington Region – No. 2; Discussion Document prepared by officers of WRC and various territorial authorities, 20 April 2001

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A further 'seventh' option was put forward by officers of the Hutt and Wellington City Councils

Ownership Options

Options[1]	Key Features
1. A new private operator	▸ A private operator buys Tranz Metro ▸ Likely to negotiate long-term access arrangements and pay a fee to Tranz Rail for use of track and other fixed infrastructure ▸ Effective continuation of the status-quo in terms of governance and subsidy framework
3. A joint venture between WRC and a private rail operator	▸ 50/50 joint venture company (LATE) ▸ WRC partner selected on competitive basis ▸ Public sector has long term lease or owns outright the corridor infrastructure ▸ Conduct of the JV governed by Shareholders Agreement and company constitution which dictates, inter alia, long term commitment to rail, full transparency of finances ▸ Initial 10 year funding agreement specifies service levels, funding and investment and rate of return constraints
7. Franchise option	▸ Public sector owns outright or has a long-term lease on the corridor infrastructure ▸ Operating assets acquired by the public sector and operation of the service immediately franchised to a private sector operator through a competitive progress for a fixed period ▸ Franchise/funding agreement administered by WRC covering term, investment, service levels, subsidy

(1) *Rail options for the Wellington Region – No. 3; Draft Discussion Document prepared by officers of the Hutt and Wellington City Councils, 18 July 2001*

The options were evaluated against a set of criteria which encapsulate the Local Authorities objectives in relation to the urban rail system

Evaluation Criteria

Criteria	Description
1. Safe operation of the network	▸ Desire for any new arrangement to at least maintain and preferably enhance the safety record for transport
2. Able to demonstrate value for money	▸ Typically related to contestability (ability to change supplier) and degree of financial transparency, to ensure that prices reflect efficient costs
3. Strong incentives for excellent service delivery	▸ Related to incentives to invest and ability to align rail operators rewards with service delivery
4. Clear lines of governance (accountability)	▸ Governance structure which provides clear lines of accountability and effective decision making
5. Minimises conflict of interest	▸ For example, potential conflict as funder of all modes and owner of one mode
6. Minimises public sector risk	▸ Desire to push risk to private sector where private sector is in the best position to manage the risk
7. Ensures long-term integrity of infrastructure	▸ Related to incentives to invest in long-term assets

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The evaluation by the local authorities did not lead to an unanimous choice as to the preferred option

Option Evaluation Results

Evaluation Criteria	WRC/TLA Analysis[1] (Option 1 vs Option 3)	Hutt/WCC Analysis[2] (Option 3 vs Option 7)
1. Safe operation of the network	Neutral	Neutral
2. Able to demonstrate value for money	Option 3	Option 7
3. Strong incentives for excellent service delivery	Option3	Option 7
4. Clear lines of governance (accountability)	Neutral	Option 7
5. Minimises conflict of interest	Option 1	Option 7
6. Minimises Public sector risk	Neutral	Option 7
7. Ensures long-term integrity of infrastructure	Option 3	Option 7

(1) Passenger Rail Options for the Wellington Region – No. 2; Discussion Document prepared by officers of WRC and various TLAs, April 2001
(2) Passenger Rail Options for the Wellington Region – No. 3; Discussion Document prepared by officers of Hutt and Wellington City Councils, July 2001

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The WRC strongly supported Option 3 while some TLAs believed Option 7 was superior

WRC Views	▸ The Council would "support neither the approach nor would it entertain the risks both financial and operational of [option 7]" (1) ▸ WRC see the benefits of Option 3 as follows: – Joint public-private ownership provides the ingredients for aligning commercial and public good objectives – Public engagement in ownership, at least during the transition period, will guarantee the long-term security of service provision – The accountability for use of public funds will be greatly improved – Public ownership would help with the integration of public transport across the region – Obstacles to rail patronage enhancement would be removed – Excellent and positive tension will be created between the WRC in its role as purchaser of services and WRC in its role as 50% owner of the provider of those services.
Hutt/WCC Views	▸ The Hutt and Wellington City believe that: – There are significant risks around the JV proposal because of likely higher costs, achievement of objectives will be difficult with the governance and accountability arrangements and we may get "locked in" to one supplier – The JV proposal raises fundamental conflict of interest issues if the Regional Council retains its role of overall funder of public transport services. The Regional Council will have a direct financial interest in a service that requires protection against bus services. – Most of the benefits of Option 3 could be achieved through Option 7 with significantly lower risks.

(1) *Letter from Stuart Macaskill to Ministers Cullen and Gosche, 24 July 2001*

Refinement of Options and Key Features

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The three options developed by the local authorities provide a reasonable basis for the analysis of feasible alternatives, although some refinement was considered worthwhile

WRC/TLA Options
1. Private operator
3. WRC/private operator JV
7. Franchise

Refined Options	Key Features
A Enhanced status-quo – New private operator	▸ As previously defined but use long-term funding commitment to leverage concessions from Tranz Rail
B Public/private JV – Negotiated procurement	▸ Public/private partnership with joint ownership of the operating company ▸ Negotiated procurement of rail services from the operating company by the WRC
C Initial public/private partnership followed by mandated franchise	▸ Transitional public ownership in partnership with a private operator prior to franchising of the operation

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A B C

A long term funding commitment could leverage concessions from Tranz Rail and overcome some of the deficiencies of the present arrangement

- There is no legal impediment to Tranz Rail selling to another private operator but the present arrangements, with no long-term funding commitment, are also sub-optimal for Tranz Rail and any potential purchaser
- The Tranz Metro business would be worth more to Tranz Rail with a long-term funding commitment attached to it – therefore Tranz Rail should be willing to give concessions to achieve it
- Possible concessions (depending on the term of the agreement) might include:
  - Commitment to invest in rollingstock renewal and other improvements
  - A defined performance regime with incentives and penalties
  - Greater information disclosure
  - Ownership of the corridor/track rights (for a fee)
- This option many provide the lowest risk for the public sector but may not provide a satisfactory long-term solution

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A B C

The public/private JV option as specified by the WRC is essentially a negotiated procurement model

