Reference: 20150211

4 August 2015

[redacted]

Thank you for your Official Information Act request, received on 9 June 2015. You requested the following:

> *"Any documentation provided to either the Minister of Finance or the Minister of State Owned Enterprise (or both) related to the financial position of KiwiRail and its need for continued funding from the Crown.*
>
> *This request should cover the period from June 1, 2013 until June 1, 2015.*
>
> *A similar earlier request for advice on a variety of state owned enterprises was rejected on the basis that the request was too onerous. I note that this request is for one state owned enterprise (although at least one more OIA is likely) and that KiwiRail is currently receiving hundreds of millions of dollars in subsidies. Therefore I would argue that this request is less onerous and the public interest, in being more targeted, is much higher."*

Upon discussion with Treasury officials, a revised timeframe and scope were agreed to:

> *"Any documentation provided by Treasury to either the Minister of Finance or the Minister of State Owned Enterprise (or both) that provides substantive advice specifically relating to the financial position of KiwiRail and its need for continued funding from the Crown. This request should cover the period from December 1, 2014 until June 1, 2015."*

The response date for this OIA was extended by 20 days based on the amount of time required to prepare and consult on the papers being released.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	15 December 2014	Treasury Report entitled KiwiRail: New Strategic Plan. This report provides an extensive examination of KiwiRail's new strategic plan and business case for ongoing Crown funding.	Released in part
2.	23 January 2015	Treasury Report entitled KiwiRail: Briefing ahead of meeting on 27 January 2015. This report gave Ministers a briefing on options for the Crown in regard to KiwiRail and also the Cost Benefit Analysis Treasury undertook on KiwiRail.	Released in part
3.	5 March 2015	Treasury Report entitled KiwiRail: Third Drawdown from $198 million Appropriation for 2014/15. This report seeks Ministers approval for KiwiRail to draw down an amount of its 2014/15 appropriation.	Released in part
4.	19 March 2015	Treasury Report entitled KiwiRail: Cabinet Paper for Funding. This report provides Ministers with a Cabinet paper seeking Cabinet's agreement to provide financial support to KiwiRail. The report also provides an update on various other aspects of KiwiRail's business in recent time. The actual Cabinet Paper itself has been released under Treasury's 2015 Budget proactive release (see next page).	Released in part
5.	26 March 2015	Aide Memoire entitled KiwiRail: Advantages of Multi-Year funding. This note details the benefits of providing KiwiRail with a multi-year	Released in part

		funding commitment versus a single year's funding.	
6.	5 May 2015	Aide Memoire entitled Briefing for KiwiRail Discussion. This note provides Ministers with an overview and background for discussing KiwiRail's funding. It includes the benefits of multi-year funding and KiwiRail's ability to defer capital expenditure.	Released in part

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials,
- names and contact details of junior officials and certain sensitive advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions,
- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information, and
- to enable the Crown to carry out commercial activities without disadvantage and prejudice, under section 9(2)(i).

Information Publicly Available

The following information is also covered by your request and is publicly available on the Treasury website:

Item	Date	Document Description	Website Address
7.	9 July 2015 as per 2015 Budget proactive release.	This Cabinet paper noted capital funding for KiwiRail that is being sought as part of the Budget 2015 process. It sought Cabinet's agreement for continued financial support of KiwiRail, and to provide some form of multi-year	http://www.treasury.govt.nz/publications/informationreleases/budget/2015/other-s-w/index.htm#trans

		funding commitment to give KiwiRail enough certainty to manage its business and investment programme accordingly.	
8.	9 July 2015 as per 2015 Budget proactive release.	This Treasury report sought confirmation of ministers' decision to change the funding package for KiwiRail in Budget 2015 from \$209.8 million in 2015/16 only to \$400 million for 2015/16 and 2016/17.	http://www.treasury.govt.nz/publications/informationreleases/budget/2015/other-s-w/index.htm#trans

Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act – the information requested is or will soon be publicly available.

Some relevant information has been removed from documents listed in the above table and should continue to be withheld under the Official Information Act, on the grounds described in the documents.

Information to be Withheld

There are no additional documents covered by your request that I have decided to withhold in full under the Official Information Act.

Public Release of this Information in this OIA

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website in approximately one week from the date of this letter.

This fully covers the information you requested, however if you disagree you have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Ant Shaw
Senior Analyst, Governance and Performance

Information Being Released
OIA 20150211 Binder V3

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: KiwiRail: New Strategic Plan

Date:	15 December 2014	**Report No:**	T2014/1805
		File Number:	SE-2-13-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** recommendations	27 January 2015
Associate Minister of Finance *(as holder of a delegation for state owned enterprises' shareholdings from the Minister of Finance)* (Hon Steven Joyce)	**Agree** recommendations	27 January 2015
Associate Minister of Finance (Hon Paula Bennett)	For your information.	None
Minister of Transport (Hon Simon Bridges)	**Agree** recommendations	27 January 2015
Minister for State Owned Enterprises (Hon Todd McClay)	**Agree** recommendations	27 January 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	04 917 6160 (wk)		✓ (for KiwiRail)
Jon Butler	Senior Analyst, National Infrastructure Unit	04 890 7298 (wk)		✓ (for policy)
Fiona Chan	Manager, Governance and Performance	04 917 6103 (wk)	[Withheld under s9(2)(a)]	

Actions for Ministers' Offices' Staff (if required)

Return the signed report to Treasury.

Enclosure: No

Treasury Report: KiwiRail: New Strategic Plan

Executive Summary

No easy choices available to materially reduce Crown funding

KiwiRail has not identified any options that will materially reduce the ongoing level of Crown funding needed whilst continuing to operate the majority of the rail freight network. The only options presented by KiwiRail that will materially reduce ongoing funding requirements involve major downsizing. The two major down-sizing options presented are operating the golden triangle only (Auckland to Hamilton to Tauranga) or full closure (excluding the Auckland and Wellington Metropolitan networks).

[Withheld under s9(2)(f)(iv)]

A number of other network configurations were tested by KiwiRail over the past six months as it has developed its new plan. ***[Withheld under s9(2)(f)(iv)]*** Other than the major down-sizing options presented, most other configuration changes result in a loss of value for the company (and either minimal, no reduction, or increases in funding). Intermediate options generally reduce revenues more than costs because they eliminate positive contribution services with lesser impacts on costs. This reflects the economics of rail – a high proportion of KiwiRail's revenue is earned from train movements that move across multiple segments of its network (which would be lost if parts of the network were closed), and the fixed costs associated with maintaining and renewing its track and infrastructure assets do not materially vary from changes in volumes.

Risks and opportunities that may impact on funding

KiwiRail is forecasting funding requirements to reduce from year four (from an average of approximately ***[Withheld under s9(2)(b)(ii)]*** ***[s9(2)(i)]*** The spike in funding in the first three years is mainly the result of specific infrastructure and facilities remediation projects that need to be undertaken, including:

[Withheld under s9(2)(b)(ii)]

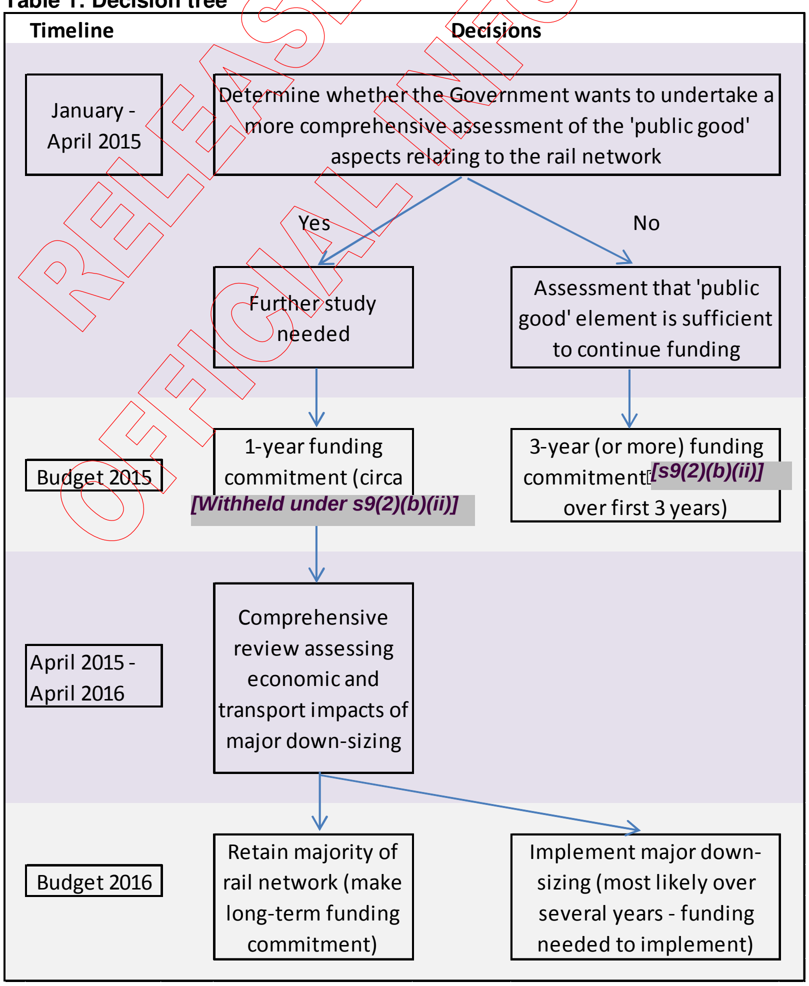
Whilst the forecast reduction in funding from year four is based on reasonable assumptions and the best information currently available, we believe KiwiRail would need to have favourable external conditions, successful delivery of its planned initiatives, and some luck to achieve the reduction in funding to the extent that is forecast. In our view, this business will face ongoing risks associated with the condition of its considerable portfolio of old infrastructure assets including tunnels, bridges, buildings, and signalling equipment. An example of unplanned remediation required on infrastructure assets is the substantial work required *[Withheld under s9(2)(b)(ii)]* which has only crystallised in the past one to two years, and is the result of heightened health and safety requirements – which we expect will only become more onerous over time. If a heavy weighting of risks over opportunities was to materialise, it is possible that funding requirements will not reduce at all, and could conceivably get higher.

Opportunities do however exist for KiwiRail *[Withheld under s9(2)(i)]* [Withheld under 9(2)(b)(ii)] [Withheld under s9(2)(b)(ii)] but we think these opportunities are most likely outweighed by the risks noted above.

Options for the Government

This report assesses some options for the Government, but ultimately there are only two realistic choices: keep rail and continue to fund it for the long-term, or implement a major down-sizing of the rail network. These choices are displayed in this decision tree:

Table 1: Decision tree



Economic costs and benefits

We have attempted to compare the benefits provided from retaining the rail network with the costs needed to keep it by taking into account the impacts on all affected parties in New Zealand, including intangible impacts and social and environmental effects.

Our assessment is somewhat high level and we do not consider it to be comprehensive enough to support a decision of major down-sizing at this point. However, our indicative view is that if the rail freight network was closed down (or alternatively if it required no funding from the Crown to retain it), it would produce an economic[1] saving of between $150 and $232 million per annum, or fiscal[2] savings of between $141 and $242 million per annum, both <u>after</u> costs of closing down rail and upgrading roads to accommodate the additional freight that would be transferred to road.

We recognise that major down-sizing of the rail freight network would represent a major change to New Zealand's transport landscape and would not be undertaken lightly. We would therefore recommend a further more comprehensive study be undertaken (perhaps by an organisation at arms' length from the government) to validate (or not) our assessment if the Government was to seriously consider major down-sizing of the rail freight network. Such a study would need to comprehensively examine the impact on KiwiRail's customers, including the extent to which they would incur additional costs of such a change, and to determine whether there would be severe constraints and lost productivity at the country's largest ports when loading newer and bigger ships.

Board performance

We do not believe that making wholesale changes to the Board will materially change the financial outlook for the company. However, we believe its focus now must shift to cost reduction in order to reduce the gap between earnings and expenditure, with revenue projections having been pared back significantly from those in the original Turnaround Plan in 2010. We believe that restructuring expertise will be needed on the Board and in the senior management team in order to provide a sustained focus on cost reduction and productivity improvement.

Funding

In the event the Government considers there to be a sufficient 'public good' rationale to retain the rail freight network, we would support a three-year funding commitment in Budget 2015 on the basis that it enables KiwiRail to have a sustained period of certainty to focus on day-to-day business improvement rather than having to focus on reassessing its future every year.

If funding was to be provided as capital, it would be a charge against the Future Investment Fund (FIF). The FIF has remaining funds of $1.7 billion available for allocation at Budget 2015 and Budget 2016. If a three-year funding commitment of *[s9(2)(b)(ii)]* was made in Budget 2015, this would be [Withheld under s9(2)(b)(ii)] after allowing for Budget 2015 capital pre-commitments.

[1] This measures the impact on all affected parties including the public, the Government, road users, and customers.

[2] This represents the direct fiscal cost to the Crown of funding KiwiRail.

Alternatively, if funding was provided as an operating subsidy it would be a charge against the $1 billion allowance for new operating funding each year. The Crown's Operating Balance Excluding Gains and Losses (OBEGAL) would be impacted under either funding mechanism given that KiwiRail impairs between 80 and 90% of its capital expenditure each year.

Conditions relating to the drawdown of funding, including monitoring arrangements and agreeing performance milestones, would need to be agreed ahead of any final funding decision in Budget 2015. There is no palatable scenario where funding will not be required in Budget 2015.

Agency Views

The Ministry of Transport supports the views expressed in this report. The Ministry believes that if the Government is minded to pursue one of the bold options outlined in this paper, that substantial work is required to understand the impact that this might have on the entire supply chain.

NZTA supports the indicative evaluation outlined in this report, and the conclusion that even taking account of the public good aspect there is currently a significant gap between the financial assistance the Crown is providing to KiwiRail and the value of the public good. However, it believes that in the event the government has some ongoing investment in the rail network as a public good, NZTA could be the appropriate policy and planning agency for investment decisions across the entire transport system (including rail). This would allow for an integrated 'whole-of-network' approach to investing in and delivering on the government's 'public good' priorities for both rail and road transport, over the long term.

Treasury and the Ministry of Transport note that no work has yet been done to assess possible different ownership or governance structures with respect to rail and that this option would therefore need to be considered in conjunction with all other possible ownership and governance structures, should the Government wish to pursue change.

KiwiRail agrees that further work would be needed before a decision was made to significantly down-size the rail network, as it believes there would be significant impacts to its customers (in particular the main ports) that have not yet been assessed.

Next Steps

We are seeking initial engagement with Ministers (and appropriate agencies) to discuss the findings expressed in this report and to determine the next steps. We understand an initial meeting has been arranged with Ministers at 4pm on 27 January 2015 to discuss options and the way forward. Engagement with Cabinet will be required ahead of Budget 2015 and we believe a Cabinet strategy session could be an appropriate avenue for an initial discussion.

Recommended Action

We recommend that you:

a **note** that KiwiRail has presented its new commercial plan, and that it has not identified any option where the company can be financially self-sustaining within the foreseeable future

COMMERCIAL-IN-CONFIDENCE

b **note** that KiwiRail has presented four network configuration options for Ministers to consider, which range from continuing to operate as largely the status quo to full closure of the rail freight network

c **note** that KiwiRail's 'trimmed network' option [Withheld under s9(2)(f)(iv)] [s9(2)(f)(iv)] has identified indicative funding requirements of [s9(2)(b)(ii)] over the next three years and that KiwiRail is seeking a multi-year funding commitment in Budget 2015 to implement the option best preferred by the Government

d **note** that Treasury, the Ministry of Transport and the New Zealand Transport Agency believe there is a net economic cost of continuing to fund KiwiRail at the levels required

e **agree** to meet with officials to discuss options and next steps, including how to best engage with Cabinet ahead of Budget 2015

Agree/disagree
Minister of Finance

Agree/disagree
Associate Minister of Finance
(as holder of a delegation for state owned Enterprises' shareholdings from the Minister of Finance)

Agree/disagree
Minister of Transport

Agree/disagree
Minister for State Owned Enterprises

Fiona Chan
Manager, Governance and Performance

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance
(*as holder of a delegation for state owned enterprises' shareholdings from the Minister of Finance*)

Hon Simon Bridges
Minister of Transport

Hon Todd McClay
Minister for State Owned Enterprises

Treasury Report: KiwiRail: New Strategic Plan

Purpose of Report

1. This report assesses KiwiRail's new strategic plan and business case for ongoing financial support from the Crown that was sent to Ministers on 17 November 2014. The report also takes into account the economic and policy considerations for the Government of continuing to fund rail at the levels required, and makes a high level assessment of what the impact would be on New Zealand's roading network if the freight currently transported by rail was transferred to road.

2. KiwiRail's business case and the associated policy and road network impact analysis exclude the Metropolitan passenger networks in Auckland and Wellington. These public transport train services (and associated capital and maintenance expenditure) are separately funded (through a combination of funding from regional authorities, the New Zealand Transport Agency, and the Crown) and will be largely unaffected[3] by the direction the Government wishes to take with respect to KiwiRail's freight business.

Background

3. 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 (TAP) for KiwiRail was developed and approved by Cabinet in 2010. The objective of the TAP was for KiwiRail to become, within ten years from 2010, a sustainable rail freight business that was able to fund its ongoing operating and capital expenditure solely from customer revenue.

4. When the original TAP was approved in 2010, it identified the likely need for a total Crown investment of $1.1 billion over the 10 years to 2020. It was forecast that this level of Crown investment would be sufficient to drive KiwiRail's earnings growth to the extent that it could then self-fund its ongoing capital expenditure requirements from customer revenues. The Crown has so far appropriated $1.1 billion toward the TAP over the past five Budgets (2010 to 2014). A proportion of this has been applied towards addressing historic underinvestment in its infrastructure and rolling stock.

5. KiwiRail's EBITDA[4] has not grown to any great extent since the inception of the TAP in 2010/11 (EBITDA was $100 million in 2010/11, and is 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.

