The Treasury

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

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

The Chair
Economic Growth and Infrastructure Committee (EGI)

KIWIRAIL CAPITAL REQUEST

Proposal

[6]

which KiwiRail has been working towards since 2010 [CAB Min (10) 13/9 refers]. This investment will be used to procure new rolling stock (locomotives and wagons), and for track refurbishment and renewals. The objective is for this investment to enable KiwiRail's freight revenue to grow, so that over time it can generate sufficient customer revenue for it no longer to require financial support from the Crown.

Executive Summary

[4], [14]

4. KiwiRail has achieved strong revenue growth in the past two years, but this has not yet flowed through to earnings growth. Its Board has implemented a number of strategic initiatives aimed at growing its earnings, as this is the most critical factor in achieving its long-term objective of financial self-sustainability. This is not without significant challenge, and if certain risks materialise, [6] may be insufficient to achieve this goal.

5. Limited analysis has been undertaken by the Treasury on identifying possible alternative options for the Crown in respect of its ownership of KiwiRail. This did not identify any clear alternative options. Should this funding not be approved, an alternative strategy for KiwiRail would need to be developed.

Comment

Background

6. Following the Crown's repurchase of New Zealand's rail and ferry business for $690 million from private ownership on 1 July 2008, the TAP for KiwiRail was developed and approved by Cabinet in 2010. The objective of the TAP is for KiwiRail to become, within ten years from 2010, a sustainable rail freight business that is able to fund its ongoing operating and capital expenditure solely from customer revenue.

7. The plan was developed following due diligence, consultation, and public policy analysis which concluded that:

- The rail freight business in 2010 was not sustainable, and would slowly decline and eventually exit as a nationwide freight sector participant without Crown investment

- Having a national rail network has an option value by preserving a freight transport solution that might otherwise be lost or diminished, and

- Key customers would put more freight on rail if reliability, timeliness performance, and the quality and supply of rolling stock improved.

8. The original TAP identified a need for [6] out of a forecast total capital investment of $4.6 billion over the life of the plan, with an initial investment of $750 million for the first three years. In 2010, the Crown made an in-principle investment of $750 million, and $250 million was then appropriated in each of Budgets 2010, 2011, and 2012. The Crown also converted $322.5 million of KiwiRail's historic debt to equity in July 2012, which saves KiwiRail approximately $19 million per annum in associated interest costs which it can instead use to invest in the TAP.

9. The Crown has so far made no commitment to funding beyond the $750 million. [6]

[4], [6], [14]

10. Limited analysis has been undertaken by the Treasury into other options for the Crown in respect of its ownership of KiwiRail. This did not identify any clear alternative options.

11. If alternative options for the Crown in respect of its ownership of KiwiRail need to be evaluated, officials will need to work with KiwiRail and report back to Cabinet with a range of options and the likely implications. It is expected that further detailed analysis would be likely to be inconclusive given the number of uncertainties impacting on the plan.

[4], [6], [14]

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1 [4], [6], [14]

[4], [6], [14]

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[4], [6], [14]

Achievements to Date

19. Whilst revenue has grown significantly, KiwiRail's earnings have been 23% below forecast over the first two years of the plan, which is the key metric on which the success of the TAP is judged. KiwiRail's financial performance has been impacted by:

- The Christchurch earthquakes
- The Pike River mine explosion
- The stilted global economy, and
- Various floods and landslides.

20. However, KiwiRail has made good progress over the past 2 years in a number of other areas, including:

- Growing freight volumes from 3.92 billion to 4.54 billion net tonne kilometres[3] (16%)
- Growing core freight revenue from $332.5 million to $409.7 million (23%)
- Improving premium freight train on time performance from 68% to above 90% of trains arriving within 30 minutes of their planned arrival time
- Introducing a new direct Auckland to Palmerston North overnight freight service
- Commissioning 20 new locomotives and 535 new flat top wagons, and
- Stretching the Aratere by 30 metres thereby increasing its revenue-generating capacity.

21. In addition, KiwiRail has implemented a number of well publicised strategic initiatives over the past 2 years with the objective of growing its long-term profitability, and ultimately sustainability. These have had limited short-term positive impact, but are expected to improve KiwiRail's performance in the long-term. These include:

- The sale of the Hillside foundry and closure of the other Hillside operations
- The restructuring of its infrastructure and engineering division through a reduction in labour resources
- Mothballing of the Stratford to Okahukura and Napier to Gisborne lines
- Negotiating new collective agreements with Interislander staff

[3] Net tonne kilometres measure the volume (by tonne) of freight carried, multiplied by the distance measured in kilometres.

[4], [14]

- Integrating freight network planning with the New Zealand Transport Agency and upper north island councils
- Restructuring its balance sheet and corporate form, and
- Investigating future options for its Tranz scenic business.

[4], [14]

Path to financial self-sustainability

24. The graph and table below show KiwiRail's forecast levels of capital expenditure and earnings, and the point where these meet[4] broadly illustrates when KiwiRail expects to become financially self-sustainable.

