10 August 2001

Greg Schollum
Chief Financial Officer
Wellington Regional Council
P O Box 11646
WELLINGTON

Dear Greg

"ROAD TESTING" OF WELLINGTON RAIL PPJV DOCUMENTATION

Thank you for the opportunity to comment on the draft documentation prepared by WRC.

We are impressed with the thoroughness of the draft documentation. I can confirm that happy that the overall concept proposed is workable and is happy with the broad details of the documentation.

We are very keen to work with WRC to provide the Wellington region with a world class urban rail service.

At this stage, I do not propose to make detailed comment on the documentation, since we have not gone to the stage of legal diligence, although our lawyers have had a perusal. We anticipate that there will be detailed negotiations, as required, at the appropriate time.

There are however several general points that we wish to make at this stage.

- How will WRC ensure that the private partner's risk is low, given the possibility that WRC's own funding streams may be reduced at the whim of third parties or as a result of political change?

- What does a "low rate of return" mean to each partner? It may be better to specify this in a formula at the outset. Expectations are best clarified.

- At this stage, further capital requirements for enhancing the system seem to be a little open ended. We would expect this to be specified more closely at the outset. We would also expect a return on those extra funds from day one of the extra investment.

- If we were to buy out WRC's shareholding at any stage, we would expect to acquire the future earnings stream. We are a little confused by the references to a 50% profit clawback contained in the Funding Agreement.

- We have a general view that the Funding Agreement could be simplified, to the benefit of both parties. In particular, the cross references to the cost of car travel are likely to prove in practice to be too arbitrary in effect and onerous to administer.

Once again, thank you for the opportunity to comment: I hope our comments are helpful.

I believe that WRC and are the natural partners to bring Wellingtonians a much improved and integrated passenger transport system. We look forward to the opportunity of working with you in the future to achieve this.

G. Schollum

TO ACTION:

FAX

TO: Greg Schollum, Chief Financial Officer, The Regional Council

Date: 3 September 2001

Subject: Wellington Rail Road testing

Dear Greg,

I am sorry not to have gotten back to you earlier on the content of your suite of Wellington Rail related draft documents for "road testing", but I considered that overall the documents were what I would have expected in terms of scope and detail.

The only two questions/issues I would raise but which are not really to be discussed at such an early stage, concern the level of return on investment for the Private Partner selected as well as the possibility of Wellington Rail and hence the Private Partner receiving bonuses for increasing patronage numbers on TranzMetro services over and above a certain threshold, as well as for providing very reliable and punctual services.

In terms of the level of return on investment for the Private Partner, which has not been defined yet, but is termed in your document as "low" considering the low risk profile of the investment, it is obvious that even if it is apparently a low risk investment with a contract over a 29 year period, a private sector operator such as would need to be able to justify to his shareholder (s) an interesting return on investment, to be allowed to fund the purchase of initially 50% of Wellington rail shares and subsequently the remaining 50%. In the light of the magnitude of the funds required. Do you have any idea at this point in time what level of return (ball park figure) WRC is thinking of?

In addition, as it is currently the case for our 12 year franchise for the Melbourne tram system, as well as for the other franchisees, we can earn a bonus called PGI (Passenger Growth Incentive) for increasing passenger numbers by a percentage above a certain threshold, as well as a bonus for providing reliable and punctual services below a certain threshold of OPR

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(Operational Performance Requirements, the threshold of OPR triggering the bonuses for service reliability and punctuality being a number of passenger weighted minutes). I should indicate that these two sources of bonuses have been shown to be a very motivating incentive in Melbourne for the various private operators. Would WRC envisage the implementation of such bonuses?

I hope these comments are useful for you and I am at your disposal to discuss them further at your convenience or provide you with information on these various incentives, and I confirm that is fairly comfortable with the rest of the documentation.

