Initiative Template for CAPITAL Proposals

Vote: Transport

Co-Votes: NA

Title: Investment in the Rail Freight Network for 2010/11 and Following Years

Brief Description: To invest in the rail freight network to provide a strategic transport option for the movement of freight in New Zealand. Freight volumes are forecast to increase by 70 to 75 percent over the next 25 years. Government investment in the national rail freight network will give major freight businesses an economically efficient means of longer distance carriage and, importantly, provide a critical link to and from ports.

The strategic transport option will be achieved by investment in KiwiRail's national rail freight network over a 10 year period.

The 2010 KiwiRail strategic plan proposes an upgrade of the major freight network corridors. Rolling stock and network infrastructure would be upgraded to improve service to its freight customers, attract new freight volumes and deliver greater yield on existing and new business. The focus of the upgrades is on the Auckland to Christchurch corridor.

The 2010 strategic plan assumes that the commercial rail businesses will fund rolling stock improvements from cash flow. Network investment would be funded by a combination of KiwiRail's own resources and a government contribution.

This upgrade will grow KiwiRail's revenue opportunities on the national rail network and should see the business in a cash positive position after 10 years. From a national perspective it will preserve the strategic option value of rail for transport.

In addition it is proposed that $50 million of government funding be provided as an equity injection to cover a cash shortfall for renewals of $50 million for 2009/10.

Initiative Type: Capital

Priority Area: 2010

PA Objective: Refurbish / replace

Initiative Ranking: [N/A]

Funding sought ($ thousands):

*$000**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	*Deleted – negotiate without prejudice*
Net capital impact	50,000	**317,000**	**226,000**	**187,000**	

Funding is being sought for 2009/10 to 2013/14. The Kiwirail 2010 strategic plan covers 10 years and the indicative funding for outyears is detailed later in this paper.

Recommended Decision in Budget 2010
Approve

Risk if Budget 2010 Decision is not made
If the Budget 2010 decision is not made then the current full rail network business would not exist. There would need to be a detailed evaluation of a radically restructured rail business, perhaps, along a regional basis. It is likely that the rail link between the North and South Islands would be discontinued. There would be a dramatic and irreversible change in the rail business and the movement of freight. There is no evidence or confidence that such a model would be sustainable long term.

Gateway Number
Not applicable

Whole of Life Cost
The Whole of Life Cost is the ten year funding request from the government. The KiwiRail business will be ongoing beyond that point but costings are not known.

Whole of Life Cost	2010 $m	2011 $m	2012 $m	2013 $m
Total national freight network	**50**	**317**	**226**	**187**

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Detailed Costings
The 2010 KiwiRail strategic plan focuses on the commercial performance of the freight business, with particular focus on the domestic market (Auckland to Christchurch) and other major freight lines serving ports.

The net investment required is heavily front loaded in the first three years of the plan to enable the provision of the quality of service that customers require. Increases in freight volumes and yields should flow from performance increases in reliability and timeliness.

The detailed costings for the capital investment programme come from the 2010 KiwiRail Group strategic plan. The costings reflect the strategic plan assumptions that the growing commercial businesses will fund rolling stock improvements from cash flow. Network investment would be funded by a combination of KiwiRail's own resources and a government contribution.

In the table below the rolling stock improvements are funded from EBITDA. The 'Network Capex' is funded by the two shaded lines titled "Balance available for network Capex" plus "Government funding request".

KiwiRail financial, capital and funding outcomes are shown in the following table.

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Scaling options
This bid presents funding requests based on the 2010 KiwiRail strategic plan. Not attempt has been made to scale the funding request, although alternative options have been evaluated.

The 2010 strategic plan states that the funding request is fully required to support the success of the plan and to take KiwiRail to a cash flow positive position at the end of 10 years.

One possible alternative scenario would be a short line approach. The short line approach would likely reduce back to two metros, a ferry and the golden triangle (perhaps) over time. It is doubtful whether this approach would enable of rail to be a significant contributor to transport and the economy.

It is likely that an alternative approach, such as the short lines, could result in additional cost to the government over a 10-year time frame. This is because a significantly reduced scale network would not be able to generate the additional net revenue which would enable KiwiRail to self fund part of the capital investment for the remaining parts of the network.