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[3] Parts of the rail network in Auckland and Wellington are shared by the freight business and the metropolitan rail services, and the associated funding requirements are therefore also shared. If material changes to the rail network were to be made, there would be implications for funding on these shared parts of the network.

[4] EBITDA (Earnings before interest, tax, depreciation and amortisation). This is the best metric for measuring KiwiRail's earnings performance as it roughly translates to the generation of operating cash flow. NPAT (Net profit after tax) does not provide a transparent view of KiwiRail's performance as it is impacted by the receipt of grant income (for the Auckland and Wellington Metropolitan rail projects), the recent write-down in assets, and the impairment of capital expenditure.

6. In the last 1-2 years it has become clear that the main objective of the TAP – for KiwiRail to become financially self-sustaining by 2020, is not achievable and that ongoing Crown funding will be required.

7. On 31 March 2014, a Cabinet strategy session was held to discuss KiwiRail's Budget bid for [s9(2)(b)(ii)] in Budget 2014, and the likely future prospects for the business. It was evident that the Government's appetite for continuing to fund rail at the current levels was diminishing, and 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.

8. On 24 April 2014, the then Minister for State Owned Enterprises 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
- that a range of options, including some bold, be presented to the Government.

9. The $198 million funding provided to KiwiRail in Budget 2014 for the 2014/15 financial year was effectively a short term funding arrangement to enable KiwiRail to continue operating on a "business as usual" basis this year, whilst it developed a new plan to assist the Government in formulating a longer-term view of the business.

Context

KiwiRail's Approach

10. From the outset, Treasury strongly encouraged KiwiRail to focus on the commercial aspects of its business, and that any associated policy considerations be led by central Government. This approach is consistent with its objectives as a State Owned Enterprise (SOE), and KiwiRail has largely followed this direction.

11. KiwiRail's approach to the development of its new plan was:

- undertaking a detailed review of cash flows attributable to each line segment
- using the National Freight Demand Study[6] as a basis for formulating likely future freight volumes

[5] KiwiRail initially [s9(2)(b)(ii)] in Budget 2014 for the 2014/15 financial year, but received $198 million following advice from Treasury.

[6] 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.

- 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.

Different approach to developing new plan

12. With the benefit of hindsight, KiwiRail's Turnaround Plan was somewhat aspirational. The original Turnaround Plan forecast earnings (EBITDA) growth from $74 million in 2009/10 to $268 million by 2014/15, a cumulative annual average growth rate of 29%. This was unrealistic 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, irrespective of the level of upfront investment that was made to drive the growth that was forecast.

13. It has been clear that when developing this plan, the Board and management have been reluctant to make the same mistakes of the past, and have instead presented a plan that can be realistically delivered. Treasury supports this approach.

14. The challenge for the Board and management was to develop a plan that shows sufficient challenge and stretch for the business and evidence that everything is being done to improve its financial prospects, but at the same time present a plan that can be delivered. In our view, this has more or less been achieved. There are some opportunities for the company to perform better than forecast and risks that could impact on performance. These are discussed throughout this report.

15. The outcome is a much more realistic assessment of the financial prospects for the business, at least in the short-term. We hope this will enable the Government to make more-informed decisions regarding the future of KiwiRail.

Policy Work

16. Over the past 1-2 years it has become clear that KiwiRail is unlikely to be financially self-sustainable (i.e. to fund its operations from customer revenues) in the foreseeable future. As a result, a more comprehensive assessment of the economic and policy considerations for funding rail was needed in order to better understand the rationale for continuing to invest in rail.

17. Consequently, in May 2014, a working group was formed with members from the MOT, Treasury, and the NZTA to establish the public policy case for rail at the same time as KiwiRail was developing its new plan. A governance group consisting of members from the MOT, Treasury, NZTA, KiwiRail and the Department of the Prime Minister and Cabinet (DPMC) was also convened to oversee the two work programmes, to ensure that there was coordination between the parties, and that the work streams were prioritised in the appropriate areas.

18. The work focussed on addressing:

- The economic case, if any, for supporting rail. Following economic theory, this involved assessing the two potential reasons for government intervention: whether rail provides significant externalities over competing transport modes (principally road), and whether other transport modes enjoy significant subsidies that would give them a competitive advantage over rail,

- The transport impact. This assessed whether there was spare capacity on competing roads to accommodate the freight currently transported by rail, and whether there would be a need for additional road construction, and

- The wider impact. At a high level, this involved looking at the industries and businesses that would be affected if parts of the rail network were closed, what the impact would be on the resilience of the transport network, and what the option value could be of retaining some or all of the rail lines.

Overview

19. This report initially assesses KiwiRail's strategic plan in isolation. It then considers the relevant economic and policy considerations for continuing to fund rail in general (with consideration given to the impact on the roading network if rail freight moved to road).

20. The Ministry of Transport and Treasury agreed that Treasury is the most appropriate agency to lead the development of this advice in the first instance, with the central focus of this report on the commercial prospects of KiwiRail's business. Our approach to reviewing KiwiRail's business case in this report has been to make an assessment of the prospects for the business (both revenue and costs) and whether KiwiRail's forecasts (and the associated funding requirements) are supported by robust and reasonable assumptions.

21. Shareholding Ministers have ultimate responsibility for KiwiRail. In the past, shareholding Ministers and the Minister of Transport have assumed joint responsibility for major decisions regarding the company given the financial and transport considerations. We recommend this joint approach be continued.

Assessment of KiwiRail's Business Case

The Investment Proposition

22. All options presented by KiwiRail will require significant investment from the Crown, whether it is to fund an ongoing business, significant downsizing, or closure.

23. KiwiRail has not presented an option that requires no investment from the Crown. As a result, it is unclear what the implications would be if no further funding was provided. However, we expect that it would result in the company being unable to meet its financial obligations within the first 1-2 months of the 2015/16 financial year, and ultimately becoming insolvent.

24. KiwiRail has also not presented an option whereby the company operates on the minimal level of funding possible, accepting a decline in service performance and

reliability, not replacing assets when they fall due, and only meeting the most basic safety requirements to keep the network operational. This could be classified as a "managed decline" scenario, where over time, customers would most likely take business away from rail, and rail would eventually exit as a nationwide freight sector participant.

25. A "managed decline" scenario could be compared to what happened to the rail network when it was under private ownership in the 1990s and the early 2000s. During this time, the infrastructure was effectively "harvested" whereby asset replacement and maintenance was deferred. Repeating this strategy now would improve short term cash flows, but would ultimately lead to closure or another period of significant "catch up" capital expenditure should the Government at the time be unwilling to close the network.

26. Such a strategy would most likely be the most fiscally attractive to the Government, at least in the short term. It is unclear what level of Crown investment would be needed to implement such a strategy, but we estimate this would be in the range of $50 to $100 million[7] per annum. However, it would be difficult to attract a Board and management team to implement such a strategy, and it is likely that Crown indemnities would be sought by directors and management given the new requirements under the Health and Safety Reform bill that is scheduled to be introduced into law in 2015. Further work would be required to understand the implications, practicalities and possible funding implications of such a strategy if the Government had an appetite to pursue this.

KiwiRail's "Base case"

27. KiwiRail's has labelled its base case view as the "trimmed network" option. Most of its analysis has been focused on this scenario. The key assumptions are:

- KiwiRail continues to operate most of the rail network[8] that it does now
- *[Witheld under s9(2)(f)(iv)]*
-
- *[Withheld under s9(2)(b)(ii)]*

7 This is based on the assumption that a level of capital investment would still be required to meet health and safety standards and to keep services operational, but that no further rolling stock be procured and all 'business improvement' related investment is discontinued. In practice, the year 1 cost of this strategy would likely be higher as KiwiRail transitioned to it.

8 A map showing the current rail network is shown in Appendix 1.

9 *[Witheld under s9(2)(f)(iv)]*

10 *[Withheld under s9(2)(b)(ii)]*

11

- the forecast volume growth in the National Freight Demand Study has been used to form the basis of KiwiRail's growth forecasts, adjusted for known customer changes where KiwiRail holds more information

- all amounts presented are in real $, with inflation assumptions in line with Treasury's forecasts, and

- economic growth is assumed to be 2.1% over the 30-year period of the plan.

28. Table 2 below summarises the financial forecasts for this scenario.

Table 2: Summary financial forecasts under 'Trimmed Network' scenario

$ Millions	**2013/14 Actual**	**2014/15 Forecast**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**
Total Revenue	688.4	*[Withheld under s9(2)(b)(ii)]*					
EBITDA	77.5						
Capital Expenditure	250.7						
Other[15]	2.2						
Free Cash Flow (Crown Funding being sought)	**(171.0)**						

29. Under this scenario, KiwiRail has identified likely funding requirements of *[s9(2)(b)(ii)]* over the next three years, or *[s9(2)(b)(ii)]* over the next 5 years. KiwiRail has developed 30-year forecasts in its plan; however, we have focused on the first 3-5 years given the uncertainty inherent in forecasting too far into the future. Unless otherwise stated, our analysis in this report is focused on assessing KiwiRail's 'trimmed network' scenario.

Cash flows by line segment / Network Economics

30. KiwiRail has undertaken extensive analysis on potential different network configurations in order to determine whether any changes would materially reduce the level of Crown funding. It engaged the Gravelroad[16] consulting firm to assist with its analysis.

31. KiwiRail tested a number of cases, as well as the impact each scenario would have on its Interislander business. The different configurations they tested included:

[Withheld under s9(2)(i)]

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12 *[Withheld under s9(2)(b)(ii)]*

13

14 *[Withheld under s9(2)(g)(i)]*

15 'Other' is the net amount of interest costs, land and property sales, working capital movements, and restructuring costs.

16 Gravelroad is a consultancy firm specialising in network economics.

[Withheld under s9(2)(i)]

- various combinations of these configurations above.

32. The analysis concluded that most changes to the network (other than material downsizing which is discussed further in the report) would be value destructive for the company. The rationale for this is described in more detail in KiwiRail's Executive Summary and main report, however, these are the key points as to why this is the case:

    - fixed costs are spread relatively evenly across the network, and these generally do not vary to any material extent due to changes in volumes being transported

    - a high proportion of KiwiRail's revenue is earned from train movements that move across multiple segments of its network

    - with high levels of fixed and common costs, KiwiRail is like many other network businesses where it is often very challenging to reduce costs faster than revenues, and

    - the infrastructure assets that generate the fixed costs are used by multiple revenue earning services, making it difficult to measure the absolute profitability of individual services without some degree of arbitrary cost allocation.

33. An example of this is *[Withheld under s9(2)(i)]* Whilst this would save below rail costs of operating that part of the network of approximately *[s9(2)(b)(ii)]* per annum, KiwiRail would also most likely lose the full contribution earned by trains travelling inter-island through this part of the network *[Withheld under s9(2)(i)]* *[Withheld under s9(2)(i)]* This is because if KiwiRail no longer offered a rail service *[s9(2)(i)]* *[Withheld under s9(2)(i)]* it is unlikely that customers would use rail for part of the journey and then transfer the freight to trucks for the remaining part of the trip[17]. The cost and time of double handling and changing from rail to road would most likely make this prohibitive, therefore it is likely that the total revenue stream would be lost.

34. *[Withheld under s9(2)(b)(ii)]*

[17] Treasury has not explicitly tested this assumption; however, it is supported by Gravelroad's conclusions.

[18] *[Withheld under s9(2)(i)]*

35. *[Withheld under s9(2)(f)(iv)]*

36. Contributing to the inability for KiwiRail to make material savings through network configuration changes is the high proportion of its costs (a combination of operating and capital) that are not directly attributable to specific line segments. These costs average approximately $160 million per annum. These costs incorporate a number of things including overheads, network control costs, plant maintenance, management, customer services, containers costs, and the cost of equipment used on multiple sections of the network.

37. Of this $160 million, approximately *[s9(2)(b)(ii)]* is capital expenditure (discussed further in paragraphs 56 to 86) *[Withheld under s9(2)(b)(ii)]* (discussed in paragraph 88), with the remaining *[s9(2)(b)(ii)]* being operating expenditure across the various parts of KiwiRail's business (discussed in general in the 'Business Improvement Initiatives' section in paragraphs 87 to 110). We believe KiwiRail should target reducing these unallocated costs.

Growth projections

38. KiwiRail has made the following assumptions when forecasting volume growth in its freight business over the period:

- Using the forecast growth rates from the National Freight Demand Study
- Adjusting for known changes from that study (e.g. forecast coal volumes are much lower than what was assumed in the study)
- Having discussions with customers to understand their growth projections and planned changes in volumes by region *[Withheld under s9(2)(b)(ii)]*
- Assuming between a *[s9(2)(b)(ii)]* market share[19] gain per annum in the domestic market *[Withheld under s9(2)(b)(ii)]* *[Withheld under s9(2)(b)(ii)]* based on an assessment by Gravelroad of KiwiRail's opportunities in that market, and
- Assuming *[Withheld under s9(2)(b)(ii)]* in the Interislander's passenger and commercial vehicle revenue streams (consistent with how this business has been tracking in recent years).

39. *[Withheld under s9(2)(b)(ii)]*

19 *[Withheld under s9(2)(b)(ii)]*

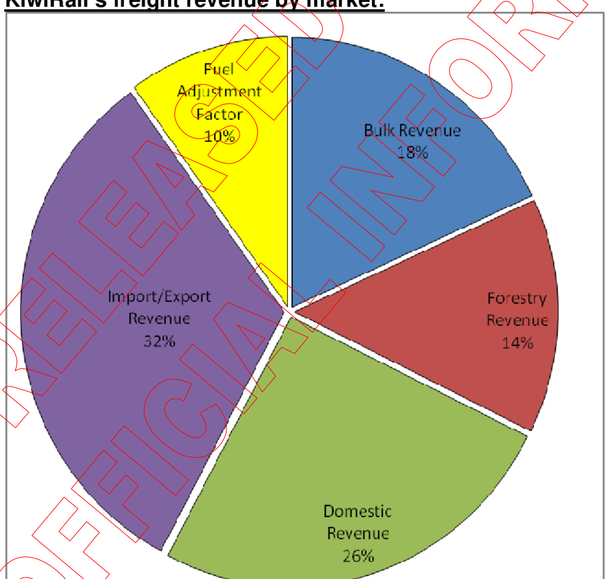
[Withheld under s9(2)(b)(ii)]

40. In our view, this is still a conservative growth outlook for KiwiRail, and is more conservative than the volume growth achieved from 2010/11 to 2012/13[20] (which averaged 4.3% per annum). KiwiRail's new plan does not forecast any new business that is not currently known about.

41. ***[Withheld under s9(2)(g)(i)]*** The approach is also in line with the Government requesting this new plan be more "realistic and achievable" than previous plans. ***[Withheld under s9(2)(g)(i)]***

42. Of KiwiRail's $450 million annual freight revenue, it is roughly split as illustrated in this chart:

KiwiRail's freight revenue by market:



43. KiwiRail's bulk and forestry volumes are directly impacted by the production volumes in catchments linked to rail, meaning KiwiRail has limited ability to grow these volumes unless there are increases in production (there are barriers to short term modal shift between road/rail due to the specialised rail equipment needed).

44. KiwiRail's import/export business primarily focuses on transporting exports to ports, with ***[Withheld under s9(2)(b)(ii)]*** Ports generally see advantages in using rail as it provides a more efficient mechanism for moving large quantities of products on/off ships. Road transport is however in direct competition with rail in this market, and rail's reliability and pricing directly affects the

[20] 2012/13 has been used as a comparison as 2013/14's volumes were impacted by one-off events including the Aratere propeller incident and the asbestos issues with the DL locomotives.

extent to which KiwiRail is able to gain market share and grow volumes. Import/Export freight is less time sensitive than the domestic freight market.

45. The domestic line-haul market (primarily transporting full container loads of consolidated manufactured products and fast moving consumer goods) is where KiwiRail's competition with road transport is the greatest. However, there is opportunity for growth in the domestic market as its main competitors (the freight forwarding companies such as Toll and Mainfreight) are also its largest customers as they use a combination of rail and road.

46. *[Withheld under s9(2)(b)(ii)]*

The north bound (or return journey) for both rail and road operators is characterised by low utilisation and pricing as they compete for limited volumes. Road transport operators have an advantage over KiwiRail for securing this backload as they are not restricted by the rail corridor and can therefore "hunt" for the backload over a wider geographic area as the truck travels north (such as returning from the South Island via Nelson).

[Withheld under s9(2)(b)(ii)]

47. Another factor that may impact on KiwiRail's competitive position in the domestic market is that trucks are becoming bigger and more efficient and this may make roading more attractive than rail in the long-term (although rail generally does not compete with the highly time sensitive freight which is predominantly transported by road). If domestic revenue varied up or down by 10% from what KiwiRail has assumed over the next five years, it would result in a net cash gain or loss of approximately *[Withheld under s9(2)(b)(ii)]*

48. When considering KiwiRail's total freight market, for every 1% growth in volumes above the levels forecast it will grow KiwiRail's revenue by approximately *[s9(2)(b)(ii)]* with $2.5 million of that translating to earnings *[Withheld under s9(2)(b)(ii)]* We believe there is an opportunity for KiwiRail to achieve growth at levels greater than forecast, but its approach in forecasting volume and market growth is not unreasonable as growth in the freight industry is expected to closely align to GDP growth.

49. *[Withheld under s9(2)(b)(ii)]*

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21 *[Withheld under s9(2)(b)(ii)]*

[Withheld under s9(2)(b)(ii)]

Yield/Pricing Opportunities

50. *[Withheld under s9(2)(b)(ii)]*

51. *[Withheld under s9(2)(b)(ii)]* In our view, this is a conservative approach from KiwiRail, and we think there are opportunities to target price increases greater than what has been assumed. *[Withheld under s9(2)(b)(ii)]* in any given year would result in approximately additional revenue that would flow straight through to the bottom line (although we note that KiwiRail has some long-term fixed price contracts meaning it would be unable to implement this across its whole customer base *[s9(2)(b)(ii)]* *[Withheld under s9(2)(b)(ii)]*

52. However, we note that KiwiRail is operating in a competitive market in most regions and for most products that it carries, [Withheld under s9(2)(b)(ii)] The domestic market is particularly competitive, and the service issues (loss of the Aratere and its Chinese locomotives due to the Asbestos issue) that KiwiRail has experienced over the past 12 months *[Withheld under s9(2)(b)(ii)]*

53. *[Withheld under s9(2)(b)(ii)]*

54. KiwiRail has had success in the past 12 months by negotiating new contracts with *[Withheld under s9(2)(b)(ii)]* where both customers have agreed to take or pay[22] arrangements for some services. *[Withheld under s9(2)(b)(ii)]*

55. [Withheld under s9(2)(g)(i)]

KiwiRail is better off with this business than without it because of the positive contribution towards the fixed costs of maintaining and renewing the network. *[Withheld under s9(2)(g)(i)]*

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22 A "take or pay" arrangement involves customers committing to and paying for the provision of a certain level of train services whether they use them or not, which reduces the risk to KiwiRail of providing services where there is uncertainty as to the level of volume that will be carried.