Comments on Draft Documentation for the proposed Wellington Rail Public/Private Partnership

Prepared for the Wellington Regional Council

22 August, 2001

Contents

- Our understanding of WRC's objectives
- partnership philosophy
- Risk allocation
- Proposed contract regulation
  - key aspects
  - comments
- Other comments
- Business transfer and establishment issues
- Modified proposal
- Process going forward

Our understanding of WRC's objectives

- Ensure sustainability of passenger services in the Wellington region and deliver on transport strategies.
- Appoint a new operator with a genuine interest in passenger transport who will make a long-term commitment and bring expertise and innovation.
- Develop a contractual relationship that works! Specifically, contractual arrangements that:
  - Facilitate and encourage improvement in service quality
  - Deliver value for money
  - Promote efficiency
  - Protect investment in assets
  - Encourage investment and innovation
  - Responsive to the changing needs of the region
  - Deliver on prerequisites (eg. safety, accessibility, affordability....)

Avoid a repeat of the current relationship with service provider

partnership philosophy

- core business is passenger transport.
- We manage each of our businesses for growth - by investing in all aspects of our services, by working in partnership with our customers and employees and by integrating our services with the wider public transport network.
- We work hard at developing long-term relationships with public stakeholders. These relationships are grounded in co-operation, transparency and shared objectives.
- We therefore support the intent behind the draft documentation prepared by WRC. Specifically, we support the introduction of a passengers charter, accountability to council and electoral bodies and operating transparency.

Our partnership philosophy is aligned with WRC's objectives

Types of risk and potential value

Type of risk	Examples	Indicative potential value
Farebox risk	• Change in car costs • Change in availability of CBD carparking	**±10% ≅ \$2m pa**
Operating risk	• Change in cost of electricity • Inter-operator relationships	**±10% ≅ \$3m pa**
Safety & performance	• Inherent defects in asset reliability • Major incident	**Eg. Railtrack paid £0.5b compensation for Hatfield**
Asset mtce risk	• Environmental and heritage issues • Hidden mtce deficit (esp. bridges)	**Eg. Bridge replacement, on J'Ville line ≅ \$5m**
Industrial relations risk	• Industrial action • Pressure on wage rates	**±10% ≅ \$1m pa**
Subsidy funding risk	• Change in Government funding policies • Change in WRC funding priorities	**±50% ≅ \$8m pa**
Law change - local	• Pricing of council carparks • Rates changes	**±10% ≅ \$2m pa**
Law change - central	• Changes in corporate tax rates and GST • Road pricing	**?**
Inflation risk	• Mis-match between inflation adjustments to costs and revenue items	**3% pa for 5 yrs ≅ \$5m**

Our understanding of the proposed risk allocation and ability to manage

WRC (Purchaser Regulator)	Type of risk	Private Operator	WRC (Major Shareholder with Board control)	Document references
○ □	**Farebox risk**	● ■	● ◩	
○ □	**Operating risk**	● ■	● ◩	
○ □	**Safety & performance**	● ■	● ◩	
○ □	**Asset mtce risk**	● ■	● ◩	Funding agreement cl.10
○ □	**Industrial relations risk**	● ■	● ◩	
● ◩	**Subsidy funding risk**	● □	● ◩	Funding agreement cl.7.1, 7.3, 4.2, 20.1
○ ◩	**Law change - local**	(?) [?]	○ ◩	Funding agreement cl.6.1, 6.6
○ □	**Law change - central**	(?) [?]	○ □	Funding agreement cl.6.1, 6.6
○ □	**Inflation risk**	● □	● □	No CPI adjustment allowed on subsidy & fares

● Allocation of risk*

■ Ability to manage risk*

* Shading denotes party is allocated risk/has ability to manage risk

Our understanding of the proposed regulatory regime

Farebox

- Prices capped at 50% of car costs (9.2)
- Prior approval by WRC of any fare changes but subsidy clawback (9.1)
- Prescribed concession fares (9.3)
- Introduction of new concessionary fares (eg. for elderly) with compensation for lost revenue (9.5)
- Co-operate with introduction of integrated ticketing (9.6)

