Office of the Minister of Finance
Office of the Minister of State Owned Enterprises
Office of the Minister of Transport

Chair
Cabinet

KIWIRAIL GROUP TURNAROUND PLAN

Proposal

1. To provide the context for consideration of the KiwiRail Group (KRG) Turnaround Plan.

2. To inform Ministers of the findings of the due diligence exercise completed on the KRG Turnaround Plan for the rail freight business and consideration of the implementation strategy.

Executive summary

3. KRG was established under government ownership in 2008. Two years on, KRG has responded to a request from the Minister of Transport and Shareholding Ministers (Ministers) to develop a Turnaround Plan for the group focussing on creating a sustainable freight business and supporting the track network. The objective of the Turnaround Plan is for KRG to become, within 10 years, a sustainable freight business that is able to fund its ongoing operating and capital expenditure solely from customer revenue.

4. The Turnaround Plan envisages total capital expenditure over 10 years of approximately $4.6 billion, of which the Crown is being asked to contribute some $1.1 billion, largely in the first five years, to complement funding generated from customer revenue. This is achieved by retaining, within the business, all cash surpluses that arise from the increased revenue streams rather than paying any dividends to the Crown.

5. The Turnaround Plan does not address the issues associated with the debt/equity balance within the KRG balance sheet.

6. Ministers requested that the Turnaround Plan be subject to engineering and financial due diligence; that major freight customers be consulted to understand their service expectations and likely response to improved rail service performance; and that advice be provided on public policy case for investing in rail.

7. The findings of due diligence, consultation and public policy analysis included:

   7.1. the status quo rail freight business is not sustainable and making no change would result in KiwiRail Group's slow decline and eventual exit as a nationwide freight sector participant;

7.2. the presence of an appropriately configured national rail network (Auckland to Christchurch) offers an option value by preserving a freight transport solution that otherwise might be lost or diminished if the network is separated into two or three separate short-line networks;

7.3. key customers indicated that improvements in reliability, timeliness performance, and in the quality and availability of rolling stock, would motivate them to put more freight onto rail.

8. Whilst the KRG Turnaround Plan is a good overall approach, it is some way short of being a detailed business case. Further work is required across a range of areas including:

8.1. *[information deleted in order to enable the Crown to carry out commercial activities without disadvantage or prejudice]*

8.2. Developing business plans and associated engagement with stakeholders focused on revenue assumptions and their ongoing commitment to rail.

9. The successful implementation of the Turnaround Plan and preservation of a national rail network will require considerable support from stakeholders (unions, management and customers). It will stretch KRG's management's capacity and capability to deliver.

10. The KRG Board and management are seeking Crown commitment to the objectives of the Turnaround Plan, and an indication of Ministers' willingness to commit the capital necessary to achieve those objectives over the next five years.

11. Rail has option value, and maintaining a rail network represents an insurance against changed future conditions, such as higher fuel prices. Once closed, it can be extremely expensive to reopen rail corridors, particularly if the land has been converted to other uses, so maintaining intact networks can keep costs down overall. This is particularly important given that forecasts indicate an approximate doubling of the current freight task by 2040.

12. Notwithstanding the considerable risks, Ministers are satisfied from the due diligence results and from officials' advice that there is a sufficient basis for the Government to provide new capital to support the objectives of KRG's Turnaround Plan, but that this support is conditional on the KRG board and management satisfying Ministers that the risks identified in the due diligence process are being addressed.

13. Ministers consider the Turnaround Plan the most viable way forward. However, the implementation of the Turnaround Plan will be subject to continual review to ensure optimisation of investment in the rail network and rolling stock.

14. The Budget 2010 package includes a request for $250 million for the rail freight business as a tangible commitment of government support for the objectives of the Turnaround Plan and notes that the government plans to support a strategy to return KiwiRail to commercial viability that forecasts a Crown contribution of $750 million CAPEX over the first three years.

