

# The Treasury

## Budget 2017 Information Release

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[36]	to maintain legal professional privilege	9(2)(h)
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[38]	to enable the Crown to negotiate without disadvantage or prejudice	9(2)(j)
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[40]	Not in scope	

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## Treasury Report: KiwiRail Holdings Ltd Capital Requirements

<b>Date:</b>	13 February 2017	<b>Report No:</b>	T2017/156
		<b>File Number:</b>	SE-2-25-0

### Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	<b>Note</b> the content of this report. <b>Provide</b> feedback on the issues raised in the report.	Friday, 17 February 2017
Minister of Transport (Hon Simon Bridges)		
Associate Minister of Finance (Hon Amy Adams)		
Minister for State Owned Enterprises (Hon Todd McClay)		

### Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
[23]		[39]	N/A
Chris Gregory	Manager, Commercial Operations - Governance and Performance	[39]	[23]

### Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

**Enclosure:** No

## Treasury Report: KiwiRail Holdings Ltd Capital Requirements

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### Executive Summary

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KiwiRail Holdings Ltd (KHL) has submitted a bid for a commitment of [33] as part of the Budget 2017 process.

This report provides Ministers with (i) a high level overview of KHL's business operations, (ii) a summary of KHL's budget bid, and (iii) a summary of other issues that relate to the Crown's ownership interest in KHL.

#### KHL's Business Operations

KHL does not generate sufficient cash flow from its operations to fund the level of capital expenditure required to operate the rail network. Over the nine year period to FY16 KHL has used \$3.9bn of cash for capital expenditure on rolling stock, the freight and metro rail networks, inter-island ferries and the corporate office. This has been primarily funded by (i) \$0.5bn of cash generated from KHL's operations, and (ii) \$3.3bn of cash from the Crown in the form of grants, equity and debt.

#### KHL Budget Bid

We note the following initial issues with KHL's budget bid:

- [33]
- KHL intend to use the funding provided by the Crown to fund further investment in the network and rolling stock. [34]
- The budget bid does not reflect the total Crown funding for rail. The bid excludes:
  - Remediation costs for the rail network as a result of damage sustained in the Kaikoura earthquake (the bid was prepared prior to completion of KHL's assessment of the damage);
  - Funding for the Wellington Metro-Rail Network, a separate bid of \$98.4m has been submitted for consideration as part of Budget 2017; and
  - [33]

#### Other Issues

There are a number of broader issues that exist about the rail network for Ministers to consider. These include the following:

- [33]

- The relative benefits from the Crown's investment in the rail network, and who receives them, are not clear. This could have implications for who should bear the cost of funding the rail network.
- KHL currently provides rail and ferry services for passengers and freight in New Zealand. The scope of KHL's business operations (i.e. passenger services, inter-island ferry services, property management) impacts KHL's funding requirements. Changes to the scope of KHL's business operations could result in alternatives for the level of funding required by KHL.
- [33]

Further detail on these matters is set out in the body of the report.

## Recommended Action

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We recommend that you:

- a **note** that KiwiRail Holdings Ltd (KHL) has submitted a bid for a commitment of [33] as part of the Budget 2017 process.
- b **note** that the Treasury and the Ministry of Transport are assessing KHL's budget bid and will provide advice to Ministers.
- c **provide** feedback on (i) the initial issues raised on KHL's budget bid, and (ii) other rail related issues discussed in this report

Chris Gregory  
**Manager, Commercial Operations - Governance and Performance**

Steven Joyce  
**Minister of Finance**

Hon Simon Bridges  
**Minister of Transport**

Hon Todd McClay  
**Minister for State Owned Enterprises**

## Treasury Report: KiwiRail Holdings Ltd Capital Requirements

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### Purpose of this Report

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1. KHL has submitted a bid for a commitment of <sup>[33]</sup> as part of the Budget 2017 process.
2. The Treasury and the Ministry of Transport (the Ministry) are currently reviewing KHL's bid for capital funding and will report to Ministers as part of the Budget 2017 process.
3. The purpose of this report is to provide Ministers with a:
  - high level overview of KHL's business operations
  - summary of KHL's budget bid and the key issues that the Treasury and the Ministry are currently working on
  - summary of other issues that relate to the Crown's ownership interest in KHL

