From: John Wilson
Sent: Tuesday, 10 April 2007 2:28 p.m.
To: Robert Barton; Stephanie Ward; David George; William Peet; Thomas Davis
Subject: Outline of franchise agreement
Attachments: 955994_1.DOC

Robert/Steph/David/William/Thomas

Attached is a note setting out where we've got to in discussions with Toll. It's intended to fulfil;l the same role as the note we worked up with them on the previous discussions, ie not necessarily resolve all the difficult issues, but simply set out for principals what sort of agreement could be established.

Any thoughts welcome. I'd liketo send it to them by COP today if possible.

John Wilson

Basic structure

- The Crown would buy the rail assets
- The Crown would grant Toll NZ a franchise for the first franchise term
- There would be an open competition for franchise rights at the end of that term.
- The length of franchise term has yet to be resolved.

Discussion

"Rail assets" should include all rolling stock, rail related buildings, freight terminals and the rail lease. The main issues arising appear to be as follows:

The Crown will need to fund and own all new and substantively refurbished rail rolling stock.

For the existing rail rolling stock, there are 2 options

- The Crown purchases them from Toll as part of the new agreement or
- The Crown takes a call option over the existing rolling stock

For rail ferries Toll suggested a call option, exercisable in the event that the Crown needed to ensure access for a new franchisee. (a potential new franchise holder could be substantively disadvantaged if they did not have access to rail ferries; and in any case rail ferries appear in the long-term to have the same problems as rail rolling stock; ie they're not an investment that stacks up for a commercial operator.) The Crown will need a bullet-proof system that assures that there will be no impediment (arising from the operation of the rail ferries-or elsewhere) to an open tendering of the rail freight franchise.

Value: Toll have $455 million in their accounts as the value of the rail assets (excluding ferries) outlined above. That includes $57 million for the access rights conferred under the lease. Neither party has yet indicated any estimate of acceptable value in a transaction.

Risks/payments: There are two options for a payments structure.

- One is to set a system of track charges and lease payments for rolling stock that assure the rail operator of an acceptable return. Given that the rail operators balance sheet will be very different (far fewer assets) than Toll NZ’s balance sheet, this will be a conceptually different problem from the issue of an adequate rate of return on rail assets for Toll NZ. One approach to this would be a kind of regulated utility, with the Crown sharing in upside or downside from the future returns from rail freight.

- A more typical rail franchise, on the other hand, attempts to set access charges and lease charges up front, and to tender the franchise rights, so that in choosing a franchisee the Crown either maximises its revenue or minimises its upfront subsidy. Any structure that made this system work in a situation where Toll NZ has the first franchise term as of right, as part of the transfer of assets, would of necessity be somewhat arbitrary.

Freight contracts: Some of Toll's freight contracts (eg the Solid Energy West Coast coal contract) should readily transfer to a new franchisee if necessary. Others (typically in the inter-modal area where rail's best growth potential probably is) would be more difficult because the existing contract will cover a wide range of transport services, including rail. Toll is confident that the internal contracting for rail services is sufficiently transparent that it could be separated as part of the assets to pass to any new rail freight franchisee. Getting all this to work will be an important requirement or the Crown in creating a functioning franchise system for freight.

Long-distance passenger: Discussion has centred round an approach under which the Crown buys all the long distance passenger assets as part of the transaction and contracts with Toll as part of the franchise arrangements to operate the existing 3 services. The Crown may or may not (at its discretion) purchase new or refurbished rolling stock for those 3 services. If it did so it could call tenders for a long-distance passenger operator to operate those 3 services. Access to the remainder of the track for long-distance passenger services would be open.

Metro services: Any assets that Toll NZ holds as part of its supply of services to Auckland metro would be part of the rail assets to be purchased by the Crown.

In Wellington the proposition being discussed is that (since Toll NZ and GWRC have already reached agreement about metro rolling stock) that rolling stock would not form part of the Crwon/Toll agreement. Because the Crown/Toll agreement would bring about the end of the lease and the associated exclusive access, at the end of the existing Toll NZ/GWRC contract, the GWRC would be free to tender for a new operator.

Co-ordination and resolution of operator-Crown disputes. As part of this agreement the Toll place on the Ontrack board would cease. Toll has suggested a "Board of Reference" which would include reps from the rail asset owning agency; Ontrack; the rail operator and perhaps others from the Crown side. Toll sees this as an arbiter of disputes and a co-ordination mechanism. Some such mechanism to replace the Ontrack board place will be necessary.

Structure of Crown agency: One of the important issues for the Crown to resolve will be the structure of the Crown agency that holds the rolling stock and other rail assets and its relationship with Ontrack (Is there one Crown agency or two?)

Next steps:

- Our joint goal is to produce a non-legalistic document that summarises the kind of agreement that could be drawn up, leaving some of the most contentious issues scoped but not finally resolved. That would take some 3-4 weeks.
- If Ministers and the Toll board gave the go-ahead, there would be several months of detailed legal and commercial work to get substantive new agreements.
- The new agreements would be a sale and purchase agreement and a franchise agreement which would replace the NRAA and the rail lease.
- Implementation (as set out in the new agreements) would need to be timed to mesh with the creation of any new or restructured entities