

Report 1: Structural Options

To: Rail Development Group

From: William Peet [WITHHELD UNDER SECTION 9(2)(a) of the OFFICIAL INFORMATION ACT 1982]

Date: 21 August 2008

Executive Summary

Ministers have directed that the Rail Development Group consider operations issues and make recommendations to them for approval.

This paper recommends merging the two organisations under one Board, with multiple business units and a Group Chief Executive. It also recommends that the Board be accountable for the implementation of the new organisation including determining the exact number and focus of individual business units to operate within the entity.

It also proposes creating an establishment unit to provide advice on policy and implementation to the organisation. The unit would include representatives from NZRC (being the merged KiwiRail and ONTRACK) and relevant central government agencies (which would continue to report to their own Ministers). The Board would then provide advice to Ministers in the normal way.

Recommended Action

I recommend that you:

- 1) **Note** this paper;
- 2) **Recommend to Ministers that they:**
 - a) **Approve** an internal separation model for the Crown's rail businesses, with New Zealand Railways Corporation as the holding company;
 - b) **Approve** NZRC purchasing KiwiRail Holdings Limited on terms the same or similar to the Crown's acquisition from Toll by injection of equity;
 - c) **Approve** appointment of the Directors of KiwiRail Holdings to the NZRC Board;
 - d) **Note** that the Board will make sure that an establishment team is rapidly put in place to provide advice on:
 - i) Business plan, including fine-tuning the subsidy contract for non-commercial services;
 - ii) Inter-group charging and performance regime;
 - iii) Termination of the NRAA and related contracts;
 - iv) Pricing strategy [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982];
 - v) Arrangements for ownership of metro rolling stock;
 - vi) Tax effect of funding mechanisms and appropriate status of various entities;
 - vii) Reporting requirements to ensure transparency; and
 - e) **Note** that:
 - i) The recommended organisation structure requires change at the executive level;
 - ii) An interim structure will be put in place, with appointment of an acting Group CE;
 - iii) The board and management will undertake consultation with affected staff, make temporary and permanent appointments and stabilise the organisation over the next few months;
 - f) **Publicly comment** only on the "one entity, one board, transparent divisions" model; and
 - g) **Maintain** confidentiality of this approach in regard to detailed structural issues.

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Report: Structural Options

Purpose of Report

- 1) We understand that Ministers want to consider final options for the structure of the rail industry.
- 2) This report describes the key issues to consider, various options, the pros and cons of their implementation and a recommended solution.

Characteristics of the new organisation

- 3) To be successful, the new organisation structure will need to have the following general characteristics:
 - a) A strong customer focus and service ethic;
 - b) The ability to attract and retain highly qualified and motivated staff;
 - c) A focus on the changing nature of the environment including an ability to change and adapt quickly in response to external events;
 - d) Full participation in Government transport and infrastructure decision making;
 - e) Ability to meet the requirements of good governance at a management level including clear accountabilities for performance, especially around safety and standards;
 - f) An ability and willingness to secure the culture change desired;
 - g) A separation of duties, where required by regulation or for transparency and good practice;
 - h) Retention and development of institutional and business knowledge;
 - i) To be efficient; and
 - j) Implement transparent reporting of financial and operating performance by operating unit.

Structural Options

- 4) There are a number of possible structural options to deliver these required characteristics. The general options can be summarised as:
 - a) Two separate companies (being ONTRACK and KiwiRail) with separate governance and management teams; and
 - b) A fully integrated company with one Board, a Group management structure and multiple business units to ensure focus and separation/transparency where required.
- 5) These two options can be contrasted as follows:

Criteria	Single entity with internal separation	Two entities
Stabilising current situation	<ul style="list-style-type: none">• Allows the best leverage of the limited rail and ferry management pool	<ul style="list-style-type: none">• Marginally weaker
Integrated decision making	<ul style="list-style-type: none">• Simplified relationship with NZTA	<ul style="list-style-type: none">• More complicated relationship with NZTA

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Criteria	Single entity with internal separation	Two entities
Laying out choices	<ul style="list-style-type: none"> Places the primary responsibility with the Board to organise for Ministers to assess Risks less transparency 	<ul style="list-style-type: none"> Places the primary responsibility with monitoring agencies to assess, making the Boards roles less relevant More inherently transparent on the track vs. operations charging
Integrated investment planning and efficiency	<ul style="list-style-type: none"> Much higher chance that projects prioritised on merit 	<ul style="list-style-type: none"> Higher chance that projects prioritised “where the subsidy is”, unless significant oversight from monitoring agency
Customer service	<ul style="list-style-type: none"> Good as all parts can be focused on the external customer 	<ul style="list-style-type: none"> Good, though scraps will occur between the entities which will reduce focus on external customers
Tension between individual businesses for services supplied to each other	<ul style="list-style-type: none"> Good 	<ul style="list-style-type: none"> Very strong, leading to litigation or imposed outcomes
Inter-business transactions	<ul style="list-style-type: none"> Simpler to resolve issues Will need express requirement to disclose between all products 	<ul style="list-style-type: none"> Harder to resolve issues (ref. Meridian vs. Transpower in early days) Will need express requirement to disclose between parts of businesses in each entity
Potential public choice consequences, compared to fully commercial operation	<ul style="list-style-type: none"> More corporate maximisation underpinned by taxpayers, offset by lower transaction costs 	<ul style="list-style-type: none"> More corporate maximisation underpinned by taxpayers, offset by lower transaction costs
Development of talent pool	<ul style="list-style-type: none"> Good 	<ul style="list-style-type: none"> Weaker
Making trade-offs	<ul style="list-style-type: none"> Simpler Big picture focus from monitoring agencies 	<ul style="list-style-type: none"> More complicated Greater product by product involvement from monitoring agencies. Lots of gaming around information
Operational efficiency	<ul style="list-style-type: none"> Good incentives to pursue efficiencies Lower overhead costs, though not excessively Low transaction costs 	<ul style="list-style-type: none"> Good incentives to pursue efficiencies Higher overhead costs, though not excessively Higher transaction costs
Ability to outsource and or franchise	<ul style="list-style-type: none"> Good 	<ul style="list-style-type: none"> Good

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- 6) The form and legal structure of the group was assessed, with the following criteria in mind:
 - a) The forecast business plan envisages freight rail users paying [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
 - b) Rail can operate in a commercial model, though in doing so it will not meet the needs of the NZ transport strategy; and
 - c) All parts of the business (other than the public policy component) need to operate in a commercial manner and earn revenue in a highly competitive transactional market.
- 7) The largest change and challenge ahead is that the allocation of capacity (e.g. network capacity, capital expenditure, systems and human resources). This will dominate rail industry strategy over the next few years. This follows from the historical underinvestment and strong desire to increase services. These allocation issues:
 - a) Require decisions to be made around the use of existing and new capacity;
 - b) Will be complex, particularly as regards investment priorities;
 - c) Could be sub-optimal if focused on “who’s got the subsidy”; and
 - d) Require a clear approach to what is desired as outputs.
- 8) Any structure needs to have robust processes for track access, common asset usage, common personnel usage, fleet management and sensible use of support services such as training, safety and operational IT. It must also ensure that the separation is undertaken in such a way that the confidence and trust of customers and key stakeholders around pricing can be maintained.

Preferred model

- 9) Having considered the various issues noted above it is recommended that the new structure be based on a fully integrated business with one board and multiple business units.
- 10) The recommended structures at the highest level are set out below.
- 11) The “day 1” interim structure will
 - a) Allow the business to continue to operate;
 - b) Gain the first tranche of the benefits of integration; and
 - c) Allow scope for the permanent or acting Group CE to continue to adjust the organisation in response to the internal and external dynamics of the time.

