



Tranz Rail Limited  
 Smales Farm  
 Cnr Taharoto & Northote Roads  
 Takapuna  
 Private Bag 92 138  
 Auckland Mail Centre  
 New Zealand

Phone: +64 9 2705391  
 Fax: +64 9 2705393

Michael J Beard  
 Managing Director

12 May 2003

Tim Robinson  
 First NZ Capital  
 PO Box 3394  
 WELLINGTON

Fax: 04 474 4055

Dear Tim

**re: Tranz Rail Restructuring**

I refer to recent discussions relating to Tranz Rail's (TRL) short term liquidity position and need to create a sustainable rail model in the longer term. TRL has set out below an outline transaction as a basis for discussion between the two parties as follows:

**Operating Entities** - TRL would be broken up with two entities; a rail operating company (Op Co providing above rail services) and a network operating company (Track Co providing the underlying network infrastructure).

**Track Co** - The Crown would purchase Track Co from TRL for \$115m based on the following valuations:

- Track, structures, signals, yards, terminals, train control and associated codes and standards. Head count of approximately 100 persons covering track management, train control and professional engineering services. The foregoing is contingent upon a track access agreement	One Dollar
- Surplus land and property	\$50m
- Revenue streams such as subleases and non Op Co access fees	\$45m
- Plant, equipment, inventory and Clear optic fibre cable	\$20m
- Total	\$115m

This information is confidential for the purposes of a confidentiality agreement dated 8 May 2003. This information is provided for the exclusive purpose of the transaction contemplated by that agreement. This information may also be 'material information' as defined in the NZSE listing rules and/or 'inside information' as defined in the Securities Markets Act 1988."

**Track Co Investments** - Track Co would invest approximately \$155m over 6 years in network improvements viz:

- Network Upgrades – easing grades and upgrading track and structures to allow for increased axle weights to 22.5 tonne	\$75m
- Midland Line Coal Route – grade elimination and tunnel deviation	\$6m
- Manawatu Tunnel enlargements	\$6m
- Rail/Ferry Interchange – direct access to/from NIMT	\$5m
- Safety – introduction of improved train control system	\$23m
- Total	\$115m

**Track Co Access Investments** - To improve access to the network the following projects would be undertaken:

- Heartland mini terminals	\$15m
- Inland Ports	\$10m
- Industry Sites	\$15m
- Total	\$40m

A number of the above projects would be eligible for ATR funding.

**Op Co Investment** - Op Co would invest approximately \$180m over 5 years in rolling stock to provide for longer, heavier trains viz:

- Upgrade of existing DX Locomotives	\$30m
- New locos	\$100m
- New wagons	\$50m
- Total	\$180m

The above Op Co investment is contingent upon Track Co investments

**Access Agreement** - The operating relationship between Op Co and Track Co would be regulated by an Access Agreement. The main elements of the agreement would include:

- Retention of TRL's current operating rights
- Leaseback of required yards, terminals and other key facilities required by Op Co (including Interisland Line and Distribution Services Group) Alstom and Transfield
- Agreed service provision and levels of performance
- Step in rights if agreed service provision and performance are not met

This information is confidential for the purposes of a confidentiality agreement dated 6 May 2003. This information is provided for the exclusive purpose of the transaction contemplated by that agreement. This information may also be 'material information' as defined in the NZSE listing rules and/or 'inside information' as defined in the Securities Markets Act 1988.

- Access fees structured so to provide a fixed and variable element such that marginal costs decline with increasing volumes which would be reflected in market pricing viz:
  - o Non-Contestable Markets – open book pricing to achieve WACC
  - o Contestable markets – marketplace sets prices

The level of access fees negotiated with the Crown would take into account:

- RUCs charged to trucking industry
- Allocation of Track Co costs between Op Co and Metro Operations
- Provision of non-commercial services on regional lines

It is anticipated that the level of access fees would be significantly lower than TRL's current network costs in order to level the playing field with the trucking industry.

The access agreement would be structured in such a way as to ensure compatibility between above and below rail safety.