Capital Expenditure

56. Table 3 below illustrates KiwiRail's actual capital expenditure over the last three years, and its planned level of capital expenditure going forward.

Table 3: Total Capital Expenditure

Capital Expenditure $ millions	**2011/12 Actual**	**2012/13 Actual**	**2013/14 Actual**
Freight (Rolling Stock)[23]	85.7	104.9	66.9
Track and Infrastructure[24]	202.8	169.7	145.3
Other[25]	69.4	36.0	38.5
Total	**357.9**	**310.6**	**250.7**

[Withheld under s9(2)(b)(ii)]

57. The three main categorisations of capital expenditure are assessed in more detail below, in addition to a summary of the external advice commissioned by Treasury in 2013 with regards to KiwiRail's capital expenditure programme.

<u>Freight Capital Expenditure</u>

58. KiwiRail is forecasting to spend between $85 and $90 million per annum on freight capital expenditure (predominantly rolling stock) over the next 3-5 years (with this forecast to remain relatively constant over the full 30-year period). Generally, this incorporates annual expenditure of:

[Withheld under s9(2)(b)(ii)]

59. KiwiRail plans to replace approximately ***[s9(2)(b)(ii)]*** each year[27] ***[Withheld under s9(2)(b)(ii)]*** ***[Withheld under s9(2)(b)(ii)]*** Its detailed modelling indicates that this number will be sufficient to carry the forecast volume

23 Refer paragraphs 58 to 68 for further discussion on freight capital expenditure.
24 Refer paragraphs 69 to 75 for further discussion on track and infrastructure capital expenditure.
25 Refer paragraphs 79 to 83 for further discussion on 'other' capital expenditure.
26 Shunt locomotives are smaller locomotives which are used to move wagons around yards into complete train sets.
27 In practice it is unlikely to procure these each year as it is more economic to make larger orders every 2-3 years.

growth (noting that new locomotives have more horsepower than its older fleet and can therefore transport heavier loads).

60. Over time, this assumes that the average age of its locomotives will be 15 years old (half the expected life of 30 years), and that its fleet is standardised so that it will only operate two to three classes of locomotives in the future. This should produce efficiencies around maintaining and servicing locomotives, but it is several years away before KiwiRail is forecasting the replacement of its existing fleet - so these efficiency gains are not incorporated within the next five years.

61. Its planned procurement of locomotives is not excessive, and is in line with what a comparable railway operator in an unconstrained cash position would do (i.e. replace its assets at the ends of their useful lives). However, there is an opportunity for KiwiRail to "sweat" its existing fleet harder and defer planned rolling stock procurement in order to reduce short term funding requirements[28].

62. KiwiRail spends between [s9(2)(b)(ii)] on refurbishments of locomotives each year, based on these key assumptions:

- bogie set replacement every 650,000 kms (approximately every 6 years)
- rotable (spare parts inventory) overhauls every 1.2 million kms
- electronic and cab overhauls every 2.6 million kms

63. In its review in 2013, AECOM advised that the assumptions underlying KiwiRail's planned refurbishments of its locomotives were reasonable and consistent with industry standards.

64. KiwiRail has a fleet of approximately 4,500 wagons. Consistent with its assumptions around planned replacement of locomotives, it plans to replace its wagons every 30 years (estimated useful lives) which equates to approximately [Withheld under s9(2)(b)(ii)]

Over time, KiwiRail plans to standardise its wagon fleet to remove the multiple classes of wagons that have evolved over time. The efficiencies from operating with a much more standardised fleet are built into the plan in outer years. AECOM noted that the unit prices KiwiRail pays for both its locomotives and wagons are cheap by international standards.

65. For its planned wagon refurbishments, KiwiRail has assumed a refurbishment cost of [Withheld under s9(2)(b)(ii)] each wagon travels. Total distance travelled by the whole fleet of wagons is forecast at between 290,000,000 kilometres and 306,000,000 kilometres within the next 3-5 years, which equates to between [s9(2)(b)(ii)] expenditure per annum. This level of service is consistent with what KiwiRail has undertaken on its fleet in the past 4 years.

66. KiwiRail maintains a fleet of approximately 80 shunt locomotives. The plan assumes fleet numbers remain constant over time and these locomotives are replaced at the

28 This will result in higher maintenance costs and more locomotive failures, which will impact service levels and may in turn have some impact on revenue. However, this impact will be much less than the savings that could be made from deferring these purchases – at least in the first three years of the plan. The long-term impact of deferring rolling stock purchases is difficult to assess.

ends of their useful lives (30 years, [Withheld under s9(2)(b)(ii)] In addition, there is scheduled refurbishment of its shunt fleet over the life of the plan.

67. We have not assessed KiwiRail's planned specific IT spend in its freight division by project, but do not consider this planned expenditure as excessive based on the size and complexity of its business, and the underinvestment in its IT systems prior to the start of the Turnaround Plan.

68. Overall, KiwiRail's planned capital expenditure in its freight division is based on reasonable assumptions and is not materially inflated. There is however, an opportunity for it to defer procurement of rolling stock in order to make short-term cash savings (an estimate of which is made in table 7 in paragraph 111).

<u>Track and Infrastructure Capital Expenditure</u>

69. KiwiRail's 30-year asset management plan has been used to formulate its capital expenditure forecasts. Its track and infrastructure expenditure is classified by both geographic location and cost type. It groups the 3,940 kilometres of track into the following categories, and plans its investment at levels appropriate to the categorisation:

Table 4: Track categorisation

Group	Length of Track (kms)	Objective	% of Track
1	154	Step change in performance – reduce temporary and permanent speed restrictions, reduce risk of disruptions	4%
2	375	Hold constant or modest improvements	10%
3	1,761	Hold constant	44%
3/3A	595	Try to hold constant, but may tolerate modest decline	15%
3/4	83	Hold constant or accept decline (asset dependent)	2%
4	479	Accept decline until decision on future is taken	12%
5	63	Safely manage decline	2%
6	430	Lines that are currently mothballed	11%
Total	**3,940**		**100%**

70. As illustrated above, KiwiRail is planning to materially improve the performance of only 4% of its track over the next 30 years, with the majority being held at relatively constant levels. Therefore, even with the significant level of Crown funding needed by the business, the rail system will not be fundamentally different or a more capable system than it was at the start of the Turnaround Plan[29].

71. Within its planned track and infrastructure expenditure, there is an element of "catch up" expenditure (needed after years of under investment), replacing assets when they reach the ends of their useful lives, and minor upgrades and improvements. It is difficult to explicitly assess the portion of KiwiRail's expenditure that can be classified as "catch up" compared to what can be classified as general renewals, as some

[29] Service levels and reliability have however improved from the 1990s and early 2000s where performance declined as a result of under investment in the network when it was privately owned.

expenditure falls into both categories (e.g. KiwiRail plans to remove structural timber from all its bridges within 25 years, and install 140,000 sleepers a year to clear the renewals backlog by 2031 – both of which have an element of "catch up" as well as general renewals).

72. There is a forecast spike in infrastructure expenditure over the next three years, which is mainly the result of these items:

[Withheld under s9(2)(b)(ii)]

-
-
-
-
-

73. *[Withheld under s9(2)(b)(ii)]* We agree there is limited option to defer these items.

74. In a rail business, there is always an element of judgement applied to asset management planning, particularly in relation to planned renewals of infrastructure assets. It is possible to make short term deferrals of infrastructure expenditure to improve short term cash flows, and that opportunity probably exists here (further work would be needed to explicitly quantify the opportunity). However, KiwiRail's asset management planning process for its track and infrastructure appears to be robust, and we have comfort from AECOM's external review (see below) that KiwiRail's planned level of expenditure is appropriate.

75. However, we do think there needs to be greater visibility of its infrastructure capital expenditure to enable a better understanding of what projects are in the investment pipeline, how projects are evaluated and prioritised, and what opportunities (and risks) exist for deferrals etc. KiwiRail has previously taken a divisionalised approach to its asset management planning where each division (i.e. Infrastructure, freight, Interislander etc.) was responsible for prioritising planned investment within each division. It is now moving to an organisational wide approach to asset management planning, which should improve the visibility and prioritisation processes for capital

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30 *[Withheld under s9(2)(b)(ii)]*

31

32

33

projects. This is an area that Treasury will look to gain greater visibility and comfort on over the next 6-12 months.

<u>AECOM Review</u>

76. In 2013, Treasury commissioned AECOM, an engineering consultancy firm with rail expertise, to provide advice on KiwiRail's planned capital expenditure programme for the 10 years from 2012/13. In comparison to the current plan, KiwiRail's rail freight (incorporating rolling stock, track and infrastructure) capital expenditure is 5% higher over the five[34] year period from 2015/16 from its plan that was assessed by AECOM in 2013 ($1.32 billion in current plan vs. $1.25 billion in 2012/13 plan). The increase is mainly due to additional spend required on its infrastructure (discussed in paragraph 72), and a better understanding of its shunt locomotive requirements.

77. The key findings from the review were that:

- the adequacy of the planned capital programme was reasonable and in line with AECOM's expectations
- KiwiRail's planned capital expenditure programme was broadly consistent with what the timing and cost would be of needing to replace its assets when they reach the end of their useful lives
- 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
- *[Withheld under s9(2)(b)(ii)]*
- in comparison with a number of Australian freight rail systems, KiwiRail's planned infrastructure capital expenditure per kilometre of track is quite low.

78. Given that there has been minimal change in KiwiRail's business since AECOM's review was undertaken in 2013, and little change in KiwiRail's planned capital expenditure programme, the conclusions from the review still provide a useful external validation that KiwiRail's planned capital expenditure does not appear to be inflated.

[34] A comparison for the full 10 years is not appropriate given the plans covered different time periods. A like for like comparison for the 5 years from 2015/16 therefore provides the best comparison.

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Other Capital Expenditure

79. Other capital expenditure is classified as follows:

Table 5: Other capital expenditure

Capital Expenditure ($ millions)	**2011/12 Actual**	**2012/13 Actual**	**2013/14 Actual**	***[Withheld under s9(2)(b)(ii)]***
Facilities	10.5	12.0	17.2	
IT	13.2	15.0	12.6	
Interislander	30.9	4.5	8.0	
Scenic	14.8	4.5	0.7	
Leasing[35]	-	-	-	
Total Other Capex	**69.4**	**36.0**	**38.5**	

80. 'Other' capital expenditure averages $52 million per annum over the next three years. The biggest component of this is the planned expenditure on its facilities. These facilities include all its yards, workshops, depots, and other buildings that are used for operational purposes.

81. The spike in expenditure over the next three years (in comparison to the forecast 30 year average) is in relation to the [Withheld under s9(2)(b)(ii)] Expenditure on facilities covers approximately 1,400 buildings (of varying size and complexity). Engineering reports from OPUS indicate that a high number of these properties have been maintained to minimum standards and are in need of capital improvements. ***[Withheld under s9(2)(g)(i)]***

82. KiwiRail has a number of ongoing IT projects either upgrading or replacing existing systems and infrastructure. Treasury's hands on experience of the business supports the need for continued investment in this space. The Interislander capital expenditure predominantly relates to ongoing work required to manage its road bridging operation following replacement of the Arahura with a non-rail enabled ferry.

83. KiwiRail's leasing capital expenditure relates to its 270 buildings that it currently leases to external parties (which generate approximately in rental income per annum). ***[Withheld under s9(2)(b)(ii)]***

Overall view on KiwiRail's capital expenditure programme

84. KiwiRail is forecasting a reduction in planned capital expenditure (particularly in relation to its track and infrastructure spend) from year 4 of its plan (from an average of ***[s9(2)(b)(ii)]*** ***[s9(2)(b)(ii)]*** per annum in years 1-3 to an average of ***[s9(2)(b)(ii)]*** per annum in years 4-6). Whilst this assumption is based off the best information currently available including an

35 Leasing capital expenditure was previously grouped within 'Facilities' and the split is not available for prior years' actuals.

36 Treasury officials visited the affected sites in 2013 and it was evident that a significant remediation project was needed.

37 ***[Withheld under s9(2)(b)(ii)]***

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asset management plan identifying asset quality etc., we expect it will be difficult for KiwiRail to reduce its planned expenditure by this quantum in that timeframe.

85. The spike in expenditure in years 1-3 is largely due to specific infrastructure items as identified in paragraph 72. Some of these *[Withheld under s9(2)(b)(ii)]* have only crystallised in the last 1-2 years, and our expectation is that additional risks will materialise over the next 3 years that are not currently known about. In a business with a vast array of legacy assets and infrastructure operating in an environment where health and safety requirements are only becoming more onerous, we think it is more than likely that expenditure requirements will be higher than those currently forecast over the medium term. However, we note that such risks materialising are unlikely to be the result of a lack of planning on KiwiRail's part, as it has undertaken a 'bottom-up' assessment of asset condition and remaining life, and has held workshops to identify potential risks or issues, and incorporated these assessments into its forecasts as it has seen fit.

86. With regards to the plan for the next 3 years, we think it is a reasonable plan based on reasonable assumptions. There are opportunities to defer rolling stock procurement for short term cash savings, but risks around the condition of KiwiRail's facilities and infrastructure assets contribute to the chance of additional expenditure being required.

Business Improvement Initiatives

87. The following savings have been incorporated into KiwiRail's forecasts (i.e. the 'trimmed network' scenario assumes these will be delivered) over the next five years.

Table 6: Assumed savings from Business Improvement Initiatives

	$ Millions	2015/16	2016/17	2017/18	2018/19	2019/20
1	*[Withheld under s9(2)(b)(ii)]*					
2						
3						
4						
5						
6						
7						
8						
	Total assumed savings built into plan	**18.1**	**38.4**	**63.7**	**66.2**	**89.5**

[Withheld under s9(2)(b)(ii)]

88. *[Withheld under s9(2)(b)(ii)]*

[Withheld under s9(2)(b)(ii)]

89. *[Withheld under s9(2)(b)(ii)]*

[Withheld under s9(2)(b)(ii)]

90. *[Withheld under s9(2)(b)(ii)]*

91. Total expenditure (capital and operating) on track and infrastructure is approximately $230 million per annum (but can be higher when large infrastructure projects are undertaken). *[Withheld under s9(2)(b)(ii)]*

92. The inefficiencies in this part of KiwiRail's business have been communicated by KiwiRail for several years, *[Withheld under s9(2)(g)(i)]*

93. *[Withheld under s9(2)(g)(i)]*

94.

[Withheld under s9(2)(f)(iv)]

95. *[Withheld under s9(2)(f)(iv)]*

96.

97.

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[Withheld under s9(2)(b)(ii)]

[Withheld under s9(2)(f)(iv)]

99. *[Withheld under s9(2)(f)(iv)]*

100.

101.

[Withheld under s9(2)(f)(iv)]

102. *[Withheld under s9(2)(f)(iv)]*

103.

[Withheld under s9(2)(f)(iv)]

104. *[Withheld under s9(2)(f)(iv)]*

105.

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[Withheld under s9(2)(f)(iv)]

Other

106. The remaining productivity improvements and/or savings that KiwiRail is forecasting to achieve in its 'trimmed network' scenario *[Withheld under s9(2)(b)(ii)]*

Overall

107. We believe KiwiRail could be more aggressive with its forecast cost savings and productivity improvements than what it is targeting to achieve (an estimate of which is made in table 6 in paragraph 87). However, given the nature of its business (high fixed costs, inflexible assets and infrastructure, *[Withheld under s9(2)(i)]* and operating in a competitive environment), we do not believe there are clear options available that will materially reduce the level of Crown funding needed.

108. *[Withheld under s9(2)(b)(ii)]*

109.

110.

Risks and Opportunities

111. Table 7 below identifies what we assess as being the key risks and opportunities for the business that could impact funding requirements over the next 3 years, and the likelihood of these materialising. We have made some high level estimates of the possible financial impacts, but caution placing too much reliance on these numbers given the significant level of uncertainties associated with each item, and the difficulty to predict which combination of opportunities and/or risks could occur.

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Table 7: Risks and Opportunities

		Risk / Opportunity	**Comment**	**Likelihood of materialising**	**Indicative net cash impact over 3 years ($ millions)**
1	O	Fluctuating demand for commodities impacts demand for transportation via rail	Forestry, coal, milk, meat, steel represent a significant portion of KiwiRail's freight	Medium	*[Withheld under s9(2)(b)(ii)]*
2		Rolling stock procurement can be slowed down with the existing assets being "sweated harder"	This is a lever KiwiRail can use to improve short-term cash flows	Medium	
3		Infrastructure projects are deferred to improve short term cash flows	Projects generally have lead-in time therefore work cannot quickly be switched on and off	Low	
4		*[Withheld under s9(2)(b)(ii)]*		Medium	
5				Medium	
6				Medium	
		Total $ range of possible opportunities			
1	R	Delays in planned land/property sales (forecast assumes sales totalling *[Withheld under s9(2)(b)(ii)]*	Planned land sales over past 3 years have taken longer to achieve than forecast	Medium	
2		Fluctuating demand for commodities impacts demand for transportation via rail	Forestry, coal, milk, meat, steel represent a significant portion of KiwiRail's freight	Medium	
3		More efficient roads/trucks marginalising rail's position in the market	Risk is likely to be greater in the longer-term	Medium	
4		*[Withheld under s9(2)(b)(ii)]*	Uncertainty as to how these will play out	Medium	
5		Unexpected infrastructure failures / work required	18 months ago, the safety work required in long tunnels had not crystallised, risk of similar situation occurring again	Medium	
6		*[Withheld under s9(2)(b)(ii)]*		Medium	

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		[Withheld under s9(2)(b)(ii)]		
7			High	*[Withheld under s9(2)(b)(ii)]*
8			Medium	
		Total $ range of possible risks		**0-250**

112. On balance, we believe that the potential financial impact of the risks outweigh the opportunities over the next three years. We also assess that risks from 2018/19 onwards *[Withheld under s9(2)(b)(ii)]* outweigh the long-term opportunities.