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[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]

- 12) The new organisation will take effect on or around 1 October. It is critical to ensure that there is a clear chain of accountability in place, recognising that it will not be possible to have the permanent Chief Executive in place by then.
- 13) [WITHHELD UNDER SECTIONS 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
- 14) A number of issues have influenced this recommendation including the recognition that:
- a) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
 - b) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
 - c) Rail effectively sets its own codes and standards, under a co-regulatory model with NZTA as the regulator and maritime legislation places significant duties on office holders in the ferry business. There are a small number of key people in ONTRACK and KiwiRail whose roles are driven by these quasi-statutory duties and the regulators are likely to increase their interest during the changes.
- 15) [WITHHELD UNDER SECTIONS 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 16) The “must wins” for the first 6 months of the development of the organisation have a mix of internal and external focus to:
- [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 17) The Board and Ministers will need to consider the priority of these issues, given that the search for a permanent Group Chief Executive may take some time.

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- 18) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 19) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 20) The exact nature of how the detailed operations will work below the first tier of management will be worked through by the Board and management over the coming months. [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

Metro Operations

- 21) Initial discussions with both the Wellington and Auckland Regional Councils indicates that there is a desire on their part to have control of the rail fleet in their areas but the method of ensuring this happens is still to be decided.
- a) In Wellington, all the Electric Multiple Units are now owned by KiwiRail, the council owns 18 carriages which operate the Wairarapa services but are powered by KiwiRail freight locomotives contracted to Tranz Metro and the Capital Connection service is a commercial service operated by Tranz Scenic with locomotives provided by KiwiRail freight;
- b) In Auckland, 19 Diesel Multiple Units are owned by the Region and operated by Veolia under contract to the Region, all SA and SD cars are owned by the Region but motive power is provided by locomotives owned by KiwiRail and the Silver Fern Railcars are owned and operated by Tranz Scenic on behalf of the Region;
- c) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- d) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 22) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 23) Decisions on the funding of new rolling stock and metro only projects such as the proposed CBD loop and potential corridors in Christchurch should also form part of the above discussions. For other capital projects where there is benefit to both metro and freight, these are included as part of the capital package provided as Paper 4 of this set, though a more enduring funding method will need to be developed.
- 24) It is also critical to continue stressing to the regions that the rail network is for freight and metro and both forms need to be allowed to operate to serve their customers. Rationing and juggling of peak capacity will need to be managed carefully and well.
- 25) [WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].
- 26) Regardless of the model chosen, it is essential that substantive transparency is provided to the taxpayer, rail users and competitors to create accountability for the performance of tasks receiving Government support. It is assumed that in all options, Ministers will continue to be involved in key investment decisions.
- 27) It will be important to quickly set out the shareholder oversight and transparency requirements for the new organisation, recognising that this entity possesses special characteristics.
- 28) The divisions as shown above would continue to work with each other under detailed service level agreements as follows:

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

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29) The key actions to be taken to give effect to the structure outlined above are:

Action:	Prerequisites
1. Recruitment of permanent Group CE of NZRC	[WITHHELD UNDER SECTION 9(2)(a) of the OFFICIAL INFORMATION ACT 1982].
2. Appointment of an acting Group CE	<ul style="list-style-type: none"> • Directors need to appoint an acting Group CE and acting Group CFO to work beside the Toll secondees from 15 September
[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].	
4. Setting up the establishment unit	<ul style="list-style-type: none"> • Agree a work plan with Directors & Shareholding Ministers required for 2009/10 SCI • Appoint a project manager • Get agreement from government agencies on level of representation from them • Engage consultant resource

Legal Structure

30) On the basis of having a one entity model the legal structural options for combining KiwiRail and ONTRACK (NZRC) are:

Options	Pros	Cons
KiwiRail Holdings to be the ultimate holding company with NZRC as a subsidiary;	New legislation would tidy up issues	KRH cannot purchase NZRC as NZRC is a statutory corporation.
NZRC to be the ultimate holding company with KiwiRail Holdings as a subsidiary; and	All the functions of the combined entity can be undertaken without legislative change	The NZRC Act is somewhat archaic in places
New legislation setting up an entity to be the holding company for both entities.	Form and function would be up to date	Takes time to finalise

31) A copy of the legal structure (as opposed to organisational) structure is attached in appendix 1.

