The Treasury

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CROWN OWNERSHIP MONITORING UNIT

Treasury Report: KiwiRail: Request for Capital

Date:	1 March 2013	Report No:	T2013/132

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** recommendations	Friday 8 March 2013
Minister of Transport (Hon Gerry Brownlee)	**Agree** recommendations **Approve** attached Cabinet paper for submission to the next available Cabinet meeting	Friday 8 March 2013
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Minister for State Owned Enterprises (Hon Tony Ryall)	**Agree** recommendations **Approve** attached Cabinet paper for submission to the next available Cabinet meeting	Friday 8 March 2013
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ant Shaw	Senior Advisor	04 917 6160 (wk)	N/A (mob)	✓
James Cunningham	Manager, Sector Monitoring (PA: Cheryl Dickenson)	04 890 7222 (wk)	[3]	

Minister of Transport's Office Actions (if required)

Once signed by the Minister of Transport, pass the Cabinet paper to the Minister for State Owned Enterprises for signing.

Minister for State Owned Enterprises' Office Actions (if required)

Once signed by the Minister of Transport and the Minister for SOEs, submit 60 copies of the attached Cabinet paper for consideration at the next available Cabinet (or Cabinet committee) meeting.

Enclosure: **Yes (attached)**
Cabinet Paper: KiwiRail Capital Request:2553022

1 March 2013 SE-2-13-1

Treasury Report: KiwiRail: Request for Capital

Executive Summary

[6]

A Cabinet paper is attached, should you agree, to inform Cabinet about this proposal.

As Budget Ministers will make the final funding decisions around this proposal, a final decision, including agreement to financial recommendations, will be made when the Minister of Finance presents the final Budget 2013 package to Cabinet.

[6]

The first $750 million has now been fully appropriated. [6]

If approved, [6] will be put towards the procurement of wagons and locomotives, and track and infrastructure renewals. This investment should result in continued improvement in the reliability of services, and provide additional capacity to capture the forecast growth in freight volumes.

[4]. [14]

KiwiRail has achieved strong volume and revenue growth in its freight business in the past two years, but this has not yet flowed through to earnings growth. It is expected that its earnings will grow as a result of the strategic initiatives KiwiRail has recently implemented, and as a result of the service level improvements that should be forthcoming following investment [6]

[7]

. The task is more difficult than when first envisaged in 2010 due to a number of unforeseen events such as the global economic downturn, the Christchurch earthquakes, and the Pike River mine explosion. [7]

1 KiwiRail's planned capital programme assumes receipt of the $333 million being sought over the next four years.

[4], [14]

Deloitte has been commissioned by the Ministry of Transport to update the public policy case for rail that was first prepared in 2010 prior to the TAP being approved. This review supports the continued investment in and support for KiwiRail by the Crown as it will enable KiwiRail to continue to provide services that, in the face of rising oil prices, will enable New Zealand exports to remain competitive. A national rail network also increases the resilience of our transport infrastructure and enables it to endure shocks.

We have undertaken limited analysis of alternative options for KiwiRail, and have concluded that there is no obvious alternative option. [4], [14] If required by Ministers, further work would need to be done to identify any alternative options; however, we believe that further detailed analysis is likely to be inconclusive given the high level of uncertainties impacting on the TAP. [4]

Recommended Action

We recommend that you:

a **agree** to support KiwiRail's request for capital funding [6] as the next tranche of the Crown's investment in KiwiRail's TAP following the initial $750 million that has been appropriated

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for State Owned Enterprises

b **agree** that the Minister of Transport and the Minister for State Owned Enterprises submit the attached paper to Cabinet for its consideration

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for State Owned Enterprises

c [6]

d **note** that should Cabinet agree to the proposal in the attached Cabinet paper to provide funding to KiwiRail, 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

e [7]

f [4]

g [4], [14]

James Cunningham
Manager - Sector Monitoring

Hon Bill English
Minister of Finance

Hon Gerry Brownlee
Minister of Transport

Hon Tony Ryall
Minister for State Owned Enterprises

Treasury Report: KiwiRail: Request for Capital

Purpose of Report

1. [6]

2. A draft Cabinet paper is attached, should Ministers agree, to present this proposal for further funding for KiwiRail to Cabinet. Should Ministers support the proposal to inject further capital into KiwiRail, a final decision, including agreement to financial recommendations, will be made when the Minister of Finance presents the final Budget 2013 package to Cabinet.

Background

3. In 2010, the Crown made a commitment of $750 million towards KiwiRail's 10-year TAP subject to business cases and expensed over the first three years. This commitment resulted in appropriations of $250 million in each of Budgets 2010, 2011, and 2012. [6] , with the balance of investment to be made up from customer revenues. The Crown has so far made no commitment to funding beyond the initial $750 million.

4. In May 2012, KiwiRail's Board completed a strategic review of its business by re-testing the assumptions in the original TAP. It concluded that whilst not without significant challenge, it believes achieving financial self-sustainability by 2020 is still achievable, [6] The outcomes and assumptions from that strategic review were reported to Ministers and Cabinet at that time, and remain largely unchanged (refer to TY2012/966 and EGI Min (12) 12/2 for more details).

Funding

5. [6]

Table 1: Timing of Funding from original 2010 TAP vs. current request

Year	2010 Business Case ($ Million)	New Business Case ($ Million)	Difference
2010/11	$250.0	$250.0	-
2011/12	$250.0	$250.0	-
2012/13	$250.0	$250.0[2]	-
[6]			

6. The change in forecast Crown equity funding reflects the fact that KiwiRail has scaled back its capital expenditure plans from its original plan, partly to accommodate its lower than forecast earnings to date, [7]

7. As discussed further in this report, we believe there is limited opportunity to extend the funding [6] . There is no opportunity to further reduce track and infrastructure expenditure without causing a decline in services, reliability, and track condition. Further delaying the procurement of rolling stock would mean KiwiRail would not have the capacity to meet the projected volume growth, meaning its earnings would not grow to the extent planned, and it would therefore not be in a position to self-fund the required portion of its capital expenditure programme.

8. [4], [6], [14]

9. [6] his is because it will better enable 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 fixed 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.

2 At the time of writing, KiwiRail is forecasting to drawdown only $198.3 million of its $250 million appropriation in 2012/13, with the balance to be drawn down in 2013/14. This would take the total forecast drawdown in 2013/14 to $145.6 million, with the $93.9 million above reflecting what would be the newly appropriated amount for the year, if approved. The $51.7 million of assumed rollover funding is also displayed in Table 2.

10. Table 2 below outlines how KiwiRail intends to invest the additional Crown equity proposed. Whilst this funding has been tagged to locomotives, wagons, and railway infrastructure, it is essentially the balance between what KiwiRail plans to spend on capital expenditure over that period, and the cash it can generate internally (mainly from customer sales). Accordingly, without Crown funding, it would need to re-work its whole capital plan and strategy, rather than just reducing expenditure on the items identified in the "Crown equity funding" column.

Table 2: KiwiRail's summarised capital expenditure programme 2013/14 to 2016/17

[4], [14]

11. The proposed Crown funding makes up approximately 1/3rd of KiwiRail's planned capital investment in the next four years. [4]

- [4]
  As Ministers will recall, Cabinet approved the conversion of $322.5 million of KiwiRail's historic debt owing to the Crown to equity [Cab MIN (12) 12/2 refers] in 2012, as there was no possibility of this debt being repaid, and the associated annual interest costs of approximately $19 million was cash better used to invest in KiwiRail's assets and infrastructure.

- [4], [14]

- [4], [14]

12. [4], [14]

13. Private investment in, or a partial sale of, KiwiRail is also unlikely to be feasible at this time because:

    - KiwiRail's latest commercial valuation (in its 2012 Statement of Corporate Intent) is negative $715 million.

    - It is therefore unlikely any private investment could generate a return or that any interest from private investors could be found.

