5 July 2004

Office of the Minister of Finance

RAIL NETWORK PURCHASE

The agreement to purchase the rail network was signed on 30 June 2004 and title for the network passed immediately to the Crown. Settlement by the end of June has avoided the creation of any additional tax benefits to Toll.

There will be a two month transition period where Toll will continue to manage the network on behalf of the Crown. The major task during this time is to arrange for the smooth transfer of TrackCo staff from Toll.

This note sets out the key features of the agreement that was reached on 30 June, starting by reference to the Heads of Agreement with Toll signed in July 2003.

HEADS OF AGREEMENT

The Heads of Agreement had the following key parameters:

1. The rail track and all the equipment needed to operate it, along with all track related staff and contracts would pass to the Crown

2. Tranz Rail would pass back to the Crown its rights over land under the rail lease, except for land it needed for its continuing rail operations

3. A set of specified land and assets, including Wellington Railway station, some leases, and land rights where some major reconfiguration was required would also pass back to the Crown.

4. The Crown agreed to pay a nominal $1 for the track assets, and an estimated $50 million, subject to valuation, for the assets in (3) above.

5. Tranz Rail would be granted exclusive access for freight, and Wellington metro. Those exclusive access rights were subject to use-it-or-lose-it provisions. If Tranz Rail's traffic fell below 70% of the average 2002-2004 freight levels for any line segment it would lose its exclusive access. Tranz Rail was required to co-operate with any new operator granted access in such terms. For Wellington metro the use-it-or-lose-it passenger levels in the existing core lease were carried forward.

6. No use-it-or-lose-it provisions were included for long-distance passenger rights, since at the time both parties (Toll and the Crown) believed those rights were held by Tranz Scenic.

7. The rights of existing operators on the network (Taieri Gorge and Heritage) were protected.

8. Toll was to pay the costs of Trackco through access charges. The costs would be set through a process of agreeing Trackco's budget, subject to an arbitration provision.

9. The Crown committed to spend $100 million on upgrading the network, and $100 million over 4 years on replacement capital (line and sleepers). Neither of these sums was to be recovered from Tranz Rail. Tranz Rail committed to spend $100 million on new rolling stock.

10. Consultation mechanisms were established to enable this capital spending to be co-ordinated as appropriate, but each party retained final decision rights over its own spending.

11. It was agreed that further capital expenditure, above this initial $200 million, would be recovered from rail operators through the track access charges.

12. TrackCo would be an independent and efficiently run entity. In recognition of the fact that TrackCo's efficiency was a key input for Toll's operation, Toll was to nominate one director for TrackCo.

13. There were to be key performance indicators (with a bonus and penalty regime) for each party.

AGREEMENT OF 30 JUNE 2004

The agreement I signed on 30 June 2004 was consistent with the key parameters of the July 2003 Heads of Agreement as described above. The June 2004 contract also contains a number of other provisions of note:

Assignment/subcontracting

One of Toll's key concerns was the possibility that the Crown would assign TrackCo's responsibilities, or enter a significant subcontract, with one of Toll's direct competitors. It has been agreed that any such decision will be made by shareholding/responsible ministers rather than the TrackCo board, and will not be made without consulting Toll.

Initial Capital Expenditure

Toll argued that it should have a substantial degree of control over capital expenditure by TrackCo. This applied both to the initial $200m, which is "non-recoverable", and further capex that will be recovered through the access charge. Toll had particular concerns about expenditure on the coal route. A Toll veto right was not acceptable to the government, but some provisions have been agreed to meet Toll's concerns.

A list of upgrade projects is appended. This list will be the starting point for TrackCo's consideration and Toll will be consulted over any departures from the list. However, TrackCo retains the final decision rights with respect to this expenditure.

It has been agreed that a maximum of $25 million of the "non-recoverable" replacement capex will be spent on the coal route expenditure. Expenditure on the coal route in excess of $25 million will be recovered from Toll through the access charge. In agreeing this limit I took into account concerns of other rail users that the "non-recoverable" capex be allocated fairly across the country and not be captured by one entity, particularly since that entity is an SOE.

The $25 million is not in any sense a cap on spending on the coal route. Rather it is a cap on the amount Toll can access without payment.

Future Capex beyond the Initial $200 Million

The initial Crown contribution of $200 million is not to be recovered from Toll. It is essentially a government contribution recognising recent low levels of investment in the network. It does not reflect an assessment of the likely costs of bringing the track up to good standards.

The Crown has not done a due diligence analysis of the track because:

- Due diligence would have had no impact on the purchase price ($1)
- Discovery of new problems in due diligence would have had no impact on the decision to purchase the network.
- The most comprehensive information about the network, and the need for investment in it, is inside Toll Rail and is coming to the Crown as part of the transaction.

Beyond the $200 million, the agreement with Toll provides for full cost-recovery. In other words the agreement provides for Toll to pay a rate of return and depreciation on TrackCo capital investment beyond the $200 million.

For those proposals where there is no commercial benefit to operators but which are justified on public policy grounds, there would be provision for direct funding from the Crown. In practice, many such proposals are likely to have both a commercial and public policy element and so the funding split would be subject to negotiation between TrackCo and users.