Background

Purchase of the whole rail business and its current condition

15. The ownership status of the rail business has changed four times in fifteen years. The most recent change occurred in mid-2008 when the Government purchased Toll's rail business for $690 million and renamed it KiwiRail. Additional debt was taken on to meet the total costs of the purchase.

    15.1. A total of $240 million in new debt has been provided to KiwiRail since the Crown purchased the rail operator from Toll.

    15.2. An additional $140 million debt facility was provided to NZRC from about March 2009 (after it purchased KiwiRail from the Crown) for the buy-out of the United Group contract ($25 million), purchase of new locomotives ($75 million) and working capital ($40 million).

16. Prior to 2004 investment in the rail network and associated rail services was minimal, leading to deterioration in the network and decline in service quality. The condition of the below track infrastructure and rolling stock continues to present serious fit-for-purpose issues. There has been a lack of a consistent and clear customer-focused strategy to preserve market position. This has led to a lack of customer confidence. There has also been an absence of organisational certainty due to differing ownership objectives.

17. The net effect is that rail has lost relevance as a time-dependant freight option and has seen its share of the total freight task decline over time. Since 1993 rail's share of the net-tonne kilometre freight task has declined from approximately 20% to 16% in a period where the total freight task grew by 87%.[1]

18. The present assessment of renewals CAPEX indicates that 72% of the CAPEX budget is required to meet existing safety requirements to maintain service levels, rather than customer service improvements.

Minister's request for a Turnaround Plan from KRG

19. The Minister of Transport requested that KRG prepare a strategy to re-position KRG as a relevant freight transport provider. That is, a sustainable rail freight business within 10 years, able to fund its on-going operating and capital expenditures from customer revenue. The Turnaround Plan was provided to the Minister of Transport and Shareholding Ministers on 3 February 2010.

Due diligence completed on Turnaround Plan

20. On 10 February 2010 Ministers requested that officials undertake financial and engineering due diligence on the Turnaround Plan. PricewaterhouseCoopers and AECOM respectively were contracted by Treasury to provide advice.

[1] Figures derived from Table 1.2 in the National Freight Demand Study (p 4).

21. The due diligence exercise also sought the views of key customers to determine the extent of their willingness to utilise rail if there were improvements in reliability, timeliness performance, and in the quality and availability of rolling stock.

Separation of metro rail policy from freight rail policy

22. KRG can be viewed as having commercial and non-commercial business components. KRG's freight, ferry, inter-regional passenger services, and the national rail network are provided on a commercial basis. The metro rail networks in Auckland and Wellington are provided for, and operated on a cost recovery basis, by the respective regional councils. Until now there has been cross subsidisation between the freight and metro services. For the freight business to move to commercial viability requires the removal of any cross-subsidisation of metro costs.

23. Decisions on metro infrastructure and services are made by KRG in conjunction with central and local government. Because the public policy reasons for funding metro rail services are different to freight, they should be funded separately to KRG's commercial business. The Turnaround Plan focuses on freight decisions.

24. Metro rail decisions are being managed through a separate work stream and the Minister of Transport has submitted a separate Cabinet paper titled *Metro Rail Network Costs* for Cabinet's consideration.

KiwiRail Group Turnaround Plan

Overall Direction

25. KRG's Turnaround Plan is designed to preserve and enhance New Zealand's national rail freight network and move KRG towards commercial viability. KRG's preferred option is to retain the national network (primarily Auckland to Christchurch) rather than just operate some form of short line service.