    - We understand that any partial sale of KiwiRail would also be inconsistent with statements that have been made by the Government in respect of its ownership of KiwiRail.

[4], [6], [14]

[4], [6], [14]

Achievements to Date

18. Whilst KiwiRail's earnings are higher than at the start of the plan in 2009/10, there was a slight reduction from 2010/11 to 2011/12, and earnings have been well below the originally forecast levels. Earnings to date are reflected in this table:

Earnings Before Interest Tax Depreciation and Amortisation ($ Million)	**2009/10**	**2010/11**	**2011/12**
EBITDA from operations	78.8	107.7	104.9
Restructure costs	(1.0)	(5.1)	(27.4)
EBITDA	**77.8**	**102.6**	**77.5**

19. KiwiRail's financial performance has been adversely impacted over the past 2-3 years by a number of factors including:

- the Christchurch earthquakes
- the Pike River mine explosion
- the stilted global economy, and
- various floods and landslides.

20. For the 6 months to 31 December 2012, KiwiRail has generated EBITDA of $47.5 million against a budget of $51.5 million, and a prior year equivalent of $43.6 million. We consider this a sound achievement, given that it has not achieved the uplift in earnings from its contract with Solid Energy that it had budgeted to do, and it lost business as a result of the threatened Interislander strike in December.

21. Whilst earnings have been well 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 has made good progress in a number of other areas, including:

- growing freight volumes from 3.92 billion to 4.54 billion net tonne kilometres[5] (16%) which is higher than market growth during that time reflecting growth in market share
- 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
- investing $386 million in network infrastructure outside of Auckland and Wellington metros
- commissioning 20 new locomotives and 535 new flat top wagons, and
- stretching the Aratere by 30 metres, thereby increasing its revenue-generating capacity.

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

22. In addition, KiwiRail has implemented the following strategic initiatives in the past 12 months with the objective of improving its long-term profitability, and ultimately sustainability:

- mothballed the Stratford-Okahukura (SOL) and Napier-Gisborne lines
- restructured its balance sheet to better reflect its commercial value
- announced the sale of the Hillside foundry and the closure of other Hillside operations
- restructured its Infrastructure & Engineering division through a reduction in management, operational and capital labour resources
- negotiated new collective agreements with Interislander staff
- undertaken integrated freight network planning with the New Zealand Transport Agency and upper north island councils
- [4], [14]
- investigated future options for its Tranz Scenic business.

23. [7]

24. The financial assumptions underpinning KiwiRail's forecasts remain largely unchanged since completion of its strategic review in June 2012 (T2012/966 refers) and are therefore not re-evaluated in detail in this report. The plan projects earnings growth to the extent where it can self-fund its ongoing capital expenditure requirements. The graph and table below show the forecast levels of capital expenditure and earnings, and the point where these meet[6] are illustrative of when KiwiRail becomes financially self-sustainable.

[4], [14]

25. The gap between the two reflects the additional cash that KiwiRail needs to fund its planned capital expenditure, and this gap will be filled by the proposed Crown funding. The size of the gap now and the extent to which earnings need to grow in the next 5 years highlights the challenge of the task ahead. [7] The challenge is greater than when the plan was first envisaged in early 2010 as a result of the factors outlined in paragraph 19.

6 [4], [14]

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

	Risk	**Likelihood of materialising**
1	Freight revenue not growing at the projected rate of 6-7% per annum	KiwiRail has achieved higher growth than this since 2010. With the right economic conditions, and continued investment in its assets, we believe it can continue to achieve these growth rates. [4], [14]
2	[4], [14]	[4], [14]
3	Global economic growth slowing, impacting the demand for a high proportion of the 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.	We expect earnings 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 were to fully materialise, it would be difficult for KiwiRail to achieve financial self-sustainability over the planned period [6]
[4]

[4], [14]

31. [4], [14]

Other Options for KiwiRail

32. We have not undertaken any comprehensive analysis into other options for the Crown in respect of its ownership of KiwiRail, given that achievement of the TAP remains the Crown's policy in respect of KiwiRail. However, we have discussed some possible options at a high level in table 3 below. Further work would need to be done to properly understand the likely fiscal impact, and implications, of any of these options. We believe that detailed analysis would most likely be inconclusive, given the number of uncertainties impacting the plan, and the various combinations of financial assumptions that could be made.