113. However, if KiwiRail received the level of funding it has indicated is required over the next three years *[Withheld under s9(2)(b)(ii)]* we think there is enough flexibility within its plans for it to mitigate against the risks that may outweigh the potential opportunities. However, if major risks materialised it would put pressure on its cash position in year 3. The biggest lever KiwiRail has to offset risks is the deferral of planned rolling stock procurement or other planned capital projects.

114. In our view, the business would have to perform very well with favourable external conditions for funding levels to reduce to the forecast *[Withheld under s9(2)(g)(i)]* If there was a heavy weighting of risks over opportunities to materialise (as has occurred in the past 4 years), there is a risk that funding requirements will not reduce at all (and could even get higher) over time.

115. KiwiRail has presented 'upside' and 'downside' variations to its base case. The key assumptions behind its 'upside' case are:

- *[Withheld under s9(2)(b)(ii)]*
-
-
-
-

116. Achievement of the ‘upside’ scenario would result in a reduction (from the base case) in Crown funding of approximately [Withheld under s9(2)(b)(ii)] [Withheld under s9(2)(b)(ii)]

117. [Withheld under s9(2)(b)(ii)]

118. This analysis is ultimately based on sensitivities in changes to volume and price growth, and is useful for assessing a range of possible financial outcomes. However, we note that the number of external factors that have impacted KiwiRail’s results in the past 4 years could not have been modelled or predicted in advance, and most resulted in additional costs being borne by the business – the impact of which are difficult to predict. There is always a risk of other unforeseen events occurring in the future, which limits the potential accuracy of such analysis.

119. We assess the biggest sensitivity and risk to KiwiRail’s business as being unplanned remediation needed on large infrastructure assets. Such risks are difficult to forecast and quantify but could materially impact on cash flows. These have the potential to significantly outweigh opportunities for volume growth, yield increases, productivity improvement and capacity utilisation improvements [Withheld under s9(2)(b)(ii)] [Withheld under s9(2)(b)(ii)] has only crystallised in the last 12-18 months as a result of increased safety requirements).

Other options presented by KiwiRail

120. KiwiRail has presented four separate scenarios/options in its report, and these are discussed in the ‘KiwiRail’s Bold Options’ section later in the report. Its base case (called the ‘trimmed network’ scenario) has been analysed in detail above. KiwiRail has advised that it can model different scenarios relatively easily should these be requested by Ministers (i.e. it can run models showing different network configurations, different yield and volume growth assumptions, different productivity improvements etc.). However, in our view, the significant level of analysis over the past six months means that most scenarios have already been tested and it is very unlikely that more optimal scenarios can be identified.

Funding Implications

121. KiwiRail’s base case has identified the likely requirement for Crown funding of approximately [Withheld under s9(2)(b)(ii)] [Withheld under s9(2)(b)(ii)]

122. If funding was to be provided on the same basis as it has been since the inception of the Turnaround Plan in 2010, the capital investment in KiwiRail would be a charge against the Future Investment Fund (FIF). The FIF has remaining funds of $1.7 billion available for allocation at Budget 2015 and Budget 2016. If a 3-year funding commitment of [s9(2)(b)(ii)] was made in Budget 2015, this would be the majority of that Budget’s forecast capital allowance of $698 million, after allowing for Budget 2015 capital pre-commitments.

123. Alternatively, funding could be provided as an operating subsidy[38] (as was the case in 2009/10 prior to the Turnaround Plan). Providing funding as an operating subsidy would impact the Crown's operating balance, and would therefore be a charge against the $1 billion allowance for new operating funding each year. However, the Crown's Operating Balance Excluding Gains and Losses (OBEGAL) would be impacted under either funding mechanism. If the funding was classified as operating, 100% of the total would hit OBEGAL. If it was capital, approximately 80-90% would hit OBEGAL, as this is the estimated portion of KiwiRail's capital expenditure that it impairs each year. Classifying it as operating funding would therefore have a *[s9(2)(b)(ii)]* worse impact on OBEGAL over the three year period, than if it was capital funding.

124. Conditions relating to the drawdown of funding, including monitoring arrangements and agreeing performance milestones, would need to be agreed ahead of any final funding decision in Budget 2015.

Validity of Data

125. KiwiRail's forecasting process has been comprehensive, and we are comfortable that the forecasts are based on sound assumptions, and provide a materially accurate view of the company's current financial situation based on the best information currently available. Any forecasting exercise is inherently inaccurate, and less reliance can obviously be placed on the data the further into the future it looks. We have therefore focused our advice on the first 3-5 years of KiwiRail's plan.

126. Due to the company being a network business (discussed in paragraphs 30 to 37), there is an element of arbitrary cost allocation to network segments and services, creating some uncertainty as to what the impact of closing certain segments and services would be.

127. The more radical options that KiwiRail has presented (full closure and operating the golden triangle only) would result in material changes from the status quo. There will always be a high level of uncertainty regarding the financial outcomes of such material changes to a business, irrespective of the level of planning undertaken in advance.

Treasury View on Base Case

128. KiwiRail has presented a realistic and achievable plan based on the best information available, which is consistent with the Government's expectations. We believe the plan is probably optimistic from year four on as in our view the potential risks are likely to outweigh the opportunities. Given the company's performance over the past 4 years and the impact that external factors have had on the business, some caution should be applied to KiwiRail's assumption of achieving a material reduction in Crown funding in four years' time, notwithstanding that its forecasts are more realistic than they have been previously. Experience across the whole SOE portfolio indicates that entities often forecast material improvements in performance in 3-4 years, but such material improvements generally do not materialise.

129. There are opportunities for growth in volume and price above what has been forecast, and there is an opportunity for the deferral of rolling stock procurement or other capital projects to either improve short term cash flows, or offset against underperformance in

38 ***[Withheld under s9(2)(g)(i)]***

other parts of the business. These opportunities are partially offset by the risk of additional expenditure required on its infrastructure assets and facilities.

130. *[Withheld under s9(2)(g)(i)]*

131. KiwiRail has not explicitly included a contingency fund[39] in its new plan. KiwiRail has been impacted by a number of unforeseen events in recent years which have contributed to it experiencing cash flow difficulties. These have been somewhat compounded by the fact that it has not had any certainty of funding beyond one year. In our view, a multi-year funding commitment would provide KiwiRail with enough flexibility to manage its planned expenditure so that a separate contingency would not be needed. The main lever it has to offset risks is the ability to defer planned rolling stock procurement (quantified in table 7 in paragraph 111) or other capital projects.

132. *[Withheld under s9(2)(g)(i)]*

Assessment of Board and Management Performance

133. The table below lists the current Board members of KiwiRail, and when their current terms expire:

Table 8: Board members' terms

	Board Member	Term	Term Expiry
1	John Spencer (Chair)	2	30 April 2016
2	Paula Rebstock (Deputy Chair)	1	30 April 2015
3	Rebecca Eele	2	30 April 2017
4	Bob Field	2	30 April 2015
5	John Leuchars	2	30 April 2016
6	Guy Royal	1	31 October 2015
7	Kevin Thompson	2	30 April 2017

134. *[Withheld under s9(2)(g)(i)]*

39 It does include a *[s9(2)(b)(ii)]* for unplanned events within its infrastructure budget each year, but not a specific contingency for material business disruptions. KiwiRail has also included an annual risk contingency from 2020/21 in relation to its infrastructure assets.

COMMERCIAL-IN-CONFIDENCE

135. A Treasury employee was seconded to KiwiRail for five months whilst the new plan was being developed, and was invited to attend 3 Board strategy sessions over that time, which provided first-hand insight into the operations of the Board, and how it interacted with the Executive Leadership Team. The Board appeared to be functioning well, and was asking appropriate questions of management.

136. *[Withheld under s9(2)(g)(i)]*

137.

138.

139. Analysing the cash flows by line segment had not previously[40] been undertaken by the business,

[Withheld under s9(2)(g)(i)]

140. The Board's main focus since 2010 has been on achieving volume and revenue growth in order to close the gap between its earnings and its expenditure requirements. Whilst this was a sound strategy given the high fixed cost nature of the business (meaning a high proportion of additional revenue should have theoretically dropped to the bottom line), with volume growth projections having now been pared back significantly; we

[40] *[Withheld under s9(2)(a)]*

COMMERCIAL-IN-CONFIDENCE

believe the Board's focus now must shift to cost reduction in order to reduce the gap between earnings and expenditure (whilst continuing to focus on safety, growing revenues, and improving capacity utilisation).

141. *[Withheld under s9(2)(g)(i)]* [redacted]

142. [redacted]

143. We do not believe that making wholesale changes to the Board will materially change the financial outlook for the company. However, should the Government wish to [Withheld under s9(2)(b)(ii)] [redacted] then it is likely that different skill sets [Withheld under [redacted] would be needed on the Board to implement either of these options. [redacted]

[Withheld under s9(2)(g)(i)] [redacted]

144. As noted in paragraph 28, KiwiRail's new plan forecasts a material reduction in Crown funding requirements from the fourth year of its plan (from 2018/19 onwards). Whist the forecasts are based off sound information that is currently available, there is a risk that with material improvements not being forecast until year four of the plan, that the improved financial situation remains a goal for a future Board to deliver.

KiwiRail's Bold Options

145. KiwiRail's four options, along with the associated Net Present Values (NPVs) of each option are outlined in this table.

Table 9: Summary of options presented by KiwiRail

	Option	**NPV[41] ($ billions)**	**3-year Funding**	**5-year Funding**
1	'Trimmed Network' Case (as analysed above)	($1.6)	$0.6	$0.9
2	Intra-Island	($1.7)	$0.8	$1.2
3	Upper North Island	($1.0)	$0.7	$0.8
4	Full closure (excluding Metropolitan passenger networks)	($0.3)	$0.6	$0.5[42]

41 This represents an estimate of the NPV of future Crown funding requirements.

42 The 5-year funding amount is lower than the 3-year amount, because if the whole network was closed, the remaining property and Interislander businesses would pay a small dividend to the Crown which would be a positive contribution for years 4-5.

COMMERCIAL-IN-CONFIDENCE

146. The NPVs for the ‘trimmed network’ and the Intra-Island scenarios factor in an improvement in net cash flows from 2018/19. As outlined earlier in the report, we have some doubt as to whether this will be achieved, and in that case, the NPVs for these two options would be worse than what is shown. However, given the inherent difficulty of forecasting ahead any length of time, the NPVs shown above should only be one consideration of many when making decisions about the company’s future. This is also pertinent because there is significant uncertainty surrounding the financial implications of the Upper North Island and full closure scenarios. The closure costs associated with these scenarios are indicative only, and do not include an estimate of the possible costs associated with breaking long-term contracts.

Intra-Island

147. The Intra Island scenario assumes the *[Withheld under s9(2)(b)(ii)]*

148. For the reasons outlined in paragraphs 30 to 37 earlier in the report, this scenario forecasts a loss in value for the company, even though it is operating a smaller network. KiwiRail has therefore disregarded this option, as it would require a similar level of funding as the ‘trimmed network’ scenario, but it will carry less freight. A sufficient amount of rigour was applied to evaluating this option. We agree with KiwiRail’s assessment of this scenario, and do not think it should be pursued further.

Upper North Island

149. KiwiRail’s ‘Upper North Island’ scenario proposes retention of the Auckland to Hamilton to Tauranga section of the network only *[Withheld under s9(2)(b)(ii)]* This section of the network is often referred to as the “Golden Triangle”. The Metropolitan passenger networks in Auckland and Wellington would also be retained.

150. The “Golden Triangle” section of the network is the most heavily used, and as a result it is the closest KiwiRail has to a section of the network that covers its costs. Given the magnitude of change under this scenario *[Withheld under s9(2)(b)(ii)]* there is significant uncertainty as to what such a model would look like after its implementation.

151. KiwiRail has forecast what this scenario would look like using its best judgements, and estimates that one-off restructuring costs of approximately $500 million and ongoing Crown funding requirements of between $20 and $50 million per annum would be required. Under this scenario it has been challenging for KiwiRail to predict what it refers to as the “2nd order effect”. This describes the situation where users of large parts of the network [Withheld under s9(2)(b)(ii)] would have to decide whether they would continue to use the Golden Triangle segment if the remaining segments were closed, or whether they would abandon rail altogether. We would expect these customers to continue to make the decisions that are most commercially attractive for their respective businesses, whatever that may entail.

152. If the Government has an appetite for major down-sizing of KiwiRail's freight operations (and the resulting funding), then we believe this model should be pursued further. It retains rail on the most heavily used part of the network (and in the areas of the most heavily congested roads). A swift change to this model would most likely minimise the fiscal cost to the Crown, whereas a managed wind-down over a period of time would provide the opportunity for customers to better adapt to the change.

Full Closure

153. Commercially, the option with the least fiscal cost to the Crown would be closure of the entire rail freight network. KiwiRail has estimated that full closure would incur net one-off costs of approximately $600 million, and an NPV of -$300 million. Following closure, KiwiRail has assumed that the Crown will continue to own the Interislander business and the associated land and properties that currently generate rental income for the company. Retention of these parts of the business would provide an ongoing dividend stream back to the Crown (and accounts for the negative NPV being lower than the upfront funding requirements).

154. Whilst KiwiRail has used sound assumptions in assessing the financial implications of full closure of its network, a much more comprehensive study would be needed to validate the likely financial and practical implications of such an option. Direction from the Government would be sought prior to undertaking such a study. In the event there was a direction from the Government to pursue such an option, discussions with customers would need to take place to determine whether they would be prepared to take ownership of parts of the network or risk losing it altogether.

Public Policy Analysis

155. This section sets out our public policy analysis, which we undertook in consultation with the Ministry of Transport and NZTA. It considers:

- rail's role in managing New Zealand's freight task, now and in the future
- the public benefits provided by the provision of rail services
- the impacts if rail services were discontinued:
  - on motorists
  - on small towns
  - on regions and industries currently using rail
  - on the roads
  - on fiscal costs
- a national cost benefit analysis of the options identified by KiwiRail.

Rail's role in managing New Zealand's freight task

156. Rail is suited to very dense freight movements, preferably over a long distance and particularly where no double handling is required (i.e. where goods are carried by rail from their source, e.g. a mine or a factory, to their destination, e.g. a port). It needs very significant freight volumes to recover its large network costs and realise its comparative advantage.

157. New Zealand's freight provides insufficient scale, in both density and distance, for rail to be an economic transport mode. Even though rail carries most coal (90%), dairy (75%), and iron and steel (65%) on a net-tonne per kilometre basis, and 30% of general freight between Auckland and Christchurch, rail remains an uneconomic transport option – many users would not pay the full costs required to supply rail services.

158. The size of this problem is demonstrated by the size of the subsidy required to keep the railway network running. The subsidy required covers around two-thirds of rail's capital expenditure – a subsidy of $200 million a year compared to KiwiRail's current operating earnings of around $100 million (EBITDA). This problem is fundamental and determined by the divergence between rail's characteristics and advantages and New Zealand's freight needs.

Will rail be needed in the future, to manage New Zealand's growing freight task?

159. Taking an historical perspective, we note that profitability has been deteriorating steadily since 1920, reached zero in around 1945 and has been clearly negative since 1970. There have been a number of attempts at reform, including corporatisation, privatisation, separation of below-track from above-track, nationalisation, turning it into an SOE and most recently by putting in place the Turnaround Plan. None have halted the decline. Roads and trucks are much better than they were in rail's heyday, and the majority of New Zealand's freight task is suited to road, as it is sparse, short distance, or time sensitive and prefers the time and reliability benefits of door to door road freight.

160. Officials have estimated the value of preserving the rail network, should it be able to provide a positive economic contribution in the future, considering the possibility of

- increases in freight demand
- increases in fuel costs, which would favour rail over road
- increases in labour costs, which would also favour rail over road
- increase in future road user charges (RUC)
- increase in demand for eco-friendly transportation, and
- shifts in supply chains.

161. Rail would need to substantially increase its freight volumes if it is to ever break even financially. The KiwiRail commercial review suggests that this would be challenging and would take more than a generation to achieve. Consequently, probabilities of rail becoming a positive economic proposition to manage New Zealand's freight task are

very small, and are significantly outweighed by the level of financial support over a long period that it would require. Mothballing the network could be an alternative that would preserve the option to provide rail services in the future at lower cost, although further work would be needed to assess the ongoing mothballing costs in comparison to the estimated costs of reopening in the future.

The identifiable public benefits associated with rail do not outweigh the costs

162. We have quantified our assessment of the costs and benefits associated with rail freight in the national cost benefit analysis table 10 in paragraph 85. Rail provides some safety and environmental benefits by reducing the number of trucks on the road. However, these benefits are estimated at around $20 million and $10 million[43] a year respectively (after allowing for a reduction in rail crossing injuries and rail emissions). Compared to the required public funding (around $200 million a year) this represents very poor value for money. Further road safety or road fuel efficiency initiatives and investments would be much more cost effective.

163. We have also considered the impacts of noise, contamination of waterways, and transport resilience and assessed that the benefits provided by rail are negligible, and we have therefore assumed no identifiable benefits for the purpose of attempting to quantify the costs and benefits in table 10 in paragraph 85.

164. There may be some public amenity benefits associated with reducing the impact of trucks on motorists and small towns. The value of these benefits depends on the public's perceptions and preferences, and ultimately their willingness to pay. We have not attempted to value this willingness, but have described the potential impacts in the next section. Ministers would have to consider how these potential impacts, and the public's willingness to pay to avoid them, stack up against the required public funding.