Objectives

26. Through the continued operation of a national network, KRG is seeking to deliver the following:

Strategic Objective	Business Outcome
Drive Growth	Market share by volume to increase from 30% to 40%
Drive Yields	Increase percentage of 'road rate' from Deleted – commercial position
Drive Productivity	Increase operational efficiency across all business units

27. The Turnaround Plan describes in general terms how these outcomes will be achieved through:

- Completion of the integration of the business units;
- Heavy investment in the Auckland to Christchurch "spine" and Golden Triangle;
- Scalable investment in the Midland Coal Route and South of Christchurch in response to customer support;
- Testing the ongoing viability of the Minor Lines;
- Improved service reliability;
- Reduced transit times;
- Increased peak capacity and flexibility of ferries;
- Improved overall network capacity;
- Full recovery of Metro network costs; and
- Greater operational efficiencies.

28. It is important to note in the absence of a compelling business case, under the Turnaround Plan, some minor lines may be mothballed. But, prior to any decisions being taken appropriate consultation with affected and potential customers, and communities will be undertaken.

Revenue Driven

29. The Turnaround Plan requires total capital investment of around $4.6 billion (including metro rail funding) in rail services and the rail network over 10 years. The Crown is being asked to contribute around $1.1 billion (excluding metro rail funding, which is the subject of a budget bid for one year's funding in 2010/11) over the 10 year period, with KRG providing the balance of $3.5 billion through increased customer revenue. The freight revenue increases are reliant upon improvements in the reliability of the network and efficiency (ie reducing the Auckland to Christchurch travel time by up to, two hours).

The cost of the Turnaround Plan

30. Excluding Metro rail costs, KRG is seeking total capital of $727 million for the first three years of the Turnaround Plan. This would be applied as follows:

30.1. Auckland-Christchurch renewals and upgrades $225 million

30.2. [deleted – commercial position]

30.3. Other network renewals $415 million

30.4. [deleted – commercial position]

Public Policy Case for Rail Freight

Freight Task

31. The overall freight task (tonne-kilometres moved) has doubled in the last 15 years. Typically the freight task tracks GDP and is therefore forecast to grow at a rate of around 2.2% per annum over the next 25 years[2]. Predictions for freight growth in the National Freight Demand Study are of the same order of magnitude, and together both forecasts indicate an approximate doubling of the current freight task by 2040. All of this suggests the need for a nationwide transport system that can cope with significant increases in various types of freight over the long-term.

32. The New Zealand freight task is dependent on a fit-for-purpose freight infrastructure. At the present time safety constraints prevent rail from optimising service delivery on major freight routes to the Ports of Auckland, Tauranga and Christchurch.

Rail's current value

33. The most substantial motivation for upfront public investment in KRG would be to enable rail to maximise its comparative advantage and thus contribute to a total transport system that effectively and efficiently manages New Zealand's current and future freight demands.

34. Rail enjoys a comparative advantage in the carriage of bulk (low value/high volume) freight and containerised export/import from point to point (such as from an inland port to a port, or from a production facility to a port). In this way, it complements road and sea freight.

35. In addition, rail can contribute directly to New Zealand's export competiveness by supporting opportunities to reduce domestic freight transport and international shipping costs.

36. Rail's potential economic contribution to New Zealand is predicated on it becoming more relevant and competitive. In doing so it can enhance the competitiveness of New Zealand's exports, for example enabling:

    36.1. freight aggregation around specific ports by international shipping services

    36.2. establishment of specific industries in proximity to raw materials, energy sources, ports and inland transport infrastructure.

Option Value

37. Rail has option value, and maintaining a rail network represents an insurance against changed future conditions, such as higher fuel prices. For example, an intact rail network would make it easier to pursue modal shift policy objectives in the future, and can be important for maintaining the future viability of ports. Once closed, it can

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[2] http://www.treasury.govt.nz/government/longterm/fiscalmodel

be extremely expensive to reopen rail corridors, particularly if the land has been converted to other uses, so maintaining intact networks can keep costs down overall.

Why has rail performed so poorly?

38. The freight sector is characterised by aggregated customers (ie freight forwarders with significant market share or industry dominant exporters) with strong market presence. The ability to raise prices is dependent upon fit-for-purpose freight capability. In the absence of an appropriate service level, rail struggles to compete with road-based freight movements and is unable to charge a price that fully meets its costs.