**Op Co Capital Structure** - Op Co would be refinanced. The Aratere lease (\$70m) and the short term bank facility (\$65m) would be collapsed and outstanding creditors (\$15m) would be brought up to date. The foregoing would be financed by:

- TRL – proceeds from Track Co sale	\$90 m
- Crown – 20% equity in Op Co	\$35 m
- Bank – new bank facility	\$25 m
- Total	\$150 m

In addition to the above the new bank facility would need to incorporate seasonal working capital requirements.

**Crown – Op Co Relationship** - Crown engagement with Op Co would be underpinned by:

- Directorships – Crown would be offered two directorships on the Board of Op Co
- Step in rights in relation to service failure or withdrawal would be incorporated in to the Access Agreement
- Equity position within Op Co's capital structure

**Creation of Viable Rail** - The goal of the above transaction is to create a viable and growing rail network that improves national economic efficiency particularly the export and import sectors of the economy. This is achieved through:

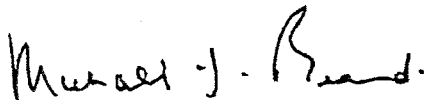
- Increasing the reach of and access to the network – Op Co would have the potential to lift its volumes by an additional 7m tonnes of freight per annum. This equates to around 250,000 truck loads of freight.

- Pricing - Op Co would have a sustainable pricing model that would be linked to road pricing. In addition marginal pricing would be consistent with marginal costs allowing for lower prices as volumes increase.
- Service Performance - Upgrading of track, locos, wagons and train control would provide for improved transit times and schedule integrity thereby making rail more competitive with trucking.
- Health Safety & Environment - Improved train control and track upgrades would significantly improve safety performance. Specific health issues such as whole body vibration affecting locomotive engineers will be addressed. The modal transfer from road to rail will have a positive impact on air and water quality, and congestion, thereby assisting New Zealand to meet its Kyoto Protocol objectives.
- Financial Stability - The new Op Co would achieve a level of earnings sufficient to cover its weighted average cost of capital thereby paying its shareholders utility rates of return and moving Op Co in to a tax paying position.

The above transaction is outlined in an attached term sheet. The proposed transaction has a significant level of detail that will need to be worked through. In addition, more background work will also need to be undertaken. This will undoubtedly take several weeks such that the parties may need to develop transitional arrangements including funding, to deal with the short term liquidity situation and shareholder issues. This will necessarily involve TRL's current Bankers. Notwithstanding this, TRL would propose that the parties capture their intent in the form of a Heads of Agreement to be agreed within the next two to three weeks.

I look forward to your response.

Yours sincerely



Michael J Beard  
Managing Director

**ATTACHMENT**  
**INDICATIVE TERMS**

1. **Status of terms:** These terms merely record Tranz Rail and the Crown's intention to enter into certain arrangements in relation to a possible sale by Tranz Rail Holdings Limited and Tranz Rail Limited (together "**Tranz Rail**"), and possible purchase by the Crown, of Tranz Rail's rail network and associated assets. These terms are not an offer that is capable of acceptance and are not legally binding on either Tranz Rail or the Crown. Tranz Rail and the Crown acknowledge that there will be no agreement between them until the parties execute a heads of agreement. The parties further acknowledge that it is their joint intention to negotiate and execute a binding heads of agreement reflecting the transaction set out in these terms by 30 May 2003.
2. **Good faith negotiations:** Tranz Rail and the Crown agree to work together in good faith with a view to executing the heads of agreement by the date referred to above and to executing complete documentation relating to the transaction contemplated in these terms and the heads of agreement and settlement of the transaction by 30 September 2003.
3. **Assets to be transferred:** The Network and all of the Network assets ("**Assets**") of Tranz Rail are intended to be transferred to the Crown including:
  - (a) track infrastructure (including rails, sleepers and associated formation and ballast);
  - (b) structures infrastructure (including bridges, formation, culverts and tunnels);
  - (c) signals infrastructure (including all signalling, level crossing alarms, signalling power supplies and related systems and equipment);
  - (d) the electric overhead power system (including wooden overhead poles and substations) in the Wellington region;
  - (e) electrification assets of the North Island Main trunk line;
  - (f) network train control centre and radio systems and related assets;
  - (g) associated inventory;
  - (h) major track plant (including the infrastructure wagon fleet);
  - (i) intellectual property rights (including Tranz Rail's operating codes and rules, designs, drawings and asset databases);
  - (j) Tranz Rail's interest in the CLEAR fibre optic telecommunications cable;
  - (k) electricity supply contracts with Meridian Energy Limited,