In other words $200 million is not expected to cover all the capital investment needs on the network, but the government expects investment beyond the $200 million (except for any public policy contribution it makes) to be recovered from rail operators. Some of the public policy funding may be recovered if the track improvements lead to increased use and thus higher track fees.

TRACK ACCESS CHARGE

The Heads of Agreement provided that the track access charge (TAC) would be set for three year periods. In case of disagreement Toll had the right to commission an independent review into the charges. It was envisaged that a specific access charge would be set for each line segment, the charge to consist of fixed ("train path") and variable ("gross tonne kilometre") components.

While this charging regime remains the intention for the medium term it has been agreed that for the first year the access charge will be a fixed lump sum. Subsequent budgets will be set for three years. This will help align the TrackCo budget with the

Transfield contract, which is TrackCo's major cost. The parties will work during the 2004/05 year establish the long term access charging regime.

Transfield

The Transfield contract is TrackCo's major cost. Toll considers that the Transfield contract can be improved and it has been agreed that through the Transition period Toll will continue to lead negotiations with Transfield to make those improvements. However, any changes to the contract must be approved by the TrackCo board.

LAND

The majority of the rail land (approximately 18,000 hectares) has now returned to the Crown as part of the $1 transaction. Toll is retaining for its operations approximately 1000 hectares under a revised lease (the "Core Lease"). The Heads also identified a small number of sites that Toll would release in exchange for value from the Crown. Most of these sites require some reconfiguration of the rail lines to land to be vacated. Four of the sites were returned on 30 June 2004 at a cost to the Crown of $371,000.

The remaining sites will be released in four tranches over several years as the reconfiguration work is carried out. Toll is contractually bound to release these sites. The timing for these projects is agreed as part of the contract. Toll will be paid for this land as it is released.

LEASES

Toll had been generating income from the rail land through a large number of sub-leases and other arrangements, such as sale of advertising rights. The Crown has purchased these income streams, on commercial terms, at a cost of $33.5 million plus GST.

PRE-COMPLETION CAPEX

I have agreed that the Crown will pay for approximately $15 million of capital expenditure incurred since Toll took control of Tranz Rail. $13.8 million of this amount was paid on 1 July, with the remaining amount to be settled once the final costs are in.

Key Performance Indicators

Detailed key performance indicators will be developed during 2004/05.

Long-Distance Passenger rights

The Heads of Agreement did not cover scheduled long-distance passenger issues, since at that stage Tranz Rail owned only 50% of Tranz Scenic, the long-distance passenger operator. Now that the other shares in Tranz Scenic have been purchased by Toll Rail, it has been possible to add long-distance passenger issues into the transaction.

Toll has accepted there is to be a use-it-or-lose-it arrangement for long-distance passenger. Toll tried to secure a Right of first refusal for itself for the term of the lease.

Rather than agree to that, the agreement provides for clean long-term arrangements but with time delays.

Toll has 3 years to decide whether it wishes to operate at least weekly services on routes it does not currently operate. After that period any routes it does not operate are open to new operators.

For the services it currently operates if Toll Rail ceases to provide a return service at least three times weekly for a 12 month period, other operators may be brought onto the route.

Tranz Rail had sold rights over some platforms to Tranz Scenic. Toll argued that since Tranz Scenic was separate at the time of the Heads of Agreement, these platforms were not part of the transaction envisaged by the Heads of Agreement. Technically this was probably correct, but in the final agreement Toll has accepted that all platforms come to the Crown.

LIABILITIES

There was a good deal of discussion in the negotiations about Toll's desire to ensure that TrackCo's costs in terms of insurance and other liability mitigation, are minimised, and also about how those costs should be met.

In the agreement Toll has agreed to TrackCo insuring independently, and that in the TAC Toll should meet a conventional allocation of liabilities, including the costs of TrackCo's insurance for liability to Toll, and the internalised TrackCo costs of meeting that liability.

Toll has also accepted that it has some responsibility for funding a recovery from a *force majeure* event (where damage to the tracks exceeds TrackCo's insurance cover. e.g. a major earthquake). If agreement is not met on apportioning those obligations, Toll's other option is to elect to terminate its rights in terms of the relevant section of track.

DOCUMENTATION

The legal agreements relating to this transaction will be made public after review to ensure that no confidential commercial information or staff details are included. The Toll access charge is not confidential.

UPGRADE PROJECTS

The agreed list of upgrade projects (with costs estimates) is:

- Waitoa: reconnect dairy site to network ($1 million)
- Manawatu Gorge Increase clearances ($6 million)
- Goat Valley Increase Clearances ($5 million)
- North Auckland Line Increase Clearances ($10 million)
- Higher axle loads Auckland-Tauranga and Auckland-Dunedin ($60 million)
- Project Safe (previously known as Project Kupe) ($15 million)
- Edendale Dairy Site ($4 million)
- Wiri siding ($2 million)
- Clandeboye branch line ($15 million)
- Crossing loop extensions (non-coal route) ($10 million)
- Crossing loop extensions (coal route) ($5 million)
- Upgrade Otira Tunnel fan ($0.5 million)
- Weather proofing coal route ($1 million)

The cost estimate on this list total $134.5 million. TrackCo will consider these projects in consultation with Toll before determining the final list of projects that the $100 million of upgrade expenditure will be committed to.