- The WRC will negotiate a funding agreement with a preferred supplier of urban rail services
- The JV operating company will be the preferred supplier for a period of up to **10 years**
  - A formal contract renewal process will occur every 10 years with an expectation of renewal but with an ability to terminate the agreement
  - The agreement may be terminated at any time for poor performance
  - Resets on the subsidy levels occur every **5 years** having regard to, inter alia, the financial performance of the operator in the previous period
  - The public owner will review its ownership interest in the JV after **5 years**
- The Funding Agreement, which is a key element of the model, outlines, inter alia:
  - Subsidy levels (operating and capital)
  - Minimum service obligations
  - Information disclosure requirements
  - Performance regime
  - Rate of return constraints
- While the existing arrangements with Tranz Rail might also be considered a negotiated procurement model, the key differences to the status quo are:
  - A practical ability to terminate the funding contract and seek an alternative supplier
  - Mandatory information disclosure by the operator
  - A more effective performance regime
  - An operator of the WRC's choosing

The model is premised on a long-term partnership (between the purchaser and provider), but with buy-out and termination provisions to retain control in the public sector

- An ability to move to an alternative supplier would be achieved through several means:

Monopoly Access Rights

- From the outset, monopoly access rights are retained in public ownership
- Access contracted to the operating company (perhaps through the funding agreement)
- Some infrastructure assets may be leased to the operating company or sold with buy-back provisions (e.g. stations)

Joint Venture Shareholders' Agreement Buy Out Clauses

- Pre-emptive rights for both parties
- Agreed mechanism for valuing shareholding

Rail Services Contract Termination

- Termination of funding agreement
- Buy back provisions for critical operating assets (e.g. rolling stock)

A B C

Public ownership of the operating company is not an essential feature of the model in the medium to long term

- Public ownership in the operating company joint venture is a transitional arrangement designed to recover control of the rail business and mitigate risk
  - Some interim public ownership is required to gain control of the monopoly assets and to put in place a framework which will allow a change of supplier should the need arise
  - It will also assist in ensuring the operating company adheres to the spirit of the strategic partnership between purchaser and provider
- Beyond the short term transitional period, there is no compelling reason for retention of the operating company shareholding in the public sector
  - WRC has suggested that it does not see any strategic advantage in retaining a long term shareholder interest in the railway

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A B C

A franchising model maintains an 'arms length' relationship between the purchaser and provider

- The purchaser specifies the services to be purchased and then runs a competition having regard to, inter-alia, the prices offered
  - The franchise agreement would include similar attributes to the funding agreement - service levels, performance obligations, investment requirements etc
- The principal advantage comes from actually testing the market and being confident of obtaining the best overall value available
  - Notwithstanding the information disclosure inherent in the negotiated procurement model, one cannot ever be absolutely confident that the outcome obtained is the best available
- The design of the franchise will have regard to the risks which are best transferred to the private sector through the franchise agreement and the risks which are best retained in the public sector
- There is less flexibility in a franchise model (compared to a negotiated procurement or alliance model[(1)]), possibly making it more difficult and more costly to adjust if there has been a mis-specification of the services required
  - Mis-specification may occur because of incomplete information, changed circumstances or just because of mistakes
  - Typically a franchise director would actively monitor the franchise and could negotiate amendments to the franchise agreement at any time

(1) An 'alliance' model is characterised by a sharing of risk with open disclosure, usually with costs covered but a 'profit' margin at risk

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A B C

Implementation of a franchising option would be extremely difficult without a transitional period involving some degree of public ownership

- A successful franchising process would require considerable information covering all facets of the railway business
  - Uncertainty creates risk for both government and the bidders, raising the price and the potential for the operator to fail (which in turn creates serious issues for government)
  - The local authorities do not have much of the necessary information and would need to rely on Tranz Rail
  - We are not certain that Tranz Rail would have all of the required data, such as separate comprehensive accounts for Tranz Metro Wellington, asset condition data etc
- Establishment of Tranz Metro as a stand alone business will not be trivial and an operating history as a stand alone operator would be desirable prior to franchising
- The franchising agreements and supporting documentation would take time to properly prepare: it is unclear whether Tranz Rail would be prepared to wait or whether the local authorities could afford to let the present arrangements continue
  - The Melbourne franchising process took 31 months to implement from the time the decision to franchise was announced in March 1997
  - Although less complex than Melbourne, franchising of the Wellington urban railway would take at least a year to implement once the business had gained a reasonable history as a stand-alone operation
- During the transition phase, the relationship with the private operator would be fundamentally different
  - With a commitment to franchise, there would be no incentive for the private operator to invest

Initial Assessment

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All options have been evaluated <u>relative</u> to the WRC (public/private JV) option, using the criteria defined by the Steering Committee and one other criterion

Evaluation Summary

Additional criterion

Option	Safe operation of the network	Strong incentives for excellent service delivery	Minimises conflict of interest	Minimise public sector risk	Able to demonstrate value for money	Clear lines of governance (accountability)	Ensures long-term integrity of infrastructure	Minimise Transaction Costs
A. Enhanced Status-quo with new private operator	0	-	++	0	- -	0	- -	+
B. Public/private JV with negotiated procurement	0	0	0	0	0	0	0	0
C. Initial public/private partnership with mandated franchising	0	0	+	+/-	+	0	-	-

- - strongly inferior - inferior 0 neutral + superior ++ strongly superior

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All options will deliver similar outcomes in terms of safety

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	0
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	0

Safe Operation of the Network

- All options have clear lines of accountability
- Access arrangements with Tranz Rail will introduce additional interfaces but this is common to all options
- It might be argued that the public part of the public/private JV could ensure "surplus" expenditure is directed to maintaining the integrity of the rail system rather than as windfall for shareholders – but as the public partner could also be the provider of funding, it is more likely that funding levels would be adjusted to remove any surplus
- It might also be argued that a franchise will allow safety objectives to be more directly linked to commercial outcomes (through the performance regime and penalties for poor safety performance) giving a stronger safety case than options which require a loss of public confidence and patronage effect to impact the operator commercially
- On balance we believe the options are relatively neutral on the safety criterion

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The franchise and JV options will deliver the strongest incentives for excellent service delivery

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	-
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	0

Incentives for Excellent Service Delivery

- Partial public ownership will likely bring a greater commitment to service delivery than the status quo, given the greater focus of the public partner to social transport outcomes
- For any private operator, incentives for excellent service delivery are related to commercial outcomes
  - Excellent service will lead to increased patronage which will lead to improved profitability
- The construction of the public/private JV will need to ensure commercial incentives for excellent service delivery are preserved within a regime that 'caps' the profitability of the private operator
- A properly specified purchasing agreement may give even greater incentives through the direct linking of service delivery to commercial outcomes (i.e. through a penalties/bonus arrangement rather than through patronage)
  - Such regimes are more costly and complex to administer but would be feasible for both options B and C
- Overall we believe a public/private joint venture and a franchise option could be equally effective in providing incentives for excellent service delivery