Impacts if rail services were discontinued

Impact on motorists

165. If no mitigating action were taken, road users would be impacted by increased truck traffic if freight was shifted from rail to road. This would manifest itself in the consequences of increased congestion (including inconvenience/annoyance) and in the social and economic cost of more accidents. It would exacerbate existing frustrations and the safety fears or discomfort of motorists.

166. Public comment of motorists' perception, or experience, of safety risks due to the presence of a heavy truck is common in the media, anecdotally, and in formal complaints received by the New Zealand Transport Agency from time to time.

167. Likewise, there is comment around the frustration of motorists having their trips disrupted by slower moving trucks, with the open road speed limit for a truck being 90kph (and uphill climbs slowing trucks further).

168. The volume moved by rail represents around 25 percent of the freight task serviced by 'big/heavy' trucks combinations (HCV2s being truck combinations with six or more axles). Moving this freight by road instead of rail would result in around a 30 percent

43 We have estimated impact of additional truck travel assuming a cost of $25 per tonne CO_2.

increase in heavy trucks on affected State highways (overall, with individual roads being impacted differently), or 1.3 million additional truck trips per year.

169. However, we expect there would be minimal impact on road service levels on average because the NZ Transport Agency (with the additional revenue received from additional truck travel) would undertake sufficient works to maintain adequate road capacity and road safety levels in most areas (noting that the impacts in some urban areas would be difficult to address). It would undertake more maintenance as a result of the increased number of trucks, and bring forward planned passing lanes or four-laning, and undertake various other works in order to maintain road service levels. This is discussed further below.

Impacts on small towns

170. Routes with high additional flows under a rail-to-road scenario already have high traffic volumes and impacts. The marginal increase in noise, vibration and community severance (also known as loss of amenity value) may not be significant on these routes. Proposed and underway Roads of National Significance and other works already plan to mitigate these effects.

171. Increased pressure for noise barriers and bypasses could arise in some small towns including Tirau, Tokoroa, Turangi, Waiouru, Taihape, Hunterville, Bulls, Sanson, Foxton, Levin, Picton, Blenheim, Kaikoura and Amberley. But the additional volumes are likely to add to the existing negative truck-related externalities, rather than qualitatively changing them.

172. There could also be a perceived exacerbation of road conflicts with rural schools.

Impacts on regions and industries currently using rail

173. As discussed in paragraph 157, there are a number of industries that benefit from having the choice to use rail because of funding support from the government. They choose rail for a number of reasons, it is cheaper than the road alternative, can provide advantages in terms of aggregation for port access, may have some public support, and can provide supply chain diversity for those that already require significant truck fleets. Some of these users, as well as ports, have made their own investments in rail support infrastructure and depots to support their use of rail.

174. However, current users are often unwilling to pay more for the use of rail. This shows that there is strong competition for rail by the alternatives from road and sea shipping – which offer other advantages.

175. ***[Withheld under s9(2)(g)(i)]***

176. It is difficult to estimate the impact on existing rail users if rail services were discontinued, because although they may currently prefer rail, for most there is a viable alternative that offers other advantages. These should largely be reflected in the price of rail and its alternatives. The fact remains that although these industries benefit from

having the choice of rail, this is only because of government support, and rail remains uneconomic – many users would not pay the full costs required to supply the service[44].

Impacts on the road

177. The main impact would be on State highways, as rail provides for primarily longer movements of freight with local road trips already undertaken when moving freight to and from rail.

178. Initial analysis has shown that the majority of the national State highway network appears to have sufficient capacity to handle most of the rail network freight, if this freight was moved to road (it is possible that some of it may end up being moved by coastal shipping). However, there would be significant 'pinch points' around cities and ports.

179. The NZ Transport Agency would receive additional revenue from additional truck travel estimated at between $100 and $150 million a year, which is expected to be roughly equal to, or exceed, the costs associated with the additional truck travel, primarily on State highways, made up of:

- additional road maintenance and renewals
- small capacity improvements to maintain road service level, and
- bringing forward planned works to address major pinch points.

180. Together these are estimated to cost between $88 and $132 million per annum[45] (or between $1.1 and $1.6 billion net present value if capitalised at 8%). The NPV reflects the cost of bringing already planned projects forward from when they are currently planned.

181. The relatively small capacity improvements to maintain road service levels reflect that due to the additional truck travel on the open-road State highways there would be instances where some additional construction projects would be required (additional passing lanes) or more substantive projects would be brought forward (road alignments, four-laning). Mitigation measures at any impacted crash black spots may also be required – the areas of Waikato, North of Tokoroa, the Desert Road, Kaikoura Coast and South of Christchurch have been identified as having concentrations of fatal and serious heavy vehicle accidents.

182. The additional truck travel would require some construction projects to be brought forward to deal with particular 'pinch points'. Some of these projects are significant, and the cost of bringing forward the projects has been estimated:

- <u>Auckland to Christchurch</u>: It would likely require around $4 billion of currently planned projects being brought forward by around 5-10 years at an NPV cost of between $400 and $600 million or annualised cost of $15 - $20 million per year.

44 In practice, we expect the only way this assumption could be validated is if users were faced with a choice of having to pay the full cost or accept closure.

45 It is recognised that NZTA's costs are likely to be substantially front-ended relative to the expected RUC revenue. A financing arrangement may need to be put in place to bridge the gap. Assuming such an arrangement is put in place, the financial impact on NZTA should be negligible.

These projects include Grafton Gully, Auckland motorway, Piarere to Taupo and Waiouru to Bulls projects.

- Auckland to Tauranga: Significant works over difficult terrain may be required to be brought forward (in particular the Kaimai ranges) if rail services between Auckland, Hamilton and Tauranga ceased. It would likely require between $1 and $3 billion in currently planned work to be brought forward at a net present value cost of between $150 million and $400 million, or annualised cost of between $10 and $20 million per year. However, one of KiwiRail's options would be to maintain these rail services, even if services in the rest of the country were ceased.

- New Plymouth to Napier: Works to mitigate slip concerns on the Manawatu Gorge at a cost of around $100 million may be required on a longer term basis, without the rail link which uses the other side of the gorge and carries a significant share of the freight through the gorge.

- South of Christchurch: The Rolleston bypass requiring two plus one lanes and four-laning strategies currently on 15 and 10 year plans respectively would likely need acceleration. Brougham St in Christchurch would need major work to cater for significant increases in truck volumes. There would be some constraints on State Highway 1 (north and south).

- *[Withheld under s9(2)(b)(ii)]*

183. There may, however, be impacts in some urban areas which would be very difficult to address either in cost or in practicalities of building more road space.

Fiscal costs

184. Discontinuing rail services would not be without cost. KiwiRail would inevitably incur costs in decommissioning the rail network if it was decided to close down rail. KiwiRail has identified significant restructuring costs and there would be ongoing costs associated with mothballing and making the network safe. KiwiRail has provided some estimates of these costs, however, given the relatively high-level analysis by KiwiRail of this scenario (i.e. it has not considered the costs of breaking long-term contracts), further work would need to be undertaken if a decision is contemplated that depends on these estimates.

185. Our analysis is based on specific work programmes that have been undertaken over the past several months, and are documented in a series of working papers. The working papers that were developed are:

- Estimated state highway impacts arising from any mode shift of rail freight (NZTA paper)
- What do heavy vehicles pay for and is it enough? (MOT paper)
- Assessment of the option value of rail (MOT paper)
- Material provided by KiwiRail in its commercial review.

186. The following cost benefit analysis table estimates the costs and benefits associated with retaining the status quo, [s9(2)(f)(iv)] (i.e. KiwiRail's 'Trimmed Network' scenario), and retaining the golden triangle only. These are all compared with full closure. For example, the 'keep golden triangle only' column reflects the costs and benefits compared to what these costs and benefits would be if the full network was closed (e.g. road costs would be between $18 and $67 million per annum less than they would be if the golden triangle was also closed).

Table 10: Cost Benefit Analysis

KiwiRail's three options (Compared with completely closing down all rail (except urban passenger))			
$ millions p.a. **All values converted to annualised equivalents**	**Keep status quo** (i.e. no closure of minor lines)	[s9(2)(f)(iv)] (i.e. KiwiRail's 'Trimmed Network' scenario)	**Keep golden triangle only** [s9(2)(i)]
<u>Benefits</u>			
Option value of retaining rail	$1.8-3 m	$1.8-3 m	$0.3-0.5 m
Avoided decommissioning and mothballing costs	$48-72 m	$45-70 m	$5-15 m
Avoided CO_2 emissions	$7.5-12.5 m	$7.5-12.5 m	$1-5 m
Avoided road safety costs	$15-25 m	$15-25 m	$4-10 m
Private benefits to rail users[46]	0	0	0
Avoided road costs	$73-117 m	$73-117 m	$18-67 m
<u>Costs</u>			
Cost of subsidy[47]	$190-230 m	$170-210 m	$30-50 m
Economic cost of taxation – 20%[48]	$38-46 m	$34-42 m	$6-10 m
Road user charges foregone	$100-150 m	$96-144 m	$25-35 m
Net social benefit[49]	**-$150 to -$232 m**	**-$124 to -$206 m**	**-$43 to +$13 m**

46 We have assumed a zero impact for rail users because for most there are viable alternatives that offer other advantages, which should be reflected in the price of rail (i.e. user's willingness to pay) and the price of alternatives.

47 The costs of subsidy reflect the current situation, rather than the 30-year average given the uncertainty when forecasting 30 years into the future.

48 A national cost benefit analysis needs to recognise the economic cost of taxation. This has been estimated at 20% of the cost of raising tax revenue. In this case, it is 20% of the fiscal cost of the subsidy.

49 These ranges are not an arithmetical sum of the numbers above. They were derived from the above numbers using a Monte Carlo simulation.

Interpretation

187. The above table shows that the status quo option of keeping rail as currently configured requires a subsidy of between $190 and $230 million[50] (plus the economic cost of taxation, equal to an additional 20%), and that this cost is significantly greater than the benefits we assess as being derived from retention of the status quo.

188. Another interpretation is that closing down rail would produce an economic saving of between $150 and $232 million per annum, or fiscal savings of between $141 and $222 million per annum (cost of subsidy less avoided decommissioning and mothballing costs identified above), both of them after costs of closing down rail and upgrading roads.

189. The net social cost is much lower in respect of the golden triangle. A viable alternative to closing rail down might therefore be to close down everything except the golden triangle, *[Withheld under s9(2)(g)(i)]*

190. We recognise that a cost benefit analysis of this nature contains significant subjective elements, and it is likely that if the equivalent analysis was undertaken by another party, different weightings or interpretations of the costs and benefits would most likely be applied which could result in different conclusions.

191. Nevertheless, the difference between the estimated costs and benefits is quite large, meaning that the errors in our analysis would have to be very large to overturn the overall result.

192. The intuitive explanation of the result is as follows. We acknowledge that rail is generally significantly cheaper than road transport. However, for freight to travel on rail, it must be transferred to or from a truck at one or other end of the journey, depending on whether the freight is being exported or imported. For domestic freight, there is double handling at both ends. These transfers add considerably to costs and to the time it takes for freight to reach its destination.

193. A supply chain that includes rail is therefore often significantly more resource-intensive and expensive than one that relies on trucks or coastal shipping only, unless distances are large, freight is not time-sensitive, volumes are large and/or the nature of the freight makes pick-up at the factory or mine feasible. KiwiRail's bulk freight and Import/Export markets generally have these characteristics, but its domestic market (which traverses most of the network) does not.

194. Either of these two major down-sizing options (close down or close down everything except the golden triangle) would represent a major change to New Zealand's transport landscape and would not be undertaken lightly. It would most likely have to be phased in over a number of years to allow customers to adapt and for the required roading construction to be planned appropriately and we have not explored how this would be undertaken. We are also conscious that there would likely be very significant public opposition to it. It may be necessary to initiate a strategy that clearly makes the case and involves public debate, informed by further analysis, perhaps undertaken by an institution that is at arms' length from the government.

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50 Whilst KiwiRail is forecasting a reduction in funding levels over the 30 years, we have taken the average from the last five years' actual funding plus the forecasts for the next three years - as we consider this a more accurate indication of funding requirements than an assessment looking 30 years into the future.

195. As a result, we think that commissioning a comprehensive external study (possibly by an organisation such as the Productivity Commission) could be an option for the Government if major down-sizing is considered a possible option, and this may have the following benefits:

- it would allow for a more rational public debate
- it would provide external validation (or not) of the cost benefit analysis we have undertaken
- following some more informed public debate, it would provide an opportunity for the Government to judge how strong public opinion is
- it would provide a stronger basis for a longer-lasting decision, and
- the public nature of the assessment may allow KiwiRail to tackle some of the more difficult challenges it faces [Withheld under s9(2)(g)(i)] [redacted]

Options for the Government

196. Neither KiwiRail, nor Treasury, has identified any options whereby the company can continue to operate the majority of services it currently does for a materially reduced level of funding. In our view, the options available for the Government are:

Table 11: Options for the Government

		Option	Comment
1	MAJOR CHANGES FROM STATUS QUO	Provide no more funding to KiwiRail.	Company likely to be insolvent by early 2015/16. Unlikely to be palatable.
2		Adopt a "managed decline" strategy whereby funding is provided at a level to safely manage the decline of the business over a period of time (further work required to determine cost but could be in the range of [Withheld under s9(2)(b)(ii)] [redacted]	More work would be needed to assess this option, including how to retain a Board and management team to implement it
3		Elect to close the full freight network (indicative upfront cost estimated to be $600 million). Key customers could be consulted to assess their appetite for taking over certain parts of the rail network.	Quick decision and implementation would likely minimise fiscal impact to Crown, whereas a wind-down over a number of years would allow customers, industry, and NZTA to better manage change
4		Retain the Golden Triangle [s9(2)(i)] [redacted] but close remainder of network (indicative upfront cost estimated to be $500 million with ongoing funding in the range of $20 to $50 million per annum)	Retains rail over the most congested part of the roading network. Same considerations as the closure option above apply.
5		If major down-sizing is considered as an option, then undertake a more public and arms' length economic assessment of rail (e.g. by the Productivity Commission)	Annual funding for 2015/16 would be required in Budget 2015 whilst this process is undertaken.

6	OF STATUS QUO	Support KiwiRail's plan to implement its 'trimmed network' case. KiwiRail has identified funding requirements of [s9(2)(b)(ii)] [redacted] over the next three years under this scenario.	[Withheld under s9(2)(g)(i)] [redacted]
7		Support KiwiRail's 'trimmed network' plan but provide less funding than being sought [s9(2)(f)(iv) and s9(2)(b)(ii)] [redacted] in order to push the business harder.	Incentivises the company to work harder, but creates a risk of funding shortfall in year 3 if not successful.
8	V	Elect to fund the full level of services that KiwiRail currently operates [s9(2)(f)(iv)] [s9(2)(f)(iv)] [redacted] Funding of approximately [s9(2)(b)(ii)] [redacted] would be needed over the next three years under this scenario.	This strategy ultimately dilutes the commercial objectives of the company as a State Owned Enterprise.
9	NZTA OPTION	Amend the Government Policy Statement on Land Transport (the GPS) to be the policy and planning instrument that directs investment decisions across the entire transport system (including rail). Mandate the Transport Agency to recommend investment to give effect to the GPS.	This would allow for an integrated 'whole-of-network' approach to investing in and delivering on the government's 'public good' priorities for both rail and road transport, over the long term; and provide greater certainty for commercial operators (KiwiRail and industry).

197. NZTA has suggested option 10 as an alternative to the status quo. However, this has not been assessed by either Treasury or the Ministry of Transport, and no work has yet been done to assess possible different ownership or governance structures with respect to rail. This option would therefore need to be considered in conjunction with all other possible ownership and governance structures, should the Government wish to pursue change.

198. Most of the options above have not been assessed in any detail, other than those presented by KiwiRail in its plan. We recommend initial engagement with Treasury, the Ministry of Transport and KiwiRail to discuss the potential options and the way forward for KiwiRail. Other than option 1 (which is unlikely to be palatable), all options will require funding in Budget 2015.

Agency Views

Overall Treasury View

199. In our view, the costs of continuing to subsidise KiwiRail at the levels required most likely outweigh the benefits attributable to the services the company provides. As a result, we do not think this is an industry (excluding Metropolitan rail services which are not covered in this report) that the Government should continue to subsidise in the long-term.

200. However, we recognise the practical realities of the Government discontinuing a subsidy of some sort in the short to medium term. We would therefore like to seek direction from Ministers and Cabinet to further investigate major change from the status

quo before any further work is done to assess the implications of exit or major down-sizing. We would recommend a further more comprehensive study be undertaken to better understand the implications of closure before any final decision is made.

201. In the event that the Government considers there is sufficient 'public good' to retain the rail freight network, we support KiwiRail's request for a multi-year funding commitment to provide the company with some certainty beyond one year. We think a 3-year funding commitment would be appropriate on the basis that:

- the company's financial situation is unlikely to materially change from one year to the next, meaning the Government will be faced with the same decisions next year as they are now
- it enables KiwiRail and its new Chief Executive to have a sustained period of certainty to focus on day-to-day and more fundamental business improvement rather than having to focus on reassessing its future every year
- it enables KiwiRail to plan its investment programme and it will provide flexibility to defer or bring forward planned investment accordingly
- it may provide an opportunity for the Crown to provide less funding than being sought, as the greater flexibility in funding will enable KiwiRail to better manage its cash flows (including risks)
- a three year period should be enough time for KiwiRail to implement plans to address the main inefficiencies within its business *[Withheld under s9(2)(b)(ii)]*
- *[Withheld under s9(2)(b)(ii)]*
- a funding commitment for a period of any longer than three years is likely to take the pressure off the company in making swift change and implementing cost reductions.

202. Although we suggest a three year funding commitment is better for both the company and the Crown than a one year commitment, the government will ultimately face a similar decision in three years as it does now.

