

Report 3: Rail Investment - Key Emerging Issues

To: Rail Development Group

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

Date: 21 August 2008

Background

- 1) Ministers have directed that the Rail Development Group report on key rail industry strategic issues as a means of informing them as to the nature of the issues they and the new Board and management will face over coming months.
- 2) The material presented below has been sourced primarily from the:
 - a) Due diligence process undertaken as part of the purchase;
 - b) Engagement with key customers; and
 - c) Briefings given by Toll management as part of the purchase.

Due diligence

- 3) The due diligence undertaken by ONTRACK's Project Merlin team, supported by the engagement with key customers, has raised a set of emerging issues that the new owner needs to consider. The importance of this process and the need to get active management systems in place to manage and or mitigate them is increased, as Toll has agreed to the barest minimum of warranties in the sale and purchase agreement:
 - a) Toll have disclosed what they know and warranted the accuracy of information provided;
 - b) Toll did own the securities they were selling;
 - c) Tax returns between 2003-2008 were not materially incorrect or inaccurate; and
 - d) The companies were correctly treated for residency considerations.
- 4) As expected at the onset of the process and recognising the very explicit views of Toll as to warranties and undertakings, the Crown has effectively self-insured the majority of risks it has assumed in acquiring Toll NZ Ltd.
- 5) The due diligence process identified a number of risks. The risks were generally characterised as having a low probability of occurrence but a reasonably high financial impact. If any of the risks were to crystallise, it would be difficult to recover the associated costs from Toll.

Emerging risks

- 6) In the view of the Merlin team, the principal emerging risks to the business are:
 - a) Pricing & commercial:

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

b) Organisation:

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

c) Business systems:

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

d) Asset condition and planning:

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

e) Profitability:

COMMERCIAL IN CONFIDENCE

- i) The broader economic environment will place significant challenges on the new business in terms of pressure on margins. Placing the recovery of track access costs to one side, profitability has been declining during Toll's ownership with a continued decline in real rates. This is compounded by an inability to recover increases in input from the marketplace, with customers experiencing pressure on their own profitability and the extraordinary (but likely to continue) increase in fuel prices;
 - ii) [WITHHELD UNDER SECTIONS 9(2)(b), 9(2)(g)(i), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
 - iii) [WITHHELD UNDER SECTIONS 9(2)(b), 9(2)(g)(i), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
 - iv) [WITHHELD UNDER SECTIONS 9(2)(b), 9(2)(g)(i), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
 - v) [WITHHELD UNDER SECTIONS 9(2)(b), 9(2)(g)(i), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]
- f) Corporate management:
- [WITHHELD UNDER SECTION 9(2)(g)(i) of the OFFICIAL INFORMATION ACT 1982]

Process of Change

- 7) Although not specifically part of the due diligence the integration of the existing KiwiRail and ONTRACK businesses will need to address a number of organisational and human resource issues. The new entity will need to quickly identify its core value and service proposition.
- 8) One of the most significant emerging issues relates to the issues associated with change and amalgamating two different businesses with different incentives, behaviours and cultures.
- 9) [WITHHELD UNDER SECTION 9(2)(g)(i) of the OFFICIAL INFORMATION ACT 1982]
- 10) The new Board will need to address these matters as a matter of urgency while at the same time:
 - a) Recruiting a new Chief Executive; and
 - b) Creating an environment where it is clear that the new entity will have a new mode of operation. It will be important that the creation of the new entity is just that and not seen as a takeover of either of the predecessor organisations.

Visits with Major Customers

11) In response to a number of enquiries from customers after the purchase it was agreed that visits be undertaken to engage with key customers to explain/outline what the basis of the purchase was and to explore with them their plans with and or their future expectations of rail as a business. There was also specific discussion with each of those visited as to their impressions and feedback on the structural option for the Governments rail assets.

12) The key messages from those visits can be summarised as:

- a) There is significant goodwill toward rail as a transport mode. While each of them had varying dependency on rail they all saw it as a key network for the country;
- b) There is a wide acknowledgement of how well Toll management had operated well within what many saw as a capital constrained environment. It was recognised that management “had done their best” and would have delivered more had there been more capital available for investment in infrastructure;
- c) [WITHHELD UNDER SECTIONS 9(2)(b), 9(2)(i) and 9(2)(j) of the OFFICIAL INFORMATION ACT 1982]

- d) There has been some barriers to potential growth opportunities around issues such as:

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

13) It is recommended that the new organisation place a high priority on developing and implementing strategies to manage these issues.

Recommended Action

I recommend that you:

- 1) **Note** this paper.