[4],[14]

25. The gap between the two lines represents the additional cash that KiwiRail needs to fund its planned capital expenditure. [6]

The size of the gap now and the extent to which earnings need to grow in the next five years highlights the magnitude of the challenge. [4]

The challenge is greater than when the plan was first envisaged in early 2010 as a result of the unforeseen factors outlined in paragraph 19.

26. There are a number of factors that will influence whether KiwiRail can achieve its financial forecasts and ultimately financial self-sustainability, some of which KiwiRail has no control over and cannot easily mitigate against. In the table below, the key risks associated with achieving the plan are considered, along with the likelihood of the risks materialising.

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4 [4]

Table 1: Risks to achieving financial self-sustainability

	Risk	Likelihood of materialising
1	Freight revenue not growing at the projected rate of 6-7% per annum	KiwiRail has achieved growth greater than this since 2010. With the right economic conditions, and continued improvement in service reliability (through investment), it is likely that KiwiRail can continue to achieve these growth rates. [4], [14]
2	[4], [14]	
3	Global economic growth slowing, impacting the demand for goods KiwiRail transports on its network, with demand for those goods being susceptible to a downturn in the global economy	This is outside KiwiRail's control. Most economists are predicting a gradual improvement in global economic growth, underpinned by continued strong growth in Asia.
4	KiwiRail continuing to be unable to translate its strong revenue growth into earnings growth, which has been the case over the past 12-18 months.	KiwiRail's earnings are expected to grow following the implementation of a number of key strategic initiatives over the past 12 months. For earnings to grow at the levels forecast, this will need to continue to be the Board's key focus.
5	An extreme weather event causes significant damage to a key part of the main trunk line	KiwiRail has been impacted by a number of weather events over the past 2-3 years, and there is a risk that a more severe event could occur. [4], [14]

27. If any of these risks was to fully materialise, it would be difficult for KiwiRail to achieve financial self-sustainability over the planned period [6]
[4]

Public Policy Case for further investment

28. A public policy case for rail was developed in 2010 as part of the process for the consideration of government investment in KiwiRail's TAP. In 2010, the public policy argument for supporting a nationally integrated rail freight network was that an efficient network could enhance New Zealand's export competitiveness and contribute to economic growth.

29. Deloitte has been commissioned to refresh the public policy case prepared in 2010. They have concluded that since the investment by the Crown in the TAP, public policy

benefits have been realised. Putting the TAP at risk puts at risk the following public policy benefits:

- Enabling port aggregation to ensure New Zealand exports remain competitive:
  - Rail has been used to convey cargos over longer distances to larger ports (the withdrawal of major liner services from Timaru and New Plymouth are two examples where this has happened).

- Providing alternative transport options to enable a more efficient domestic freight market:

  - The freight forwarder market has continued to grow and some of the major players in the sector have invested in rail-served depots to take advantage of cost savings, capacity flexibility and rail's "green" credentials.
  - [4], [14]

- Contributing to resilience in the freight transport system:

  - KiwiRail ensured the movement of cargo during the Port of Auckland strike, the Christchurch earthquake and the Manawatu Gorge closure. For example, following the earthquake, rail was able to convey substantially more product to replenish Christchurch's major distribution centres than was possible by road or coastal shipping (given damage to Lyttleton port).

- Providing direct economic savings:

  - Direct economic savings of rail were forecast and costed as part of the 2010 analysis. These included fuel and driver time savings compared to road, avoided road maintenance costs, and reduction in externalities such as road accidents and green house gases.

30. Continued investment in KiwiRail will enable it to continue to provide services that, in the face of rising oil prices, will help enable our exports to remain competitive. It will also increase the resilience in our transport system. On this basis, a public policy case exists for the continued investment in and support for KiwiRail by the government.

Use of funding

31. Table 2 below outlines what KiwiRail intends to spend this proposed Crown funding on. Whilst this funding has been tagged to be spent on locomotives, wagons, and railway infrastructure, it is essentially the balance between what KiwiRail plans to spend on capital expenditure over the 4 year period, and the cash it can generate internally (mainly from customer sales).

[4], [14]

33. This is on top of the $815 million capital expenditure in the first two years of the plan, and the forecast capital expenditure of $431 million in the current year. The original TAP forecast total capital expenditure of $4.6 billion over 10 years. This forecast was

subsequently reduced to $3.1 billion as a result of the strategic review undertaken by KiwiRail in 2012. [6]

34. As a result, if KiwiRail was not to receive this funding it would need to rework its whole capital programme and strategy rather than just reducing expenditure on the items identified in the 'Crown equity funding' column in the table below.

[4]. [14]

35. The Crown investment and KiwiRail's overall capital expenditure programme, are intended to achieve the following objectives, which are fundamental to achievement of the TAP's objectives:

- Improving reliability, transit times, and service levels of rail freight that will ultimately result in the volume of freight being transported by rail, and KiwiRail's revenues, increasing, and

- Procuring the rolling stock that is needed to meet the projected volume growth from customers and improve service reliability.

36. KiwiRail's Board will ultimately be responsible for implementing this capital expenditure programme, and for achieving the Turnaround Plan objectives. Whilst there have been some issues with the procurement of locomotives and wagons from China over the past 1-2 years, this was not unexpected given that equivalent assets had not been procured by KiwiRail for over 30 years. There was also the well publicised overspend on the Aratere extension project.

37. There is a risk that achieving financial self-sustainability remains a goal for a future Board to deliver given the long-term nature of the plan; however, the current Board is committed to doing what it can in the short-to-medium term to try and achieve that long-term goal.

Financial case

38. [6]

[4], [14]

39. [6] This is because it will most likely result in economies of scale for large scale procurement projects (i.e. for wagons and locomotives), and efficiencies when assessing workforce requirements given the high proportion of labour costs associated with KiwiRail's capital expenditure programme. A large portion of capital expenditure on infrastructure renewals and upgrades relates to the salaries and wages of permanent employees.

40. [6]

[4]. [14]

44. Whilst no detailed investigation has been undertaken, there is also unlikely to be any opportunity for this investment to be funded by way of a public private partnership, or through any partial sale of KiwiRail. The latest valuation for KiwiRail (in its 2012 Statement of Corporate Intent) is negative $715 million, meaning it would be unlikely that private investors could generate any return on an investment in KiwiRail.

Consultation

45. The Crown Ownership Monitoring Unit within the Treasury drafted this paper, in consultation with the Ministry of Transport and the National Infrastructure Unit. All parties agree with the content of this paper.

46. The Department of the Prime Minister and Cabinet has been informed.

Financial Implications

47. [6]

A Budget initiative has been submitted for consideration by Budget Ministers as part of the Budget 2013 process. As discussed earlier in the paper, there is a risk that further funding will be sought by KiwiRail, [6]

48. A final decision on the proposal, including the detailed financial recommendations, will be made when the Minister of Finance presents the final Budget 2013 package to Cabinet. This funding has been provided for in the draft Budget 2013 documentation.

Human Rights

49. Not applicable.

Property Rights

50. Not applicable.

Legislative Implications

51. Not applicable.

Regulatory Impact Analysis

52. Not applicable.

Treaty of Waitangi Implications

53. Not applicable.

Publicity

54. If Cabinet is to approve further funding for KiwiRail, it would be appropriate for a public announcement to be made outlining the Crown's continued support for KiwiRail's Turnaround Plan as part of Budget 2013. Our offices will coordinate with the Minister of Finance's office and the Department of the Prime Minister and Cabinet to agree a suitable communications plan.

Recommendations

55. The Minister of Transport and the Minister for State Owned Enterprises recommend that the Committee:

About KiwiRail's Turnaround Plan

1 **note** that the objective of the original Turnaround Plan was for KiwiRail to become, within ten years from 2010, a sustainable rail freight business that is able to fund its ongoing operational and capital expenditure solely from customer revenue

2 **note** that this original Turnaround Plan [6]

but that the Crown has made no

commitment to funding in excess of the first $750 million that has now all been appropriated

About this Budget initiative

3 **note** that a Budget initiative has been submitted for consideration by Budget Ministers as part of Budget 2013 to invest more equity into KiwiRail as it continues to try and achieve the objective of becoming financially self-sustainable by 2020

4 [6]

5 **note** that a final decision on the proposal, including agreement to financial recommendations, will be made when the Minister of Finance presents the final Budget 2013 package to Cabinet

6 [4], [14]

7 **note** that KiwiRail has achieved strong freight revenue growth since the inception of the Turnaround Plan in 2010 but that this has not yet flowed through to earnings growth

8 **note** that KiwiRail's Board has implemented a number of strategic initiatives over the past 12 months with the intention of growing earnings in the medium- to long-term

9 [6]

10 [4], [14]

11 **note** that an independent review concluded that the public policy case supports the continued investment in and support for KiwiRail by the Crown on the basis that rail will enable New Zealand's exports to remain competitive, a national rail network increases the resilience of our transport infrastructure, and enables it to endure shocks

If further Crown equity investment in KiwiRail's Turnaround Plan is approved

12 **note** that this funding will provide KiwiRail with the best chance of achieving its long-term objective of financial self-sustainability by 2020

13 [4], [14]

14 **note** the significant challenges KiwiRail faces in achieving financial self-sustainability by 2020

15 [4], [14]

16 **agree** that this proposal be submitted to Budget Ministers for consideration in Budget 2013

17 **agree** that the annual drawdown of funding is subject to approval by shareholding Ministers

If further Crown equity investment in KiwiRail's Turnaround Plan is declined

18 **note** that KiwiRail will be unable to achieve financial self-sustainability without further Crown investment and that a new strategy for KiwiRail will need to be developed

19 [4], [14]

20 [4], [14]

21 [4], [14]

22 **note** that further investigation would need to be done to identify alternative options for KiwiRail.

Hon Gerry Brownlee
Minister of Transport

Dated:__________

Hon Tony Ryall
Minister for State Owned Enterprises

Dated:__________