

25 May 2004

Barry Leonard  
Greater Wellington Regional Council  
Wellington  
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Dear Barry

## Rail Funding Contract

### 1 Introduction

As requested I have reviewed the latest draft (21 May 2004) version of the Funding Contract (**Agreement**), including the revisions to clauses 9, 10 and 11.

I will in this note confine my observations to major issues rather than comment on detailed drafting. The document is clearly a working draft and some drafting tidy up would be desirable. My comments cover the following major issues.

- Any major omissions?
- Overall balance of Agreement.
- Asset Management Plans.
- Capital funding.
- Step-in Rights.
- Miscellaneous.

### 2 Any major omissions?

In certain respects the Agreement has been completed in a vacuum. Uncertainty exists as to track access, maintenance and responsibility of infrastructure associated with the tracks. Also Tranz Metro's organisation and whether the urban passenger rail services will be held in a separate stand alone subsidiary or merely a division of Toll Rail etc is unknown. That information will have considerable bearing on the content and structure of the Agreement. This may result in significant amendment to the current draft.

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Subject to those important caveats, and our comments below, we have not identified anything major that is currently not contained in the Agreement. The content is comprehensive and covers all issues we would expect in an agreement of this nature.

The Agreement is subject to four important conditions precedent. The draft should be amended to make it clear that the Agreement does not commence until these conditions are met to the satisfaction of Greater Wellington. A time period should be included. The condition precedents cover the approval of a suitable track access Agreement, and a Business plan (which will also incorporate an Asset Management Plan). Equally important is agreement on the initial funding level for the first year which is to be split between operational and capital.

While we do not believe that there is anything important missing from the Agreement, there are certain areas of uncertainty which should be tidied up. We think you should expect considerable discussion and negotiation with Tranz Metro before a final Agreement is concluded.

### **3 Overall balance of document**

The document, in its various drafts, has evolved over a long period of time. You have had the input of many people including Transfund. However we understand that there has been little, if any, input from Tranz Metro.

Considered individually, all of the provisions of the Agreement have considerable merit. Standing back and looking at the package, we consider there is a risk that the balance of the document may have moved unreasonably against Tranz Metro. While having adequate protection for a funding contract as significant as this is both desirable and appropriate, if the balance goes too far, this can be counter productive. Undue restrictions may not incentivise the operator to provide the best services or to invest to improve the services. They could include risk premiums that adversely affect pricing. Many of the provisions of the Agreement reserve wide discretions to Greater Wellington. The operator is likely to have some concerns about how this will work in practice.

In addition Greater Wellington has comprehensive reporting and monitoring requirements, and extensive rights which go to the core of the operator's business. This includes the pre-emptive rights to buy the business should Toll Rail ever wish to sell, and extensive 'Step-in Rights' which give Greater Wellington the ability to effectively appoint a receiver to manage the business in the event of default.

For tactical or negotiation purposes it may be desirable to present a 'boiler plate' contract covering all possible circumstances reserving significant rights to Greater Wellington. However we consider that many are likely to meet stern resistance from Tranz Metro and Toll. It is inevitable negotiation will occur. It would be unrealistic to expect agreement will be reached on all the measures that you have currently included. As a minimum you should make that possibility clear to both your Councillors and Transfund.

#### **4 Asset Management Plan**

The Agreement is a little unclear as to the role of the various plans. It envisages a comprehensive Business plan, which must be approved at the outset. The Business plan must incorporate an Asset Management Plan, but there is also reference to Infrastructure, Infrastructure agreements, Capital Expenditure Programme, and Rolling Stock Management Plan. The inter-relationship of these various plans should be tidied up. Recital H, and the condition precedent envisages the Business plan will be agreed before commencement. The definition envisages that the plan will be approved after commencement. We would have thought it difficult to agree the initial funding level, or at least the capital component part, until the Business plan was complete. Clause 11.5 also refers to a three yearly review of the Business plan whereas clause 3.2 envisages it being revised on Review Dates (five yearly).

#### **5 Capital Funding**

It is very difficult to lay down any regime at this stage regarding the funding of capital improvements. This is particularly so when the responsibilities for infrastructure upgrading between Trackco and Toll Rail remain unclear.

The current draft of the Agreement contemplates two types of capital funding. The first under clause 20.1 is where the operator commits to capital expenditure under the Asset Management Plan. In those circumstances the operators' commitment to that work will be a factor in determining the appropriate level of funding. The provisions of clause 20.2 contemplate the possibility that Greater Wellington may fund a lump sum in which case the asset could remain in the ownership of Greater Wellington and be leased to the operator on an agreed basis. This would be practically very difficult for a part-funded purchase of any capital item.

Whether the provisions contained in clause 21 will be acceptable to Tranz Metro or be able to be implemented as a matter of practice, remains problematic at this stage without better knowledge of all relevant circumstances. While practical implementation remains unclear, there is nothing in the provisions of clauses 20 or 21 dealing with funding of capital which commits Greater Wellington to anything at this stage.

#### **6 Step-in Rights**

Clause 27.7 confers on Greater Wellington 'Step-in Rights'. This enables Greater Wellington in circumstances where it is entitled to terminate the Agreement, to enter into and run the Rail Services. This is equivalent to Greater Wellington being able to appoint a receiver and manager of the business of Tranz Metro.

The reserving of such rights requires very careful consideration. The current wording is not sufficient.

While you may encounter significant opposition to the reservation of such rights, they could be particularly effective. Their mere inclusion, even if not exercised, could significantly improve your negotiating position with Tranz Metro should default occur. While Tranz Metro may object, the level of your funding is very significant

relative to their fare revenue. Were Tranz Metro to borrow from a bank, a lender's right to appoint a receiver and manager is customarily accepted.

These rights will be subject to the provisions of the Receivership Act. This imposes various administrative and other duties on Receivers. We recommend that the provisions enable you to appoint a person or person(s) to be the 'receiver manager' rather than you having to personally carry out the role. In order to take priority over any lender to the group, registration should also occur. The machinery provisions as to how the rights can be exercised should be expanded in greater detail.

## **7 Other miscellaneous comments**

Other points we noted in our review were:

- Toll Holdings Limited, the ultimate parent of Toll Rail is included as guarantor. We imagine that they would prefer the parent of the rail group, Toll Rail Limited (the old TranzRail) to be the guarantor.
- Clause 4.2 gives Greater Wellington the option to extend the term for a further five year period up to a maximum tenure of 31 years. There is no basis or criteria recorded for your exercise of that option. From a legal point of view, TranzMetro will derive little comfort from its inclusion beyond the certainty of 10 years.
- Clause 7.1 refers to an approved 'Annual Operating Plan'. We could see no other reference in the Agreement to this plan or any requirement for the operator to produce one.
- In clause 9.2 the Track Access Agreement is deemed to confer to benefits on Greater Wellington. This is so Greater Wellington can enforce its provisions. To be effective, this provision needs to be included in the Track Access Agreement itself. This will require the agreement of Trackco.
- The provisions of clause 9.4 give Greater Wellington the ability to acquire assets leased by TranzMetro which are essential for the provision of the Rail Services. Obtaining this will require the approval of the party leasing the Infrastructure or Rolling Stock to TranzMetro.
- The regime for reduced payments for non-performance in clause 16 are not always clear as to their practical application to a non-expert. We imagine Tranz Metro will ask for equivalent incentives for good performance.

Extensive redrafting of the Agreement at this stage may not be productive. While uncertainty remains about arrangements for track access, the operating structure of Tranz Metro, and their own plans regarding capital funding, much effort could be spent changing the Agreement for little practical purpose. If you wish to retain the 'step-in rights' some changes would be necessary to that clause.

Kind regards

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