The Treasury

Budget 2015 Information Release

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[10] 9(2)(h) - to maintain legal professional privilege

[11] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

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[14] Not in scope

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

The Chair
Cabinet

FUNDING FOR KIWIRAIL

Proposal

1. This paper notes capital funding for KiwiRail of [5][11][12] over three years that is being sought as part of the Budget 2015 process. It seeks Cabinet's agreement for continued financial support of KiwiRail, and to provide some form of multi-year funding commitment to give KiwiRail enough certainty to manage its business and investment programme accordingly.

Executive Summary

2. KiwiRail undertook a comprehensive review of its business over nine months during 2014. The key findings from the review were that:

   - rail's high fixed costs are spread across the network and do not materially vary with changes in volumes being transported

   - revenue earned from train movements on most parts of the network is interdependent with other parts of the network because most freight movements travel across multiple network segments, and

   - as a result of the high fixed costs and interdependence of revenue between the different network segments, it is challenging to reduce costs as fast or to the same extent as a reduction in revenue.

3. Therefore, as a result of the characteristics of the business, which are consistent with other network business (e.g. electricity transmission businesses), the options for the business are either relatively small scale rationalisation of the existing network (and improving capacity utilisation and efficiency) or very significant downsizing of the rail freight network, including exit. The options presented by KiwiRail are therefore to:

   - retain most of the freight network and rationalise unprofitable services and some lines on the fringes of the network, or

   - close most or all of the freight network, with the option of retaining the upper north island section only (Auckland to Hamilton to Tauranga) as this part of the network carries the most freight volumes and covers most of its costs.

4. The plan presented by KiwiRail to the Government would retain most of the rail network at a cost of [5][11][12] in funding over three years. The plan also identified ongoing funding following this three year period of between [5][11][12] per annum for at least the next ten years. Treasury believes that if a greater weighting of risks over opportunities crystallises, ongoing funding could be between [5][11][12] [5][11][12 per annum for the foreseeable future.

5. Funding is higher in the next three years due to a number of major one-off or remediation projects that KiwiRail needs to undertake, [5][6]

6. [8]

Background

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

8. Over the past five Budgets (2010 to 2014), the Crown has provided funding of $1.067 billion towards KiwiRail's Turnaround Plan, at an average of $213 million per year. This excludes funding for the upgrading and extension of the Metropolitan passenger rail networks in Auckland and Wellington.

9. KiwiRail's earnings have not grown to any extent since 2010 (in 2010/11 operating earnings were $100 million and they are forecast to be about the same in 2014/15). This is partly due to the impact that external factors have had on KiwiRail's business including the Canterbury earthquakes, the Pike river mine explosion, Solid Energy's financial difficulties, extreme weather events and the Aratere being out of service for a period earlier this year. Although it is normal for businesses to have to deal with negative external problems, the magnitude and extent of those which affected KiwiRail have arguably been greater than expected.

10. The company has however achieved a great deal since the inception of the Turnaround Plan in 2010 including growing both customer numbers and freight volumes, improving the reliability and performance of its services, upgrading infrastructure and rolling stock assets, and improving its safety record.

11. On 31 March 2014, a Cabinet strategy session was held to discuss KiwiRail's Budget 2014 bid for [8] (it received $198 million), and the likely future prospects for the business. KiwiRail was requested to develop a new plan for its business with some options that would materially reduce the level of ongoing Crown funding needed.

12. On 24 April 2014, the then Minister for State Owned Enterprises, Hon Tony Ryall, wrote to KiwiRail's Chair, Mr John Spencer, requesting the company present a new plan to Government by 31 October 2014. Specifically the letter requested that:

- the new plan be realistic and achievable and shows a reduction in Crown funding over time

- the plan illustrates the forecast expenditure needed to replace and upgrade KiwiRail's infrastructure assets in both the short and long term

- the new plan assesses the cash flows associated with each different segment of the network, and

- a range of options, including some bold, be presented to the Government.

13. Following the review, KiwiRail now has a much greater understanding of its business, including the profitability of each different line segment, the interconnectedness of each line from a revenue generating perspective, the long-term capital expenditure requirements, the importance of the ferry business to its rail operations, and the importance of the domestic freight market to its overall freight business (particularly Auckland to Christchurch).