Subsidy

- Initial 10-year term with 5-year subsidy reset (4, 5.1, 5.2, 7)
- Two renewal options with subsidy re-negotiation (4)
- Intra-period reductions for changes in statutory car charges and fare increases (6.6, 9.1)
- No obligation on WRC to pay if non-compliance with CPP (7.3)
- Increases "may be" given for changes in service levels and assets (6.5)
- Compensation for changes in statutory charges (6.1)
- Right to terminate if substantial reduction in WRC funding sources (20.1)
- Reduction in subsidy for suspended services (12.3)

Costs

- Obligation to provide specified levels of service (9.1)
- Responsibility for infrastructure maintenance and renewal (10.1)
- WRC to determine when deficiency in condition of assets and issue notice to rectify (10.2)
- Compliance with station upgrade programme (13.1)
- Completion of works agreed in AMP (13.4)

Profit

- WRR allowed to earn a reasonable capital charge on net assets employed (6.3)
- "Economic" surplus shared 50/50 with WRC (6.3)
- 50% of economic loss carried forward into next 5-year period and factored into funding review (6.4)

Farebox regulation - comments

- We suggest the operator should be allowed to introduce new innovative non-regulated fares (eg. family off-peak ticket).
- supports inter-modal co-operation and the introduction of integrated ticketing. From our experience it is crucial that operators have the opportunity to play a lead role in the design and implementation of new arrangements. would also consider investing in a concession to develop and manage the system.
- We suggest WRC should commit to using its best endeavours to influence regional transport policies to encourage use of public transport (eg. availability and pricing of carparks in CBD).
- Fares (and subsidy payments) should be automatically adjusted for CPI. Otherwise, WRRL is exposed to cost base increases without compensating increases in revenue.

Fare policies should encourage increased patronage and protect revenue base.

Subsidy regulation - comments

- Funding uncertainty and risk created by:
  - 5-year resets
  - contingent risks though CPP compliance and termination conditions
- Uncertainty will act as a dis-incentive on WRRL to invest in long-term projects and generally increase the risk profile of the business.
- Under Clause 6.6, are fares permitted to be increased to maintain relativity with car costs? How was 80% determined?
- The level of commitment to providing compensation for a request to increase services or assets is unclear (refer clause 6.5).
- Suggest the proposed subsidy adjustment for suspended services only applies beyond a benchmark level of service reliability.

Funding risk will discourage investment

Cost regulation - comments

- Suggest objective measures of asset condition are developed for infrastructure and maintenance obligations defined in terms of measurable condition targets.
- Asset condition would need to be independently assessed as part of the due diligence process.
- Option to include "escrow" arrangements for a portion of the subsidy applied to asset maintenance.
- An objective measure of condition would make WRC's right to issue a works order redundant and remove potential source of uncertainty for WRRL.
- Nature and extent of warranties and indemnities from Tranz Rail for latent defects will affect risk profile.

For the protection of both parties, asset condition needs to be objectively assessed and monitored

Profit regulation - comments

- The process for determining a "risk margin" in the cost of capital calculation is undefined. Risk will be a function of contractual arrangements, business characteristics and inherited factors.
- Drawbacks of rate-of-return regulation
  - Reduces incentives for pursuing efficiency and revenue initiatives since allowed returns are fixed and leakage of benefits through sharing of surplus
  - Encourages capital rather than operating solutions since the operator will receive 100% of allowed return
  - Compliance costs (eg. development and monitoring of valuation and capitalisation rules, accounting for capital subsidies)
- Unclear to what extent WRRL is an asset intensive business and whether ROR regulation is appropriate
  - Infrastructure assets are held on the balance sheet of WRC Holdings?
  - Lease to WRRL with obligation to maintain?
  - Ownership of rolling stock and plant & equipment?

