Parliamentary Budget Office - Policy Costing

Referred By: The Greens
Referred Date: 18-Mar-11

Proposal No: C001
Released Date: 25-Mar-11

Proposal Title: Buyout of the privately owned airport stations - International, Domestic, Mascot, Green Square

Lead Agency: Rail Corporation New South Wales

General Government Sector Impacts

	2010-11 $'000	2011-12 $'000	2012-13 $'000	2013-14 $'000	4 Year Total $'000
Expenses (ex. depreciation)					0
Depreciation					0
Less: Agency Offsets					0
Agency Revenue					0
Net Operating Balance:	0	0	0	0	0

	2010-11 $'000	2011-12 $'000	2012-13 $'000	2013-14 $'000	Other Years $'000	Total Cost $'000
Capital Expenditure						0
Capital Offsets						0
Net Capital Expenditure:	0	0	0	0	0	0

Net Worth:	0	0	0	0
Net Financial Liabilities:	0	0	0	0

Total State Sector Impacts

Net Financial Liabilities:	0	0	0	0

Costing assumptions used:

The attached exploratory paper shows that the relationship between Airport Link Company and its associates and shareholders, and between that group and Railcorp, are complex. Any proposal for a government to purchase these entities thus requires more consideration than could be undertaken by the Parliamentary Budget Office. But the paper offers some indication of the magnitude and uncertainty of a purchase price.

There would be no initial impacts of a purchase on the government's operating balance. And the increase in debt required to fund a purchase would be offset by the acquired financial asset. There would be important second round effects (interest on debt; profit and dividends received) but these are too uncertain to quantify.

A.C Harris
Acting Parliamentary Budget Officer

Purchase of Privately Owned Railway Stations: Green Square, Mascot, Domestic air Terminal, international Air Terminal

Estimating Purchase Price and Budgetary Impacts

This proposal has been interpreted as a purchase of the Airport Link Company (ALC) and associated entities which have control over these stations. A purchase of the stations themselves could be an option but it would not of itself involve the acquisition of the rights to collect station access fees, which is assumed to be an important purpose of the proposed policy. The latter rights are likely to be significantly more expensive than the underlying infrastructure.

One buy-out price can be obtained from the Restated Stations Agreement (see below) which provides that RailCorp, in the event of its defaulting, shall pay ALC $168.1 million plus incidental costs plus any residual of the $80 NPV settlement figure agreed in 2005. That amounts to around $200 million for a pay-out which occurs in 2012. It should not be taken as a commercial buy-out figure.

Another approach is to determine the NPV of future after-tax profits to be earned by ALC. If the 2010 profit figure of $9.3 million could be assumed to be typical, and if a 15 per cent discount were applied to future earnings over the 20 year leasehold life remaining, the NPV of future net earnings would be about $94 million. (The 15 per cent discount factor can be assumed from the earning rate which Westpac currently reports. It is assumed that Capital Partners, the majority owner of ALC, would employ a similar rate.)

However, it is clear that ALC's net profit is only determined after significant related party payments have been deducted from gross revenues. Moreover, a good deal if not most of the future profit earned by ALC will be dedicated to repaying borrowings, which have also been provided by its shareholders. The extent and full nature of these inter-party arrangements are not well understood by the Parliamentary Budget Office and extensive work would be needed to understand their consequences. Another, this time offsetting, issue is the right which RailCorp has to participate in any excess profits earned by ALC. The value of this right is not known to the Parliamentary Budget Office but it is greater than zero.

In light of the above, a more easily calculated buy-out figure entails the purchase of the company which entails the assumption (and eventual repayment) of all of ALC's liabilities, valued at $140 million as at 30 June 2010, plus a consideration for existing shareholders' future profit. That profit consists of the net return available for distribution to shareholders, if any; any related party benefit treated by ALC as an expense; and any above-market interest rate imposed on ALC borrowings by its shareholders. The value of the consideration for these shareholder benefits is an unknown, negotiable figure. But it can be argued that it ought to be no more than $60 million (otherwise the total would exceed the price paid for a purchase by default, see above).