### Overview of KHL's business operations

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4. In July 2008, the Crown acquired the share capital of Toll NZ Ltd from Toll Holdings Ltd for \$690m. At the time, Toll NZ Ltd owned and operated rail rolling stock and the inter-island ferries. These business operations were subsequently combined with ONTRACK, a Crown company which owned and operated the rail network, to establish KHL.
5. In 2010 KHL presented a 'Turn Around Plan' requesting the Crown to invest \$1.25bn of capital with the intention of returning the business to a financially sustainable position. The Crown invested \$750m under the Turn Around Plan over a three year period. However, the Turn Around Plan failed to deliver financial sustainability for KHL's operations.
6. In 2014 a new KHL management team commissioned a Commercial Review of KHL's operations which presented alternatives for the configuration of the rail network. A key finding of the Commercial Review was that there is no network configuration that will allow KHL to be financially sustainable. Shareholder guidance was to keep the existing rail network intact.
7. KHL management's current strategy for the business is to:
  - Simplify the existing business operations (i.e. refine service offerings)
  - Standardise the asset base (i.e. consolidate the classes of locomotives and wagons)
  - Invest in core-area of the business (i.e. growth corridors, labour productivity)

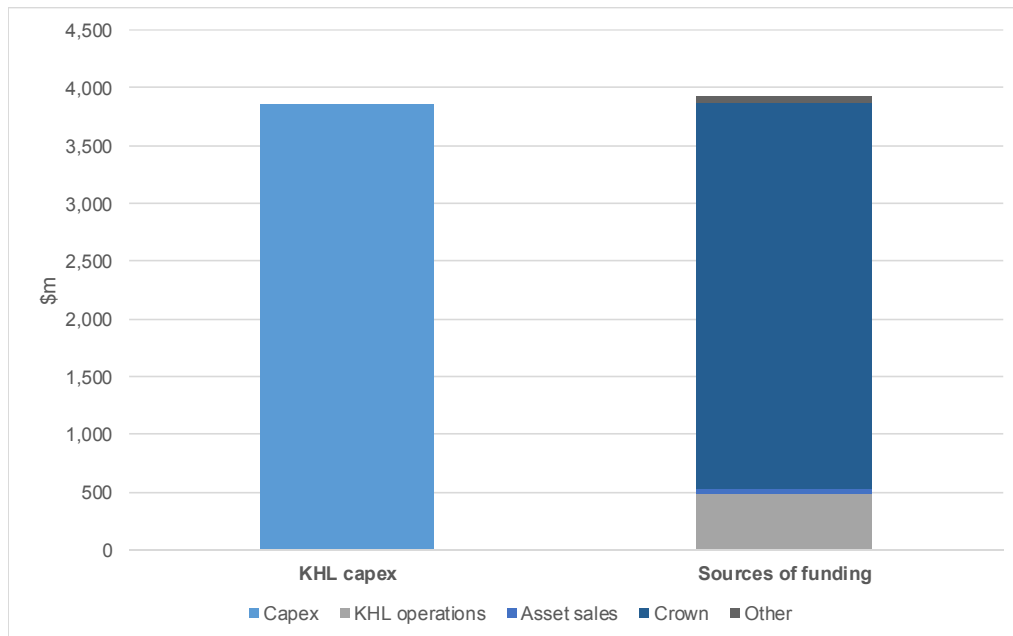
*Capital Investment*

8. The Crown's investment in rail comprises (i) \$690m paid to acquire the rolling stock and ferries from Toll Holdings Ltd, (ii) \$3.3bn of cash provided to KHL since the acquisition (discussed further below), and (iii) railway land owned by New Zealand Railway Corporation (NZRC), a related company to KHL, with a value of \$3.3bn.
9. KHL owns and manages assets and infrastructure with long term lives (e.g. a span of track is expected to have a useful life of 40 to 50 years, tunnels have a useful life of 75 to 200 years). Decisions made in regard to KHL's assets and infrastructure have a long term impact.
10. [34]

*KHL's Financial Position*

11. KHL does not generate sufficient cash flow from its operations to fund the level of capital expenditure required to operate the rail network. KHL's capital expenditure is funded by (i) revenue from customers, (ii) capital investment by the Crown, (iii) grants from the Crown for the metro network, and (iv) to a lesser extent, the proceeds from the sale of assets.
12. The chart below presents (i) KHL's total capital expenditure (capex) and the sources of cash funding for the nine year period to FY16 (i.e. since acquisition of the rail and ferry operations from Toll Holdings Ltd).

**Figure 1: Funding of KHL capex since FY08**



13. Over the nine year period to FY16 KHL has used \$3.9bn of cash for capital expenditure on rolling stock, the freight and metro rail networks, inter-island ferries and the corporate office. This has been primarily been funded by (i) \$0.5bn of cash generated from KHL's operations, and (ii) \$3.3bn of cash from the Crown in the form of grants, equity and debt.
14. Summary financial statements for KHL are presented in the Appendix.

KHL Budget Bid

15. KHL has submitted a budget bid for [33] A summary of (i) the significant matters contained in the budget bid, and (ii) key issues to be addressed are presented below.

**Financial Summary of KHL’s Budget Bid**

16. The table below presents a summary of (i) the KHL’s historical financial, and (ii) the forecast financial performance presented in KHL’s budget bid (shaded grey).

**Table 1: Summary of KHL actual and forecast financial performance**

<b>\$m</b>	<b>FY13</b>	<b>FY14</b>	<b>FY15</b>	<b>FY16</b>	[25]
Revenue	727	741	721	694	
Expenses	621	664	630	618	
<b>EBITDA<sup>1</sup></b>	<b>105</b>	<b>77</b>	<b>91</b>	<b>76</b>	
Asset Sales	6	2	18		
Other	(60)	51	(57)	(54)	
<b>Total Cash Available</b>	<b>54</b>	<b>130</b>	<b>51</b>	<b>44</b>	
Total capex	304	249	249	254	
<b>Crown Funding</b>	<b>250</b>	<b>119</b>	<b>198</b>	<b>210</b>	

17. We make the following observations:

- The forecast decline in FY17 revenue and expenditure is in part due to a change in the accounting treatment for fuel costs that are passed onto customers. Previously the fuel adjustment charge was presented ‘gross’ as a revenue and expense. From FY17 the fuel adjustment charge is presented ‘net’ as an expense. This treatment has no impact on KHL’s earnings.
- KHL’s earnings declined over the four year period to FY16. KHL was forecasting an improvement in earnings for FY17 however it is unlikely that this will be achieved following the impact to the business after the Kaikoura earthquake.
- [25]

– [25]

– [25]

- [25]

<sup>1</sup> Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) is a measure of financial performance.

<sup>2</sup> Import Export (IMEX) is freight that originates or ends at a port in New Zealand.

- [25]

18. The table below presents a summary of historical and forecast (shaded grey) capital expenditure:

**Table 2 Summary of KHL actual and forecast capital expenditure**

<b>\$m</b>	<b>FY15</b>	<b>FY16</b>
Network	153	155
Interislander	8	24
Scenic	-	1
Rolling Stock	65	59
Property, ICT and Corporate	23	15
<b>Total capital expenditure</b>	<b>249</b>	<b>254</b>

19. We make the following observations:

- Over [25] [25] and rolling stock [25] [25] comprises the rail network
  - KHL expects that the [25] [25] will (i) meet the level of service required by current customers, and (ii) deliver progressive improvement in service levels for priority routes. KHL has also put forward two alternatives for rail network capital expenditure (discussed further below).
  - rolling stock capital expenditure of [25] [25] is for purchases of new locomotives and wagons. [25]

locomotives follows the purchase of 40 Dalian locomotives over the last six years and 15 locomotives which are currently on order.

- [25]

***Issues to be addressed***

20. We summarise the initial issues identified with KHL's budget bid below. The Treasury and the Ministry are working through these issues and will report back to Ministers as part of the Budget 2017 process.

***Increase in the Crown Contribution***

21. KHL is requesting a [25] [25] In the last five years the Crown has invested capital of \$967m in KHL. [25]

<sup>3</sup> A 'shunt' locomotive typically refers to a smaller locomotive used for movements in rail yards or over short distances.



*The benefits from the increased level of investment are not clear*

22. The funding from the Crown will primarily be used by KHL to fund further capital expenditure on the network and rolling stock. The link between this investment and improvements in operational and financial performance of KHL is not clear. It is not possible to distinguish (i) the level of investment required to keep the network 'safe' from the additional investment required to improve the service performance for priority routes on the network, and (ii) the resulting level of service performance and benefits that will result from the additional investment.

*Risk that KHL is not able to achieve the forecast increase in earnings*

23. [25]
- If KHL is not able to achieve the forecast increase in earnings it will need to either (i) request additional capital from the Crown, or (ii) defer capital expenditure to future periods.
24. Deferral of capital expenditure into future periods is an alternative for KHL (and the Crown). However, it could be at the expense of achieving improvements in KHL's operational and financial performance and may result in higher maintenance costs in the near term.

*Network Configuration remains unchanged*

25. No change is assumed in the configuration of the rail network. The budget bid is based on (i) a differentiated quality of service across the network, and (ii) a higher level of capital expenditure targeted towards priority routes.
26. There is a wide variation in the volume of freight moved across different lines. There is a cost to the Crown of retaining lines with low freight volume. [25]

*The Bid does not reflect the total level of Crown investment in rail*

27. The budget bid does not reflect the total Crown funding for rail. The bid excludes:
- Remediation costs for the rail network as a result of damage sustained in the Kaikoura earthquake (the bid was prepared prior to completion of KHL's assessment of the damage);
  - Funding for the Wellington Metro-Rail Network, a separate bid of \$98.4 million has been submitted for consideration through Budget 2017; and
  - [33]

*Alternatives for Network Expenditure*

28. The budget bid presents KHL's 'Resilient' alternative for capital expenditure on the rail network. Two other alternatives are also discussed ('Future Proofed' and 'Deferred').
29. **Future proofed** – an immediate investment to get the rail network to a required minimum standard. This alternative is expected to result in an increase in performance across the entire rail network. KHL has not costed this alternative as it is not considered to be affordable.
30. **Deferred** - This alternative (i) defers expenditure on the rail network out beyond the expected life of the assets, and (ii) accepts service outages and a higher maintenance

spend. This approach is expected to meet customers' minimum service levels and maintain a safe level of operations, but the deferral of expenditure results in a level of asset decline.