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The status quo delivers the best outcome in ensuring minimal conflict of interest

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	++
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	+

Minimise Conflict of Interest

- A public owner may have a broad set of social and community objectives which may conflict with the commercial objectives underpinning the efficient and effective governance of its operating business
  - In practice, both real and perceived conflicts can be a problem
- Governments have tended to deal with this issue by clearly separating shareholder interests from portfolio interests (i.e. the purchaser/provider or funder/operator model)
  - In NSW Australia, the shareholders of the publicly owned freight railway are the Treasurer and the Minister for Sport and Recreation. The portfolio minister is the Minister for Transport who purchases non-commercial freight services by contracting directly with the freight railway
- The JV option has a clear potential conflict of interest which needs to be managed
  - A key issue is whether internal mechanisms (e.g. separation of roles and responsibilities) can be effective, or as effective, in dealing with conflicts of interest issues as full organisational separation
- The status quo has a delineation of the funder and operator of the urban railway and this separation is maintained with a franchising model
  - Under a franchise model, there may be some conflicts to manage at the time of franchising – protecting the rail franchise from competition may reduce overall funding requirements

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An analysis of the likely risk allocation under each option is not conclusive

Extent of Risk Allocated to the Public and Private Sectors

Risk	A		B		C	
	Public	Private	Public[1]	Private	Public	Private
Fare box/revenue risk	○	●	◑	◑	○	●
Operating/performance risk	○	●	◑	◑	○	●
Safety risk	○	●	◑	◑	○	●
Maintenance risk	○	●	◑	◑	○	●
Industrial relations risk	○	●	◑	◑	○	●
Subsidy funding risk	◑	◑	◕	◔	◑	◑
Regulatory risk	○	●	◑	◑	●	○
Cost inflation risk	○	●	◑	◑	○	●
Investment risk	●	○	◕	◔	◑	◑
Transition risk	N/A	N/A	◕	◔	●	○

With a fixed period franchise, regulatory risk will typically stay with government

With a franchise it is likely more of the investment risk could be pushed to the private sector

Some of the transition risk could be pushed to the private sector under the JV option

(1) Includes both 'funder' and 'owner' risks – public ownership may be sold down over time shifting more risk to the private sector

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The option which minimises public sector risk is therefore less clear cut …

- Prima-facie, the enhanced status-quo minimises public sector risk because the private sector is fully responsible for the management, operation, maintenance and development of the railway system
- Because the governments (central and local) cannot afford, either politically or economically, to let the Wellington urban rail services ‘fail’, it could be argued that ultimately all material risks will fall to government
  - While this might be the case, there are some risks which are better managed in the private sector
- Public private partnerships have developed in recognition that some risks are better managed in the public sector and some risks are better managed in the private sector
  - In urban transport, it is rare to find examples of a 50/50 joint venture where the public and private sectors share all risks equally
- Both options A and C imply an allocation of risk between public and private sectors, although the allocation of risk may not be optimal
  - Under the status quo the public sector bears much, if not all, of the investment risk
  - A franchise option may inadvertently also seek to push too much risk to the private sector
- In this situation there is an additional risk to be considered for any option which involves public ownership which is the risk associated with the transition
  - Transition risk will include asset condition, access agreements, lease agreements etc.

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... with the outcome depending on the weight attributed to the short term transition risks

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	0
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	+ (long term) - (transition)

Minimise Public Sector Risk

- Some risks are better managed in the private sector – this criterion therefore reflects the extent to which such risks would be borne by the private sector
- Under the WRC JV proposal:
  - A one year discovery period is proposed which would see all risks borne by the funder (WRC)
  - A four year funding agreement would then be put in place which transfers most of the risks associated with operating the railway to the JV company (50% public/50% private)
  - Arguably, the public sector is still bearing the majority of risk during transition through its funding role and it ownership role
- Under the franchise option, the public sector is likely to bear 100% of the risk during the transition phase
- The real value of the private operator JV during the transition phase is the likely reduction in aggregate risk
  - E.g. assisting with the due diligence of Tranz Metro and the negotiation of the various commercial agreements likely to be required
  - While this expertise could be acquired under contract for a fee, the private operator having a direct commercial interest is a stronger incentive

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The franchise option is most likely to deliver the best value for money because it involves greater competition

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	- -
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	+

Deliver Value for Money

- Value for money is assured when prices reflect efficient costs
- The enhanced status-quo generally gives little comfort of value for money because of the lack of transparency and having to deal with a monopoly supplier of rail services
- The PP JV gives greater comfort because of the transparency and insight which comes from a negotiated procurement model and to some extent from the ownership interest. Incentive arrangements and sharing of benefits would encourage on-going efficiency
- A franchise model delivers value for money through the competitive process (i.e. competition for the right to operate the service)
  - The benefits of more competition must be weighted against the higher transactional costs involved in franchising
- On balance, we believe a franchise model is more likely to deliver value for money than a public/private JV, where there is limited price competition to select the private partner and once selected, the private operator has a privileged position
  - The purchaser of transport services is never sure whether the negotiated deal is the best available

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There is no significant difference between the options in terms of clarity of accountability provided the PP JV has appropriate governance arrangements

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	0
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	0

Clear Accountability

- This criterion relates to governance structure which provides clear lines of accountability and effective decision making
- Both the enhanced status quo and franchising options have clear lines of accountability for the operation of the railway business
  - Private sector operators are focused on creating shareholder value within certain constraints (minimum service requirements, funding agreement etc)
- The lines of accountability for the public/private JV are a little more ambiguous, depending on the nature of the governance arrangements
  - This issue can be effectively managed with appropriate governance arrangements for the public shareholding interest

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The public/private partnership is more likely to ensure the long-term integrity of the infrastructure

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	- -
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	–

Ensures Long-term Integrity of Infrastructure

- Under the enhanced status quo, there is relatively little incentive to invest for the long-term
  - Operator focus will be on maximisation of financial returns, particularly if there isn't a long-term funding commitment
- There might be issues with 'gifting' the benefit of public investment expenditure to the PP JV (and the private operator) without a contestable process to ensure the public sector recovers as much of the benefit as possible
- The franchise option generally has less flexibility to deal with changes in business scope than a public/private partnership
  - If the Government wanted to enhance the quality of rail infrastructure or expand services it would have to work within an existing franchise agreement
- Incentives for the franchise to invest near the end of the franchise period may be reduced unless there are appropriate buy-back/compensation arrangements in the franchise agreement (which are difficult to write)
  - In some cases, an extension to the franchise term may be negotiated in return for certain investments being made