ROR regulation has drawbacks especially for a "thin" operating business

Other comments (1)

- Termination clauses
  - "any event occurs which has a significant material adverse effect.." is widely worded (20.4)
  - Judgement order of $1m may not threaten business viability (20.4)
  - Any breach constitutes termination (20.5) - consider applying concept of materiality and "call-in" process prior to termination
- Indemnity clause (17.2)
  - Precedent for limiting indemnity to direct damages
  - Consider reducing proposed cap (30 years @ $15m pa = $450m)
  - Carve-out for pre-existing defects

Other comments (2)

- Board composition
  - All directors should be suitably qualified
  - Precedent for controlling share?
  - Reduce uncertainty of C-Share by defining matters on which C-Share has jurisdiction and specify guidelines on voting (eg. best interests of the company in terms of…)
- Competition
  - Agreement not to subsidise other public transport services as alternative to rail corridors
  - Benefits of separate rail & bus operators (innovation, back-stop to ensure continuity)
- Heads of Agreement
  - Timing of conditions precedent and commencement of due diligence
  - Suggest detailed due diligence plan, transition plan, budget and cost allocation is developed and agreed by parties
  - Justification for “low risk”
  - Capital contributions provided reasonable return

Business transfer and establishment issues

- Financial, asset and operational data available from Tranz Rail is likely to be limited and potentially unreliable (eg. internal allocations).
- Maintenance deficits and safety issues may exist for infrastructure and rolling stock (eg. crash worthiness of Loco carriage stock).
- Business will need to be defined and inter-operator agreements negotiated. For example:
  - Responsibility for the carriage maintenance depot shared with Tranz Scenic
  - Traction power
  - Station access arrangements with Tranz Scenic and Tranz Rail
  - Track access arrangements
  - Separation of joint contracts (eg. carriage cleaning)
- Environmental audits will be required with definition of responsibility for latent or pre-existing defects.
- Implications of Tranz Rail's maintenance out-sourcing plans.

Business separation will take time and due diligence may be insufficient to address risks

Modified proposal - key themes

- Reduced risks for all parties
- Encourage investment
- Incentives to improve service and grow patronage
- Promote efficiency
- Value for money
- Flexibility

Modified proposal - components (1)

Initial 2-year discovery period to reduce risk for all parties

- Establish reliable standalone operating history and ensure adequate knowledge of cost structure and asset performance and condition
- Jointly develop "blueprint" for passenger rail in Wellington with detailed planning support (eg. marketing plan, service plan, fleet upgrade plan, station upgrade plan, integrated ticketing, etc.)
- Opportunity to fine-tune contractual framework.
- "Open-book" policy with subsidy based on actual cost recovery plus a set margin. Margin based on benchmarks plus sliding scale incentive linked to reductions in subsidy levels (eg. additional 1% margin for every 10% reduction in subsidy).
- Avoids WRC committing to a 5-year subsidy stream based on incomplete knowledge and necessary "risk premiums"
- Option for both parties to terminate relationship after discovery period and re-tender.
- Could coincide with WRC ownership review.

Modified proposal - components (2)

Longer resets to encourage investment

- Remove conditions on funding continuity.
- Extend subsidy review period to every 10 years. Contract term and subsidy reset becomes 2+10+10+10=32 years.
- 10-years is a minimum period for recovery of investment.
- Residual value arrangements for substantial long-life investments and projects undertaken towards the end of a review period.

Per passenger subsidy to encourage growth and service improvement

- Consider structuring a portion of the subsidy payments (say, 25%) on a per passenger basis to encourage investment in patronage initiatives and hedge WRC's exposure to Transfund's subsidy payments.
- Cap mechanism can be applied to manage exposure.