but excluding assets relating to Tranz Rail's rail freight, distribution services and inter-island operations (including ferries, terminal and other buildings, stations, inter-island terminals, mechanical depots, workshops and storage facilities relating to locomotives, wagons and passenger operations, inventory and plant, loading shelters, terminal improvements at major and certain regional sites such as asphalt and light towers, terminal services such as container and forklift repair and management, amenities and administration facilities).

The "**Network**" means the rail system currently owned and operated by Tranz Rail including the Swanson to Helensville section of the North Auckland line which is the subject of an agreement between the Crown and Tranz Rail.

Legal and beneficial title to the Network and Assets will (to the extent of Tranz Rail's interest in those Assets) pass to the Crown on settlement subject to the Crown paying the consideration referred to below. No warranties will be given to the Crown in relation to the condition of the Network and the Network Assets.

4. **CLEAR Cable:** Tranz Rail and the Crown will work together with a view to Tranz Rail transferring to the Crown its rights and obligations in the fibre optic system sale and purchase agreement and easement agreement dated 28 September 1990 between CLEAR and the New Zealand Railways Corporation (as assigned to Tranz Rail Limited pursuant to the deed of assignment dated 27 October 1990) in relation to the CLEAR fibre optic telecommunications cable. The parties acknowledge that the Crown may use that fibre optic telecommunications cable for the purposes of a 'university network'.
5. **Employees:** Tranz Rail and the Crown will work together to identify those Tranz Rail employees currently employed by Tranz Rail in connection with the assets and operations to be transferred to the Crown. The Crown will offer each such employee employment with effect from the transfer of the Network on terms which are the same as, or more favourable than, the terms applicable to that employee immediately before transfer. Any redundancy payments and costs associated with the transfer of such employees will be payable by the Crown.
6. **Core Lease:** Tranz Rail and the Crown will agree to the surrender of the memorandum of lease (the "**Core Lease**") dated 20 December 1991 between the Minister of Finance, the Minister of State-Owned Enterprises and the New Zealand Railways Corporation (as lessor) and Tranz Rail Limited (as varied by subsequent variations). The Crown will procure New Zealand Railways Corporation's agreement to the surrender of the Core Lease.
7. **Lease to Tranz Rail:**
  - (a) The Crown and New Zealand Railways Corporation will grant in favour of Tranz Rail, on substantially the same terms as the Core Lease, a lease for certain parcels of land subject to the Core Lease which Tranz Rail identifies that it currently uses for its operations. For the purposes of these terms, this land is described as 'core terminal land'. The term of this lease will be for the same period as the Core Lease (including the existing right of renewal contained in the Core Lease). The rental payable by Tranz Rail under this lease will be the same as amount as payable under the Core Lease.

