

Notes for Michael Cullen/ Paul Little meeting 30/6/03

- Govt will continue to promote its Heads of Agreement with Tranz Rail. However, our first preference is not to enter a bidding war, and so it is sensible for us to discuss the options if the Toll bid succeeds.
- Toll has made a bid without seeking any prior agreement support from govt. In the meantime Govt has been developing the Heads of Agreement, which resolve Tranz Rail's short-term financial problems, give government greater control over the future use of the rail network, and reflect that in our view maintenance of the rail network at an acceptable standard is beyond the capacity of an operator acting within commercial constraints. If Toll takes over the network without any agreement with the government, govt will not have as much influence over the future use of the network as it would under the Heads of Agreement. On the other hand govt would be relieved of any financial obligations towards the rail operator or the network. That is not an unthinkable outcome.
- Govt will not enter into any agreement with a new operator that it would not have entered into with a previous operator.
- Govt has no interest in funding a set of ad-hoc subsidies to rail. Any government payments to the rail industry must reflect a parallel level of government control over the outcomes in the rail industry. So for example the commitment in the Heads of Agreement to spend \$100 million refurbishing the network is an intrinsic part of the Heads, but is absolutely not a general commitment.
- Govts preferred option, if the Toll bid were successful, would be to have an agreement with Toll along the lines of the HoA. Govt would be happy for Officials and Toll to try to reach agreement. Any agreement may differ from the HoA, but the outcome must be at least as good for the Crown as the HoA. There has been some discussion with Toll about the HoA. Key issues are as follows:

Equity

- HoA provides for Crown to have 35% equity in Tranz Rail. That is for several reasons.
 - o Company needs more equity, and a new strategic direction. Under Toll bid Toll itself can resolve those
 - o Equity issued at 67c creates value for govt. It's a claw back of the concessional access price
 - o Equity provides govt with some comfort about the future performance of the rail operator
- Govt is open to options without govt equity, but they must in aggregate be of at least the same value to govt, and must give govt at least the same level of comfort about the rail operator's performance.

Access Charges

HoA sets access charges so as to enable Tranz Rail to recover its WACC over the medium term. Govt is open to other approaches to access charges, but they must be clear to both parties and workable over a long period. This is a key value issue. Is the govt to be subsidising Trackco and if so by how much?

Purchase price for network and land rights

HoA provides for land rights to transfer at valuation (estimated at \$50 million). Network transfers at \$1. That is because in commercial terms we see the network as a liability. That price is a bottom line for our transaction. Govt is not open to paying a higher price for the network in return for a commitment from the operator to pay higher access charges because we don't believe that is sustainable.

Key performance Indicators/Step in Rights

This is a very important area for govt. Previous regime with a reputable commercial operator who had a very good reputation and with impressive references promised they would deliver, and in fact failed. HoA represents bare minimum in terms of volume-based step in rights. Key Performance Indicators foreshadowed, with financial penalties and incentives are very important.

Commitment to refurbish network

\$100 million is a modest estimate in our view. Funding is only available under the HoA. Govt would be comfortable with ensuring that where rail operators were bearing the costs network development was focused on areas most useful to those operators.

Summary

- Govt does not believe the current rail network is sustainable under a commercial model
- Govt is prepared to come to an agreement to support the rail network.
- The model of such an agreement is set out in the HoA, which establishes govt control over the network, sets out how much govt is prepared to commit to sustain the network, and provides govt with a level of comfort about the performance of the rail operator.
- Any agreement with Toll would need to be at least as good for Govt as the HoA.