Comment

KiwiRail's review

14. KiwiRail undertook a comprehensive review of its business over nine months during 2014. KiwiRail engaged consultants Gravel Road and Cameron Partners to assist with its analysis, and also seconded a Treasury employee to work on the project to enable a better understanding of the business and the review's findings. KiwiRail's approach to the development of its new plan was:

    - undertaking a detailed review of cash flows attributable to each rail line segment

    - using the National Freight Demand Study[1] as a basis for formulating likely future freight volumes

    - analysing the effect on the cost and revenue cash flows from changing the service and network structure

    - developing plans to reduce costs and/or increase revenues in order to reduce the ongoing level of Crown funding, and

    - developing "bold" options that could materially reduce the ongoing level of Crown funding needed.

Network economics

15. Rail's revenue and cost structures result in high operating leverage, meaning that fixed costs are spread across the network and do not materially vary with changes in volumes being transported. Revenue earned from train movements on most parts of the network is interdependent with other parts of the network because most freight movements travel across multiple network segments. As a result of the high operating leverage and interdependence of revenue between the different network segments, it is challenging to reduce costs as fast or to the same extent as a reduction in revenue (e.g. such as what would occur if parts of the network were closed).

16. Therefore, as a result of the characteristics of the business which are consistent with other network business (e.g. electricity transmission businesses), the options for the business are either relatively small scale rationalisation of the existing network (and

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1 This is a comprehensive study of likely future freight demand within New Zealand by geographic location, freight type and transport mode. It was published by the Ministry of Transport in March 2014.

improving capacity utilisation and efficiency), very significant downsizing of the rail freight network, or full exit.

17. As part of KiwiRail's review, a number of network configuration options were explored to determine the impact each would have on the level of Crown funding required. The impact each option would have on KiwiRail's Interislander business was also tested. The different configurations tested included:

[5][6]

18. The analysis concluded that most of these network configuration options would be value destructive for the company (and would actually increase funding requirements), which is due to the economics of a network business such as KiwiRail (described in paragraphs 15 to 17 above).

19. The only real options available to the Crown with respect to KiwiRail are therefore to:

- retain most of the freight network, or
- close most or the entire freight network, with the option of retaining the upper north island section only (Auckland to Hamilton to Tauranga) as this part of the network carries the most freight volumes and covers most of its costs.

20. KiwiRail estimates the funding requirements over the next five years for the three options presented to Government as being:

Table 1: Funding required for the three options presented to the Government

Option	$ millions	2015/16	2016/17	2017/18	2018/19	2019/20
1	Retain most of rail network (see paragraph 21 below)	[5]				
2	Full closure (excl. Akld & Wgtn passenger)					
3	Retain upper North Island only (+ Akld & Wgtn passenger)					

21. Under option 1 where most of the rail network is retained, the funding requirements effectively represent the difference between the company's earnings, and what it needs to invest in capital expenditure, as outlined here:

[5]

[5]

Assumptions underpinning funding requirements

[5]

[5]

[5]

29. Treasury's preference is outlined in paragraphs 49 to 52 below. However, on the basis that the major down-sizing options (refer table 1 above) are not pursued, Treasury supports a multi-year funding commitment for the reasons noted above. Providing the company with multi-year funding certainty is the most efficient mechanism for funding the entity. KiwiRail estimates total efficiencies of between [5] over the next three years from having certainty of funding, which will enable it to contract with suppliers for long-term contracts on better terms than it would otherwise be able to do with only one year's funding. These estimates have been tested externally and assessed as reasonable.

Scaling options to reduce funding levels

30. Treasury has undertaken a detailed review of KiwiRail's financial forecasts, including its capital expenditure plans. There is no evidence of KiwiRail "gold-plating" its investment and/or inflating its funding requirements. Treasury believes that the funding requirements outlined in table 1 above may prove to be too low if a greater weighting of risks over opportunities crystallises.

31. In 2013[3], Treasury commissioned AECOM (an engineering consultancy with rail expertise) to provide advice on KiwiRail's planned capital expenditure programme. The key findings from the review were that:

- Based on the current size of the network, AECOM did not identify any opportunities to reduce track and infrastructure expenditure from what was planned without significantly impacting on levels of service or mothballing less busy parts of the network, and

- In comparison with a number of Australian freight rail systems, KiwiRail's planned infrastructure capital expenditure per kilometre of track is low.

