1 Audit summary

1.1 Introduction

1.1.1 The intrastate rail network

The non-metropolitan intrastate rail network is a significant state asset, particularly for regional communities that rely on it for passenger and freight services.

One of the aims in the government's *Growing Victoria Together* policy is to increase the proportion of freight transported to ports by rail on this network from around 10 to 30 per cent by 2010. To achieve this, the network needs to be well maintained and efficiently run.

In 1999 the state leased the network to a private company for 45 years as part of the sale of the V/Line Freight Corporation. The state was paid $70.4 million for the 'above-rail' freight business and $89.7 million for the rail network lease. The lease did not require the lessee to maintain the network other than for the last five years of the lease.

In August 2004 the lessee was taken over when its business, including its plant and equipment and the infrastructure lease over the intrastate rail network, was acquired for $285 million. The state consented to this transfer of control over the lease. The new lessee was owned jointly by two major corporations operating in the Australian freight and logistics sector.

There was a maintenance backlog on the network when the first lessee took control from the state in 1999. The lessees took a contractually compliant, minimum maintenance approach on freight-only lines, and effectively allowed some lines to fall out of service. This arose from the ineffective maintenance obligations in the lease combined with lower than expected revenues from freight services because of the drought, especially for grain. The infrastructure deteriorated further, which added to the maintenance backlog. The state responded in 2005–06 when it began directly funding the lessee for maintenance work over and above contractual requirements.

In 2006 the Essential Services Commission confirmed that maintaining the intrastate freight network at reasonable levels of service was unsustainable without ongoing government financial support.

In August 2005 one of the joint owners of the second lessee announced it intended to acquire the other joint owner, which it did in May 2006. This triggered another change in control over the network leaseholder, but the state's consent was not obtained triggering a termination event under the lease. This allowed the state to consider the future of the network and the lease.

The lease presented a number of practical concerns. In addition to the inadequate maintenance expenditure, having the network leased to and controlled by a third party added to the complexity, time and cost when the state sought to do major capital works such as the regional fast rail project. The state was also the key revenue source for the lessee through access fees paid by V/Line Passenger Corporation (V/Line).

The lessee also ran its own 'above-rail' business, running rail freight services on the network. Control of the network by a private company that also ran an above-rail business was perceived as a limiting factor in encouraging greater use and competition on the network. The state also saw this as a risk to its ability to run regional fast rail services at their maximum intended speeds.

1.1.2 The buy-back

In April 2007 the government announced it had reached agreement to 'buy back' the intrastate regional rail network from the lessee for $133.8 million. This confirmed an earlier 'in principle' sale agreement announced in November 2006 at the start of the caretaker period before the state election.

The state determined that a buy-back of the network would result in savings and other benefits including:

- greater flexibility to develop and deliver integrated transport plans to achieve government objectives for regional rail
- aligning the interests of the below-rail network with the government's interests rather than a private access provider's commercial interests
- cost savings through competitive outsourcing of maintenance and by removing the state's obligation to make margin payments to the lessee on infrastructure maintenance on the network
- improving track maintenance and major project delivery on the network without having to negotiate with a third party leaseholder on matters such as track access and safety issues
- facilitating progress on an open access regime to create competition from other rail freight operators and for greater freight efficiency
- allowing the government to make rail services in and around the Port of Melbourne more efficient to improve direct rail access to the port
- enabling the government to increase capacity on certain rail lines through expanding and converting selected track to standard gauge leading to greater efficiency for interstate rail freight.

1.2 This audit

The objective of the audit was to examine whether the state's decision to buy back the regional intrastate rail network was adequately informed and whether the transaction was effectively managed.

This involved examining the advice given to government on the buy-back, assessing whether the state paid a fair and reasonable price based on sound valuation and other relevant advice and analysis, its management of the transaction and negotiations, and the state's risks, benefits and future obligations arising from the buy-back.

1.3 Conclusions

There is little doubt that the buy-back unwound a lease which was ineffective in maintaining the asset. It also mitigated financial and other impediments to the state's capacity to carry out major investments in upgrading the network.