203. We would only recommend a further one-year funding commitment in Budget 2015 if the Government is considering material down-sizing, but needs a further comprehensive study to be undertaken ahead of making any decisions. The communication around this approach would need to be managed carefully. If a one-year funding package was considered appropriate – it is likely that some contingency would be needed on top of the amount that KiwiRail has identified as its indicative funding requirement for 2015/16 *[Withheld under s9(2)(b)(ii)]* to avoid the situation that occurred in 2013/14 when emergency funding ($25 million) was required by the business as a result of having no contingency for unplanned events (which manifested itself in the loss of the Aratere's propeller).

204. We would caution on "institutionalising" (e.g. either by funding through NZTA's National Land Transport Fund or another operating funding mechanism) a funding arrangement as this would make it more difficult for the Government to exit at some point in the

future if the appetite for doing so changes. This is on the basis of our assessment of there being a net economic cost of funding rail at the levels required.

Ministry of Transport View

205. The Ministry of Transport supports the views expressed in this report. The Ministry notes that there are no easy options for the Government with regards to the financial future of KiwiRail as all options require a significant amount of Government subsidy.

206. If the Government is minded to pursue one of the bold options outlined in this paper, the Ministry is of the view that substantial work is required to understand the impact that this might have on the entire supply chain as in the time available, officials have not been able to determine this.

207. The Ministry also considers that any future review must be undertaken with caution as KiwiRail is in a precarious situation and a further wide-ranging review has the potential that *[Withheld under s9(2)(b)(ii)]*

208. If on the other hand the Government is rather inclined to support the Trimmed Network option, the Ministry considers that strong conditions must be imposed on KiwiRail to ensure that it is able to deliver on the plan. This is because the Crown support would no longer be considered as an investment but rather as a subsidy and therefore subject to conditions.

209. The Ministry considers that a process should therefore be put in place to determine what the appropriate range of conditions that KiwiRail should be subjected to. *[Withheld under s9(2)(g)(i)]*

New Zealand Transport Agency View

210. NZTA supports the indicative evaluation outlined in this report, and the conclusion that even taking account of the public good aspect there is currently a significant gap between the financial assistance the Crown is providing to KiwiRail and the value of the public good. The evaluation also highlights that realistically that gap will take 10-20 years to close even if significant action is taken.

211. The future of the rail network needs to be considered within the wider transport context. It is likely that the government will need to have some ongoing investment in the rail network as a public good. The question then is what governance and investment arrangements would best deliver on the government's desired outcomes for the rail network.

212. This may not require significant further analysis by agencies. NZTA considers that the Government Policy Statement on Land Transport (the GPS) could be readily adapted to provide the appropriate policy and planning instrument for investment decisions across the entire transport system (including rail). The Transport Agency could then use investment frameworks that are the same as, or similar to, those which are already in place to give effect to direction provided in the GPS. This would allow for an integrated 'whole-of-network' approach to investing in and delivering on the

government's 'public good' priorities for both rail and road transport, over the long term.

213. The GPS is not limited to the investment of the National Land Transport Fund, and already incorporates other Crown investments, such as in specific regional projects and cycle ways. It could readily be revised to incorporate the government's desired outcomes for rail as a component of the entire transport system – such as improved safety, reduced congestion, improved freight transport choices, and greater value for money.

214. As well as better delivering on the government's desired outcomes, placing rail within a stable, long-term planning and investment framework could:

- Improve evaluation and scrutiny of changes in the commercial viability of networks over time, including changing requirements for maintenance and improvements, to ensure investments deliver best value for money
- Optimise investment across road and rail, including capital improvements for freight and public transport (such as rail improvements between Wiri and Southdown)
- Ensure rail can better respond to changes in freight demand, such as the growth of potential rail freight like dairy products (forecast to grow by 65 percent over the next 30 years)
- Give the industry more confidence in the long-term use of rail in their supply chains, and their investment in complementary infrastructure, such as intermodal terminals; and
- Provide a more stable environment for KiwiRail to optimise its commercial business.

215. Detailed options could be developed on the concepts above, including governance, investment, and operational arrangements.

Next Steps

216. This report provides an overview of KiwiRail's projected financial situation and the associated policy considerations for continuing to invest in KiwiRail at the levels required. We are seeking direction from Ministers and Cabinet before undertaking the next stage of analysis. The following factors have therefore not yet been considered in any detail, but further work may be required depending the direction received from Government. These include:

- What practical implications (e.g. impacts on customers, regions, contractual commitments etc.) would need to be considered should the Government wish to pursue any of the "Bold" options that KiwiRail has presented (only relevant under a major down-sizing scenario),

- Whether the current structure of KiwiRail is the most appropriate for achieving the Government's objectives[51] with respect to the business (only relevant under a largely "status quo" scenario), and

- Whether the current funding model is appropriate and whether funding could be "institutionalised" into some form of operating funding (only relevant under a largely "status quo" scenario).

217. We recommend initial engagement with Ministers, Treasury, the Ministry of Transport, NZTA, and KiwiRail to discuss the findings expressed in this report and to determine the next steps.

218. Cabinet engagement will be required ahead of Budget 2015, and we believe a Cabinet strategy session could be an appropriate avenue for an initial discussion.

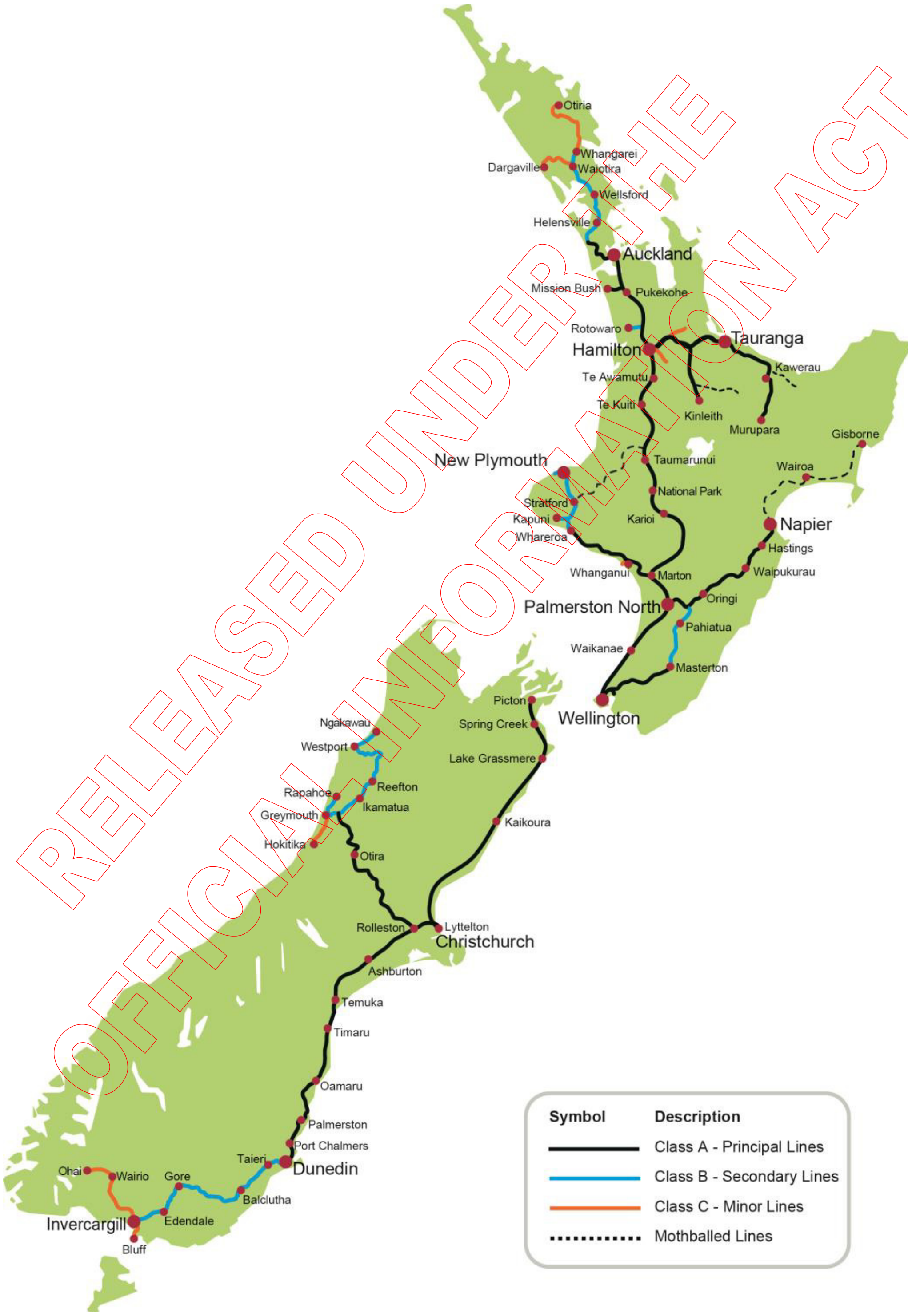
Consultation

219. The Ministry of Transport and NZTA have been consulted in the development of this paper. Where their views differ to Treasury's, these have been expressed in the 'Agency Views' section above.

220. KiwiRail has verified this report for factual accuracies in relation to the "assessment of KiwiRail's base case" section in paragraphs 22 to 144. As noted throughout the report, Treasury's views do not always align with KiwiRail's regarding KiwiRail's forecasts. KiwiRail's views regarding the public policy assessment are not reflected in this paper, however, it believes that a much more comprehensive review is needed before a decision to significantly down-size the rail network is made as it believes there would be significant impacts to its customers ***[Withheld under s9(2)(b)(ii)]*** that have not yet been assessed.

51 The company's objectives may need to be reassessed if the Government elects to retain largely the status quo i.e. what does the Government want from its investment in rail ***[Withheld under s9(2)(g)(i)]***

Appendix 1: Map of the current rail network. The current operating rail network covers 3,510 kilometres of track, with a further 430 kilometres mothballed.



Source: KiwiRail Commercial Review – Main Report.

COMMERCIAL-IN-CONFIDENCE

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: KiwiRail: Briefing ahead of meeting on 27 January 2015

Date:	23 January 2015	**Report No:**	T2015/40
		File Number:	SE-2-13-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** to meet with officials, either immediately after meeting with KiwiRail, or separately	27 January 2015
Associate Minister of Finance (Hon Steven Joyce)	**Agree** to meet with officials, either immediately after meeting with KiwiRail, or separately	27 January 2015
Associate Minister of Finance (Hon Paula Bennett)	For your information.	None
Minister of Transport (Hon Simon Bridges)	**Agree** to meet with officials, either immediately after meeting with KiwiRail, or separately	27 January 2015
Minister for State Owned Enterprises (Hon Todd McClay)	**Agree** to meet with officials, either immediately after meeting with KiwiRail, or separately	27 January 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	04 917 6160 (wk)	N/A	✓
Dieter Katz	Principal Advisor, National Infrastructure Unit	04 917 6264 (wk)	N/A	
Fiona Chan	Manager, Governance and Performance	04 917 6103 (wk)	*[Withheld under s9(2)(a)]*	

Actions for Ministers Offices' Staff (if required)

Return the signed report to Treasury.

Enclosure: Yes (attached)

Treasury Report: KiwiRail: Briefing ahead of meeting on 27 January 2015

Executive Summary

Meeting on 27 January 2015

A suggested agenda and approach to Ministers' meeting with KiwiRail and officials at 4pm on Tuesday 27 January 2015 is:

	Agenda Item	Discussion between	Suggested time
1	Presentation by KiwiRail on its new plan	Ministers, KiwiRail, officials	15 minutes
2	Ministers' questions for KiwiRail on its plan	Ministers, KiwiRail, officials	15 minutes
3	Discussion on policy considerations and next steps	Ministers and officials only	15 minutes

If it is impractical to have time at the end of the meeting to discuss the policy considerations and next steps with Ministers without KiwiRail being present, we request another meeting between officials and Ministers be set up shortly thereafter. We are seeking direction as to whether further analysis is required prior to any engagement with Cabinet, or whether initial early engagement with Cabinet is preferred, and in what form that may take.

Cost Benefit Analysis

We have been asked to reassess some of the assumptions underlying the cost benefit analysis in our previous report on KiwiRail in December (Treasury Report T2014/1805 refers) regarding the net social cost of continuing to fund rail at the levels being sought. If we take a more optimistic approach and amend the assumptions regarding the cost to KiwiRail's customers if rail was discontinued and the range of the possible future subsidy, we conclude that the net social cost would be lower than our previous assessment:

Network configuration option:	Keep status quo			*[Withheld under s9(2)(i)]*	
$ millions	**T2014/1805 (more pessimistic)**	**Amended (more optimistic)**		**T2014/1805 (more pessimistic)**	**Amended (more optimistic)**
Net Social cost	$150 - $232	$85 - $200		$124 - $206	$55 - $170

Whilst the assumptions underlying the analysis of this nature are subjective and some require further work to validate, we believe it will not change the conclusion that there is a net social cost of continuing to fund rail at the levels required.

Recommended Action

We recommend that you **agree** to meet with officials to discuss the options available to the Government with respect to KiwiRail and next steps, either immediately following the meeting scheduled for 27 January 2015, or at a separately scheduled meeting shortly thereafter.

Agree/disagree Minister of Finance	*Agree/disagree* Associate Minister of Finance
Agree/disagree Minister of Transport	*Agree/disagree* Minister for State Owned Enterprises

Fiona Chan
Manager, Governance and Performance

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Simon Bridges
Minister of Transport

Hon Todd McClay
Minister for State Owned Enterprises

Purpose of Report

1. Ministers have a meeting with KiwiRail and officials at 4pm on Tuesday 27 January to discuss KiwiRail's new plan and the options available for the Government with respect to the future of the business.

2. We recently provided advice to Ministers on KiwiRail's new plan and the associated policy considerations (Treasury Report T2014/1805 refers), and that report forms the basis of our comprehensive advice ahead of the meeting. This report discusses a number of issues that have been drawn to our attention since then, and that seem relevant to ministers' deliberations.

Meeting on 27 January

3. KiwiRail's Chief Executive, Mr Peter Reidy, and Chair, Mr John Spencer, will attend the meeting on 27 January, along with officials from Treasury, the Ministry of Transport and possibly the New Zealand Transport Agency (NZTA), should Ministers agree.

4. KiwiRail intends to present its new plan to Ministers at the meeting, with its key objective being to gain certainty of its future and a clear direction from the Government ahead of Budget 2015.

5. We request some time with Ministers without KiwiRail at the end of the meeting to discuss the options available for the Government (see below). If this is impractical, we request another meeting with Ministers shortly thereafter to discuss options. We are not seeking decisions at the meeting, but are looking for direction as to whether further analysis is required prior to any engagement with Cabinet, or whether initial early engagement with Cabinet is preferred, and in what form that may take. A suggested agenda is included here:

	Agenda Item	Discussion between	Suggested time
1	Presentation by KiwiRail on its new plan	Ministers, KiwiRail, officials	15 minutes
2	Ministers' questions for KiwiRail on its plan	Ministers, KiwiRail, officials	15 minutes
3	Discussion on policy considerations and next steps	Ministers and officials only	15 minutes

Options for Government

Network configuration options

6. As described in T2014/1805, KiwiRail has presented three possible network configuration options for the government. These are summarised in the table below, along with key implications associated with each option. We have also included a 'status quo' option whereby all lines and services currently operating are retained (KiwiRail did not include this option in its plan).

Table 1: Network Configuration Options

	Configuration option	Key implications
1	***Retain status quo*** *[Withheld under s9(2)(f)(iv)]*	• Funding of *[s9(2)(b)(ii)]* likely to be required over next three years. • Continual requirement for significant Crown investment from year four onwards.
2	***Trim network*** *[Withheld under s9(2)(f)(iv)]*	• Funding of *[s9(2)(b)(ii)]* likely to be required over next three years.

	[Withheld under s9(2)(f)(iv)]	• Continual requirement for significant Crown investment from year four onwards.
3	***Retain Golden Triangle only*** i.e. *[Withheld under s9(2)(f)(iv)]*	• Significant reduction in ongoing Crown funding requirements. • Significant one-off "change costs" and associated Crown funding. • Major change from status quo and we recommend further work be undertaken to assess the implications and process for change.
4	***Full closure*** i.e. close all freight only lines (but retain metropolitan services in Auckland and Wellington)	• No ongoing Crown funding requirements • Significant one-off "change costs" and associated Crown funding • Major change from status quo and we recommend further work be undertaken to assess the implications and process for change.

Ownership/Funding options

7. Our report assumed that if rail is not closed down, ownership/funding options would be considered subsequent to ministers' consideration of the network configuration options. *[Withheld under s9(2)(f)(iv)]*

Management options

8. *[Withheld under s9(2)(f)(iv)]*

9.

Cost Benefit Analysis

10. We have given further consideration to the possibility that we may have been too pessimistic in our cost benefit analysis. There are four components of our cost benefit analysis that may warrant further consideration. We conclude that two of these may warrant adjustment to the cost benefit analysis (cost to KiwiRail's customers and Crown subsidy). However, these do not change our initial conclusion (in T2014/1805) that there is a material net social cost of continuing to fund rail at the levels required:

No cost to KiwiRail's customers if rail was discontinued

11. We assumed there would be no cost to KiwiRail's customers if rail was discontinued. This was on the basis that there are viable alternative transport modes available for

most of its customers, and KiwiRail should therefore be setting its prices at the highest possible levels i.e. almost to the point of indifference where customers are indifferent between using rail and competing modes, taking all customers' costs and benefits into account.

12. *[Withheld under s9(2)(b)(ii) and s9(2)(g)(i)]*

Option value associated with retaining rail

13. Our assessment of the option value associated with retaining rail was based on analysis of the company's forecasts as a whole, rather than on a railway line by railway line basis. This was due to the fact that the true cash flows for each line segment cannot be calculated without some form of arbitrary cost allocation of common/unallocated costs to each line (these unallocated costs total approximately $160 million per annum[1]).

14. It is possible that a line by line analysis would produce a somewhat higher option value, on the grounds that a future Government would have the ability to close rail down except for the lines that add value, but this is probably only realistic in respect of the *[Withheld under s9(2)(b)(ii)]* given the interdependence of the other routes. A more sophisticated analysis of option values could be worthwhile, but at this stage we do not anticipate that it would make a game-changing difference.