Modified proposal - components (3)

- *Incentive to improve efficiency and invest in service quality*
  - Fixed subsidy payments subject to CPI-X adjustment.
  - WRC's share of efficiency gains through the X-factor are effectively guaranteed or "banked".
  - X-factor sets minimum hurdle and encourages WRRL to out-perform within the review period.
  - Upside potential for WRRL improves business case for investment in service quality.
  - Fixed subsidy payments and x-factor negotiated based on detailed business plan developed after 2-year discovery period. Resets every 10 years.
  - WRRL accepts profit risk during 10 year periods - no loss carry-forward

Modified proposal - components (4)

- *Confidence that future service enhancements provide value for money*
  - Adopt "Alliance" model used successfully in Victoria for major capital projects (eg. line extensions).
  - State jointly agree project brief. conducts transparent competitive tender for works. undertakes project management for pre-agreed fee based on benchmarks and independent risk assessment.
  - Ensures contestability and value for money for the State.
  - Project management by ensures disruption to existing services is minimised and safeguards system integrity.

Process going forward

- Progress on Government negotiations
  - Auckland
  - Wellington
- Position of Tranz Rail
- Timing of selection process
- Funding of acquisition cost
- Plan B
- Further assistance

Greg Schollum
Chief Finance Officer
Wellington Regional Council
PO Box 11-646
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WELLINGTON

"Road Testing" Public Private Partnership Documentation, Wellington Rail

17th August 2001

Dear Greg

We have reviewed the Draft Public Private Partnership, Wellington Rail documentation and would like to complement the Wellington Regional Council (WRC) on the information provided. It has enabled to understand the strategy and objectives of the WRC, and the process intended to achieve these objectives.

applauds the Wellington Regional Councils objective of owning the right of way, which are monopoly assets. We have long believed that a principal problem with the sale of the NZ rail system to Tranz Rail was that it replaced a state with a private monopoly that controlled the strategic assets of the countries public transport system. future depends on the popularity of the private management of public services and our experience is that this only flourishes when Governments can prove that this approach delivering communities quality services and value for money. As a consequence we are vitally concerned with the competition models that Governments design.

Our detailed comment is shown below:

- We understand that the track access and any future agreements are dependent upon the purchase price negotiated with Tranz Rail, which remains unclear. agrees that infrastructure ownership is best vested in WRC but would like to see in place an agreement on how the valuation of Tranz Metro and the associated infrastructure is calculated.
- From our reading of the document Wellington Regional Rail (WRRL) would be responsible for the maintenance of the rail infrastructure in the future. We are concerned as to how this will fit with the current outsourcing project being undertaken

by Tranz Rail, whereby the Wellington Electrification and Track Maintenance are being contracted out to a private company. Any sale of the Infrastructure might include the novation of these contracts on terms that may or may not be suitable for WRRL.

Heads of Agreement

- Clause 3.6 sees some difficulty with this clause related to the C share and the effective control it gives the WRC, this does not reflect the 50:50 partnership.

Shareholders' Agreement / Constitution

- As a 50% partner in the proposed company, would have concern over the power of the "C" share and the ability of the holder to have effective control of the company, where a majority decision is required.
- would seek a clear indication of the WRC intentions at the end of 5 years. If the WRC were comfortable would they consider doing this earlier? If the WRC sells down to 10% there will be no requirements for the company to be a LATE, with the associated reporting requirements, would the WRC be agreeable with this?
- Further details on the funding of WRRL will be required and clarified in the documents. In particular, the source and assurance of subsidies.
- The document talks about continued directorship and financial information at the end of 5 years, even when majority ownership passes to the private company. As there will be no LATE reporting requirements at this stage, we would seek clarification on what level of detail will be required.
- is concerned at the ability of the WRC to sell to a third party if the participant does not wish to acquire the shares. We believe the participant should have first right of refusal to either buy or find a suitable partner. A forced partnership may have an impact on the services offered due to differing business objectives.
- We understand that the final form of arrangements cannot be confirmed until negotiation is completed with Tranz Rail. Some of the issues arising are:
  - The rights of access and use of the rail corridor?
  - To what extent will WRRL own infrastructure?
  - would seek an active role in negotiating the purchase with Tranz Rail.
- A definition of low return needs to be quantified and reflect a legitimate commercial return. The return has to be sufficient to cover the cost of capital for the investing partner and allow the business to reinvest in assets and infrastructure.
- Clause 7 - We note that certain decision are reserved under clause 7.5 and require a unanimous decision of the board. If an agreement cannot be reached for decisions where a simple majority is required, (i.e. all other matters at board level) then the WRC as holder of the C share can appoint a director under schedule 8 of the constitution. This gives WRC effective control of the decision making process in relation to non-unanimous board decisions. would like further clarification on how this process sits alongside the dispute resolution process in clause 23.2 and 23.3.