In negotiating the buy-back the state also made other strategic gains of broader significance to Victoria's freight and logistics network. This primarily related to freeing up rail access to the Port of Melbourne.

However, the audit cannot give any assurance that the state paid the lowest reasonable purchase price obtainable in the circumstances for the buy-back and it is clear that the cost of the buy-back exceeded the cost publicly announced in April 2007.

The announced cost was $133.8 million. The full cost is likely to exceed $200 million. Further, in addition to direct payment for the buy-back, the lessee also secured other significant benefits from the transaction including extended lease terms for the South Dynon inter-modal terminal and over a small part of the Tottenham Yard, and reduced rates for access charges for its above-rail business.

Once the decision to seek a buy-back was taken the terms were negotiated and agreed soon after. A non-binding buy-back agreement was signed on 31 October 2006 immediately prior to the start of the caretaker government period for the 2006 state election. The terms of that agreement including the purchase price did not materially change in the final agreement of May 2007.

When the state signed the non-binding agreement, sufficient advice had not been obtained to support its decision about how much to pay, for example there was not an adequate business valuation. In addition, gaps and deficiencies in the advice given to government on the buy-back included the lack of a robust and agreed business case and a failure to advise government on the limitations of some external advice.

These matters, however, do not necessarily mean that the buy-back failed to represent value for money to the state. There were clear arguments to have the network back under state control and opportunities to save and/or avoid future costs and delays on routine maintenance and capital upgrades of the network.

The question that remains is whether such outcomes could have been achieved at a lower cost had the state:

- offered less for the below-rail business based on its market value not its book value
- negotiated an amended infrastructure lease with incentives for the lessee to work cooperatively with government, or
- terminated the lease and contested any legal challenges mounted by the leaseholder.

V/Line managed the transition of the network to state control well. However, there is potential conflict between its roles as both access provider and rail passenger services provider. Furthermore the 2006 government decision that a separate entity be established to control the network has not been acted on.

The government has commissioned a review of the freight network since the buy-back and has started an investment program for the regional rail network to improve regional passenger and freight services.

1.4 Findings

1.4.1 Cost of the buy-back

In April 2007 the government announced it had agreed to buy back the regional intrastate rail network lease for $133.8 million. This was not the full known cost of the buy-back. The state estimated the full cost to be $164.4 million excluding estimated transaction and transition costs of $9.7 million. The full cost of the buy-back is likely to exceed $200 million based on more realistic assumptions about the cost of reduced network access fees for the vendor agreed as part of the transaction.

One hundred and fifty million dollars was approved as the upper limit for the buy-back negotiations. This ‘remit’ was defined to exclude certain costs which were nonetheless incurred. Under this restricted definition the purchase price of the buy-back was within the approved remit.

However, the cost to the state is not just what it paid directly, but also the lower rail access fees agreed as part of the buy-back. The difference between access revenue from the lessee and other users and the cost of running the network is a cost to the state. The state agreed to access rates for the lessee that would earn $15.3 million in an ‘average grain year’. While these rates were higher than those sought by the lessee, they were also well under break-even and would not cover the efficient cost of running the below-rail network.

At the time of the buy-back the state estimated this additional access fee ‘subsidy’ was $27.6 million over 10 years in net present value terms, assuming average grain years. This was not a realistic assumption based on information available at the time about the continuing drought. Experience since the buy-back shows that the actual additional access fee subsidy will be at least $40 million more than the state’s estimate in net present value terms.

1.4.2 Determining how much to pay

The value of the assets acquired

The state accepted the lessee’s position that the ‘book value’ of the assets to be acquired by the state should be the reference for determining the purchase price for the buy-back. Audit was informed that this was based on undertakings given by the joint owner of the lessee to the Australian Competition and Consumer Commission (ACCC) about its proposed acquisition of the other joint owner. The government was advised that the book value of the assets was $120 million.

The undertakings given to the ACCC included a commitment to selling key assets to address concerns about a loss of competition resulting from the proposed acquisition. One of those assets was the lessee. The commitment required the joint owner of the lessee to protect the value of assets to be sold by maintaining their trading and financial position and not making any material adverse changes to the nature or key features of the business. The lessee’s lease over the intrastate rail network was a key asset.

