Commercial Sensitive

Note to Minister of Finance, 11 April 2003

National Rail - Current Status and Next Steps

This note summarises the current status of discussions with the three third parties who have expressed some interest in working with the Crown, and then makes some suggestions for the path ahead, particularly in the light of Tranz Rail's profit warning of 7 April.

The third parties

Treasury and First NZ Capital (FNZC) have passed to the third parties a brief note setting out the type of arrangement that would be acceptable to the Crown. The key points set out in that note were that the Crown would expect to take over the rail network for no charge, would commit to refurbishing the network and Tranz Rail would retain the dominant freight rights.

Mainfreight led consortium

While Mainfreight itself remains very interested in being involved in rail in New Zealand, including through taking an equity position in a restructured Tranz Rail, our most recent discussions indicate its two financial partners have lost interest in Tranz Rail, particularly as a result of the latest profit warning. Mainfreight itself has the capacity to take only a modest part of the equity in Tranz Rail.

Toll Holdings

In response to the note from FNZC, Toll Holdings have made a counterproposal that would involve them owning both the network and the operating company, the Crown funding 100% of the cost of refurbishing the network, and other financial concessions from Government. Toll Holdings have been informed this proposal would be unacceptable. We have yet to hear whether they are prepared to come up with a more acceptable proposal.

Ports of Auckland

Ports of Auckland could be interested in a modest equity position in Tranz Rail alongside other buyers.

In summary, the third parties do not at present appear prepared to fund takeover proposals that would be acceptable to the Government. They will most likely seek major funding commitments from the Government as part of any deal.

Tranz Rail's financial situation and implications

Tranz Rail's most recent statements to the share market confirm that the company is in a weak financial position and has no capacity to fund any major reinvestment in the network, rail rolling stock or the ferries. In addition to refurbishing the network, the company needs to renew its locomotive fleet, build new wagons and within a few years replace the Arahura. This means that any purchaser of Tranz Rail must also factor in a substantial recapitalisation if the company is to be viable.

The company has been looking to asset sales to generate some of this capital. It has explicitly linked any Crown payment for the network to a rolling stock renewal programme.

However, a realistic payment for the network would not be sufficient to fund a rolling stock renewal programme. The Crown essentially faces the choice, if it wishes to have a strong rail operator in New Zealand, of either doing a soft deal with Tranz Rail or a third party over the network to fund new investment, or of taking equity in the company, along with a proportionate amount of control of the company.

Next steps

Over the next week or so we will be able to confirm whether or not there is any prospect of a sensible deal with a third party. At present this does not appear to be very likely.

In our view, if a third party deal is not possible the next steps should be to:

1. Explain to Tranz Rail that we don't see a network transaction with them as sensible at present, since it would leave Tranz Rail still without sufficient capital to be a strong rail company.

2. Leave the company with an opportunity to invite the Crown to make a recapitalisation offer with the Crown taking a significant, majority equity stake

3. Work with Tranz Rail to establish what level of new equity is needed to place the company in a sound financial position and enable it to fund the necessary investment programme. That work, which would require us to access Tranz Rail's commercial information, would help establish whether Tranz Rail can be made commercially viable.

If it can, a recapitalisation led by the Crown (possibly involving other transport/rail operators) would be the lowest cost path to a strong rail company. If it cannot be made commercially viable, and Government wants a strong rail company, the only option (both for the Government and the company) would be a Crown takeover of the company.

An accompanying note sets out these alternatives in detail.