Funding Agreement

Our comments on the funding agreements include:

- We note the potentially onerous obligations under the Funding Agreement for the maintenance and development of capital items, some of which may only be leased and not owned by WRRL.
- The payment of 50% of Economic Gain to the WRC, dis-incentivises WRRL to generate profits, and any payments made would reduce the ability of WRRL to reinvest in the business.
- The obligations to comply with Regional Transport Strategy are ambiguous and would need further clarification.
- would prefer to see an automatic right of renewal as long as the conditions and service standards continue to be met.
- We would recommend a link between the rail standards required and the funding levels. Any significant reduction in the funding would be reflected in a reduction in the standards required. The funding agreements should also be linked to the agreements for track access.
- We are unsure from reading the funding agreement whether or not this is reflective of the current agreement, if it is not some form of transition period should be allowed to enable WRRL to put in place improvements.
- . notes the dependency of Transfund funding. The current wording puts all risk of funding decreases on WRRL. Some form of guaranteed funding from WRC would spread the risk between the two entities.

Alternate Model:

understands that the possible models are complex, and require detailed consideration before settling on the most effective solution. We have considerable experience in this through our operations in the UK and are willing to discuss alternative options/models with the WRC. These proposed models would draw on events that have been tested in a commercial environment. I have indicated an alternate model below.

Considering that it is the WRC's annual subsidy to the operators of the Wellington system that gives the Tranzrail asset value, believes that an alternate model would deliver the Wellington community better value for money and higher service levels. The alternate model would have the following features:

- The WRC announces that any purchaser of the system cannot be assured of a continuing subsidy.
- The WRC negotiate direct with Tranzrail for the purchase of the right of way, the rolling stock and other assets.
- That the asset ownership be placed in a separate corporate structure to the operating organization.
- The WRC call a tender for a management franchise of the Wellington system for a term no longer than 10 years. The franchise would require the operator to bear all operating costs and minor capital expenditure, take a risk on revenue and quote to the

WRC an annual subsidy.

- That the selected operator acquires the operating organization for a price based on net assets (which will be mainly staff accruals) as a method of ensuring a smooth transfer of operations.
- That this company be kept in existence during the term of the operating contract so that it may be transferred to a new operator should one be selected after 10 years.
- That the first contract be considered a period when the WRC might consider upgrades and replacements of assets for inclusion in the subsequent operating franchise, which might be for a longer period than 10 years.

has customers in Docklands Light Rail and Manchester Metrolink who have adopted key aspects of this model with great success. If the WRC would like to talk to customers about their experiences we would be pleased to arrange a meeting, which might be by video conference if the WRC is unable to sent people to the UK.

Yours faithfully

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Chief Financial Officer
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Wellington
New Zealand

14th August 2001

ROAD TESTING of PUBLIC PRIVATE PARTNERSHIP DOCUMENTS

WELLINGTON RAIL

Dear Greg,

We have reviewed the draft documents prepared by WCR, and within the time available we can provide the comments detailed below.

In such an exercise we have been honest and straightforward in our approach, and inevitably this gives the comments a critical bias. We have no intention of being negative, but we believe it is better to be upfront now whilst you are going through a consultative phase rather than later.

in common with most of our competitors, could tender on most structures and forms of documentation. However, competence is in operating, and we are not used to being an infrastructure builder. Where contracts require that competence we normally partner with an appropriate organisation.