Audit was advised that given these commitments the state considered it had to ‘act reasonably’ when negotiating the price for the buy-back with the lessee. Audit considers that the ACCC undertakings were aimed at preventing substantive changes to the business that could have undermined competition in the freight forwarding sector, and need not have limited the state in seeking to negotiate a purchase price less than book value. Of course, even without the ACCC undertakings the vendor was motivated by commercial considerations to achieve a sale price at least equal to book value.

The state did not try to secure a purchase price which was substantially below the book value of the assets despite advice from two expert external advisers that the market value of the relevant assets was likely to be significantly less than book value.

The book value of assets acquired by the state was $75 million for the infrastructure lease and $58.8 million for the physical assets. The state had legal advice saying it had no legal obligation to pay back the value of the remaining 37 years on the infrastructure lease but did not pursue termination of the lease to avoid legal dispute and the likelihood of severe disruption to passenger and freight services.

The state commissioned a due diligence review of the lessee's financial records on the book value of assets to be acquired but it was qualified because of difficulties in obtaining the required information from the lessee.

The value of the business as a going concern

Two preliminary 'desk top' market valuations of the lessee's below-rail business using unverified data but based on conventional discounted cash flow analysis, were considerably less than the book value of the assets. One valuation was from $57.6 million to $65.3 million. The second valuation was between $70 million and $96 million.

Advice to government in September 2006 included these valuations but did not set out their limitations. One of the valuations was also used by the then Department of Infrastructure (DOI) in the development of assumptions for its business case about the range of potential purchase prices for a buy-back.

The acquisition's 'special value' to the state

The price for the buy-back was justified on the basis of potential cost savings to the state from owning the below-rail business. The savings were based on advice from DOI and external consultants on the 'value to the state' of acquiring the below-rail business. The government was advised that the state could realise savings of $204–250 million in net present value if it bought back the network. The robustness of some assumptions underlying these estimated savings, including whether there was evidence to substantiate the assumption that once the state ran the network it could achieve ongoing savings on maintenance, is questionable.

Conclusion

The full cost of the buy-back will likely exceed the special value or future savings to the state in regaining control of the intrastate network depending on the assumptions adopted about costs and savings. The state will pay over $200 million for assets of $58.8 million and for control of the network from which future 'savings' can be derived, but only by incurring significant expenditure.

There is a lack of data to demonstrate whether the new operator, V/Line, is doing maintenance more efficiently than the lessee.

1.4.3 Advice to the government on the buy-back

Nature of advice

Between late 2005 and late 2006 the government was advised on options and strategies for negotiations with the lessee. Options included negotiating a revised infrastructure lease, terminating the lease, or buying back control of the network.

The government was not provided with consolidated advice which robustly analysed and assessed all the options available to the state despite repeated requests, and assurances that such advice would be supplied. While a business case was developed by DOI, the three departments involved in advising the government did not agree on and nor did they present the results of a comprehensive business case for the buy-back to government.

The business case prepared by DOI to analyse buy-back options was based on data sources from the Essential Services Commission (ESC) 2006 regulatory process to establish a rail access arrangement for the regional intrastate network. Those data sources included information prepared by the lessee and the ESC and its advisers. The departments advised that they accepted the veracity and reliability of the ESC data and that the state had no other option or alternative sources of data available.

Audit does not question the veracity of the ESC data set, or suggest that there was a more credible pre-existing set of data available at the time of the deliberations. However, the ESC data was prepared for a different purpose and did not directly examine the likely cost of network operation under government ownership. Therefore it is questionable whether the ESC data set should have been solely relied on. In addition, the departments had explicit external advice noting limitations in the available data set and recommending that a more detailed valuation process, based on more comprehensive information sourced directly from the lessee, be undertaken in order to support a decision on a buy-back.

Advice to government at various stages by DOI and the Department of Treasury and Finance indicated that the financial outcome of a buy-back was uncertain. These departments used different assumptions when estimating the net present value of a buy-back to the state and consequently their estimates varied widely and ranged from positive to negative returns to the state.