31. The table below presents the capital expenditure required under the Resilient and Deferred alternatives.

**Table 3 Resilient and Deferred alternatives for rail network expenditure**

<b>\$m</b>	<b>FY15</b>	<b>FY16</b>	[25]
<b>Actual</b>	153	155	
<b>Resilient</b>			
<b>Deferred</b>			
<b>Difference</b>			

32. The Deferred alternative required [25] period than the resilient alternative.

[33]

33. The budget bid does not present any alternatives on the time period of the funding commitment from the Crown. [34]

*KHL Board Position*

34. [34]

*Other Alternatives*

35. The budget bid presents potential alternatives to reduce the level of Crown funding for KHL which include a change in network configuration (as noted above), leveraging KHL's property related assets, and alternative financing arrangements. Alternative financing arrangements could include sale and leaseback and supplier financing. [25]

**Other Matters**

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36. There are a number of broader issues that exist about the rail network and its place in New Zealand's transport system. We summarise some of the key issues for Ministers to consider.

[33], [34]

37. [33], [34]

[33], [34]

[33], [34]

## Next Steps

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49. The next steps to progress in relation to KHL are:

- [25]
- The Treasury will provide advice on the total expected costs for the reinstatement of the road and rail on the South Island Transport corridor as part of Budget 2017.
- The Treasury and the Ministry are currently reviewing KHL's budget bid for capital funding and will report to Ministers as part of the Budget 2017 process.

Appendix: Summary KHL financial statements

We present below summary financial information from KHL's audited financial statements since FY12.

**Table 4: Summary KHL Statement of Financial Performance**

<b>\$m</b>	<b>FY12<sup>1</sup></b>	<b>FY13</b>	<b>FY14</b>	<b>FY15</b>	<b>FY16</b>
Revenue	715.8	727.0	740.9	720.6	694.0
Expenditure	(638.2)	(618.8)	(663.4)	(630.1)	(618.1)
<b>EBITDA</b>	<b>77.6</b>	<b>108.2</b>	<b>77.5</b>	<b>90.5</b>	<b>75.9</b>
Depreciation	(309.4)	(61.9)	(69.7)	(68.8)	(67.5)
Impairment	(2,199.2)	(399.3)	(331.3)	(224.7)	(216.3)
Other	96.9	178.3	75.5	36.5	13.9
Tax	14.5	-	-	-	-
<b>NPAT</b>	<b>(2,319.6)</b>	<b>(174.7)</b>	<b>(248.0)</b>	<b>(166.5)</b>	<b>(194.0)</b>
Net tonnes (000)	17,455	17,265	17,196	n/a	n/a
NTK (m)	4,581	4,547	4,492	4,516	4,500

**Table 5: Summary KHL Statement of Financial Position**

<b>\$m</b>	<b>FY12<sup>1</sup></b>	<b>FY13</b>	<b>FY14</b>	<b>FY15</b>	<b>FY16</b>
Current assets	211.6	210.8	171.7	202.7	247.2
Property, plant, equipment	4,045.2	792.6	710.4	675.9	676.3
Other assets	5.6	6.2	40.6	70.0	71.5
<b>Total assets</b>	<b>4,262.4</b>	<b>1,009.6</b>	<b>922.7</b>	<b>948.6</b>	<b>995.0</b>
Current liabilities	199.9	162.6	188.8	186.8	172.4
Debt	559.7	218.5	214.0	201.7	224.8
Other liabilities	42.6	41.0	42.9	39.7	43.9
<b>Total liabilities</b>	<b>802.2</b>	<b>422.1</b>	<b>445.7</b>	<b>428.2</b>	<b>441.1</b>
<b>Net assets</b>	<b>3,460.2</b>	<b>587.5</b>	<b>477.0</b>	<b>520.4</b>	<b>553.9</b>

**Note:**

1. These figures are for the New Zealand Railway Corporation (NZRC). NZRC and KHL's business operations were subsequently restructured and the accounting policy for recognition of the rail network and rolling stock was changed. This resulted in an impairment to the carrying value of the rail network and rolling stock being recognised in FY12 and each year thereafter.