The Minister of Transport has indicated that the funding request should be submitted without scaling. He has indicated that additional analysis and possible scaling and phasing may occur as negotiations progress.

Funding Options
The proposed investment in the national rail network will be a balance between KiwiRail's own resources and the Crown. There does not appear to be any alternative source of funding that could substitute for Crown funding.

Problem Definition
How to deal with a substantial increase in freight volumes
There will be a substantial increase in the volume of freight carried in New Zealand over the next 25 years (see *National Freight Demands Study*; Richard Paling et al, September 2008.) The pattern of carriage is also likely to change significantly.

The increases in freight volumes will place pressure on the roading network both in terms of infrastructure requirements and in terms of congestion levels. The businesses that generate and receive freight will be affected by any failure to provide the infrastructure to efficiently handle the increase in freight volumes.

How do we know this initiative will deliver the outcomes (intervention logic)?

Rail as a strategic transport option

Rail in New Zealand provides a strategic transport option for both freight and metro commuters. Over the last 30 years, investment in rail has failed to match business customer and passenger demand. It has also failed to match asset management requirements. In the freight area the lack of a quality service, reliability and lack of timeliness has resulted in a loss of market share to road transport. In the metro commuter area demand has been suppressed by a relatively poor quality service. Central and local government are now addressing the demand in the Auckland and Wellington metro areas with significant infrastructure and operational upgrades. The major outstanding issue now is the level of upgrade required for the national rail network for freight.

Rail has high fixed costs and generally cannot recover all its costs through its service prices. Also competition from road transport places a ceiling on rail prices. In most countries the government provides funding to rail to reduce highway congestion and provide commuters with public transport opportunities. Rail in New Zealand is no different to most countries overseas.

Rail in New Zealand carries about 14 million tonnes of freight a year. This is equivalent to about 6 percent of the national freight load and about 15 percent when distance is taken into account. Rail carries up to 50 percent of export and import volumes to a number of major ports.

The present volume of freight on rail represents over 700,000 truck journey equivalents a year. Any reduction in the capability of the key rail corridors would see a large part of this freight move back onto the road with safety and congestion impacts.

Rail can offer real resource cost savings to the economy. Real resource costs include driver time costs, track/road maintenance, and vehicle operating costs. In addition to these economic benefits, rail can reduce negative effects of land transport such as congestion, accidents, and emissions. It has been estimated that the carriage of freight by KiwiRail, rather than by road, has an annual real resource cost saving of about $200 million.

Investment in rail provides a strategic transport option for the future. It gives major freight businesses an economically efficient means of longer distance carriage and, importantly, provides a critical link to and from ports.

Factors that support upgrading rail to maintain its strategic option value

Rail and road transport are generally complementary in the carriage of freight. Rail has cost and efficiency advantages for the higher volume, longer distance carriage of freight. It can also provide significant efficiency and congestion benefits where freight is carried between sea ports and inland ports. It performs particularly well when there is fixed point-to-point transit.

Increasingly throughout the world, freight for longer distance carriage, and for export and import, is carried by truck to an intermodal transfer facility for carriage by rail. The heavy vehicle productivity project also identified opportunities for greater use of rail through the transport of fully laden containers.

Freight volumes are forecast to increase by 70 to 75 percent over the next 25 years, so if rail does not maintain its share of the increased volumes approximately 500,000 additional truck journey equivalents a year would be carried on the road. This has implications for both safety and roading infrastructure investment needs.

Rail, with its sunk cost network, can carry greater volumes for relatively minor additional expenditure. For example, on the line between Auckland and the Port of Tauranga it is estimated that the freight capacity could be doubled by the expenditure of about $60 million for track infrastructure, and a similar amount for rolling stock.

Changes in the shipping patterns for export and imports favour the use of rail:

- the use of larger ships requires the rapid clearance of containers from ports. Rail is better suited to this task.
- the routing of export freight to ports to connect with preferred shipping services is a growing role of rail. For example, Fonterra moves export freight from its plant at Whareroa by rail to the ports of Auckland, Tauranga and Napier to access preferred shipping services.
- concerns in European markets about the environmental impact of exported New Zealand goods points to the use of rail and ships for transport. This 'food miles' issue contributes to the decision by major exporters, such as Fonterra, to use rail for transport within New Zealand.