Subsidy reduces in line with KiwiRail's forecasts

15. Table 4 below shows a comparison between KiwiRail's forecast annualised funding requirements over the next 30 years with Treasury's assessment that funding levels are unlikely to materially reduce from current levels. The comparisons are shown for both the status quo and KiwiRail's 'Trimmed Network' scenario *[Withheld under s9(2)(b)(ii)]* *[Withheld under s9(2)(b)(ii)]*

Table 4: Comparison of KiwiRail's and Treasury's forecast funding assumptions

Midpoint of ranges ($ millions)	Keep status quo *[Withheld under s9(2)(f)(iv)]*			*[Withheld under s9(2)(i)]* (i.e. KiwiRail's 'Trimmed Network' scenario)		
	KiwiRail's forecast	**Treasury mid-point Assumption**	**Variance**	**KiwiRail's forecast**	**Treasury mid-point Assumption**	**Variance**
Average annual subsidy[2]	*[s9(2)(b)(ii)]*	210	*[s9(2)(b)(ii)]*	*[s9(2)(b)(ii)]*	190	*[s9(2)(b)(ii)]*

16. As illustrated above, the variances are material, and we have reflected KiwiRail's forecasts in the new cost benefit analysis table attached in Appendix 1. We have not amended the upper end of the likely subsidy range, but have reduced the lower end of the range to be equal to KiwiRail's estimates as reflected in the table above. However, we remain comfortable with our assessment of the likely ongoing funding requirements for the business, given its performance in recent years (with further discussion on the rationale for our assessment in T2014/1805). We recognise that opportunities exist to reduce funding over time, and KiwiRail should continue to do all it can to crystallise

[1] *[s9(2)(b)(ii)]*

[2] This has been calculated by annualising the Net Present Value over 30 years at 8%.

those opportunities. However, in T2014/1805 we also identified risks that could result in funding increasing.

17. *[Withheld under s9(2)(b)(ii) and s9(2)(f)(iv)]*

Economic cost of taxation

18. We have included in our evaluation an economic cost of taxation of around $40 million p.a. (20% of the subsidy). This cost is often ignored in evaluations of other Government spending decisions. Nevertheless, we consider it a real cost that should be taken account of. Future tax reductions (or avoidance of tax increases) are an option for Government and savings by way of reduced subsidies to rail would contribute to the probability of those occurring, or to the magnitude or timing of any such tax cuts. We consider it appropriate, therefore, to take the cost of taxation into account in any evaluation that could influence a decision on whether or not to spend money.

Overall impact of amended assumptions

19. The table below reflects amendments to our cost benefit analysis as discussed above. As a result, our estimate of the total net social cost has decreased, and the range has increased – reflecting the significant uncertainty surrounding what the average annual subsidy could be over 30 years.

	Keep status quo			*[Withheld under s9(2)(i)]*	
$ millions	**T2014/1805 (more pessimistic)**	**Amended (more optimistic)**		**T2014/1805 (more pessimistic)**	**Amended (more optimistic)**
Net Social cost	$150 - $232	$85 - $200		$124 - $206	$55 - $170

20. We expect KiwiRail to voice its concerns to Ministers at the meeting on the 27th as to the comprehensiveness of the work done on the public policy case for rail, and may also disagree with the values applied to some of the aspects in our cost benefit analysis. As noted in T2014/1805, a cost benefit analysis of this nature contains significant subjective elements, and it is likely that if the equivalent analysis was undertaken by another party, different weightings or interpretations of the costs and benefits would likely be applied which could result in different conclusions. We reiterate that the public policy conclusions we have drawn that indicate support for major down-sizing of the rail network are not yet of decision-making quality, and more comprehensive analysis would be needed before such decisions were made.

Appendix 1: Clarification of public policy case for rail

Contents

Public Policy Case

Page 2 sets out our public policy story. This reflects our amended cost benefit analysis (which is more optimistic than that presented in T2014/1805)

Page 3 sets out the rationale behind our conclusion, and some questions and answers.

Technical Annex

Page 5 sets out the benefits and costs of making a change, from the point of view of the status quo. It is based on the same numbers, amended as discussed in this report.

Public Policy Story	Keep all lines	*[s9(2)(i)]* [redacted]	Keep golden triangle only
Cost of rail: Annualised subsidy (including economic cost of taxation)	$180-276m	$151-252m	$30-46m
Public Policy Question: What are the public policy benefits that the taxpayer gets for paying the subsidy?			
Avoided CO_2 emissions from sending freight by rail	$7.5-12.5m	$7.5-12.5m	$1-5m
The option value ...of retaining rail in case future developments make rail desirable. Our analysis suggests that this is very small because the changes in the general business environment that would be required to make rail profitable would need to be of such magnitude as to render it very unlikely.	$1.8-3m	$1.8-3m	$0.3-0.5m
Private benefits to KiwiRail's customers *[Withheld under s9(2)(b)(ii)]* [redacted]	$10-40m	$10-40m	$2-7m
Fewer accidents and less road congestion ...as a result of fewer trucks. These figures equal the additional RUC minus the additional road construction costs and safety impacts. They suggest that the additional revenue from RUC paid by the additional trucks would likely be more than sufficient to expand and improve the road network so there is no increase in accidents or congestion.	-$44 to 24m	-$38 to 28m	-$16 to 35m
Avoided decommissioning and mothballing costs Indications are that they would be around $600 – 900 million, which for comparison purposes we annualised at $47 – 72 million.	$48-72m	$45-70m	$5-15m
Shortfall in benefits from continuing to fund	**$85 - 200m**	**$55-170m**	**$37 to -16m**

The Rationale

The rationale behind the result is that although rail is cheaper than road transport on a per-km basis, much of the freight must be transferred to or from a truck at one or other end of the journey, depending on whether the freight is being exported or imported. For domestic freight, there is double handling at both ends. These transfers add considerably to costs and to the time it takes for freight to reach its destination.

A supply chain that includes rail is therefore often significantly more resource-intensive and expensive than one that relies on trucks or coastal shipping only, unless distances are large, freight is not time-sensitive, volumes are large and/or the nature of the freight makes pick-up at the factory or mine feasible. KiwiRail's bulk freight (e.g. coal and timber) and Import/Export (e.g. milk powder) markets generally have these characteristics, but its domestic market (which traverses most of the network) does not.

Q & A

1. Why is the option value so low?

   A: An option value does not arise until KiwiRail's accounts turn positive, which it doesn't forecast to happen until after 30 years. That value must then be multiplied by the expected probability of that happening, which we expect to be relatively low, and then it must be discounted to the present. Discounting over 30 years reduces values by around 90%.

2. Would motorists' road experience be worse as a result of so many more trucks on the road?

   A: Not necessarily. The cost benefit table includes our estimate of the cost of improving roads sufficiently so that the overall road experience (travel times, perceived congestion and rate of accidents) does not deteriorate. The net benefit at the bottom of the table is <u>after</u> taking those costs into account.

3. Should ministers take into account motorists' willingness to pay to keep those trucks away by keeping freight on rail?

   A: That 'willingness to pay' is already taken account of in the cost benefit table. To treat it as an additional consideration would be double counting.

4. Is it realistic to assume that there is no private cost to rail users if the rail network is closed down?

   A: Probably not. We put in zeros in the previous Treasury report T2014/1805 because firstly, we have no information, and secondly, [redacted]

   [Withheld under s9(2)(b)(ii) and s9(2)(i)]

5. Is it realistic to assume that NZTA could improve the roads quickly enough so that the additional trucks would cause no impact on motorists' road experience?

   A: Improving the roads would clearly take some time. But we assume that closing down part or the whole of the network would also take time. The extent to which the two actions are matched will depend on how the whole process is managed.

6. The additional Road User Charges (RUC) revenue will accrue over time, but the road improvements would need to be carried out straight away. How would NZTA do that, given it has no surplus cash?

   A: NZTA would need to be given a loan to bridge the time period. This need not have any net economic cost, although it would increase the Government's debt temporarily.

7. *[Withheld under s9(2)(b)(ii)]*

8. Ports may also suffer costs of change, and some may suffer permanent increases in freight handling costs. Was this taken into account?

   A: We have no information on such costs. *[Withheld under s9(2)(b)(ii)]* See the answer to question 4 above. Secondly, we considered that the financial consequences for ports are not necessarily net negative. It is conceivable that the freeing up of rail yards for other purposes would enable some ports to improve their logistical operations so as to result in a net overall improvement in productivity.

Technical Annex

Cost Benefit Analysis table (costs and benefits of making a change)[3]:

CBA of KiwiRail's three options (compared with status quo) – annualised			
$ millions p.a. All values converted to annualised equivalents	**Close all lines**	**Keep golden triangle**	*[s9(2)(i)]*
Benefits			
Avoided subsidy	$150-230m	$125-192 m	$7-37 m
Avoided economic cost of taxation[4] – 20% of subsidy	$30-46 m	$25-38 m	$2-8 m
Additional road user charges	$100-150 m	$75-115 m	$4-6.5 m
Costs			
Lost option value of retaining rail	$1.8-3 m	$1.4-2.6 m	~$0 m
Decommissioning and mothballing costs (annualised)	$48-72 m	$37-63 m	$0.5-5.5 m
Increased CO_2 emissions	$7.5-12.5 m	$4-10m	~$0 m
Road safety impacts[5]	$15-25 m	$7-19m	~$0 m
Private costs to rail users[6]	$10-40 m	$8-33 m	~$0 m
Increased road expenditure[7]	$73-117 m	$51-74 m	~$0 m
Net social benefit of making a change p.a.[8]	**$85 to $200 m**	**$84 to $176 m**	**$13 to $44 m**

3 This differs from table 10 in the Treasury report in that it looks at the costs and benefits of change from the point of view of the status quo. It also differs in that it includes updated assumptions about the avoided subsidy and the private costs to rail users. The table in the Treasury report looked at the costs and benefits of having a rail network from the point of view of having no rail network.

4 A national cost benefit analysis needs to recognise the economic cost of tax that is used to pay for the subsidy. This has been estimated at 20% of the cost of raising tax revenue. In this case, it is 20% of the fiscal cost of the subsidy.

5 This could be road expenditure incurred to mitigate the increased accident rate that would otherwise occur.

6 [Withheld under s9(2)(b)(ii)]

7 Additional maintenance costs and improvements to mitigate the increased congestion that would otherwise occur.

8 These ranges are not an arithmetical sum of the numbers above. They were derived from the above numbers using a Monte Carlo simulation.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: KiwiRail: Third Drawdown from $198 million Appropriation for 2014/15

Date:	5 March 2015	**Report No:**	T2015/291
		File Number:	SE-2-13-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** recommendations **Sign** attached share subscription agreement	Friday 13 March 2015
Associate Minister of Finance (Hon Steven Joyce)	For your information.	None
Associate Minister of Finance (Hon Paula Bennett)	For your information.	None
Minister of Transport (Hon Simon Bridges)	For your information.	None
Minister for State Owned Enterprises (Hon Todd McClay)	**Agree** recommendations **Sign** attached share subscription agreement	Friday 13 March 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	04 917 6160 (wk)		✓
Fiona Chan	Manager, Governance and Performance	04 917 6103 (wk)	*[Withheld under s9(2)(a)]*	

Actions for Ministers Offices' Staff (if required)

Once signed by shareholding Ministers, **return** the signed report and signed share subscription agreement to Treasury.

Note: The Minister of Finance and the Minister for State Owned Enterprises can sign separate copies of the share subscription agreement.

Enclosure: KiwiRail letter to shareholding Ministers 27Feb2015 (Treasury:3131382v1)
KiwiRail Share Subscription Agreement $48 million (Treasury:3131378v1)

Treasury Report: KiwiRail: Third Drawdown from $198 million Appropriation for 2014/15

Purpose of Report

1. This report seeks shareholding Ministers' approval for KiwiRail Holdings Limited (KiwiRail) to draw down $48 million in March 2015, which will be the final amount of its $198 million total appropriation[1] for 2014/15. Should you agree, a share subscription agreement is attached for shareholding Ministers to sign authorising this increase in the capital of KiwiRail.

Background

2. KiwiRail has an appropriation of $198 million for the 2014/15 year to fund a portion of its ongoing capital expenditure. Total funding provided to KiwiRail over the past five years is $1.067 billion, made up as follows:

   - 2010/11 year: $250 million,
   - 2011/12 year: $250 million,
   - 2012/13 year: $198 million,
   - 2013/14 year: $171 million, and
   - 2014/15 year: $198 million.

3. In July 2014, KiwiRail made its first drawdown of $60 million for 2014/15 (T2014/1131 refers), and in September 2014 it made its second drawdown of $90 million (T2014/1553 refers). If Ministers approve this current request to drawdown $48 million, KiwiRail will have drawn down the full amount of its $198 million appropriation for 2014/15.

Analysis

Process of drawdown / share subscription

4. As KiwiRail is a company, any capital paid to it needs to be done by way of a share subscription by both shareholding Ministers. Accordingly, a share subscription agreement signed by KiwiRail's Chief Executive, Mr Peter Reidy, is attached to this report for shareholding Ministers to sign.

5. Normally, a share issue would be authorised by a shareholder resolution. In this instance, KiwiRail has elected to issue shares under section 107(2) of the Companies Act 1993 which does not require a shareholder resolution. We are comfortable that the attached share issue agreement meets the requirements of the State-Owned Enterprises Act 1986, the Companies Act 1993, and KiwiRail's constitution for issuing shares.

[1] Capital Appropriation – "KiwiRail Turnaround Plan Funding"

Cash Flow Forecast

6. KiwiRail has requested that this $48 million funding be paid on 18 March 2015. Assuming it receives the full $48 million, its most up to date forecast is for it to have between [Withheld under s9(2)(b)(ii)] at the end of the financial year (see cashflow forecast below). This compares to a budgeted yearend cash balance of [Withheld under s9(2)(b)(ii)] Its cash flow forecast is reflected here:

[Withheld under s9(2)(b)(ii)]

7. The reasons for its cash forecast having deteriorated since it undertook its Budget are:

- [Withheld under s9(2)(b)(ii)]

- A further delay to its planned sale of land in Parnell. The land sale is expected to generate between [s9(2)(b)(ii)] of which KiwiRail is now only forecasting to receive the initial [s9(2)(b)(ii)] in this financial year.

8. The shortfalls noted above (combined impact between [s9(2)(b)(ii)], have been partially offset by KiwiRail deferring some planned capital expenditure to ensure it will not experience cash flow difficulties in 2014/15 (as it did in 2013/14).

Risks to current forecast

9. The main risks to its current forecast include:

- A further delay to its planned sale of land in Parnell meaning it does not receive the initial [s9(2)(b)(ii)] in 2014/15 that it is forecasting to,

- [s9(2)(b)(ii)] in upfront costs relating to the customisation and upgrading of the Stena Alegra becoming due[2] in 2014/15 instead of 2015/16 when the payment is currently forecast to be made, and

- A further deterioration in earnings from its current forecast.

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[2] This payment is due on delivery of the ship to New Zealand, which is currently expected in July 2015, but could possibly occur prior to 30 June 2015.

Potential mitigations

10. Following the Aratere propeller incident in 2013/14 (which resulted in KiwiRail having to seek emergency funding of $25 million from the Crown half way through the financial year), KiwiRail established a working capital facility for $15 million *[s9(2)(b)(ii)]* which is available for KiwiRail to draw upon in the event it experiences cash flow difficulties. To date, no funds have been drawn from this facility, but it remains in place and could be used in 2014/15 if necessary.

11. KiwiRail also has the ability to further defer planned capital expenditure in the latter part of 2014/15 if need be, although given the lead in times for most of its investment, the closer towards year end it gets, the more limited ability it has to defer investment.

12. Given the existence of the working capital facility, and the fact that KiwiRail is still forecasting to have a positive cash balance at year end *[Withheld under s9(2)(b)(ii)]* we think it is very unlikely that KiwiRail will experience cash flow difficulties before 30 June 2015, barring any major unforeseen events.

Future funding

13. As previously advised (T2014/1805 refers), KiwiRail will require funding in 2015/16 irrespective of the direction the Government wishes to take with respect to KiwiRail. It is likely that KiwiRail will seek to make an initial drawdown of any appropriation it receives in Budget 2015 in July 2015.

14. In its commercial review, KiwiRail identified likely[3] future funding requirements of *[s9(2)(b)(ii)]* million over the next five years as outlined in this table:

$ millions	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**
Indicative funding requirements	*[Withheld under s9(2)(b)(ii)]*				

15. In the event that only one year's funding is committed to in Budget 2015, the amount earmarked for 2015/16 may need to be reassessed given the lack of flexibility and contingency that KiwiRail will have with only one year's funding.

Treasury View

16. We have reviewed KiwiRail's cashflow forecasts, and are comfortable that the amount and timing of this request is reasonable. KiwiRail intends to put this funding towards capital expenditure projects outlined in its business plan, with the majority to be spent on track and infrastructure renewals and upgrades. This expenditure is consistent with its business plan that we reported to shareholding Ministers on in March 2014 (T2014/52 refers). We therefore recommend shareholding Ministers sign the attached share subscription agreement.

[Withheld under s9(2)(b)(ii) and s9(2)(f)(iv)]

Recommended Action

We recommend that you:

a **agree** to sign the attached share subscription agreement authorising an increase in capital of KiwiRail Holdings Limited (KiwiRail) by $48 million to be paid to it on or about 18 March 2015

Agree/disagree
Minister of Finance

Agree/disagree
Minister of State Owned Enterprises

b **note** that following this issue of share capital of $48 million, KiwiRail will have drawn down the full amount of its $198 million appropriation for 2014/15, and

c **note** that KiwiRail will require further funding in Budget 2015 and that it will likely seek to make an initial draw down of that funding in July 2015.