ALC's sale and leaseback of its station infrastructure to its shareholders is another issue which needs to be factored into calculations. The consideration for this sale is not known nor is it known how the sale affects RailCorp's rights and obligations. Taken at face value, the need to acquire these assets or to continue to meet lease payments would add significantly to a purchase price. Twenty years of lease payments at $12 million a year - the current lease fee - would add $240 million in nominal dollars to the cost. In real terms

this additional impost could amount to $112 million to the cost (depending on the rate of indexation and discount used).

The operational costs which RailCorp would need to assume from ALC amount to $13.3 million a year (net of related party transactions). RailCorp would have some economies of scale (for example, there is no need for a separate corporate office or separate audit after the buy-out) but its other costs are likely to be higher than borne by the private sector. These costs might amount to $10 million a year and an assessed NPV of these costs is $70 million.

Offsetting these costs would be the cancelation of the government's escalating subsidy, commencing at $4 million a year, to be paid to ALC for passengers who use Mascot and Green Square stations. (The economic cost would be shown as a reduction in the value of the asset.) Similarly, RailCorp would not need to make any further settlement payment from the $25.8 million outstanding at end June 2010.

Putting these together:

Payout Figure:	$140 million for liabilities (as at 30 June 2010 $60 million assumed payment for foregone profit
Sub-Total `	$200 million
NPV purchase of station infrastructure	$112 million
Total cost of acquisition	$312 million
Less NPV of RailCorp Settlement	$ 26 million (as at 30 June 2010)
Net cost of acquisition	$286 million
Plus NPV of operational costs	$ 70 million
Capital cost of acquisition	$356 million
Less NPV of shadow payment for Mascot and Green square	$ 80 million
Net cost	$276 million

ALC's principal asset is the right to set and collect station access fees. RailCorp has, on behalf of the government, affectively purchased this right with respect to Green Square and Mascot. And the government has advised that the revenues from the station access fee for the Domestic and International terminals stations is $40 million a year. In nominal terms this equates to $800 million. Again depending on the factor chosen to increase the charge annually and the discount factor used to obtain a net present value, this amount would have a present value of more than $400 million. (ALC has forecast customer growth numbers for the International and Domestic airport stations over the next few years at between 8 per cent and 6 per cent per annum.) This is a gross revenue figure; it is the figure from which ALC must meet its operating costs - those costs external to the company and its shareholders. It compares with the capital cost of $356 cited above. This suggests the buy figure for ALC and relevant assets is between $356 and $450 million – say $400 million.

This suggests that for around $400 million, the government could acquire the rights to the 20 years leasehold currently owned by ALC and its shareholders. The value of that asset to the government – as distinct from the private owners – has already been diminished because of its decision to cover the cost of

the station access fee for Mascot and Green Square. If the government also effectively abolished the station access fee for the airport rail terminals, the asset would carry a negative economic value: like other rail stations, they would cost more than the revenue they collected.

Background

These four railway stations were funded and constructed as part of an early so-called Private Provision of Public Infrastructure. The Minister for Transport in the Fahey government, Bruce Baird, initially advised that the project would not involve public monies. But under the finally agreed arrangements RailCorp - as it is now called - funded construction of the tunnel and railway lines at a reported cost of around $700 million and the private sector construction consortium (later known as ALC, Airport Link Company) funded the reported $200 million cost of the four railway stations. (The NSW Government's Restated Stations Agreement, available at "Working with Government", a website under the Department of Premier and Cabinet, noted (page 5) that the initial finance available to ARC totalled $220 million of which $210 million was debt.)

Under an agreement between ALC and RailCorp, ALC sets the fee for using its stations (according to ALC, this fee is currently $11.80 for an adult using the domestic or international airport stations). The fee is additional to cost of railway tickets imposed by RailCorp. RailCorp's published standard adult train fare from Central to one station beyond the four private rail stations (where there is no station use fee) is $3.20.

The NSW Audit Office (Auditor-General's Report to Parliament, 2005, Volume four, pages 172-173) reported that ALC went into receivership in November 2000: patronage for the four stations was considerably less than expected and less than needed to meet ALC's financing and operating costs.

The audit report further advised that on 13 October, 2005, RailCorp reached a settlement with the receiver of ALC under which RailCorp agreed to pay $106 million to ARC. (The Restated Stations Agreement records the agreed sum as being $80 million as at 30 September 2001 indexed at 7.75 per cent per annum.) ALC under receivership continued as the owner of the 30 year leasehold over the four stations and agreed to drop all claims against RailCorp. RailCorp's Annual Reports advised that at 30 June 2010 the residual amount owing from the $80 million was $25.8 million. (According to the Restated Stations Agreement, it is paid at a rate of 85 per cent of RailCorp's ticket revenues raised from passengers using any of the four stations.) The payment was in respect of a capped risk borne by RailCorp that passenger numbers using ARC stations might be less than anticipated.

ALC and RailCorp also agreed that, as at 30 September 2001, the net value of ALC was $120 million. This amount, plus the above-mentioned $80 million less payments made between that date and 30 June 2005 approximately equals what is called the Revenue Sharing Threshold of $181,969,549. Under the 2005 agreement between RailCorp and ALC, 50 per cent of ALC cash-flow which exceeds that amount is paid to RailCorp. Under the same agreement, 85 per cent of ALC's cash-flow which exceeds the net present value of $212,009,777 (described as the Debt Equivalent Amount) is to be paid to RailCorp. The discount rate used here is also 7.75 per cent.

The 2005 agreement requires RailCorp to acquire ALC in the event of a defined, sustained default (such as a RailCorp failure to pay due monies). The maximum amount is the sum of ALC's redundancy and breach of contract costs, plus any remainder of the $80 million payment noted above, plus a Maximum Lump Sum amount (see below) less the costs of rectifying the four stations. The Maximum Lump sum is the amortised $120 million net value at 30 September 2001 brought to current value. (At 30 September 2012,

the Maximum Lump Sum would be $168.1 million.) If ALC defaults, a Minimum Lump Sum is exchanged. It is calculated using CPI instead of the 7.75 per cent discount factor.

ALC sold the station infrastructure and occupancy rights to a Trust (comprised of its shareholders – see below) then leased these back for its own use from 29 March 2007 to 30 May 2030. The lease is a non-cancellable operating lease for which there is no formal rental agreement in place. The relationship between this sale to a third party and RailCorp's conditional obligation to acquire ALC is unknown. Similarly, the impact of this sale on RailCorp's right to super profits is unknown.

On 30 March 2007, Westpac announced its purchase of ALC (with Capital Partners which describes itself as a private equity investment firm) from ALC's receiver and manager for an undisclosed price. ALC's leasehold over the four stations, the company's principal asset, expires on 30 May 2030. The extent of any loss borne by the previous owners and financiers is not known. Westpac purchased 49.9 per cent interest in the company and Capital Partners owned the balance and thus the majority share although voting rights are equal. It is presumed that these owners have replaced parties which had a beneficial interest in ALC.

According to ALC's filings with ASIC, the company made an after-tax profit of $9.3 million in 2010. Its operational expenses for the year were $25.3 million (including a $12 million payment to a related party for "rent"). Its financing costs (also paid to related parties) were $18.4 million. At 30 June, 2010 ALC's borrowings amounted to $133.3 million. It repaid loans amounting to $12.6 million during the year. Its accumulated deficiency from past losses amounted to $103.7 million.

ALC prepared its financial reports on the basis that it was an ongoing entity. Notwithstanding that it had insufficient assets to meet its liabilities, the company and its auditor believe that the company can, over the remaining 20 year life of its leasehold, earn sufficient from operations to meet all of its obligations.

Westpac's Annual Report for 2010 records that its return on equity on a cash basis for 2010 was 16.1 per cent, up from 14 per cent in 2009. Its reported return on average ordinary equity was 17.4 per cent and 10.8 per cent respectively.

On 2 March 2011, the NSW Government announced that it had decided to subsidise users of the Mascot and Green Square stations over the remaining life of the station leases. The subsidy, which meets the station use fee charged by ALC, $2.60 per adult single access, was not extended to use of the two airport rail stations. At the time, the NSW government noted that the annual station use fee for Green Square and Mascot totalled around $4 million a year. The fee for the international and domestic stations was said to be $40 million a year. Over the 20 year residual leasehold, the net present value of this subsidy might amount to around $80 million – assuming that the expected rate of passenger number growth together with growth in the station access fee was equivalent to the discount rate. (ALC forecasts of medium term growth in customer numbers is between 3.5% and 8%, depending on the station and the forecast year.)

Parliamentary Budget Office

25/3/2011