Major cargo movers support the upgrade of rail
The Ministry of Transport carried out direct interviews with over 50 of New Zealand's largest cargo moving businesses/organisations in late 2009. International competitiveness is regarded as the number one priority for all businesses interviewed.

Rail specific feedback from the freight sector included:
There has been a steady decline with companies' use of rail freight transport because of poor performance, non-existent services and lack of rolling stock availability.

There was general agreement that rail should operate "solid spine services" only. For example, Palmerston North–Auckland, Tauranga–Auckland, Dunedin–Christchurch and the Interislander.

Lesser used corridors should be closed and the cargoes from these fed by trucks to the main trunk routes. This would ensure that more rolling stock was available on the main trunk routes.

The lines that are making a commercial return should be retained. Evidence suggests that transport businesses are not prepared to cross-subsidise non-performing rail routes within the current rail freight tariffs.

Rail is not an option for time sensitive cargoes such as chilled meats, apples and other temperature controlled cargoes.

The use of inland ports in other centres should also be investigated as these can relieve traffic congestion over peak periods.

A sizeable portion of the firms interviewed stated that road was the least preferred option to and from ports. However reliability, speed and frequency of deliveries are important for most of the businesses questioned as they all are trying to meet or exceed customer requirements. The largest benefit using road is that cargo is only handled once.

Current situation provides a strategic investment opportunity
The purchase in 2008 of Toll NZ's above-rail trading business places the total national rail business in government ownership. This provides a significant strategic investment opportunity for the rail industry and the economy. Previously the split of ownership between the government and the private sector made it difficult to justify and coordinate investment, or to know what the true costs were. With the government as owner it is appropriate to invest to obtain the synergies between the two parts of the business.

From an economic policy perspective the key factor in deciding the level of investment in rail is not the price paid for previous purchases or whether rail can cover its full long-term economic costs. It is whether investment in rail will provide an option value that is likely to provide significant benefits for the economy.

Investment in the rail business is likely to increase rails share of freight volumes. If rail also maintains its share of future freight growth then it is likely that the rail business will become cash flow positive after 10 years.

Success factors for KiwiRail
There is substantial ability for KiwiRail to increase its share in the domestic, bulk and IMEX (import/export) markets.

The domestic market has a particular focus on the Auckland to Christchurch line. Currently rail has an 18 percent share for all modes of traffic between Auckland and Christchurch. This has declined from approximately 60 percent in 1995. This decline is directly correlated with the investment profile which has failed to maintain a time definite service on the corridor and eroded rail's competitive position.

The opportunity to significantly increase volume and capture some of the lost market share will require an investment in catch-up capital and removal of specific constraints on the main trunk line.

The bulk and IMEX freight segments have excellent growth potential and there exists significant opportunity to pick up volumes and drive yields.

To achieve this KiwiRail needs to deliver time definite service to its customers, and to get closer to and better understand its existing and potential customers and their businesses.

The successful upgrade of the rail business will both position rail as a sustainable business but also provide the platform for rail to carry additional freight volumes beyond 10 years. This will help to meet the forecast growing demand for the carriage of domestic freight and the carriage of freight to and from ports.

Evaluation of initiative's contribution to outcomes
It is intended that investment in the KiwiRail rail business will be subject to intensive monitoring by treasury and the Ministry of Transport. An output plan will be established which will consider capital expenditure against plan, increases in freight volumes, increases in anticipated revenue and increases in yield. The Ministry of Transport will lead this monitoring. Reports will be provided to relevant Ministers, most likely on a quarterly basis.

An annual review will be undertaken against business plans and the release of funding, within the Budget appropriation period will be based on this review.

Funding in Years beyond 2013/14

This bid seeks funding for 2009/10 to 2013/14. The Kiwirail business plan is for 10 years. It is likely that Budget funding would be limited to 4 years (plus 2009/10) and any funding for outyears would be the subject of a new Budget request. Ministers may give indicative support of the 10 year 2010 KiwiRail strategic plan. But any future funding is likely to be based on the business achieving its goals in the 2009/10 to 2013/1. The indicative future funding request is detailed below:

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