Table 3: Possible options for KiwiRail

	Option	Possible Outcome / Implications
1	The Crown invests no more money than the $750 million it has already appropriated	• [4] • • • • • The benefits from the $750 million investment would be likely to erode.
2	Develop an alternative plan where KiwiRail downsizes and only operates the sustainable parts of its network	• [4] • • Long-term Crown funding needs would reduce. • Some upfront funding to implement this strategy would most likely be needed. • Some of the benefits from the $750 million investment would be likely to erode.
3	Develop a no-growth strategy for KiwiRail where it maintains its current services but does not look to grow its revenue	• Crown funding needed in short-to-medium term would reduce as rolling stock procurement for volume growth could be scaled back. • [4] •

7 [4]

4	The Crown invests [6]	• KiwiRail should (if it meets its earnings forecasts) have sufficient funding to procure the required rolling stock, infrastructure and track renewals. • It gives KiwiRail a chance of becoming financially self-sustaining in the long-term. • [4] • A new strategy for KiwiRail may need to be developed if certain risks materialise.
5	Convert KiwiRail into a Crown entity and dilute its main objective of being commercial	• Financial self-sustainability would be unachievable and ongoing Crown funding would be needed. • Inconsistent with current Government policy.
6	Sell part or all of KiwiRail	• Private investment unlikely given KiwiRail's latest commercial valuation of negative $715 million. • Inconsistent with current Government statements.
7	Provide Crown guarantee to directors for this investment of [6] to be financed by private debt	• [4] • Approach is inconsistent with Cabinet conversion of historic DMO debt to equity in 2012. • Associated financing costs would be too prohibitive for KiwiRail in the long-term given the current profitability of the company.
8	Provide [6] of funding as debt by DMO rather than equity	• Would have the same financial impact to the Crown as external debt, as the unlikelihood of it ever being repaid would mean that the loan would have to be impaired at the time of issuing it. • Approach is inconsistent with Cabinet approval of conversion of historic DMO debt to equity in 2012. • Associated financing costs would be too prohibitive for KiwiRail in the long-term given the current profitability of the company.
9	Investigate other funding mechanisms such as funding from the NZTA or collection of levies	• Inconsistent with NZTA's current mandate. • Difficult to justify any kind of levy to be payable by anyone other than direct users of rail. • Difficult to implement.

33. If no further Crown funding is appropriated to KiwiRail beyond the $750 million, a new strategy for KiwiRail will need to be developed. This would most likely result in a down-sizing of its current operations / network, and a thorough analysis of options will need to be undertaken by officials and KiwiRail over a period of several months.

34. In order to maintain a fully integrated national rail network that delivers a reliable service and meets customers' needs, further investment in KiwiRail is needed. The proposed investment will give KiwiRail a chance of achieving its long-term objective of financial self-sustainability, although not without significant challenge and/or risk.

Public Policy Case for Rail – Provided by the Ministry of Transport

35. 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.

36. Deloitte has been commissioned to refresh the public policy case prepared in 2010. It has concluded that since the investment by the Crown in the TAP, public policy benefits have been realised which include the following:

- Enabling the option of 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.

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

Consultation

38. COMU consulted with the Ministry of Transport and the National Infrastructure Unit within Treasury when writing this report. All three parties agree with the report's contents and recommendations.

Conclusion

39. [6], [7]

40. However, there are no clear alternatives if the Crown wants to maintain the level of services and lines that KiwiRail is currently operating, as it is not currently in a position to sustain these services without Crown funding. We therefore recommend Ministers support this budget bid, and take the attached paper to Cabinet.