From: John Wilson
Sent: Tuesday, 17 April 2007 9:32 a.m.
To: 'David George'; 'William Peet'; 'Thomas Davis'; Robert Barton; Stephanie Ward; 'Kwok, Ivan'
Subject: Note summarising rail concession
Attachments: 955994_1.DOC

David/William/Thomas/Robert/Steph/Ivan

Attached is a revised version of the papaer on rail freight concesiions we have been working up with Toll. Changes from the earlier version are marked. Pieces in italics are issues identifiedd for further clarification with Toll.

All comment welcome. I would like to get it to Toll by late afternoon.

John

Basic structure

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

Discussion

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

The working assumption driving this prospective transaction is that because it is not commercially viable, the Crown will need to fund and own all new and substantively refurbished rail rolling stock, and in the long run any new rail ferries.

For the existing rail rolling stock, there are 2 options

- The Crown purchases them from Toll as part of the new agreement **or**
- Toll retains ownership of the existing rolling stock and t~~T~~he Crown takes a call option over ~~the existing rolling stock~~ it

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For rail ferries Toll NZ suggested a call option, exercisable in the event that the Crown needed to ensure access for a new concessionaire. (a potential new concession 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, or to growth of inter-modal traffic.

Value: Toll NZ has $455 million in its accounts as the value of the rail assets (excluding ferries) *–my read of the Toll NZ accounts is that this number includes ferries.*~~outlined above~~. That includes $57 million for the access rights conferred under the lease. These values reflect an apportionment of the price that Toll Holdings paid for its shares in Toll NZ in 2003. Toll has also accrued $27 million in land release revenue. Neither party has yet indicated any estimate of acceptable value in a transaction.

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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 operator's 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 concession, on the other hand, attempts to set access charges and lease charges up front, and to tender the concession rights, so that in choosing a concessionaire the Crown either maximises its revenue or minimises its upfront subsidy. A system structured in this way would have charges reflecting all (or a proportion of) the costs of the track and the rolling stock. Any structure that made this system work in a situation where Toll NZ has the first concession term as of right, as part of the transfer of assets, would of necessity be somewhat arbitrary. It would however maintain some pricing and efficiency monitoring between the operator and ONTRACK.

A firm commitment to service levels, nationwide freight services and growing rail volumes during the concession would be required. These parameters would be expressed through a set of service level agreements and key performance indicators. The Crown would continue to have the ability (as exists within the NRAA) to purchase additional rail services. Sanctions (including termination of the concession for gross breach) would be available to the Crown to deal with failure of the concessionaire to perform.

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Freight contracts: In the event the concession is transferred, some of Toll NZ's freight contracts (eg the Solid Energy West Coast coal contract) should readily transfer to a new concessionaire 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, and even-handed in its distribution of returns (or could be made so) that it could be separated as part of the assets to pass to any new rail freight concessionaire. Getting all this to work will be an important requirement or the Crown in creating a functioning concession system for freight. *We should discuss how well a model with TTL as the holder of "umbrella" contracts can be expected to work when the rail freight concession is tendered..* There is relatively little evidence of successful concession systems for freight internationally, and the Crown team believes that problems with freight contracting will be one of the main reasons for that.

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Maintenance and capex: The agreements will need to make clear which party has responsibility for each level of maintenance and for design~~,~~ and purchase for each type of capital spending (rolling stock, buildings, and other assets). At the least the Crown would have some role in specifying rolling stock, and responsibility for major refurbishments of its assets. 3rd party contracts will be novated accordingly.

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 concession 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.~~The agreement would include consultation provisions in the event that the Crown decided to purchase new or refurbished rolling stock for those 3 services. Access to the remainder of the track for passenger services would be open (ie for other long-distance passenger or metro services).

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 Crown/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. The Crown's current understanding is that GWRC would be able to purchase all remaining rolling stock on realistic terms during the current contract term.

Contracts
There would have to be a process to ensure that contracts made within the concession do not skew value to the benefit of the concession holder, or away from the Crown or future

concessionaires, or limit the rights of future concessionaires. All the concession related contracts need to be transferable to a new concessionaire without penalty or impediment.

Length of term
The length of concession term has yet to be resolved. Under the proposed model the rail operator will do very little long-term investment, so that argument for a long concession term no longer applies. However, each re-tendering of the concession will cause uncertainty for customers, and a short term would discourage development of long-term customer relationships. Toll has indicated that the length of term will be important to it. From the Crown perspective, recent experience has confirmed the view that a long contract would lock in the Crown's obligations but not its financial receipts.

Land
Toll NZ's non-rail business (ie Toll Tranz Link except for inter-modal) would have a lease at market rent for the land that it occupies. ~~No compensation for land release would be payable.~~

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 representatives 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 Toll's ONTRACK board representation will be necessary. *(We need to discuss what decision rights this agency would have-bearing in mind that the rail operator, ONTRACK, and perhaps if it is a separate agency Assetco, will all be companies with normal corporate responsibilities and director's duties.)*

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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 terms sheet 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. Materially important issues may arise at this stage, although it is the intention of the parties to identify them at an earlier stage.
- The new agreements would be a sale and purchase agreement, service agreements, and a concession 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 (For some options this may require legislation)