COMMERCIAL SENSITIVE

National Rail – Alternatives Under Option Six
9.30am Thursday 22 August 2002

Following receipt of the Revised National Rail Options Paper we understand from your office that you want further detail on alternatives under the company purchase option (option 6). This note meets that purpose and attaches advice from First NZ Capital on takeover process and timetable.

Crown takeover

In order for the Crown to successfully launch a takeover of the company there are a number of implementation issues that would need to be resolved. The most substantive of these include:

- A communication strategy to support the takeover bid;
- A well developed pricing strategy including a credible exit strategy should the takeover prove too difficult or too expensive to complete; and
- A more detailed understanding of principles to guide reconfiguration of the company on acquisition.

This implementation work is substantive but could be undertaken for when you return from overseas travel in October. You would then be in a position to take the detail of this option to Cabinet.

Timing would be critical and the management of a takeover bid within the policy process would be complex. Full delegation including the ability to make decisions and act would have to be sought by a small group of Ministers (most probably yourself and the Prime Minister) and management of the process would require a significant proportion of your time.

Once announced (immediately following the Cabinet decision), a takeover could be completed within a minimum of about 2 months but would likely take between 3-4 months to complete. Execution of the takeover offer itself would be relatively simple - the Crown's financial advisers and lawyers could execute a takeover offer with very little notice (days).

To avoid giving investors conflicting or incorrect signals, it would be essential that there is a single person who is authorised to speak on behalf of the Crown – this should be you. No other person in the Government should make any public comment on the offer. This would form the basis of the communications strategy mentioned above.

Under the Takeover Code, an offer cannot be made conditional on due diligence. First NZ Capital advise that the risk of leakage and the detrimental effect it would cause (on price) far outweigh the benefits to the Crown of undertaking due diligence, particularly since the Crown would be making a takeover offer for public policy rather than investment reasons.

The offer price would be critical to the success of the offer. Because the Crown would be perceived as having no financial constraint and a need to acquire Tranz Rail for public policy reasons, there would be a serious risk that investors hold out for a higher offer price, irrespective of what the Crown said about its price.

A credible exit strategy and financial bottom line will be crucial. Under this takeover option the Government must be prepared to walk away should the price become too high. There are significant fiscal and reputational risks of paying too much for the company. The cost of an offer to the Crown, and the ultimate success or otherwise of that offer, would depend in part on the Crown's ability to convince investors of the Crown's position on the offer price and the alternatives available to the Crown.

A takeover offer would also likely to attract opportunistic buying in Tranz Rail shares by other parties. The objective of these parties would be to acquire at least 10% of Tranz Rail to block the Crown's ability to reach the 90% threshold required for compulsory acquisition. They would then hold out for a higher price from the Crown.

The possibility of hold out occurring means that there would be a high risk of the Crown being thwarted or forced to pay an excessive price.

Re-engage with the company

Given the high risk attached to Crown takeover of the company a credible first step might be to re-engage the company on negotiations to acquire the infrastructure directly. This alternative would not preclude the Crown from acquiring the company at a later date should negotiations to acquire the infrastructure be unsuccessful or prove too expensive.

Await entry of a third party

An alternative is that the Government could await entry of a third party to acquire Tranz Rail and enter into a prior agreement with that party for the Crown to acquire the rail infrastructure post acquisition.

Given the media recent speculation about the Crown's interest in the network it is most unlikely that any party would make an offer on the company without first approaching the Government to understand its position on the rail network.

The Crown could agree to acquire the rail infrastructure for a specified amount. The acquirer would pay the balance needed to acquire 100% of Tranz Rail. This discussion would need to include preliminary understanding on rights of access, charging and maintenance arrangements.

If the parties could not agree, the Crown could agree to acquire 100% of Tranz Rail from the acquirer at the price (including transaction costs) paid by the acquirer. Hence, the Crown would need to agree the price offered by the acquirer.

Neither the Crown nor the acquirer would have the information needed to agree the detail of access and other financial arrangements in advance of the offer. These negotiations would likely have to take place post acquisition and would contain some risk for the Crown.

More work would be required on the merits or otherwise of this option.