32. For rail businesses, there is always an element of judgement applied to asset management planning, particularly in relation to the timing and extent of planned renewals of infrastructure assets. It is possible to make short term deferrals of infrastructure to improve short term cash flows, but this may manifest in a greater financial cost in the long term if the deferral of investment results in asset failure. The assumptions behind KiwiRail's asset management planning appear robust, and an appropriate balance between affordability and investment appears to have been

[3] Reliance can still be placed on this review even though it is two years old because KiwiRail's planned investment programme that was reviewed by AECOM in 2013 is only 5% different to its updated plan.

applied. There are no clear opportunities for providing a materially lower amount of funding than what is being sought.

33. [8]

KiwiRail's performance is heavily impacted by international demand and KiwiRail's corresponding transportation of commodities. It is currently transporting lower than forecast volumes of dairy products due to depressed prices, significant reductions in coal volumes as a result of the significant drop in coal prices, and reduced logging volumes also as a result of low prices.

34. As a result of the forecast performance in the current year, it will start from a lower earnings and cash base in 2015/16 than what it had forecast, which could result in a cash shortfall of between [5] over the three years (the 2014/15 shortfall plus the impact over the next three years from starting from a lower base). If commodity markets do not improve, and the earnings gap cannot be filled, KiwiRail will therefore most likely already have to defer planned capital expenditure of between [5] from what it has assumed in its review.

35. [8]

Long-term prospects for the business

36. KiwiRail's review is forward looking for a period of 30 years, designed to reflect the long term nature of its assets and to adequately capture sometimes lumpy capital investment and operating cashflows. Obviously a review looking this far forward will be limited in its accuracy, but it is useful to understand likely asset replacement timings and costs.

37. The review has identified that there will be no material reduction in planned capital expenditure over time, with this forecast to be between [5] per annum in perpetuity. Whilst KiwiRail is expecting its earnings to grow over time to reduce the gap between earnings and investment, the funding requirements for the Crown are forecast to remain between [5] per annum from 2018/19 for at least the next 10 year period. Treasury believes that funding requirements could be higher in the event that a greater weighting of risks over opportunities crystallise.

38. The review presents a much more realistic view of the future prospects for the business than what was forecast in the Turnaround Plan in 2010. The original Turnaround Plan forecast earnings growth from [5] million in 2009/10 to [5] million by 2014/15, a cumulative annual average growth rate of [5] This was always likely to be extremely challenging for a mature business operating in an industry where growth is heavily linked to overall Gross Domestic Product and where there is strong competition from competing modes (principally road).

39. Reasonable and achievable assumptions have been applied by KiwiRail in assessing its future prospects, which have resulted in a much greater and ongoing financial burden for the Crown than what has previously been presented. However, Treasury notes that in the event that the business declines, rather than achieves the growth it expects to, the financial burden to the Crown could be higher than what KiwiRail is forecasting.

Performance Agreement

40. Treasury is currently working with KiwiRail in an attempt to develop an agreement that allows the shareholder and the Board to track progress against agreed performance measures and behave predictably and appropriately in response to any variations from these.

41. The key objective of an agreement between the Board and the Crown would be to ensure commercial tension in the relationship between the Board and the Crown with respect to meeting agreed productivity and performance measures, reducing costs and staying within funding envelopes.

42. [5][11][12]

43. The agreement will ensure heightened monitoring of KiwiRail's performance against key objectives including its progress on addressing the inefficient and unproductive parts of its business. We will ensure there is more regular reporting to shareholding Ministers on KiwiRail's progress, and we will report back to Cabinet at least once a year with updates.

Policy considerations

44. During 2014, the Treasury, the Ministry of Transport and NZTA undertook an assessment of the economic and policy considerations for continuing to fund KiwiRail at the levels required. The key findings from this work were:

- if all the freight currently transported on rail was transferred to road, the additional road user charges (RUC) earned by NZTA from the additional trucks on the road would be sufficient to adequately address road capacity[4] and safety issues (resulting from the additional trucks) in most areas

- the estimated environmental and safety benefits from transporting the current volume of freight by rail of ~$10 million and ~$20 million per annum respectively do not outweigh the costs of continuing to fund rail, and

- a national cost benefit analysis[5] estimated the net social cost of continuing to fund rail at the levels sought in this paper at between $55 million and $170 million per annum, which takes into consideration all the costs and benefits associated with funding rail at the levels required (another interpretation is that there is a shortfall in benefits of between $55 million and $170 million per annum at the current levels of funding).