Our overall impression of the documents is that they are structured quite strongly in favour of WCR. The simple fact is that the more risk or burden that is placed on the Operator, the higher the tender price will be.

Our comments are best divided into two sections. The first discusses the overall structure without addressing the details of the documents. The second part discusses individual parts of the documents taking the structure as given.

1. Structure

Whilst the proposal does address WRC's concerns regarding visibility and control, it does pose some problems for private sector partnership. In particular, it places an unknown and uncontrollable investment liability on the PP.

It is possible that Governments may change policy and direction over the medium and longer term, and this may mean more and different investment, for returns which are partly social rather than commercial. This risk of funding being required without commercial return, coupled with the proposed Board and Company structure whereby the WRC has an effective control, would be unattractive. In particular, the various assertions that this is a low risk (and therefore low return) proposition would not hold true.

An alternative is to structure the new arrangement in line with competences and control. This would minimise tensions between potentially conflicting objectives, and enable better focus by the parties concerned.

We believe that a private sector operator is best placed to have responsibility for operating to defined guidelines and standards, and that Government is best placed to take primary responsibility for longer term investing in infrastructure and setting policy. Through open book management, WRC could remain clear that it was achieving value for money, whilst at the same time retaining control over policy and direction.

If the provision of funding is one of the objectives, then a third, funding party should be brought into the arrangements (such as a bank). Inevitably such an institution will require some certainty to the returns and cash flows.

A potential structure is therefore:

WRC -	Supervises operator, sets policy and direction, controls investment, owns assets.
PP Operator -	Provides services to a standard and quantum set out in a comprehensive operating contract. Fees would be payable for services received, and could be adjusted every few years to reflect profitability of the operation. A revenue growth incentive might be appropriate. Open book arrangements with WRC, and possibly Board membership. Could carry out investment projects for WRC.
Bank -	Provides long term finance to Government for investment, on security of operating projections and Government control.

Such structures have worked in other cities quite satisfactorily, and has experience of operating variants in Rouen, Barcelona and Stockholm. We would be pleased to elaborate on these arrangements if requested.

Such a structure should address WRC's concerns regarding replacing the Tranzrail monopoly with another Company monopoly, and would ease concerns expressed elsewhere that WRC should not become involved in day-to-day operating.

2. Detailed comments

Overall principles

1. 50:50 ownership – this may lead to consolidation difficulties for a private company – i.e. an inability to consolidate WR's results.

2. The proposed shareholding arrangements and Director nominations effectively give WRC control. Whilst this may be the desire of WRC, this is not attractive to investors.

3. WRC will have conflicts of interest between its 50% holding in WR and its ownership and duties in other areas. It is difficult to see how it might resolve those conflicts without putting WR at risk of coming second.

4. WCR wishes to maintain considerable control over commercial railway matters such as fares, concessions, and relativity compared to car transport costs. This does not sit easily with the fact that the revenue risk lies with the operator WR. In our view, WR needs more room to manoeuvre to manage its top line, or revenue risk needs to be partially carried by WCR.

5. There is a competitive environment between buses and rail in Wellington, which puts rail at a disadvantage as buses receive their infrastructure virtually free of charge. It is important for the viability of WR that WRC makes a form of commitment to the rail mode for the life of the contract, otherwise there is a real risk of future policy favouring buses. For example, to save funds a branch could be closed and replaced with buses, specified and controlled by WCR.

6. The 'low risk' assertion is not clear from the way the documents are structured. Most key clauses on this matter claw back super profits but do not provide any downside protection. If this structure persisted, a private operator would be obliged to build in a financial cushion to its fees, which is not ideal.

7. There is potential competition law problems with WR having exclusive rights to subsidy from WCR. We would need to take specialist advice on this matter.

8. There are circumstances in which the agreements could be terminated which are completely outside the control of the operator e.g. Transfund reducing funding. Any investment that the operator made could, therefore, be at risk or completely wasted.

Shareholder's Deed

Cl 6.2 On-selling of infrastructure rights/assets

We can understand that WRC does not want to be disadvantaged, but equity would suggest that WCR pay the same net cost as WR, not up to the same.

Cl 7.1.4 C Shares and additional Directors

This method of breaking a stalemate is rather unbalanced in favour of WRC. There are more equitable methods such as dispute resolution.

Cl 7.1.4 Directors and votes

We believe that any Director should be able to have the proxy votes of other Directors, not limited to two. In the draft, it would be possible for three Directors to outvote one, purely on physical presence.

Cl 8.2 Additional funding

This is an open ended obligation, which if not met by the PP, could lead to termination. Such an obligation, without scope for negotiation, is unattractive to the private sector.

Cl 15 Sale of WR shares to PP

This clause is a little grey, as it does not give the PP any rights to acquire, and it is not clear if WRC will sell or not. Also, WRC could sell to a third party without giving the PP a pre-emption right.

Funding Agreement

Cl 4.1 Term

The tenure beyond the initial 10 years is uncertain, as an unintentional breach (in the opinion of WRC), could cause the agreement not be extended. We believe that the non- extension path should relate to serious events which cannot be remedied.

Cl 4.2 Funding

The link of WR funding to Transfund, which is controlled by Government outside of this agreement, is a serious risk that the private sector would not find attractive. There are a multitude of reasons why Transfund may reduce funding, all of which would have a severe impact on the investment by the PP.

Cl 6 Net economic gain and dividends

The proposal relating to the distribution of net economic gain to WRC, but no increase in funding for economic loss is rather one-sided. The provisions regarding dividends and the need for reinvestment, coupled with the 5 year funding regime, probably imply that dividends could not be distributed within the 5 years. Whether or not the PP would want a dividend flow, the very fact that access to dividends and retained cash is so restricted will severely reduce the value of the investment to the PP.

Cl 7.1 Subsidy review

This clause does not give much comfort that WR would receive a fair subsidy. It is likely that costs and performance will go through both up and down cycles, particularly given the ambitious plans of WRC. To expect forever falling costs, when within the economy in general some costs are rising (such as wages), is not realistic.

Cl 9.1 Fares and subsidy

The link between fare increases and subsidy removes one of the key commercial levers of WR. Whilst WRC may want to have overall control over fare levels for political or social reasons, it seems unbalanced to expect WR to take the commercial risk on revenue.

Cl 10 Infrastructure ownership and maintenance

There is a potential conflict from WRC owning the infrastructure, and improving and investing in it, and WR being responsible for maintaining it. This clause would need considerable support from schedules detailing what is actually expected from WR in terms of maintenance. Otherwise there will be many detailed discussions over why a piece of infrastructure is, or is not, suitable and fit for purpose.

Cl 11 Station upgrade

Such a capital programme would need definition before entering into the contract, and specific funding within the WR business plan.

Cl 12 Suspension rights and penalties

These appear quite limited for WR. The allowable reasons for suspension would need to be expanded to provide for an enlarged category of force majeure events, and those caused by WRC or WRC's obligations, such as infrastructure availability.

The rate of penalty ($0.5 per seat km) is extremely high – for example, the cancellation of an eight car train with, say, 600 seats, travelling 20 kms, would cost $6,000. This is despite the fact that alternative transport was provided, and maybe only a few people wanted to use the train. A penalty regime is appropriate as an incentive, but there needs to be balance in the size of the penalties, and there needs to be an upside to any performance regime in terms of bonuses.

Cl 13 29 Year capital plan

This is extremely long range for a business, and is more appropriate for public sector projects. Such a plan may need to be structured in stages so that it can evolve over the period.

Sch 2 Minimum Service Standards

It is important to know whether these standards are realistic or not, and for that we would have to assess current performance. If Tranzrail are some distance from achieving these standards, WR would have to factor in expenses to provide the desired quality.

We hope that our comments are helpful, and we would be pleased to elaborate on any points if required.

Yours sincerely