Using the work of experts

Advice from external consultants and advisers was central to the government's final decision to buy-back the network and the price it was prepared to pay. DOI wrote a business case in 2006 which was the main source of information and assumptions for the consultants and advisers. Audit identified issues both with the robustness of this business case and the advice from external consultants that the government relied on when approving the buy-back and deciding on the price.

The departments had clear advice from external consultants that the state should obtain a formal and unrestricted business valuation of the network and below-rail business before committing to a purchase price. There is no evidence that this advice was passed on to the government.

The consultants clearly explained the qualifications and caveats on their analysis and opinions to the departments. However, in some instances government decisions were at least in part based on this external advice without being advised of these limitations.

Timing of advice and announcements

The terms of the buy-back including price were negotiated and agreed within a very short timeframe after the government decided on 21 September 2006 to pursue a buy-back. The buy-back was agreed ‘in principle’ on 31 October 2006 and it was announced at the start of the caretaker government period for the 2006 state election. Sufficient advice, most notably an adequate business valuation, was not obtained or provided before committing to the buy-back.

The public announcement of the non-binding agreement and the purchase price placed the future government in a weakened negotiating position during preparation of the final binding agreements. Publicly announcing the ‘in principle’ agreement effectively committed the state to the buy-back and limited its capacity to withdraw or renegotiate key aspects of the agreement.

Valuation procedures undertaken after the signing of the non-binding agreement focused only on the value to the state of the transaction, and did not demonstrate bringing into consideration the value of the business itself.

Limited action was taken in response to adverse due diligence findings received after the signing of the non-binding agreement and documentation indicates those findings were not passed on to government decision makers when the departments sought approval of the buy-back agreements. This was countered by the outcomes of a completion accounts process included in the agreement which resulted in net adjustments in favour of the state, reducing the base purchase price by $890 000 to $132.9 million.

1.4.4 The negotiation process

The departments administered the negotiations adequately. The state obtained appropriate expert external advice and engaged a commercial adviser to lead negotiations with the lessee.

DOI documented the process adequately.

1.4.5 Transition of the network to state control and management

At the time of the buy-back V/Line was best placed to take immediate responsibility for running the below-rail network. V/Line became the access provider for the intrastate regional rail network on 4 May 2007.

V/Line managed the transfer of the network back to state control effectively and within the approved budget of $5.2 million. A further $1.3 million was allocated for V/Line’s accreditation to operate the network under the state’s rail safety legislation. V/Line developed and implemented a thorough plan for the transition and there was minimal disruption to the day to day running of the network or to V/Line operations.

V/Line was endorsed as the agency responsible for the below-rail business on an interim basis, due to concerns about having a rail services operator also providing access to the network to third parties. The view was that V/Line's operation of the below-rail business on a long term basis had the potential to take its focus away from its core business, the delivery of passenger rail services. Also, as for the former lessee, V/Line could not be seen as an impartial and independent party in providing network access.

In December 2006 the government directed that a new body be established under the *State Owned Enterprises Act 1992* (SOE) to enable transfer of the below the rail network from V/Line to the new body at a date promptly following its safety accreditation.

In September 2007 the Treasurer approved the postponement of the establishment of the new state body and the declaration of V/Line as a state body under the SOE.

The new body has yet to be established. In October 2008, V/Line was declared a state body under the SOE to provide a shared governance role for the Treasurer and the Minister for Public Transport.

V/Line management advised they consider it is the appropriate entity to run the below-rail business and do not believe that rail operators on the network are concerned about V/Line's dual role as access provider and access taker.

1.5 Recommendations

- That the 2006 decision to establish a state body under the *State Owned Enterprises Act 1992*, independent of VicTrack and V/Line, to operate the below-rail business for the intrastate rail network be revisited and actioned or set aside (**Recommendation 6.1**).
- That the actual cost savings achieved compared to the business case be determined and a full accounting of the transaction, based on actual costs, be disclosed (**Recommendation 6.2**).