Ministry of Transport
TE MANATŪ WAKA

THE TREASURY
Kaitohutohu Kaupapa Rawa

Aide Memoire

Minister of Finance
Minister for State Owned Enterprises
Minister of Transport

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KiwiRail Turnaround Plan: Officials' Due Diligence

The due diligence work that you commissioned on 10 February has largely been completed, and officials are finalising their report. The attached material (krg due diligence; power point version of key findings:1792998v1) summarises the main findings and conclusions. Key points for your consideration are set out below:

Strategic Options for the Rail Freight business

The status quo is not sustainable – it leads inevitably to slow decline and eventual exit. The main alternatives to the status quo are:

- The Crown endorses KRG's long-term plan, with attendant capital expenditure implications (of around $1 billion over 10 years).

- The Crown exits this business, and explores options for its disposal.

- The Crown endorses key aspects of the long-term plan – this preserves future options to determine the optimal configuration for rail for the long-term – but could cost up to $750 million over three years *(officials' preferred option).*

Findings from due diligence

PWC and AECOM were contracted by Treasury to undertake, respectively, financial and engineering due diligence on the KRG plan. Due diligence did not identify any glaring holes in the modelling but did reveal a number of limitations and risks in the assumptions/plan, most of which were known and understood by KRG management, and are being acted upon.

KRG's infrastructure and rolling stock expenditure forecasts are based on bottom up analysis rather than the stated objectives of the turnaround plan. Capital investments are driven primarily by engineering and safety needs rather than service delivery improvements to meet customer expectations and/or revenue generating priorities.

Costings are indicative and broad brush, rather than being derived from specifically costed investment projects. The lion's share of expenditure would go to renewal and maintenance of existing track and other infrastructure, to protect existing revenue. A more modest proportion is directed towards new capacity/capability. In the turnaround plan, there is no new capital expenditure for rolling stock in the first three years (over and above what has already been committed by KRG). Both sets of advisers commented that a "quick win" strategy, focused on revenue generation, might argue for some additional rolling stock investment on the main trunk, instead of "below the line" works.

The commercial business case also assumes a range of efficiency benefits associated with service and reliability improvements, but these are not separately specified or costed. A clear strategy for securing these gains would be desirable.

In short, whilst the KRG turnaround plan is a good start, in terms of overall direction of change from a business that is not a going concern at present, to one that has the potential in due course to be commercially viable, it is some way short of being a detailed business case for capital investment projects with specific outcomes. It sets out "what" KRG wants to achieve, but not – in concrete, measureable terms – the "how".

Customer Response

Engagement with senior customer representatives has confirmed that improvements in reliability, timeliness performance, and in the quality and availability of rolling stock, would motivate customers to put more freight business onto rail. Precisely what this would mean in terms of the pace and magnitude of volume and yield growth is uncertain. For customers, the highest priorities for capital investment are to upgrade the NIMT and improve InterIslander capacity.

Options

Of the options included in the KRG turnaround plan, only their "preferred" option was fully tested and costed. The two short-line alternatives considered by KRG return NPVs that are slightly less negative than the preferred case, but these outcomes are heavily dependent on the assumptions made by KRG management. Moreover, the wider economic or social costs of the other options were not considered (and were not possible to estimate in the time available).

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Public Policy

Rail clearly contributes positively to the economy for carriage of high volume commodities over long distances. It carries 15% of the total freight task in terms of net tonne kilometres. This task is estimated to grow by 40% by 2020 and to double by 2040, reinforcing rail's importance as part of New Zealand's transport infrastructure. Ongoing efficiency and effectiveness in the transport sector will contribute to export competitiveness. Rail already moves certain kinds of freight at lower marginal cost than road. Bringing the existing track and rolling stock back up to an acceptable standard supports these objectives. Assuming no price distortions exist that favour roads, these services should cover their full cost.

As an SOE, KRG needs to be commercially viable for it to contribute positively to the transport system. Securing its current revenue, and enabling revenue growth is consistent with this objective.

The presence of an appropriately configured rail network also offers an **option value** - preserving or expanding transport solutions that otherwise might be lost or diminished, such as supporting port aggregation (in response to changes in international shipping schedules/services), supporting firms to achieve production and distribution efficiencies, hedging against major and prolonged oil price rises and providing transport resilience and insurance against future events including flexibility should freight volumes grow sharply.

Other Risks

A major, front-loaded investment programme would stretch KRG's project management and delivery capacity and capability. More efficient operations within KRG will improve the prospects for securing the objectives of the business case. Efficiency gains will come from better and more reliable rolling stock etc, but also from different working practices. Indeed, without improvements in the workplace, performance gains from capital investment may be hard to realise.

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What KRG needs

KRG's Board and management are looking to Ministers for commitment in principle to the objectives of the turnaround plan, an indication of willingness to commit the capital necessary to achieve these objectives, and an initial instalment. They expect funding to be accompanied by conditions, and draw down of any funding to be based on approved business cases.

What we suggest

There is no easy or right answer. Rail freight's role as part of New Zealand's transport system may be optimised by being limited to the current set of commercially viable IMEX (import-export) lines, by the full network solution as proposed by KRG, or by something in-between

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It is not necessary (nor desirable) to commit to any one of these options at this time. We suggest instead that the options be tested further by:

- Ministers indicating support for KRG to become a sustainable business.
- Appropriating funding in this budget for Year 1 only of $215 million (and rolling over $35 million of 2009/10 allocation).
- Indicating that this is the first year of an ongoing programme, subject to performance and business cases.
- Requiring production of a costed 3-year investment case, and detailed examination over that period by KRG and officials of all the options *[deleted – negotiate without prejudice]*

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