TO: ONTRACK

FROM: Russell McVeagh

DATE: 9 September 2008

SUBJECT: Process for agreeing the purchase price for the Toll businesses

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1. INTRODUCTION

1.1 You have asked us to summarise the process by which the Crown negotiated the purchase price for Toll NZ Limited.

2. SUMMARY

2.1 In October 2007, the Crown initiated formal discussions for the purchase, and requested detailed information from Toll. During November, ONTRACK continued discussions with Toll, and proposed a process for negotiations and determining the price. The parties agreed confidentiality arrangements and exchanged initial information.

2.2 An indicative offer for equity of up to $350 million was made by ONTRACK on 10 December. That offer was rejected by Toll, who suggested the potential value of the Toll NZ business was in the vicinity of $1 billion. A process was then agreed for further negotiation in January 2008 and the deferral of the NRAA process during those negotiations.

2.3 Discussions over price continued during January 2008, with Toll presenting material valuing the Toll NZ enterprise at $1,150 million. Toll then reduced its equity offer to $950 million and ONTRACK increased its maximum equity offer to $550 million.

2.4 During February 2008, negotiations and exchanges of some information continued with Toll reducing its equity price for the business, less Tranz Link, to $850 million and ONTRACK increasing its equity offer for the entire business to $575 million, subject to due diligence and other conditions.

2.5 Negotiations over price continued throughout March, with both parties indicating a possible movement in their offers.

2.6 In April, the parties commenced initial documentation, and in mid April a tentative agreement was reached on an equity price of $665 million which, together with payments to Toll for transition services and the value of a rent free period of access to rail terminals for TTL land, totalled $690 million. The debt owed by the Toll New Zealand companies to other Toll companies was not included. A Frame Agreement incorporating the indicative terms, subject to due diligence, was signed on 5 May 2008.

2.7 Due diligence was then carried out during May and June 2008 and final documents signed on 1 July 2008.

3. DETAILED PROCESS

3.1 On 1 November 2008, the Minister of Finance, Hon Dr Michael Cullen, sent a letter to Toll NZ Limited ("**Toll**"), stating that Cabinet had instructed him to progress with the purchase of all Toll's transport business in New Zealand.

3.2 In response to this letter, Toll replied to ONTRACK stating Toll's concerns surrounding the detail ONTRACK was proposing to understand about the Toll business before an indicative offer was made. Toll's view was that an indicative offer should have been made so it could be determined whether Toll Holdings' expectation of value could be met. Furthermore, Toll claimed that for ONTRACK to receive the requested information, Toll would have to disclose substantial commercially sensitive detail that as a publicly listed company they were not comfortable with.

3.3 ONTRACK made a proposal on 13 November 2007 proposing the following steps:

(a) Toll to provide information allowing ONTRACK to make a high quality (but not binding) indicative offer for Toll (with or without Tranz Link);

(b) ONTRACK would make this offer prior to Christmas;

(c) Toll would respond to this offer; and

(d) Subject to Toll's response, final due diligence (largely confirmatory) would follow early in the New Year.

3.4 The parties met on 14 November 2007 to agree the process for progressing negotiations. ONTRACK sought to avoid a situation where ONTRACK put forward an "uninformed" indicative offer that might require substantial revision post the receipt of detailed information, while Toll proposed ONTRACK making an early indicative offer for Toll's complete NZ business based almost entirely on public information. Based on that indicative offer, Toll would decide whether to proceed with further discussions.

3.5 After the meeting on 14 November 2007, Toll sent ONTRACK a letter requesting an indicative offer by the end of November and described the type of information that Toll were willing to disclose in order for the indicative offer to be made.

3.6 As a result, the parties negotiated a confidentiality deed to govern the disclosure of information. This Deed was dated 22 November 2007.

3.7 The parties met on 6 December 2007 after which Hon Dr Michael Cullen sent a letter to Cam Moore, the Chairman of ONTRACK, stating his comfort with ONTRACK making an offer to Toll in the range of $300 million - $350 million for equity. It was noted that alongside this initial offer, the position ONTRACK was to represent was to include:

(a) The indicative offer was reflective of the limited information provided to date;

(b) ONTRACK and its advisors believed Toll had a low value in the event that standard NRAA terms, conditions and charges were implemented;

(c) The Government wished ONTRACK to proceed with full implementation of standard NRAA terms, conditions and charges;

(d) The Government expected that, post acquisition, the rail network would offer equal access to different freight forwarders; and

(e) The Government wished to see substantial progress towards a transaction by 20 December 2007. Failing this, the Government reserved the right to terminate the acquisition discussions.

3.8 ONTRACK wrote to Toll Group (NZ) Limited's Directors on 10 December 2007, detailing the indicative offer described above. The letter also stated that ONTRACK envisaged a final offer to Toll only after due diligence was undertaken and sufficient information had been reviewed to develop a post-acquisition plan.

3.9 Toll replied on 14 December 2007 raising concerns about the following:

(a) The methodology used for the valuation, with the appropriateness of discounted cash flows as a basis for determining a value of Toll was a major concern.

(b) They made particular mention of the following:

(i) Toll Group was a reluctant seller of Toll;

(ii) The Crown was both the potential purchaser and a major supplier of services to the company; and

(iii) In particular, with the Track Access Charge being unresolved, the value of Toll's business using DCF was inherently indeterminate.

(c) Mr Jackson then suggested many different valuation methods that may suit the valuation of Toll and asked numerous questions in respect of ONTRACK's usage of the DCF valuations.

(d) The letter finished by stating that Toll Group remained committed to negotiating with the Crown in good faith and in that spirit offered the following proposals:

(i) That the parties and their advisors meet to discuss the methodologies and assumptions;

(ii) That ONTRACK then submit a revised indicative bid, based on the most appropriate methodology and documented assumptions; and

(iii) Thereafter, and assuming the revised indicative bid was considered acceptable to Toll Group, Toll Group were happy to assist ONTRACK in undertaking due diligence.

3.10 ONTRACK responded by letter on 17 December 2007 stating that it considered it was free to decide the valuation method used. Toll would then have to decide whether the level of ONTRACK's offer gave Toll confidence that a satisfactory transaction could be concluded and that further engagement and negotiation to that end was warranted.

3.11 On 17 December 2007 Toll wrote to ONTRACK stating its disappointment in regards to ONTRACK's response. Particular mention was made of Toll's view that good faith negotiations required Toll to understand fully the assumptions underpinning ONTRACK's indicative offer. Reference was also made to the fact that Toll had not provided ONTRACK with any cash flows post 2011 and therefore questions were raised as to the viability of the valuation by ONTRACK.

3.12 William Peet then sent an email to David Jackson on 18 December 2007 reiterating the position stated in the ONTRACK letter dated 17 December 2007, that ONTRACK were not contemplating a process where valuation methodologies and assumptions were to be negotiated and agreed. However, Mr Peet did then provide some detail of the ONTRACK calculations.

3.13 In response to this email, Toll wrote to ONTRACK on 20 December 2007 advising that:

(a) The advice in the ONTRACK letter outlined above that "ONTRACK is not contemplating a process where valuation methodologies will be negotiated and agreed" was seen to be not in good faith;

(b) The Board of Toll Group had asked them to meet with ONTRACK again to discuss an alternate valuation method; and

(c) Notwithstanding the above, the view of the Board of Toll Group was that the current offer was not in a range that would be acceptable, particularly "in light of independent market valuations and multiples that would see the potential value of the Toll NZ business in the vicinity of $1 billion."

3.14 ONTRACK replied on 21 December 2007 rejecting Toll's assertion that ONTRACK were not acting in good faith. The letter detailed a process forward for negotiations.

3.15 The parties met on 17 January 2008. At that meeting, Toll stated that:

(a) Toll did not wish to sell Toll Tranz Link ("**TTL**") and described the terms of their retention of TTL as a "potential deal-breaker";

(b) Toll maintained that ONTRACK's indicative offer of $300 million - $350 million equity value was inadequate and did not reflect the 'option value' to the Crown of owning an integrated rail business or the economic cost to New Zealand from a drawn out series of disputes seeking enforcement of the NRAA; and

(c) Toll presented valuation material that sought to justify an enterprise value of around $1.15 billion and equity value of around $950 million, and included approximately $120 million for land release in Wellington and a 30% ($200 million - $250 million) premium for control.

3.16 At that meeting ONTRACK advised:

(a) Toll retaining TTL was likely to be acceptable;

(b) ONTRACK rejected Toll's suggested valuation methodology largely on the grounds that it bore no relationship to likely future earnings of the business, nor the value of rail assets in an alternative use and also noted that in ONTRACK's view, the ONTRACK indicative offer was substantially in excess of the value of the business were the NRAA to be implemented in a non-concessional manner.

3.17 On 18 January 2008, Toll sent ONTRACK an email stating their concerns surrounding a number of issues, and repeating Toll's contention that the Crown was not acting in good faith.

3.18 ONTRACK wrote to Toll on 22 January 2008 rejecting Toll's $1 billion offer. ONTRACK stated that earnings under any scenario only supported a value for equity between zero and $550 million.

3.19 On 4 February 2008, ONTRACK wrote to Toll further outlining ONTRACK's position and including a revised indicative equity offer of $575 million with a potential revision after due diligence of up to 10% (ie up to $632 million). On 8 February 2008, Toll sent a letter requesting further information and discussion regarding valuation methods and assumptions before a decision is made as to the indicative offer. In response, on 14 February 2008, ONTRACK asked for Toll's reply to ONTRACK's indicative offer, in order to decide whether the negotiations should continue. By letter dated 14 February 2008, Toll made a counter indicative offer of $930 million gross for the equity of Toll NZ Limited or $850 million net for the equity of Toll NZ exclusive of TTL.

3.20 The Government negotiating team then indicated that they had no authority to discuss figures anywhere near the level of Toll's price. Hon Dr Michael Cullen then sent a letter to Toll on 12 March 2008 stating that the Government did not see any agreement being possible at a value materially in excess of the value in the Toll offer to its minorities ($630 million). Dr Cullen stated that he believed that the current Crown indicative offer of up to $632 million represented a fair offer and a good outcome for Toll and its shareholders. Dr Cullen noted Toll had indicated a possible reduction in its gross equity price from $930 million to $880 million.

3.21 During the first part of April, the parties had several meetings in which they sought to define the details of the assets to be acquired in order to facilitate further discussions on price and terms. Outline terms of purchase, and initial draft purchase documents, were exchanged.

3.22 In mid April the Minister of Finance and his advisors met with the Chief Executive of Toll and agreed that, subject to finalising the documents already being discussed, and to resolving some commercial issues, the price for the equity in the Toll business, less the TTL business would be $665 million. In addition, Toll would be provided rent free access to rail terminals for up to 2 years, subsequently estimated to be worth $15 million. Toll was also to be paid $10 million for providing transition services.

3.23 During the remainder of April the parties negotiated the terms of an overarching "Frame Agreement" to which drafts of a number of commercial agreements were attached. The Frame Agreement was signed by Toll, the Minister of Finance and the Prime Minister and was dated 5 May 2008.

3.24 Between 5 May 2008 and 1 July 2008 the Crown, acting through ONTRACK, carried out due diligence on the Toll business, and negotiated final purchase agreements. In order to ensure that TTL was not placed in a position of advantage over its competitors, the Crown required that Toll forego its period of rent free access to rail terminals in exchange for an equivalent increase in the price for the Toll shares. In addition, the $10 million fee for Toll's provision of transition services was incorporated in the purchase price, making the total purchase price $690 million. Finally, the Crown required Toll to sell the rail terminal buildings to KiwiRail for $18.5 million.

3.25 The final documents were signed on 1 July 2008 and the share transfer and associated transactions completed on that day.