- (b) Tranz Rail and the Crown acknowledge that the land surrendered to the Crown includes land identified by Tranz Rail as 'future use rail land' (including for the proposed development of freight villages) and 'surplus land'. The Crown agrees to undertake certain identified capital projects which will result in the release of such land and which will improve Tranz Rail's operating efficiencies. The estimated cost of these capital projects is \$30 million.
8. **Designation arrangements:** Tranz Rail agrees to ensure that the Crown has the benefit of the designations relating to the surrendered land subject to the Core Lease in a manner which does not require any prior consent from Tranz Rail or any other party to be able to exercise the rights inherent in those designations, acknowledging Tranz Rail's ongoing rights to use those designations for the purposes of its rail service operations and agreeing to enter into suitable contractual arrangements with Tranz Rail to protect Tranz Rail's continuing exercise of those rights.
9. **Third party leases to be assigned:** Tranz Rail intends to assign to the Crown its rights and interests in all third party leases in relation to the surrendered land subject to the Core Lease. The annual revenue from these leases and other third party revenue is approximately \$5 million.
10. **Intellectual property licence:** The Crown will provide a licence to Tranz Rail to use the intellectual property to be transferred to the Crown as referred to in paragraph 3.
11. **Tranz Scenic:** Tranz Rail and the Crown will work together to transfer to the Crown certain obligations of Tranz Rail to Tranz Scenic 2001 Limited which relate to Tranz Rail's role as owner and operator of the Network. The annual revenue from Tranz Scenic 2001 Limited is approximately \$2 million.
12. **Consideration:** In consideration of the transfer of the Network and Assets to the Crown and the other obligations of Tranz Rail referred to in these terms, the Crown agrees to pay to Tranz Rail the amount of \$120 million being the aggregate of the following amounts:
- (a) for the Network \$1;
  - (b) for the Assets (excluding the Wellington station building, associated inventory, major track plant and intellectual property rights) \$1;
  - (c) for associated inventory, major track plant and assigning to the Crown Tranz Rail's rights and interests in the fibre optic telecommunications cable \$20 million;
  - (d) for the Wellington station building and associated land \$8 million;
  - (e) for the land identified as 'core terminal land', 'future use rail land' and 'surplus land' \$42 million;
  - (f) for intellectual property rights \$1; and
  - (g) for assigning to the Crown Tranz Rail's rights and interests in the third party leases and access fees payable by Tranz Scenic 2001 Limited \$45 million.

13. **Condition:** The transaction contemplated in these terms is subject to the shareholders of Tranz Rail Holdings Limited granting all approvals as may be required under the Listing Rules of NZSE Limited or under the constitution of Tranz Rail Holdings Limited and (if applicable) under section 129 of the Companies Act.

14. **Crown's Network responsibilities:** The Crown will be responsible for:

- (a) all maintenance and engineering functions required to operate the Network;
- (b) all incident management and investigation functions required in relation to the occurrence of incidents on the Network;
- (c) all network control functions required to operate the Network;
- (d) implementing, co-ordinating and maintaining the approved safety system in respect of the Network;
- (e) implementing, co-ordinating and maintaining the operating codes and rules in respect of the Network; and
- (f) implementing, co-ordinating and maintaining the certification system (including in respect of vehicles and personnel) in respect of the Network.

Tranz Rail and the Crown will agree transitional arrangements for a period of six months in relation to the maintenance, engineering, incident management and network control functions to be transferred to the Crown. Tranz Rail will use all reasonable endeavours to procure the consent of Transfield Services Infrastructure (New Zealand) Limited to Tranz Rail assigning its rights and interests in a services agreement relating to infrastructure engineering services dated December 2002 between Tranz Rail and Transfield Services Infrastructure (New Zealand) Limited and Tranz Rail and the Crown will terminate the maintenance and network control agreement dated 13 May 2002 between Tranz Rail Limited and the Crown

15. **Changes to safety system and operating codes and rules:**

- (a) Tranz Rail and the Crown will agree a process to implement the recommendations of the Halliburton Report to separate policy from operating process and infrastructure from operations in Tranz Rail's existing safety system and operating codes and rules. Tranz Rail's consent will be required to any changes to such safety system and operating codes and rules.
- (b) Further changes to the safety system and operating codes and rules following the implementation of the process described above will require the input and consent of Tranz Rail.

16. **Access to the Network:**

- (a) The intent of the parties in entering the transaction is for the ownership of the Network and Assets to be separated from Tranz Rail freight operations, thereby providing Tranz Rail with capital and for the ongoing maintenance and development of the Network and Assets by the Crown. In all other respects, the status quo will remain the same and Tranz Rail will continue



to have unrestricted and exclusive access to the Network for freight transportation on substantially the same terms as currently exists. The Crown acknowledges that Tranz Rail will continue to have the right to operate to Tranz Rail's existing timetable and any additions to that timetable. Priority rules applicable to the interaction between Tranz Rail's access rights and the rights of other operators on the Network will be agreed between Tranz Rail and the Crown.