39. Because rail lacks the capacity to compete effectively, over the past 20 years it has lost volume on critical routes. On the Auckland to Christchurch line rail has an 18 percent share of the freight task. This has declined from approximately 60 percent in 1995 and is directly correlated with an investment profile which has failed to maintain time definite service on this corridor. On time performance for key services on the line is 70 percent rather than the targeted 95 percent.

40. The Turnaround Plan aims to address these issues by increasing volume of freight carried and to increase yields in the bulk freight market through improved reliability to meet customer needs.

Results of Due Diligence Exercise

Customers

41. *Information deleted – would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied*

42.

43. In terms of relative priorities, customers stated that the focus should first be on service improvements on the Auckland to Wellington section of the North Island Main Trunk Line, then Auckland to Christchurch. Freight customers would also like to see improved reliability, timeliness performance and availability and quality of rolling stock and they indicated that such changes would motivate them to put more freight onto rail.

Other Findings

44. The due diligence exercise did not identify any glaring holes in the modelling but did reveal a number of limitations and risks in the assumptions underpinning the Turnaround Plan, most of which were known and understood by KRG management, and are being acted upon.

45. 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 (72% of investment) rather than service delivery improvements to meet customer expectations and/or revenue generating priorities.

46. KRG's Turnaround Plan 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.

47. 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. Without improvements in the workplace, performance gains from capital investment may be hard to realise.

Conclusions from due diligence

48. Whilst the KRG Turnaround Plan is a good overall approach, 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".

49. Moving forward, KRG needs to put flesh on the bones of the Turnaround Plan by developing a three-year strategy covering, among other things:

49.1. a prioritised and costed investment programme, focused on delivering quick wins against customer service improvements and revenue generation;

49.2. identification and mitigation of capacity and capability risks associated with delivering this programme; and

49.3. ongoing culture change, including an efficiency programme to secure cost reductions and/or other productivity improvements.

Proposed Way Forward

The way forward – Supporting the Turnaround Plan

50. KRG's Board and management are looking to Ministers to endorse 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.

51. Rail freight's significant role as part of New Zealand's transport system is not at issue. The due diligence process explored a number of options, specifically:

    51.1. exiting rail freight in a managed manner completely or variants thereof (i.e. break up KRG and sell business units, exit minor/unprofitable lines); or

    51.2. maintaining the status quo (ie keep services at existing levels, with limited investment); or

    51.3. moving to a set of a shorter line options supporting the import/export lines of business.

52. Exiting rail freight in a managed manner avoids the cost of the current operating subsidies now and in the future. It may also generate some direct revenue. From an economic perspective, the gain would be from redeploying assets to better economic use, and aligning the ownership interest with the main beneficial users. This option might take some years to conclude to maximise returns whilst minimising costs.

53. However, exiting rail removes the option value of rail meeting New Zealand's growing freight demand and has significant risks associated with the management of the exit. We do not consider this to be a viable alternative.

54. There is little to commend the status quo option in terms of the wider benefits it might generate. Volume and revenue growth might keep pace with GDP growth, but rail would stand still relative to the competition, and a more likely outcome is that rail would lose ground in terms of relevance and market share. The bare minimum of asset renewal and maintenance would mean ongoing risks around reliability and safety. The end-result is likely to be insolvency and receivership – in effect an unmanaged exit, with higher Crown costs.

55. We consider that investment in the Turnaround Plan will result in investment in the key export and import lines of the business.

56. The Turnaround Plan focuses on the core national rail network and notes that closure of minor rural lines (North Wairarapa and Stratford-Ōkahukura) with no sustainable freight volumes and the mothballing, until major freight customers emerged, of other minor lines (Napier-Gisborne, Northland and Southland rural) presented potential cost savings but came with ongoing costs to meet legislative and safety requirements.