45. The work undertaken to date is not sufficiently comprehensive to support major down-sizing of the rail network without further analysis. Further assessment of the likely impact on the transport supply chain (including the impact on New Zealand's major ports), KiwiRail's customers, and regional economies would be needed before a decision to major down-size could be made (see Treasury comment below). It is not expected that this analysis would produce a case for retaining all the current network,

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4 There would be a timing difference between when the RUC was earned and when the costs of building new roads was incurred, but this could be managed through a financing arrangement with the NZTA.

5 A national cost benefit analysis attempts to quantify all costs and benefits to society (including all of KiwiRail's stakeholders) in monetary terms. In this instance, the cost benefit analysis considered the roading costs and revenue associated with transferring the rail freight to road, the environment and safety impacts, the fiscal cost of continuing to fund vs. the cost of closure, the option value of retaining rail, and the impact on KiwiRail's customers (at a high level).

but it would help a wider audience appreciate the realities of rail freight in the 21st century.

46. For these reasons I believe more work is required to properly evaluate the effects of road safety and environmental impacts prior to cabinet giving it further consideration.

47. [8]

Consultation

48. The Treasury drafted this paper. The Ministry of Transport has been consulted, and the Department of the Prime Minister and Cabinet (DPMC) and KiwiRail have been informed.

Treasury Comment

49. Treasury believes there is a net economic cost of continuing to fund rail at the levels required. The net social cost is estimated at between $55 million and $170 million per annum based on a national cost benefit analysis. Whilst the assumptions underlying analysis of this nature are subjective and some require further work to validate, Treasury believes that it will not change the conclusion that there is a net social cost of continuing to fund rail at the levels required.

50. Treasury believes that a more comprehensive study be undertaken to better understand the implications of closure to enable the Government to make the most informed choice possible. The comprehensive study should be public, and at arms' length from the Government. Treasury therefore recommends a one-year funding commitment for KiwiRail whilst this process is undertaken. It is critical that any study be done publicly, as it will not only ensure that all relevant stakeholders and information can be accessed, but it will also provide an opportunity to inform the public on the ongoing costs associated with funding rail, and what benefits are being generated from this investment.

51. In the event that closure or partial closure is not pursued, Treasury supports a three year funding commitment for KiwiRail on the basis that it needs certainty to manage its business accordingly, and have a sufficient period of time to focus on improving productivity and efficiency in order to reduce the level of ongoing Crown funding needed.

52. [8]

Ministry of Transport Comment

53. The Ministry of Transport, which has been closely involved with the KiwiRail review over the last nine months, supports the provision of multi-year funding for three years for KiwiRail as outlined in this paper.

54. [8]

55. The Ministry does not support the Treasury view that one-year funding be provided to KiwiRail whilst a public process is undertaken. The Ministry's view is that a minimum of three years' funding be provided.

Financial Implications

56. The cost of this proposal totals million in capital over three years. with $209.8 million expected in 2015/16, [5] million expected in 2016/17, and [5] million expected in 2017/18. A Budget initiative has been submitted for consideration by Budget Ministers as part of the Budget 2015 process. Ongoing funding will be sought by the company following this three year period, and the company had originally forecast annual funding requirements to be between [5] million per annum for at least the next ten years. [5][11][12]

57. [8]

58. The funding amount in year one of $209.8 million includes $15 million to provide for unplanned events such as utility outages, unplanned mechanical failures, loss of a major customer or freight volumes, or a natural disaster. Funding in year two has been reduced by a corresponding $15 million to ensure the three year funding total remains the same at [5] million. Providing $15 million at the start of the three year period gives KiwiRail more flexibility to manage unforeseen events and avoid a repeat of the situation in 2013/14 where it sought emergency funding mid-year following the loss of its Aratere ferry for a significant period of time.

59. A final decision on the proposal, including the detailed financial recommendations, will be made when the Minister of Finance presents the final Budget 2015 package to Cabinet.