- (b) Tranz Rail shall retain its right to exclusive access to the Network for the carrying out of freight operations unless the level of freight operations on a particular part of the Network falls below those levels set out in the Core Lease (other than for the reasons set out in clause 3.8.2 of the Core Lease) in which case the Crown shall have the right to introduce another freight operator on to that part of the Network. The Crown's right to introduce another freight operator will not apply until after the Crown has completed its investment programme as specified in paragraph 18(a).
- (c) The transfer of the Network to the Crown will be subject to access rights granted by Tranz Rail to any third party. Such third parties with existing access rights are Tranz Scenic 2001 Limited, Taieri Gorge Railway Limited, and certain members of the Federation of Rail Organisations of New Zealand who carry out heritage train journeys on the Network.
- (d) Tranz Rail will agree to pay to the Crown an annual access fee that will include a fixed and variable component. In determining the level of the access fee payable by Tranz Rail the Crown will take into account the value of the intellectual property rights to be transferred to the Crown (less the amount payable for those rights as set out in paragraph 12). Tranz Rail and the Crown will agree the value of those intellectual property rights. The following additional principles will apply for determining the level of the residual annual access fee payable by Tranz Rail to the Crown (ie, after taking into account the value of the intellectual property rights not paid for):
  - (i) there will be an incentive for Tranz Rail to carry increased tonnage on the Network;
  - (ii) the level of road user charges charged to the trucking industry;
  - (iii) the allocation of costs between Tranz Rail and the metro operations; and
  - (iv) the provision of non-commercial services on regional lines.

In addition, the access agreement would be structured in such a way as to ensure compatibility between above and below rail safety.

17. **Land transport policy:** The Crown and Tranz Rail agree to develop a process to provide Tranz Rail with an incentive to operate an increased level of services to particular regional parts of the Network as initiated by the Crown to meet the objectives of the Crown's land transport policy.

18. **Crown investment in the Network:** The Crown agrees to make the following investment in the Network:

(a) the following Network improvement projects:

Project	Time period for completion	Investment commitment by the Crown	Benefit to the Crown
Upgrading tunnels including Manawatu	Within year one	\$6 million	Eliminates blockage in the Network converting truck traffic to rail.
Coal route enhancements: <ul style="list-style-type: none"> <li>• grade elimination</li> <li>• tunnel deviation</li> </ul>	Within year one	\$6 million	Ensures access to increasing coal tonnages now and in the future
Introduction of improved train control system	Within year two	Total cost of \$23 million	Improved safety, reduction in incidents, elimination of track warrant control and improvements in track occupancy management.
Rail – Ferry Interface	Within year two	Total cost of \$5 million	Reduced congestion in Wellington and reduction in Auckland to Christchurch transit
Upgrade North and South Island main trunk lines and the East Coast main trunk line to 22.5 tonne axle loads	Within year six	\$75 million	Future proofing the Network and improving overall rail economics.

This information is confidential for the purposes of a confidentiality agreement dated 8 May 2003. This information is provided for the exclusive purpose of the transaction contemplated by that agreement. This information may also be 'material information' as defined in the NZSE listing rules and/or 'inside information' as defined in the Securities Markets Act 1988

(b) the following projects increasing access to rail:

Project	Time period for completion	Investment commitment by the Crown	Benefit to the Crown
Increasing access to rail: <ul style="list-style-type: none"> <li>• Heartland terminals</li> <li>• Improved connectivity to production sites</li> <li>• Inland ports (Microports)</li> </ul>	Within year two	Heartland terminals: \$15 million  Improved connectivity: \$15 million  Inland ports: \$5 million	Increase access to the Network and converting truck traffic to rail.

(c) The Crown will continue to invest in the Network and the Assets in line with the Crown's 2002 land transport policy to achieve the principles set out in that policy including the movement of heavy freight from road to rail.

19. **Tranz Rail investment:** Tranz Rail agrees to make the following investments:

Investment	Time period	Cost
Upgrading locomotives: <ul style="list-style-type: none"> <li>• DX fleet</li> <li>• EF fleet</li> <li>• HSE improvements</li> </ul>	DX fleet: within year four  EF fleet: within year two  HSE improvements: within year three	DX fleet: \$19 million  EF fleet: \$2 million  HSE improvements: \$9 million
Build 500 new wagons	within year 5	\$50 million
Lease new locomotives	Within year six	Value of locomotives: \$100 million

\*HSE improvements include cab upgrades and the introduction of other safety features.