57. Ministers consider the Turnaround Plan the most viable way forward. However, the implementation of the Turnaround Plan will be subject to continual review to ensure optimisation of investment in rail network.

Deleted – negotiate without prejudice

To that end, Ministers suggest that Cabinet:

57.1. through initial budget 2010 commitments, indicate support for the objectives of the Turnaround Plan – ie that KRG becomes a sustainable rail freight business within 10 years, able to fund its ongoing operating and capital expenditures from customer revenue;

57.2. acknowledge the level of Crown contribution over 3 years (c. $750 million) that will be required to give effect to a strategy to achieve these objectives;

57.3. provide a tangible commitment of this support by appropriating funding in this budget to Vote: Transport for Year 1 only of $250 million;

57.4. make drawdown of funding contingent on the Ministerial approval of specific business cases;

57.5. expect KRG's Board and management to develop a costed 3-year investment CAPEX profile; note that implementation will require enhanced performance regarding reporting to provide Ministers with assurance that KiwiRail Group is achieving the desired outcomes form the Crown's investment.

58. Ministers will report back to Cabinet on a quarterly basis on progress with the Turnaround Plan.

Sending the right signals to customers and the market

59. One expectation Ministers have in supporting the Turnaround Plan is that a clear signal is sent to all stakeholders (freight forwarders, significant customers, and unions) that rail will continue to be a significant contributor to the New Zealand economy provided all the parties affected pull together.

60. This can be achieved by enhanced multi-modal freight hubs, more efficient rolling stock, time reliant services meeting customer needs, and improved work practices within KRG. Early stakeholder decisions in respect of these improvements will be critical to early achievement of the turnaround in the rail freight business.

61. In return Ministers are looking for a tangible response from customers and the wider market to share the risk. There is a need to develop complementary freight relationships with current and potential freight users. This includes assessing revenue assumptions and ongoing stakeholder commitment.

Consultation

62. The Treasury (including Crown Ownership Monitoring Unit and National Infrastructure Unit) were involved in the preparation of this paper. DPMC has been advised.

Financial implications

63. The financial implications of the Turnaround Plan will be considered by all Ministers as part of the 2010 Budget process. It is important to note that in 2009 Cabinet set aside $55 million of the between budget contingency for KRG to assist them in the event of a cashflow shortfall [Cab Min (09) 37/11]. Cabinet approval is required before the contingency could be accessed.

64. At the time the Turnaround Plan was being prepared KRG had not requested any contingency funding. For budget purposes the unspent contingency was transferred into the Budget 2010 allocation. KRG have since indicated that they will require $20 million for cashflow purposes in 2009/10.

Human rights implications

65. Not applicable.

Legislative implications

66. Not applicable.

Regulatory Impact Analysis

67. Not required.

Gender implications

68. Not applicable.

Disability perspective

69. Not applicable.

Publicity

70. A communication strategy will be prepared as part of Budget 2010 announcements.

Recommendations

71. It is recommended that Cabinet:

Freight network

1. **Note** that the KiwiRail Group business consists of a commercial rail freight business and the non-commercial metro rail business in Auckland and Wellington;

2. **Note** that KiwiRail Group has submitted to Shareholding Ministers and the Minister of Transport a 10-year Turnaround Plan;

3. **Note** that the objective of the Turnaround Plan is for KiwiRail Group to become, within ten years, a sustainable rail freight business that is able to fund its ongoing operating and capital expenditures solely from customer revenue;

4. **Note** that the Turnaround Plan envisages total capital expenditure over ten years of approximately $4.6 billion, of which the Crown is being asked to contribute some $1.1 billion, largely in the first five years, to complement funding generated from customer revenue;

5. **Note** that the Turnaround Plan contemplates closure and mothballing of minor lines and that these decisions would be the subject of separate processes;

6. **Note** that Shareholding Ministers directed officials on 10 February to:

   6.1. undertake a due diligence investigation into the suitability of the engineering, capital and revenue assumptions embedded within the Turnaround Plan;

   6.2. consult significant existing or potential rail freight customers to understand their service expectations and likely response to an improved rail service performance;

   6.3. advise on the public policy case reasons for investing in rail;

7. **Note** that the findings of the due diligence, consultation and public policy analysis concluded that:

   7.1. the status quo rail freight business is not sustainable and making no change would result in KiwiRail Group's slow decline and eventual exit as a nationwide freight sector participant;

   7.2. the presence of an appropriately configured national rail network (Auckland to Christchurch) offers an option value by preserving a freight transport solution that otherwise might be lost or diminished;

   7.3. key customers indicated that improvements in reliability, timeliness performance, and in the quality and availability of rolling stock, would motivate them to put more freight onto rail;

8. **Note** that there remain areas where further work is required, including:

   8.1. a prioritised and costed investment programme, focused on delivering quick results for improving customer services and greater revenue generation;

   8.2. identification and mitigation of capacity and capability risks associated with delivering this programme;

   8.3. ongoing culture change, including an efficiency programme to secure cost reductions and/or other productivity improvements;

8.4. [deleted – negotiate without prejudice].

8.5. engagement with stakeholders focused on revenue generation and their ongoing commitment to rail;

9. **Note** that the successful implementation of the Turnaround Plan and preservation of a national rail network will require considerable support from stakeholders (unions, management and customers) and that this will stretch KiwiRail Group's management's capacity and capability to deliver;

<u>Way forward and implications for Budget 2010</u>

10. **Note** that the KiwiRail Group Board and management are seeking Crown commitment to the objectives of the Turnaround Plan, and an indication of Ministers' willingness to commit the capital necessary to achieve those objectives over the next five years;

11. **Note** that, notwithstanding the considerable risks, Shareholding Ministers are satisfied from the due diligence results and from officials' advice that there is a sufficient basis for the Government to provide new capital to support the objectives of KRG's Turnaround Plan, but that this support is conditional on the KRG board and management satisfying Ministers that the risks identified in the due diligence process are being addressed;

12. **Note** that the Budget 2010 package:

12.1. includes $250 million CAPEX appropriation as a tangible commitment of government support for the objectives of the Turnaround Plan;

12.2. notes that the government plans to support a strategy to return KiwiRail to commercial viability that forecasts a Crown contribution of $750 million CAPEX over the next three years;

13. **Note** that in 2009 Cabinet set aside $55 million of the between-Budget contingency for KiwiRail Group to assist them in event of a cashflow shortfall [CabMin (09) 37/11], none of which has been drawn down yet;

14. **Note** that for budget purposes the unspent contingency ($55 million) was transferred into the Budget 2010 allocation;

15. **Note** that KiwiRail Group has indicated that it will require $20 million for cashflow purposes in 2009/10;

16. **Note** that the split of funding provided in Budget 2010 is $20 million for 2009/10 cash flow purposes, $230 million be provided in 2010/11 for the purposes of the KiwiRail Group Turnaround Plan;

17. **Note** that the drawdown of capital injections into KiwiRail Group are contingent on joint Ministerial approval of specific business cases;

18. **Note** that the KiwiRail Group Board will be required to provide a detailed 3-year investment CAPEX profile;

19. **Note** that implementation will require enhanced performance reporting to provide Ministers with assurance that KiwiRail Group is achieving the desired outcomes from the Crown's investment

20. **Note** that Ministers will report back to Cabinet on a quarterly basis on progress with the KiwiRail Group Turnaround Plan.

Hon Bill English
Minister of Finance

Dated: ____________________________

Hon Simon Power
Minister for State-Owned Enterprises

Dated:__________________________

Hon Steven Joyce
Minister of Transport

Dated: ________________________

[Pages 15 and 16 deleted in order to protect the commercial position of the person who supplied the information, or who is the subject of the information]