

11 March 2002

Mr Chris Mackenzie
Senior Advisor
Office of Dr Michael Cullen
Parliament Buildings
Wellington

Dear Chris

Further to discussions between Dr Cullen and Mr Beard and at our meeting last Thursday, we have started to draft a proposal that we believe will be acceptable to both Tranz Rail Limited and the Crown.

Our proposal is in four parts:

- (a) Part 1 – Sale and purchase of Tranz Rail's infrastructure assets;
- (b) Part 2 – Services agreement for maintenance of the infrastructure assets, train control and train services;
- (c) Part 3 – Road / rail pricing equalisation through Transfund project funding;
- (d) Part 4 – Extensions and upgrades.

Part 1 – Sale and purchase of the infrastructure assets

- (a) The Crown would purchase title in the mainline track, structures, signals and electrification from Tranz Rail. Tranz Rail would retain the access right to use the assets for its business through a leasing arrangement similar to Tranz Rail's current lease of the rail corridor, but with added rights, such as the right to sub-lease (the "Lease").
- (b) The Lease may include step-in rights for the Crown in the event of breach by Tranz Rail or covenant certain parts of Tranz Rail actions (similar in concept to Kiwi share).
- (c) Tranz Rail would retain the Wellington Metro access right and right to the Tranz Scenic access fee or these could be assigned to the Crown for suitable value.
- (d) Tranz Rail would initially retain capital and operating expenditure obligations.
- (e) The purchase price would be paid upon completion in two parts:
 - i) Part 1 is immediately reinvested in the business through specific and identified projects agreed between the Crown and Tranz Rail. These projects would be selected to improve service levels and functionality of Tranz Rail, preserve future traffic options and shift freight off road and onto rail.
 - ii) Part 2 is a payment retained by Tranz Rail.

Part 2 – Services agreement for maintenance, train control and train services

- (a) Tranz Rail would contract with the Crown to provide:
 - i) An agreed network size and capability to agreed maintenance levels and asset condition;
 - ii) An agreed set of services (including bulk freight upgrade).
- (b) To the extent that these outcomes would be beyond those Tranz Rail would pursue or put Tranz Rail in a position of not earning its WACC plus a reasonable profit margin, the Crown would contract to subsidise the value gap.
- (c) The services agreement(s) would be for an initial term of 5-10 years with review and possible renewal at expiry.
- (d) The contract term would need to be linked to any capital investments Tranz Rail is required to make or these risks would need to be passed back to the Crown.

- (e) Payment for the services by the Crown would be PV lump-sum and an annual fee, reflecting annual maintenance and service provision operating expenditures plus appropriate coverage of capital investments. This could be developed through an Open Book approach whereby Tranz Rail presents its preferred network and services model. The Crown then prioritises and Tranz Rail and the Crown negotiate for the Crown to meet the costs of the difference. Possible expert determination could be used if required.
- (f) The Crown would hold the catastrophe insurance risk (say >\$5m per event).

Part 3 – Road / rail pricing equalisation through Transfund project funding

- (a) Transfund processes would be altered to allow for Tranz Rail to access Transfund funding on a level playing field – i.e. Tranz Rail could claim subsidies from Transfund instead of Transfund upgrading roads. This could be structured as a funding pool for heavy freight and would apply across key routes and non-key routes. We will need to develop a mechanism for this to be assessed and be implemented.
- (b) Tranz Rail would participate in the governance of Transfund.

Part 4 – Extensions and upgrades

- (a) Track extensions, upgrades and/or new services which are not covered by the services agreement in Part 2 above could be provided by Tranz Rail on an open book basis whereby Tranz Rail will be paid the required subsidy to provide these.
- (b) This process is most likely to be appropriate where Transfund road / rail pricing does not achieve the desired objective.
- (c) As in Part 2, we would need to spell out in that process what costs are included in the analysis to avoid gaming between each party's opportunity costs.

Relationship to Government Priorities

Although the proposal does not represent the “first-best” option for either party individually, it is intended to meet the principal policy priorities as we understand them. These priorities are:

- (a) Network preservation and maintenance
 - i) Government acquires underlying ownership of track with certain step-in rights.
 - ii) Government avoids assuming maintenance and investment risk.
 - iii) Agreed linear continuity is assured.
- (b) Efficiency
 - i) A large proportion of any up-front cash paid to Tranz Rail is re-invested in the business.
 - ii) A large headline price that will be retained by Tranz Rail is avoided (especially compared to the costs of the Government acquiring open access and Wellington Metro rights).
 - iii) Investments and subsidies are linked directly to outcomes (i.e. asset condition, train service levels).
 - iv) Efficiency is assured through an agreed costing and open-book basis with an expert determination process in the event of dispute.
 - v) Regional lines are retained at low cost with the ability to expand services.
- (c) Rail Viability
 - i) The Government has ongoing flexibility (through an agreed process) to effect changes to services, coverage etc.
 - ii) Single operator retains scale economies and avoids safety issues.
 - iii) Government seen as business partner.
 - iv) Changes to Transfund process encourage correct transport investment decisions.
 - v) Better safety outcomes especially in regard to logging trucks.
 - vi) Better environmental outcomes.
 - vii) Less trucks on the road, more freight on rail.

Relationship to Tranz Rail Priorities

The proposal allows Tranz Rail to focus on making a return through activities that are commercially viable in their own right, and to receive subsidies where such activities do not generate commercial returns.

It also gains the ability to compete with roading on a project by project basis, and we are confident that the proposal will create many win-win outcomes for both parties.

Like the Crown, the key determinants for Tranz Rail are deal structure, allocation of risks, financial quanta and level of commitment from each side. Together, these must be sufficiently compelling to convince shareholders that the new environment is more worthwhile than the status quo.

I look forward to your comments and trust this assists in progressing towards our joint goals.

Yours sincerely

William Peet
Group GM Strategy & Development