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An additional evaluation criterion relevant to an analysis of ownership and contracting options is the desire to minimise transaction costs

Option	Initial Assessment
A. Enhanced Status-quo with new private operator	+
B. Public/private JV with negotiated procurement	0
C. Initial public/private partnership with mandated franchising	–

Minimise Transaction Costs

- Transaction costs include the costs of establishing and monitoring the contractual framework
  - Typically transaction costs increase with the complexity of the governance arrangements
  - Increased costs from a more complex contracting arrangement are normally offset by the benefits from greater competition, innovation and supervision
- The potential benefits from a more complex contractual framework are a function of the scale and scope of the operating business
  - The Wellington urban services are about one tenth the size of the total Melbourne rail passenger business (rail and tram) and about half the size of the smallest franchise
- Both of the public ownership options will involve greater transaction costs than the status quo, although franchising will be more costly to establish and monitor than the public/private JV

Discussion of Alternatives

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The strengths and weaknesses of the franchise and JV options are finely balanced, so a closer examination of the key attributes of each option is required

Evaluation Summary

Evaluation Criteria	Option		
	A Enhanced Status quo	B PP/JV	C PPP/ Franchise
1. Safe operation of the network	0	0	0
2. Incentives for excellent service delivery	-	0	0
3. Minimise conflicts of interest	++	0	+
4. Minimise public sector risk	0	0	+/-
5. Deliver value for money	- -	0	+
6. Clear accountability	0	0	0
7. Ensure long-term integrity of the infrastructure	- -	0	-
8. Minimise transaction costs	+	0	-

- None of the options is clearly dominant hence the need for a closer examination of each option
- The best performing option would be very dependent on the relative weightings given to the various evaluation criteria
  - Any such weighting is highly subjective
- There might also be measures which can mitigate many of the disadvantages of an option, influencing the overall assessment

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Each option has some significant weaknesses

Major Weaknesses of Each Option

A. Enhanced Status Quo

- Inability to deliver value for money
  - Particularly if changes in government objectives require modifications to the funding arrangements
- Failure to ensure long-term integrity of Infrastructure
  - Lack of incentives for operator to invest

B. Public/ Private JV

- Conflict of interest issues
  - WRC funder and part owner/operator of WRRL
- Weak contestability and potential “lock in” to initial JV partner

C. Public/Private Partnership with Mandated Franchise

- Higher risks during transition period
- Poor investment incentives towards end of franchise period
- Higher transaction costs (establishment and monitoring)

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A B C

Even if an appropriately tailored long-term funding agreement were established, the Enhanced Status Quo offers little leverage for WRC to ensure overall transport objectives are achieved

- A funding commitment of a least 15 years is likely to be required to prise any meaningful concessions from Tranz Rail
  - This would be sufficient to encourage commitments to some rolling stock upgrades but unlikely to cover any significant infrastructure enhancements
- All of the public sector leverage is lost once the initial contract is signed
  - This places a strong onus on the initial contract negotiations to cover all contingencies
- It is possible that once the Tranz Metro business is sold to an operator more committed to the urban rail business, a more productive negotiating environment might be forthcoming
  - The new operator will likely have the same commercial imperatives and will enjoy the same modal monopoly as Tranz Rail
- To get the investment incentives right requires a longer term funding commitment, but the longer the funding commitment the longer the period the WRC has zero leverage with the operator
- Government regulation is probably the only available mechanism to mitigate the deficiencies of this option
  - Regulation could be justified because of Tranz Metro's monopoly and the significance of rail transport to the region
  - It is unclear whether appropriate incentives could be maintained in a regulated environment

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A B C

Multiple responsibilities of WRC relating to regional rail services create the potential for conflicts of interest in option B

WRC Roles and Responsibilities

Responsibility	Comment
Regulatory	▸ WRC determines, in consultation with RLTC, policy and its implementation in relating to service (bus vs rail) competition and/or coordination: – Determines overall policy – Accepts or rejects commercial service notifications – May/may not contract individual services ▸ Policy adopted and its manner of implementation are liable to have significant effects on rail service revenue and subsidy requirements ▸ WRC has a major role in setting fare structures and fare integration/coordination policies and practices within the region – This may have significant impact on attractiveness of bus-rail transfer trips, and hence on rail service revenue and subsidy requirements
Funding	▸ WRC is responsible for the funding of non-commercial public transport services and infrastructure in the region – As part of this role it funds regional rail services – About 45% of total funding comes from subsidy; of this amount about 60% is recovered from Transfund, about 40% through regional rates
Ownership	▸ Option B involves WRC in having a 50% shareholding in WRRL, which will own and operate the rail system ▸ Current legislation prohibits regional councils from holding an interest in any transport undertaking – This legislation was designed to prevent arrangements such as that being proposed by WRC, in order to avoid conflict of interest ▸ Government thinking about the need for complete separation of funder and provider roles in all situations is now perhaps more flexible than the current legislation allows

A B C

The WRC proposal includes governance arrangements designed to reduce any conflict of interest problems ...

Key Features of the Governance Model

Feature	Comment
▸ A holding company would manage WRC's ownership interest in the rail operation receiving regular (at least quarterly) reports from WRRL	– WRC Holdings Ltd currently manages WRC's other shareholding interests – Councillors hold seats on the Board; minimum 2 external directors
▸ A Statement of Corporate Intent (SCI) and business plan would be established by WRRL for approval by WRC Holdings Ltd	– This would set out its objectives, policies and performance targets
▸ WRC director appointments to the WRRL Board would be based on skills and expertise	– 3 WRC directors, 3 private directors – No councillors or WRC officers permitted on the Board – C-share and the right to appoint a seventh director held by WRC (likely that private operator will want to limit possible application of C-share)
▸ The regulatory policies (as set out in the RLTS) are determined by the Regional Land Transport Committee	– Comprises representatives from a wide range of organisations with interests in transport in the Wellington region – The implementation of these policies and the funding of services and infrastructure are undertaken through the WRC Passenger Transport Committee
▸ A Funding Agreement would be established between WRC and WRRL and administered/monitored through the Passenger Transport Committee	– This would include rigorous requirements relating to information disclosure, which would facilitate monitoring of performance by the Committee
▸ A Mayoral Community Monitoring Committee would also monitor the quality of service provided by WRRL	– Inter alia, this Committee could be expected to raise concerns if the conduct of WRRL appeared to be inconsistent with the Community Charter