60. [8]

[5]

Human Rights

61. Not applicable.

Property Rights

62. Not applicable.

Legislative Implications

63. Not applicable.

Regulatory Impact Analysis

64. Not applicable.

Treaty of Waitangi Implications

65. Not applicable.

Publicity

66. [8]

Recommendations

67. The Minister of Finance, the Minister of Transport and the Minister for State Owned Enterprises recommend that Cabinet:

About KiwiRail's New Plan

1 **note** that KiwiRail has developed a new plan designed to provide clarity on the likely funding requirements for the business over the long term

2 **note** the review was undertaken over a period of nine months, and was supported by consultants Cameron Partners and Gravel Road, and Treasury was also closely involved in its development

3 **note** that the review attempted to identify options that would materially reduce the ongoing level of Crown funding, but for the reasons noted in recommendation 4 below, there are limited options available for achieving this

4 **note** the key findings from the review were:

4.1 the high fixed costs of KiwiRail's business are spread across the network and do not materially vary from changes in volumes being transported

4.2 revenue earned from train movements on most parts of the network is interdependent with other parts of the network because most freight movements travel across multiple network segments

4.3 as a result of the high fixed costs and interdependence of revenue between the different network segments, it is challenging to reduce costs faster or to a greater extent as reductions in revenue

4.4 the findings noted above support the only options available as being relatively small scale rationalisation of the existing network (and improving capacity utilisation and efficiency), very significant downsizing of the rail freight network, or full exit.

5 **note** that KiwiRail has presented three options to the Government, being

5.1 retain most of the rail freight network, [5][11][12]

5.2 retain only the upper North Island section (Auckland to Hamilton to Tauranga) and close the remaining lines (excluding the metropolitan passenger networks in Auckland and Wellington), or

5.3 close the full rail freight network (excluding the metropolitan passenger networks in Auckland and Wellington).

6 **note** that KiwiRail tested a number of other network configuration options throughout the course of its review, but most were value destructive and resulted in higher funding requirements than what is outlined in this paper

7 **note** that KiwiRail is forecasting a spike in funding requirements over the next three years as a result of a number of one-off remediation projects that it needs to undertake, including:

[5]

8 [5][11][12]

9 [8]

About the policy considerations

10 **note** that Treasury, the Ministry of Transport, and the New Zealand Transport Agency have completed a national cost benefit analysis which attempted to

quantify in monetary terms all costs and benefits to society (including all of KiwiRail's stakeholders) of continuing to fund rail at the levels required

11 **note** that the cost benefit analysis considered the roading costs and revenue associated with transferring the rail freight to road, the environmental and safety impacts, the fiscal cost of continuing to fund vs. the cost of closure, the option value of retaining rail, and the impact on KiwiRail's customers (at a high level)

12 **note** that the cost benefit analysis assessed that there was a net shortfall in benefits (i.e. a net economic cost) of between $55 and $170 million per annum

13 **note** that NZTA advises that if all the freight currently transported on rail was transferred to road, the additional road user charges earned from the additional trucks on the road would be sufficient to adequately address road capacity and safety issues in most areas

14 **note** the estimated environmental and safety benefits from transporting the current volume of freight by rail of ~$10 million and ~$20 million per annum respectively do not outweigh the costs of continuing to fund rail, and

15 **note** that a further assessment of the likely impact on the transport supply chain (including the impact on New Zealand's major ports), KiwiRail's customers, regional economies, road safety and environmental impacts would be needed before a decision could be made to significantly down-size the rail network

16 **note** that different funding models will be explored that better consider rail as part of New Zealand's integrated transport network.

About this Budget initiative

17 **note** that a Budget initiative has been submitted for consideration by Budget Ministers as part of Budget 2015 to invest more capital into KiwiRail on the basis that the Government wishes to retain the rail freight network

18 **note** that the costs of this proposal total [5] million in capital over three years, with $209.8 million expected in 2015/16, [5] million expected in 2016/17, and [5] million expected in 2017/18

19 [8]

20 **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 2015 package to Cabinet

21 [8]

22 **agree** that KiwiRail needs certainty of funding beyond one year at a time in order to adequately manage its business and capital investment accordingly

23 **agree** that this proposal be submitted to Budget Ministers for consideration in Budget 2015

24 **note** that if only one year's funding is committed now, KiwiRail will make further funding requests in Budget 2016. Whilst major downsizing options will improve the funding required in the long term, they cannot reduce the funding required over the next three years and may result in increased funding pressures in the near-term. Regardless of the option chosen, KiwiRail will continue to place significant pressure on the Future Investment Fund.

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

26 **note** that shareholding Ministers will report back to Cabinet on KiwiRail's progress against its plan at least once a year

Hon Bill English
Minister of Finance

Dated:

Hon Simon Bridges
Minister of Transport

Dated:

Hon Todd McClay
Minister for State Owned Enterprises

Dated: