

3 June 2003

Hon Dr Michael Cullen
Minister of Finance
Parliament Buildings
WELLINGTON

Dear Minister

PURCHASE OF RAIL NETWORK AND ASSOCIATED ASSETS

I write to you today in the hopes that between us we can find an effective solution to enable the Crown to move forward with its Land Transport Strategy by securing the national rail infrastructure and restructuring Tranz Rail into a viable rail operator.

As you are aware, negotiators from Treasury and Tranz Rail have been in intensive discussions over the last fortnight. The negotiations have been conducted on the premise that the Crown wishes to have a sustainable, viable rail operator providing services throughout New Zealand. The discussions to date have traversed a wide range of issues and a transaction structure has developed with the following elements:

- The railway will be split into Track Co and Op Co.
- The Crown to provide an advanced deposit to Tranz Rail of \$44m to assist the company through its short term liquidity situation.
- The Rail Network and associated assets will be sold to the Crown for \$1.
- The Crown will pay Tranz Rail a commercial valuation for land that we release to the Crown in addition to the rail corridor. It is anticipated that this will be valued in the \$20m - \$30m range.
- The Crown will pay to Tranz Rail the capitalised value of existing leases and network encumbrances. It is anticipated that this would be valued in the \$30m - \$35m range.
- The Crown intends to invest \$100m over the first 5 years upgrading the network.
- Tranz Rail will manage the rail network as agent for the Crown until 30 June 2004.
- Tranz Rail will pay Track Co a Track Access Charge that will enable Tranz Rail to be commercially viable.
- The Crown to subscribe to an equity position equal to 35% of ordinary shares in Tranz Rail Holdings.

It is these last two issues that have become the crux of the matter. There seems to be a reasonable level of philosophical agreement on the issues but agreement at a practical level has proven elusive.

In the last few days, the board of Tranz Rail has become concerned with the lack of progress. In an effort to try and bridge the gap between the negotiators, I would like to put to you two potential solutions.

Track Access Charge (TAC)

The Crown and Tranz Rail agree that the TAC should ideally be set at a level to ensure that Tranz Rail can be commercially viable but not earn excessive profits. It is fair to say that reaching agreement on the mechanics of how to calculate that has proven difficult. In addition, the WACC based approach may drive a cost plus mentality amongst our suppliers and staff which would inhibit Tranz Rail's commercial efficiency.

Although there has been significant work by both our teams of advisers, we remain concerned that a large amount of the inputs relate to untested assumptions, which can only be verified after some years of activity under a new regime. This will make it difficult to reduce the uncertainty for shareholders inherent in the renegotiation process envisaged by your advisers.

We would propose that a practical solution would be to agree on the TAC for a 5-year period (plus a PPI type escalation) at a rate of \$50m. The TAC would adjust thereafter according to the previously agreed process (based on WACC at 9.5%). This is consistent with the Treasury models but provides a much higher rate of certainty for Tranz Rail. The board considers this to be critical to ensuring a successful special meeting of shareholders.

At this level, Tranz Rail's EBIT will remain consistent with today but there will be a cash gain of \$15m per annum from a reduction in capex on the track. We would commit to no distributions to shareholders during this period and envisage reinvesting that cash back into the business.

The five-year period will enable both sides to gain a better understanding of economics of the split operation. At that point, agreeing on a methodology for setting the Track Access Charge will be a more straight forward exercise.

Issue Price for Equity

The Crown and Tranz Rail have agreed to a 35% equity issue to the Crown. However, the appropriate issue price for the shares is still under discussion. The Crown has put forward a position of \$0.67 and Tranz Rail has put forward the volume weighted average price over the last five days, \$0.86.

We base our position on the assumption that the Market is the best arbiter of share price. I am aware that the Crown does not want to be seen to be paying a premium to market and would be more comfortable at a discount. In order to accommodate this, a way forward may be a trade off between the share price and certain gains in the TAC.

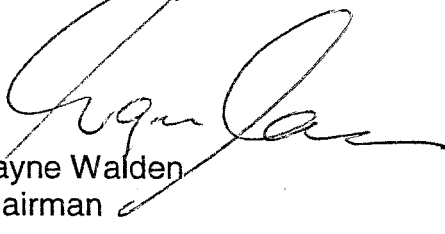
I believe that the proposals above will provide an effective set of solutions that we can take to our shareholders and are consistent with the Crown's Land Transport Strategy.

We are aware of the dual time pressures of our impending liquidity squeeze and the pending Toll Holdings takeover bid and do not want to see events overtake us.

I would like to request a direct meeting with yourself as a matter of urgency. I will make myself available at a time and place that is convenient for you.

Thank you for your consideration of the above points.

Yours Sincerely,



Wayne Walden
Chairman

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