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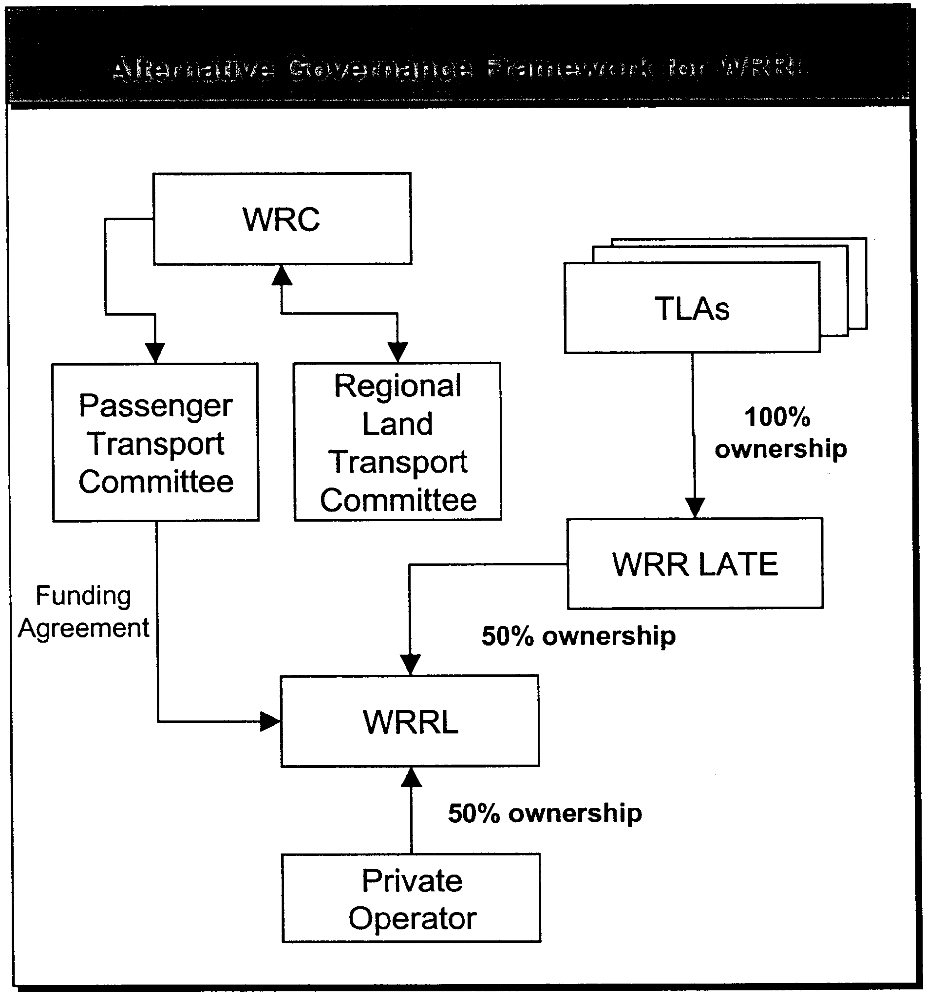
A B C

Separate ownership by TLAs is an alternative mechanism for dealing with the conflict of interest issues, but is probably sub-optimal



- The TLAs would hold the 50% public ownership through a LATE
  - There would be no councillor directors on the LATE board to ensure appropriate skills are in place
- WRRL may have considerable on-going funding requirements
  - In part funds could be borrowed by WRRL, underwritten by a long-term funding agreement with WRC
  - But further equity injections may be required, with different TLAs having varying appetites for investment in the railway –TLAs may also be reluctant to levy ratepayers directly, potentially starving the railway of capital
- The LATE Board would be obliged to take direction from the elected representatives of their public owners with the diffuse shareholding possibly leading to protracted decision making
- To the private operator, the relative attractiveness of the TLAs as a JV partner is likely to be much less
  - The "added value" to WRRL from a TLA shareholding is unclear (e.g. commitment and interest in urban rail, expertise, source of capital?)

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A B C

On balance, the joint funder/owner responsibilities of WRC is insufficient cause for ruling out the WRC JV proposal

- It is acknowledged that the potential conflict of interest would need to be managed and the proposed governance arrangements are as robust as could be expected
  - Overall, WRC's proposed JV governance arrangements (including ownership structure, board membership, monitoring and reporting) are not inconsistent with the comments and recommendations given in the recent Auditor-General report on the governance of local authority commercial trading enterprises
- As central government is an unlikely participant, particularly in the operation of the railway, that leaves only the TLAs as an alternative public owner
- A TLA-owned LATE as the public owner has a number of disadvantages relative to WRC ownership
  - Mixed commitment and interest in urban rail operation and ownership
  - Mixed ability and commitment to meet on-going capital requirements
  - More fragmented shareholding, which may prejudice effective decision-making
  - Relatively less attractive to a private operator
- Pursuit of a TLA ownership arrangement in order to enforce an organisational separation of funder/owner is probably therefore unwarranted
- A key issue is whether the arrangements can be easily changed if they prove to be ineffective
  - This may require a formal acknowledgement in the JV agreement that the public shareholder could change to another public authority (requiring approval of the private operator?)
  - If the TLAs are unduly concerned about the potential conduct of the WRC as both the owner and funder of the urban railway, they could seek an option to purchase the WRC shareholding after a defined transition period

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A B C

A significant drawback of the present PP JV proposal is that contestability is relatively weak with the potential to be "locked-in" to the initial JV partner

- The initial competition will be a "beauty contest" with many unknowns
  - Track record and willingness to sign up to the Funding Agreement, Shareholders Agreement and the company constitution will be the primary criteria
  - There will be little, if any, price competition
- The private operator will join WRC to negotiate the sale price with Tranz Rail
  - The private operator may have little incentive to negotiate hard on the sale price given that WRC, as a partner in the negotiation, will almost have to guarantee to fund the railway to the extent required to deliver a commercial return on the private funds invested
- Once the private operator has invested in WRRL, it will have ownership rights which may be difficult to recover
  - The private operator will be required up-front to pass access rights to the WRC for an agreed consideration
  - Notwithstanding the termination provisions, the private operator will require adequate compensation arrangements for their stake in the business
- Transfund may also be more reticent to provide long-term funding commitments if it believes that the JV proposal does not satisfy CPP requirements

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A B C

The WRC proposes to include a buy-back clause for the rolling stock in the funding agreement as a means of securing an ability to change operators

- The funding agreement is seen as pivotal in the WRC retaining an ability to change operators if the rail operator is performing below expectations
  - The WRC may elect not to renew the funding agreement after 10 years, triggering the buy-back provisions for the rolling stock
  - It is unclear the extent to which the private operator would be compensated for the rest of the 'business' which would be lost
- Failure to renew the funding agreement would be an extreme measure – presumably if such action were warranted, the JV partnership (if still in existence) is likely to have deteriorated well before that time, with implications for level of service and investment
- An issue is whether 'turning off the funding tap' is a reasonable mechanism for dissolving an under-performing funder/operator partnership (e.g. where operating performance may not be extremely poor but perhaps mediocre)
  - The WRC may offer to buy out its private partner but the offer may not be accepted
- Arguably, the WRC proposal is deliberately framed in the spirit of partnership with no easy divorce
  - Both parties need to be committed for it to work
  - But this makes the selection of partner extremely important – with only a limited courtship

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A B C

There are few options for dealing with the weak contestability of the PP JV proposal other than moving to a franchise model

- Benchmarking is one mechanism for testing the efficiency of operations but is generally crude and relatively ineffective
  - There are many reasons, unrelated to productivity and efficiency, why the costs of one rail operation will differ from another, including economies of scale, level of service objectives, design standards, age and technology of major assets
- The WRC negotiated procurement model relies heavily on incentives and transparency to ensure efficient service delivery
  - It is unclear to what extent efficiencies will be encouraged given regulation of the rate of return
  - The funding agreement can provide incentives to grow patronage and earn returns in "excess" of the base rate of return
- Ultimately, a competitive process is required to be assured of efficiency and value for money
  - Recognising that competition 'within the market' is impractical (i.e. competing train services), a franchise establishes a processes to compete 'for the market' for a defined period
  - 'Peer competition', involving published performance comparisons between 2 or more operators, would not be sensible in Wellington given the size and structure of the rail system

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A B C

A franchise would however fundamentally change the relationship with the private operator and increase the risks in the transition period

- Having a private operator involved up-front is important in order to:
  - Assist with the negotiations and due diligence of Tranz Rail – with separation of Tranz Metro a myriad of lease/access and operating agreements may be required
  - Provide operating and management expertise during the transition period (in purchasing Tranz Metro as a going concern, it is unclear the extent to which sufficient management and operating expertise would transfer with the business)
  - While Tranz Rail may be encouraged to act in a caretaker role, it is likely it will want to exit the business in the near term
- With an intention to franchise within 3 years (say), there will be little incentive for the private operator to invest capital in the business
  - The public owner would need to fund 100% of the acquisition cost for Tranz Metro
  - In the lead-up to a franchise process, the public owner may also have little incentive to invest
- An operating/support contract could be established with a private operator for the transition period
  - The private operator's compensation could be fee for service or linked to the outcomes of the franchise competition – if they win they get nothing, if they lose they get compensated on an agreed basis
  - Early involvement in the business may advantage the operator in the subsequent franchise competition and provide strong incentive for them to perform well over the transition period

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A B C

With any fixed period franchise, there are concerns about how to ensure the proper incentives are maintained towards the end of the franchise period

- As the end of the franchise draws nearer, the operator's incentive to invest will be reduced because the full benefits may not be able to be captured
  - This issue requires adequate compensation arrangements to be negotiated up front in the franchise agreement or negotiated during the franchise period (e.g. through buy-back provisions or extending the term of the franchise)
- The risk of value being stripped from business towards the end of the franchise period which needs to be considered
  - This is generally dealt with by specifying the minimum condition of assets when they are returned to the government at the end of the franchise period
  - An asset monitoring regime is put in place to monitor condition, particularly in the lead-up to the termination of the agreement
  - Security bonds/bank guarantees are put in place to protect against default by the operator
- In the UK, franchises have been re-let before full term for a variety of reasons
  - Loss-making operator - in Sheffield the operator voluntarily surrendered the franchise
  - System extension - in Manchester the authorities had the power to refranchise at the time of making arrangements for system extension
  - Urgent need for investment – the rail franchise director invited operators to offer major investments in return for franchise extension but sought alternative bids on the basis of buying out existing franchisees

A B C

Establishing and monitoring a franchise process can be costly, although Wellington can benefit from experience elsewhere

- Transaction costs incurred when establishing the franchise and when monitoring compliance over the franchise period
  - The quality of outcomes achieved will be directly correlated to the quality of the franchise structure and the associated documentation
- Given many of the transaction costs will be the same whether the franchise is a 100 million passenger railway or a 10 million passenger railway, the scale of the business (and hence the potential quantum of benefits) needs to be considered
- There are precedents however for rail operating franchises of a comparable scale to Tranz Metro Wellington (and smaller)
  - UK Strategic Rail Authority lets Island Line as a self-contained franchise
  - In Sweden, local authorities let franchises for small groups of regional services
  - Modest light rail franchises have been let or relet by local transport authorities (e.g. London Docklands, Manchester, Sheffield, Birmingham)
- There are many recent rail franchise precedents (UK, Melbourne) so concepts and documentation would not have to be created from scratch
  - Also, there is now more of an understanding of what works well and what doesn't

Conclusions

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The key differentiating factor between the three options is not ownership but the nature of the relationship between the funder of rail transport services and the rail operating company

Option	Nature of the Funder/Operator Relationship	
A. Enhanced Status Quo – New Private Operator	**"Adversarial"**	▸ Sole source monopoly supplier ▸ Lack of trust on both sides ▸ Minimal transparency
B. Public/Private JV with Negotiated Procurement	**"Alliance"**	▸ Negotiated price and quality ▸ Sharing of all risks with preferred supplier ▸ High degree of disclosure and transparency throughout
C. Initial PPP with Mandated Franchise	**"Managed Competition"**	▸ Competition based ▸ Selective allocation of risks to private sector

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An enhanced status quo would not allow a reasonable purchasing framework for WRC

- Even with a new operator in place, the deficiencies of the current purchasing framework are likely to remain
  - Lack of transparency leading to value for money concerns
  - WRC bears all investment risk
  - Inadequate incentives on both sides
- Without government regulation, there is no means to overcome these deficiencies without resorting to non-rail alternatives (e.g. more buses adding to urban congestion)
  - There is no indication the Central Government would be willing to regulate urban rail services
- Even a Central Government takeover of the monopoly track assets is unlikely to offer a feasible solution
  - Ownership of the rolling stock would form a formidable barrier to entry
  - A multi-passenger operator environment is impractical
  - Even if WRC funding were withdrawn, the operator may elect to operate some commercial rail services restricting the WRC's ability to viably engage another operator

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Longer term, the franchise model is likely to deliver superior overall results ...

- A managed competition model would allow periodic contestability of the operating contract to ensure the best available result can be achieved, having regard to the mix of outcomes sought and constraints imposed
- A franchise would also allow selective allocation of risks to the private sector and a competitive process for the pricing of these risks
  - A negotiated funding agreement under the JV model would similarly allow the selective allocation of risks to the private sector (albeit shared) but with no competitive process to price the risks
- While the up-front transaction costs are typically greater in a franchise model, the benefits are dynamic and enduring (i.e. enjoyed year after year)

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... but the issue is how best to transition to the franchise model

- An immediate move to franchising is impractical given the Local Authorities currently don't own the railway and would need to properly set up Tranz Metro Wellington as a stand-alone business and collect the information needed to develop the franchise
  - To move to a competition-based model with significant uncertainty is likely to lead to a sub-optimal outcome in terms of both price and risk
- While Tranz Metro Wellington would be acquired as a going concern, separation from Tranz Rail may not be trivial
  - There may be shared systems which need to be duplicated or replaced (if a myriad of service agreements with Tranz Rail are to be avoided)
  - Long-term access agreements will need to be negotiated, covering a range of operational, performance and financial issues
  - Interview and transfer of staff would need to be effected
- Some operating history as a stand-alone entity would be desirable prior to franchising to establish performance benchmarks and minimise uncertainty for the bidders
  - Information needed to develop the franchise would include operating costs, asset condition, maintenance history etc

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A 'fast track' transition to managed competition could be achieved via a short term operating support contract

- The relationship with the operator would be fundamentally different to that envisaged under the WRC JV proposal
- An operator would be retained on contract for the period of the transition
  - In our view, a transition period of 3 years is a reasonable expectation, but it may be shorter if data limitations prove to be minimal
- The operator would be required to manage the transition from Tranz Rail and to setup and operate the rail business as a stand-alone enterprise
  - Their remuneration would be cost plus or a success-based management fee
  - Almost all of the risk would fall to the public sector
- While a good performance on the operating contract would advantage the operator in the subsequent franchise competition, it is likely that the operator would manage in a 'caretaker' capacity
  - They would be unlikely to initiate (or be allowed to initiate) actions which had material longer term implications for the railway
  - The operator would likely save any cost or revenue initiatives until the franchise process

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The negotiated procurement framework proposed by WRC would have a number of advantages, albeit involving a longer transition period ...

- The negotiated procurement framework inherent within the WRC JV proposal has three major advantages
  - It ensures strong operator commitment from the outset through the initial 10 year funding agreement
  - The high degree of transparency which underpins an alliance type arrangement is well suited to contractual situations where, at the outset, information is poor
  - It facilitates an immediate start to service improvements (rather than the danger of a 'caretaker' operation for up to three years pending franchise)
- The WRC proposal would give greater confidence that the Tranz Metro business would be properly set up as a stand-alone business to operate effectively over an extended period
  - Strong operator commitment is important because of the uncertainties surrounding the establishment of Tranz Metro as a stand-alone operation
  - For instance, a new operator may have to import or buy a new system to replace an existing Tranz Rail shared system
- A relatively longer transition period will be necessary in order to encourage the operator to make the degree of commitment, and possibly investments, required to manage the transition from Tranz Rail

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... but we would be cautious about locking into the JV partner

- While the negotiated procurement model might be a sensible approach for the short/medium term, it is doubtful that it will endure in the long term and deliver consistently superior results
- Retention of the ability to franchise the operation is therefore vitally important
- Although the WRC option provides a mechanism for a potential change of operator, we are concerned that the process may be too difficult and so would be considered only as a last resort
  - There are outstanding questions about the buy-back arrangements for critical assets (which assets and how will the buy-back mechanism work?)
  - What happens to the operator's equity in the business and the non-core assets if the funding agreement is not renewed? - would the incumbent have a significant advantage in any franchise process?
  - Would potential bidders be at a significant information disadvantage relative to the incumbent?
  - Is all of the necessary information to franchise the business going to be collected and where would it be held?

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The more complex the issues to be addressed, the more the WRC JV option is favoured for the transition ...

- The more complex the transition issues, the higher the risks and potential costs
- The alliance procurement approach, inherent in the WRC joint venture option, allows establishment issues to be addressed with a high degree of transparency and with a view to the medium to long term (as the operator will have to operate within the new arrangements for at least 10 years)
- The question is whether the benefits of the alliance approach during transition outweigh the benefits from running a full contestability process (franchising) sooner[(1)]
  - The former is mostly related to managing complexity and risk
  - The latter is mostly related to achieving efficiency and innovation from competition
- Having a private operator with a 10 year commitment to operate the business involved in the negotiations with Tranz Rail and the establishment of the stand alone railway company must be a significant advantage relative to an operator with a 3 year support agreement
- The high degree of transparency and performance obligations required by the WRC purchasing agreement would mitigate any potential additional costs over the extended transition period
  - Because Tranz Metro has already been in private ownership, efficiency benefits following franchising are likely to be less in Wellington than experience elsewhere (where typically the railway is moving from public ownership for the first time)

(1) The initial selection of an operator is based on non-price criteria

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There is insufficient information to make an unequivocal choice of the preferred model for the transition period

- The difficulties in establishing Tranz Metro Wellington as a stand-alone business has not been analysed
  - This will include the extent to which it would require new systems, modification of existing systems or creation of new contractual agreements, staff allocation and transition issues
- There is also a lack of understanding of the information likely to be available from Tranz Rail to support a franchising process (although WRC's believes it will be minimal)
- In our view, both the WRC proposal and an operating support contract are reasonable approaches which can achieve an effective transition to a franchising model
  - If a decision on the way forward had to be taken quickly, we believe the downside of incorrectly choosing one approach over the other is likely to small
- If the WRC JV proposal is pursued, a key requirement should be that the JV and funding agreement be established with an intention to franchise at the end of the initial funding period

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Ultimately the best option may depend on the deals that can be cut with the private operator and Tranz Rail

- WRC has 'road-tested' its initiative (including draft documentation) with various private operators and received general support for the approach, albeit qualified
  - A summary of operator comments is attached as Appendix A
- At least one operator has suggested the documentation is biased in favour of WRC and not in keeping with the spirit of a 50/50 partnership
- With the WRC option, there are a variety of important issues yet to be resolved, such as
  - The mechanism for determining a reasonable rate of return for the operator
  - The buy-back provisions for the critical operating assets
  - Incentive mechanisms and performance regimes
  - Restrictions on use of the 'C' share
  - How the access rights would be valued separately from the overall business
- If WRC is forced during operator negotiations to give away too much in terms of risk or control, then the franchise option becomes a more sensible alternative, even with the current data limitations
- Similarly, in negotiations with Tranz Rail, there must be a price threshold above which it is sensible to stay with the status quo

If it is decided to pursue the WRC option, then should the operator negotiations prove to be unsatisfactory, the near term franchise would be an effective fall back option

- Initiate the WRC model with a funding commitment to the preferred operator of up to 10 years (consideration should be given to a reduced period depending on the type of investment commitments envisaged during the transition phase)
- Ensure the JV agreement and the funding agreement allow an easy transition to franchising
- Should the operator negotiations not proceed satisfactorily (ie meet expectations in terms of risk and performance), Plan B is a viable alternative

PLAN B

- Establish an operating/support contract with an operator for up to 3 years
- Acquire Tranz Metro and franchise as soon as possible

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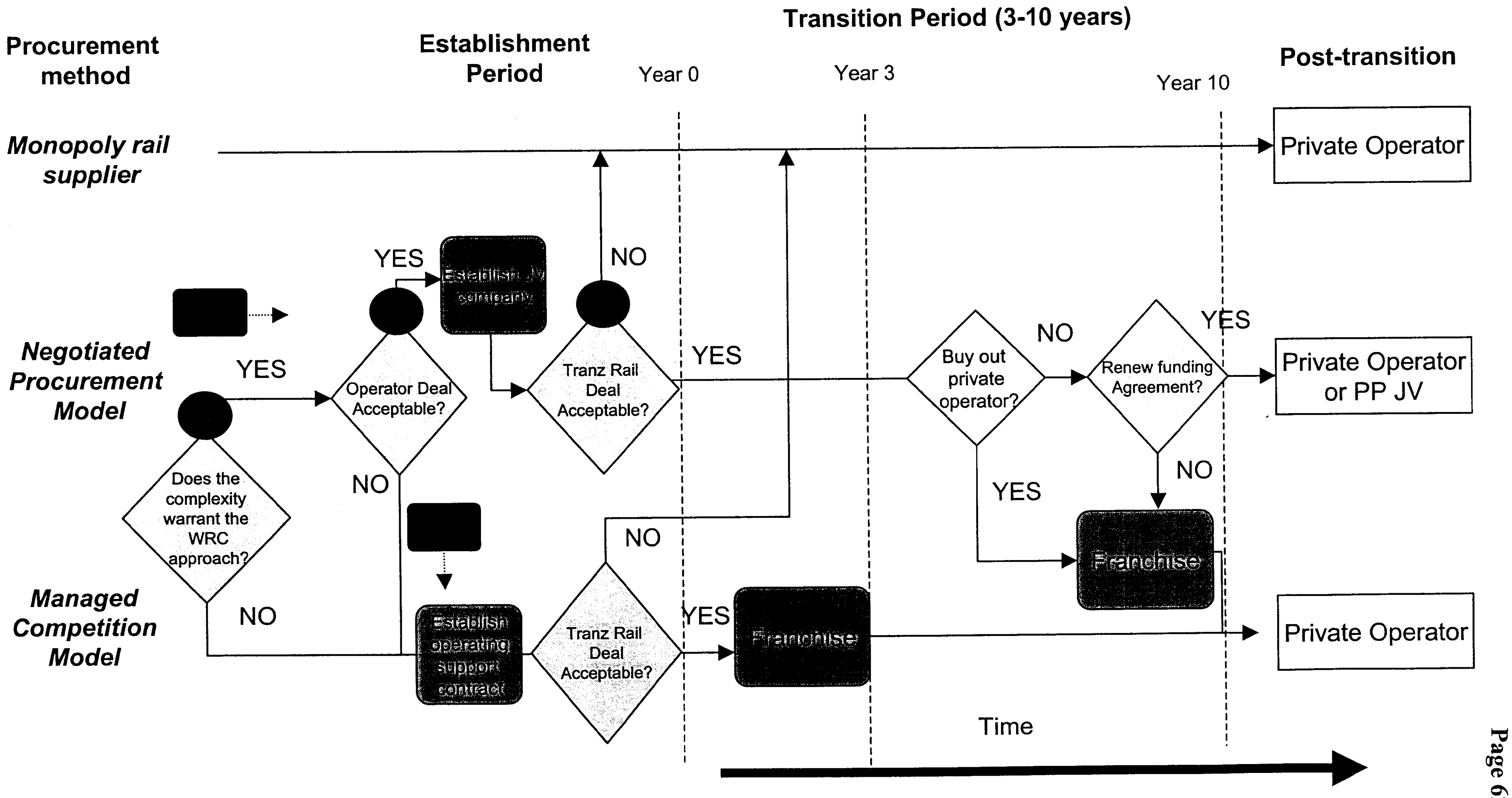
Three critical decisions need to be taken in order to confirm the final procurement and governance model



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Several important issues need to be resolved at an early date whichever model is proposed

- The Central Government position on track issues needs to be clarified
  - If there is to be wider Central Government involvement in taking ownership of track assets from Tranz Rail, this will have an important bearing on the structure of the preferred model
- The authorities involved in public ownership of the rail operating company needs to be confirmed
  - For WRC involvement, a legislative change is required
- Available funding needs to be confirmed
  - The capital commitment required to acquire the Tranz Metro business is uncertain but some upfront capital outlay will be required
  - A long term commitment from Transfund must be secured

Appendix A

- Summary of private operator feedback on the WRC model

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The WRC has "road tested" its proposed model with several private rail operators and received a variety of comments

Summary of Private Operator Comments

Issue	Comments
Overall	Support the concept and confident partnership is workable Some aspects of draft documents biased in favour of WRC
Rate of Return	What would be the mechanism for determining "low" rate of return? How will WRC ensure that the private partners risk is low? Suggest inclusion of bonuses for increasing patronage over and above a certain threshold There are drawbacks to rate of return regulation Concern about assertion of low risk with open-ended capital funding, board control funding resets
Capital Commitments	Open-ended, expect to be more closely specified at the outset
Funding	Funding uncertainty and risks created by five year resets Concerned about CPP compliance issues and termination conditions
Governance	Concern about scope of application of C share (does not reflect the 50:50 partnership)
Transition	Business separation will take time and due diligence may be insufficient to address risks

Some suggested modifications were received

Some Suggestions

- Possible separation of asset ownership from operating contract and a franchise-based approach
- Initial two year discovery period to reduce risk for all partners
- Longer subsidy resets to encourage investment
- Per passenger subsidy to encourage growth and drive improvement
- Incentives to improve efficiency and invest in service quality (e.g. CPI-x)
- Possible use of alliance model for major capital works