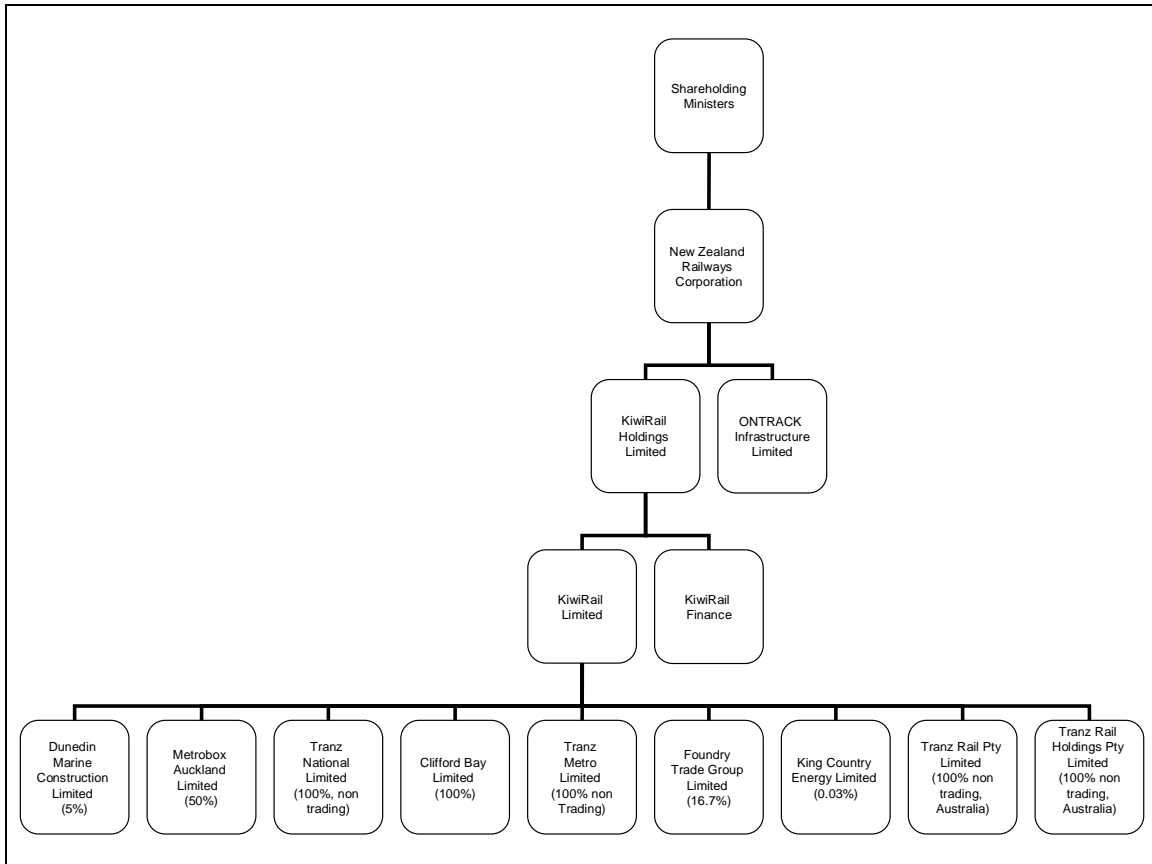
32) While appropriate as a starting point further analysis and enquiry will be undertaken by the entity into the assets and liabilities of the individual subsidiaries to ensure:

- a) Gradually optimising the number of companies in the group, to reduce the proliferation of operating and dormant companies which will minimise the governance complexity, overhead duplication and compliance costs;
- b) An appropriate tax status and tax position;
- c) Strategic alignment between the various operating activities. The structure should facilitate and not inhibit the consistent operation of strategy within the group;
- d) Balancing the need for management focus on particular activities and achieving operational synergies and cooperation between the business units;

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- e) The need for transparency in relation to the activities of the rail network in particular;
and
 - f) Clear roles and responsibilities and effective accountability.
- 33) The effectiveness of the structure will depend in part on the governance arrangements:
- a) The board of NZRC, which will be the effective parent of the group, will be the fundamental governance board. It will have responsibility for setting strategy for the whole group and for monitoring consolidated performance;
 - b) Depending on its activities, each subsidiary may initially have a board made up of mix of main board directors, the Group Chief Executive and the head of Corporate Services. It is important to ensure that subsidiaries do not have freedom to pursue a strategic agenda different to that mandated by the parent.
 - c) For the alignment of strategy and operations, the structure would have to primarily be driven by operational focus and ensure all rail functions are aligned;
 - d) Relative to the assessment issues noted above, the structure will not produce adverse consequences:
 - i) Strategic alignment and operational cooperation can be “enforced” by the parent company Board and corporate management team;
 - ii) Some separation of businesses will assist management focus and transparency;
and
 - iii) Accountabilities can be clearly defined.
- 34) It is understood that the Board of KiwiRail Holdings will become the Board of NZRC on or around 1 October.
- 35) It will be important to quickly set out the shareholder oversight and transparency requirements for the new organisation, recognising that this entity possesses special characteristics.

APPENDIX 1: Legal Structure



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APPENDIX 2: Structural issues

- 1) The Crown-owned businesses are currently split as follows:
 - a) KiwiRail Freight
 - i) Freight sales & marketing – bulk, intermodal and kombi;
 - ii) Service centres in Auckland and Christchurch, including a shift service manager, managing the interface with ONTRACK's network control manager;
 - iii) Linehaul operations;
 - iv) Terminal operations;
 - v) Container transfer operations;
 - vi) Fleet
 - (1) Design & development;
 - (2) Field work (currently outsourced to UG);
 - (3) Workshops (Hutt (UGI) and Hillside (KR));
 - b) Interisland:
 - i) Freight sales & marketing;
 - ii) Passenger sales & marketing;
 - iii) Ship operations;
 - iv) Terminals; and
 - v) Onboard services.
 - c) Passenger
 - i) Tranz Scenic:
 - (1) Passenger sales & marketing;
 - (2) Terminals and stations;
 - (3) Linehaul operations (drivers shared with KRF);
 - (4) Onboard services;
 - (5) Fleet
 - (a) Field work (own staff);
 - (b) Access to design & development and workshops via KRF;
 - ii) Metro:
 - (1) Passenger sales & marketing;
 - (2) Terminals and stations;
 - (3) Ontrain staff;
 - (4) Fleet
 - (a) Field work (own staff);
 - (b) Access to design & development and workshops via KRF;
 - d) ONTRACK:
 - i) Operations;
 - (1) Network control, including train control;
 - (2) Field work (inside OIL);
 - ii) Engineering - track, signals, structures, traction and mechanical;
 - iii) Network investment – investment planning, major projects;
 - iv) Commercial & property;
 - e) Each unit has management support services and both KiwiRail and ONTRACK currently have corporate offices. The support services are finance; legal; health, safety, quality & environment (HSQE); IT; public affairs; and HR.

Duplication and interfaces

- 2) There are areas of current duplication and inefficiency created by the operator – access provider split which can be improved if the organisations are merged under NZRC as the ultimate holding company.

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3) Corporate

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

4) Fleet

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

5) Operations

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

6) Tourism

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

7) Property

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].

8) Group corporate office location

[WITHHELD UNDER SECTIONS 9(2)(b)(ii), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982].