Fiona Chan
Manager, Governance and Performance

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: KiwiRail: Cabinet Paper for Funding

Date:	19 March 2015	**Report No:**	T2015/393
		File Number:	SE-2-13-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** recommendations and **submit** attached Cabinet paper to next available Cabinet committee or Cabinet meeting	26 March 2015
Associate Minister of Finance (Hon Steven Joyce)	For your information.	None
Associate Minister of Finance (Hon Paula Bennett)	For your information.	None
Minister of Transport (Hon Simon Bridges)	**Agree** recommendations and **submit** attached Cabinet paper to next available Cabinet committee or Cabinet meeting	26 March 2015
Minister for State Owned Enterprises (Hon Todd McClay)	**Agree** recommendations and **submit** attached Cabinet paper to next available Cabinet committee or Cabinet meeting	26 March 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	04 917 6160 (wk)		✓
Fiona Chan	Manager, Commercial Operations	04 917 6103 (wk)	*[Withheld under s9(2)(a)]*	

Actions for Ministers Offices' Staff (if required)

Return the signed report to Treasury.

Once the Cab100 form is signed by Ministers, **submit** attached Cabinet paper to the Cabinet office for tabling at the next appropriate Cabinet or Cabinet Committee meeting.

Enclosure: Cabinet Paper: Funding for KiwiRail (Treasury:3127034)

Treasury Report: KiwiRail: Cabinet Paper for Funding

Purpose of Report

1. This report provides Ministers with a Cabinet paper seeking Cabinet's agreement to provide financial support to KiwiRail, as requested by the Minister of Finance's office. We recommend the Cabinet paper be presented by shareholding Ministers and the Minister of Transport. This Treasury report also provides an update on various aspects of KiwiRail's business that have progressed over the past few months, which provide some more context to the Cabinet paper.

2. The paper needs to be presented to Cabinet ahead of final Budget decisions being made in mid-April, as it seeks Cabinet's agreement to support a policy that will have implications for the Budget. The financial recommendations will be incorporated as part of the Budget package and are not included in the attached paper.

Funding model

Treasury's Recommendations

3. Treasury's recommendation, as noted in the attached Cabinet paper, is for one year's funding to be provided in Budget 2015 whilst a comprehensive and public review of closing rail is undertaken. In the event that a review is not progressed, we recommend a three year funding commitment to enable KiwiRail to manage its business and investment programme effectively. Our recommendations are illustrated here:

<u>1st Preference:</u>

Provide one year's funding of $194.6m whilst a comprehensive review of the impact of closure is undertaken over the next year. No contingency is provided on the basis that because this course of action presents the possibility of major down-sizing in the medium term, KiwiRail should be more prudent with its planned level of investment for the next year – and deferral of planned investment can effectively act as a contingency.

<u>2nd Preference:</u>

In the absence of any appetite to further assess possible major down-sizing, provide a three year multi-year appropriation of *[s9(2)(b)(ii)]* on the basis that the company needs certainty to manage its business and investment programme accordingly, and enter into more favourable contractual terms with suppliers.

<u>3rd Preference:</u>

In the event that a three year multi-year appropriation is unaffordable in Budget 2015, provide one year's funding of $209.6 million (representing funding of $194.6 million + $15 million contingency[1]), plus an 'in-principle' commitment[2] for years two and three of

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[1] Contingency funding is recommended because KiwiRail should continue to invest in its assets and business on the basis that the Government is making a medium-term commitment to retain the business, and deferral of investment is only a short-term fix. Deferral of capital expenditure is not always possible, with some investment spanning across multiple financial years.

[2] An 'in-principle' commitment was applied at the start of the Turnaround Plan in 2010 when a $250 million appropriation was made in Budget 2010, with an 'in-principle' commitment to provide a further $500 million in Budgets 2011 and 2012.

[s9(2)(b)(ii)] (taking the three year total to *[s9(2)(b)(ii)]* – the amount being sought by KiwiRail in its review).

'Contingency' in the event of single-year funding

4. In the event that only a one year funding commitment is made in Budget 2015, KiwiRail has indicated that it is seeking a 15% contingency[3] above the amount it has identified as being required in 2015/16, being *[s9(2)(b)(ii)]* as illustrated here:

$ millions	2015/16	2016/17	2017/18	2018/19	2019/20
[Witheld under s9(2)(b)(ii)]					

5. This would be *[Witheld under s9(2)(b)(ii)]* identified for 2015/16. This is on the basis that i) its forecasts do not include a contingency for unforeseen events, and ii) it is less cost effective to contract with suppliers when it can only do so for periods of up to one year. Specifically, KiwiRail has identified the need for a contingency to cover unexpected events including utility outages, mechanical failure, loss of a major customer, market or volume, or a natural disaster.

6. We consider it reasonable for KiwiRail to seek some level of contingency if it receives only one year's funding commitment. If the Government elects to retain most of the rail freight network in the medium term, it is appropriate for KiwiRail to continue to invest on this basis, which is what its plan assumes. If risks crystallise (which some already have – as discussed below), then it will need to defer planned investment, particularly if it has no contingency to mitigate against the crystallisation of risks.

7. However, this needs to be balanced in the context of affordability, and the fact that KiwiRail should be incentivised to operate more efficiently and re-prioritise expenditure in the event it has less funding available than planned, as an equivalent privately owned company would do.

8. In our view, a contingency of $15 million would be appropriate in the event that only one year's funding is committed to. This is equivalent to *[s9(2)(b)(ii)]* planned annual capital expenditure. It is difficult to be too formulaic when assessing an appropriate level of contingency given the amount of variables that could impact the business. If a contingency is provided, we would recommend it not being additional funding over the three years, but rather be funding that is brought forward from years two and three, with the three year total of *[s9(2)(b)(ii)]* remaining the same.

9. In the event that no contingency is provided, there should be enough flexibility within KiwiRail's business to manage within a funding envelope of $194.8 million for 2015/16, by deferring capital expenditure. However, in this situation, KiwiRail will argue that it will then be implementing a different plan to what it has presented to Ministers, and that deferring investment is only a short term solution that will have to be caught up in future years. It will also be more acutely exposed to unforeseen events.

10. It is possible that KiwiRail will already have *[s9(2)(b)(ii)]* less funding available in 2015/16 than it has forecast due to earnings shortfalls (see below), and it is not reasonable or affordable for the Government to fully fund every earnings shortfall the company experiences. KiwiRail will need to absorb some of these earnings shortfalls otherwise the financial burden to the Crown will only increase and become untenable.

[Withheld under s9(2)(b)(ii) and s9(2)(f)(iv)]

11. Even with the provision of a contingency, there will always be a risk that a material unforeseen event will occur that will require emergency funding. By continuing to support the business, the Government is effectively committing to fund such events if they occur in the future.

12. KiwiRail wants to avoid a repeat of the situation that occurred in 2013/14, and believes that provision of a contingency would mitigate against that. KiwiRail had been seeking a multi-year funding commitment that year as well, but only received a one-year appropriation of $94 million[5], which was equivalent to the amount it was forecasting to need in year 1 (of the 4 years it was seeking funding for). There was no contingency attached to this amount, and with no flexibility to draw upon funding from a multi-year appropriation, it had to seek emergency funding of $25 million mid-year when its Aratere ferry lost its propeller and was out of service for ~9 months.

Advantages of multi-year funding certainty

13. Previously Treasury has advised that a multi-year appropriation provides sufficient flexibility to indirectly act as a contingency, by giving the company the ability to draw down funding tagged for future years in the event that unforeseen events materially impact its business. Although this mechanism does not mitigate against cash shortfalls as such, it allows KiwiRail to commit to long-term capital plans and invest in the most appropriate and cost effective way.

14. Under any funding model, KiwiRail will indirectly be committing to expenditure in future years, whether it has secured funding or not. The majority of KiwiRail's assets have economic lives of 30+ years and many of the renewal and/or upgrade programmes span multiple years and require significant upfront time and cost to establish the project.

15. For projects that will be substantially contracted out to third parties *[Witheld under s9(2)(b)(ii)]* multi-year funding certainty enables KiwiRail's suppliers to price contracts in ways that allow them to recover substantial up-front resourcing / establishment costs and deliver economies of scale over a number of years. Without multi-year funding certainty, KiwiRail is less able to negotiate favourable contractual terms with suppliers. KiwiRail may still be able to deliver its long-term projects using short-term contracts, but this is likely to result in higher costs and sub-optimal solutions.

16. With single-year funding and the *[Witheld under s9(2)(b)(ii)]* KiwiRail is less able to pursue an optimum programme for renewing its legacy assets, and is likely to continue spending a higher proportion on reactive maintenance than the expected benchmark for mature asset management. While higher maintenance meets short-term objectives, it results in sub-optimal work practices and inefficiency from a whole-of-life cost perspective. It ultimately results in value destruction if there is no intention to exit the industry.

Solid Energy

17. KiwiRail's commercial review assumed Solid Energy would transport approximately *[s9(2)(b)(ii)]* of coal per annum from the West Coast to Lyttleton Port. Solid Energy has recently advised KiwiRail that this will reduce to *[s9(2)(b)(ii)]* per annum in 2015/16. KiwiRail estimates this will have an adverse impact of *[s9(2)(b)(ii)]* its annual earnings forecasts from next year on.

5 It also had $52 million of the prior year's appropriation that year as it drew this down just prior to the start of the financial year, effectively meaning it had funding of $146 million in 2013/14 prior to the $25 million emergency funding.

18. In the event that there are further material changes to Solid Energy's production levels or scope of business, it is likely to have material implications for KiwiRail's business. If there are significant changes, KiwiRail will need to make an assessment of the following factors:

[s9(2)(b)(ii)]

19. KiwiRail is currently working through such scenarios given recent media reports regarding Solid Energy's financial position, and we expect it to share this information with Treasury in due course. Subject to KiwiRail's analysis, we expect a significant reduction in volumes being transported by Solid Energy is likely to have a detrimental impact on KiwiRail's cashflows in the short term. *[Witheld unders9(2)(b)(ii)]*

Earnings shortfall

20. As previously advised, KiwiRail is *[Witheld under s9(2)(b)(ii)]* (largely as a result of transporting lower volumes of commodities than budgeted) *[Witheld under s9(2)(b)(ii)]* (KiwiRail is targeting *[Witheld under s9(2)(b)(ii)]*

21. KiwiRail will therefore start from a lower cash and earnings base in 2015/16 than what it had assumed in its recently completed commercial review. Assuming it does not recapture these lost earnings, the cumulative impact over the next three years will be lower cash flows than assumed of between *[Witheld under s9(2)(b)(ii)]* (the 2014/15 shortfall plus the impact over the next three years from starting from a lower base). This is excluding the potential reduction in earnings from Solid Energy of *[Witheld under s9(2)(b)(ii)]* as noted above, which could take the shortfall over the three years to between *[Witheld under s9(2)(b)(ii)]* (with all other assumptions remaining unchanged).

22. KiwiRail will therefore most likely need to defer planned capital expenditure in order to offset this cash shortfall. This reduces the likelihood of funding requirements decreasing to *[s9(2)(b)(ii)]* per annum from 2018/19 as KiwiRail has forecast, and reinforces Treasury's view that funding requirements are unlikely to materially reduce in the foreseeable future (T2014/1805 refers).

23. It also limits the Government's options for providing a lower level of funding over the next three years than what is being sought by KiwiRail *[s9(2)(b)(ii)]* as doing so would increase the risk of KiwiRail investing at sub-optimal levels and being exposed to unforeseen events.

COMMERCIAL-IN-CONFIDENCE

Performance Agreement

24. We continue to work with KiwiRail on a potential service agreement. We have put a proposal to KiwiRail's Board that focuses on:

- agreeing certain financial performance measures that focus on improving productivity, efficiency, and ultimately Crown funding requirements
- implications if the agreed measures are not met, ranging from increased monitoring and reporting to withholding a portion of "at-risk" funding, and
- providing shareholding Ministers with discretion to withhold the "at-risk" funding, and be able to prioritise this investment with other spending priorities.

25. ***[Withheld under s9(2)(f)(iv)]*** [redacted] We will continue to work with KiwiRail in an attempt to progress an agreement that is workable and appropriate for both parties. We will provide further advice once this has been progressed further. ***[Withheld under s9(2)(f)(iv)]*** [redacted]

Cabinet paper

26. We recommend the attached Cabinet paper be submitted by joint Ministers to the next appropriate Cabinet committee or Cabinet meeting. The main advice supporting the information in the Cabinet paper was our comprehensive report on KiwiRail's commercial review (Treasury Report T2014/1805 refers). The Ministry of Transport has been consulted on the Cabinet paper, and KiwiRail and the Department of the Prime Minister and Cabinet have been informed.

COMMERCIAL-IN-CONFIDENCE

COMMERCIAL-IN-CONFIDENCE

Recommended Action

We recommend that you:

a **note** that Treasury expects KiwiRail to [Withheld under s9(2)(b)(ii)] by between [Withheld under s9(2)(b)(ii)]

b **note** that the forecast earnings shortfall in 2014/15 noted above, combined with a potential [s9(2)(b)(ii)] reduction in earnings from Solid Energy from 2015/16 on, could have a cumulative adverse impact of between [s9(2)(b)(ii)] on its cash flows over the next three years

c **note** that Treasury and KiwiRail continue to work on a potential service agreement

d **agree** to submit the attached Cabinet paper seeking further financial support for KiwiRail to the next appropriate Cabinet Committee or Cabinet meeting

Agree/disagree	*Agree/disagree*	*Agree/disagree*
Minister of Finance	Minister of Transport	Minister for State Owned Enterprises

Fiona Chan
Manager, Commercial Operations

Hon Bill English
Minister of Finance

Hon Simon Bridges
Minister of Transport

Hon Todd McClay
Minister for State Owned Enterprises

COMMERCIAL-IN-CONFIDENCE

COMMERCIAL-IN-CONFIDENCE

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2015/587 SE-2-13-1

Date: 26 March 2015

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)
Associate Minister of Finance (Hon Paula Bennett)
Minister of Transport (Hon Simon Bridges)
Minister for State Owned Enterprises (Hon Todd McClay)

Deadline: Monday 30 March 2015

Aide Memoire: KiwiRail: Advantages of Multi-Year Funding

Previously Treasury has advised (T2014/1805 and T2015/393 refer) that in the event the Government wishes to retain KiwiRail over the medium-term, a multi-year funding commitment is a more efficient way of funding the business than continuing to fund on a single-year basis.

Efficiencies to be achieved

For projects that will be substantially contracted out to third parties and span over a number of financial years, multi-year funding certainty enables KiwiRail's suppliers to price contracts in ways that allow them to recover substantial up-front resourcing / establishment costs and deliver economies of scale. The significant multi-year projects that KiwiRail intends to contract out over the next 3 years include:

[Witheld under s9(2)(b)(ii)]

The total value of these multi-year projects that KiwiRail intends to contract out to external suppliers is [s9(2)(b)(ii)] over the next 3 years. KiwiRail estimates that the efficiencies it can achieve through contracting out these projects over their whole of life, as opposed to commissioning a part of each project in each financial year, [redacted] [Witheld under s9(2)(b)(ii)]

KiwiRail also estimates that it can achieve between [Witheld under s9(2)(b)(ii)] [redacted] savings in relation to its planned rolling stock procurement over the next three year [s9(2)(b)(ii)] as a result of optimising the timing and quantity of the purchases (compared to buying fewer units of rolling stock each year).

In addition, KiwiRail estimates that it can achieve between [Witheld under s9(2)(b)(ii)] [s9(2)(b)(ii)] in efficiencies from the remainder of its capital expenditure programme [redacted] as a result of contract certainty (for work that has an element of external contracting) and production efficiencies (e.g. equipment purchases etc.).

It therefore estimates total efficiencies of between [Witheld under s9(2)(b)(ii)] over the next three years from having certainty of funding over that period and being able to contract and operate more efficiently as a result. These savings are summarised in this table:

3 Year Totals	Total Investment ($ millions)	Forecast Efficiencies ($ millions)	% Efficiencies
Significant 'contracted-out' projects	[Witheld under s9(2)(b)(ii)]		
Rolling stock procurement			
Other Capital expenditure			
Total			

We have discussed KiwiRail's assumptions with AECOM[1] to gain some independent verification of the assumptions. AECOM advises that it is standard practice for costs to be lower for construction projects and large-scale equipment procurement that span across multiple years compared to short-term, stop-start investment. This is mainly the result of there being continued production and mobilisation of staff over longer periods. AECOM believes[2] KiwiRail's estimates of efficiencies are conservative for what could be achieved given the nature of its investment.

Other benefits

With single-year funding and an [Withheld under s9(2)(g)(i)] KiwiRail is less able to pursue an optimum programme for renewing its legacy assets, and is likely to continue spending a higher proportion on reactive maintenance than the expected benchmark for mature asset management. While higher maintenance meets short-term objectives, it results in sub-optimal work practices and inefficiency from a whole-of-life cost perspective. It ultimately results in value destruction if there is no intention to exit the industry.

1 AECOM is an engineering and construction consultancy firm with rail experience.

2 This was based on an informal discussion with AECOM. AECOM is currently undertaking a more detailed assessment of KiwiRail's assumptions, but this was not available in the timeframe required to complete this Aide Memoire. We will advise if their formal conclusions are materially different from what is noted in this paper.

COMMERCIAL-IN-CONFIDENCE

[Withheld under s9(2)(f)(iv) and s9(2)(g)(i)]

Multi-year funding certainty also provides KiwiRail with sufficient flexibility to indirectly act as a contingency, by giving the company the ability to draw down funding tagged for future years in the event that unforeseen events materially impact its business. Although this mechanism does not mitigate against cash shortfalls as such, it allows KiwiRail to commit to long-term capital plans and invest in the most appropriate and cost effective way.

Under a one-year funding model, KiwiRail is effectively competing for new funding each year. Whilst multi-year funding certainty is uncommon within the Crown's portfolio, the majority of other organisations have a much greater degree of certainty as they receive operating funding (which is more "institutionalised" and certain than KiwiRail's new capital funding) and effectively have depreciation funding to efficiently manage their investments (that may span across financial years).

Treasury's recommendation for funding

On the basis that there is no appetite to further investigate closure or major down-sizing of the rail freight network, our recommendation is for a multi-year funding commitment for KiwiRail in Budget 2015 on the basis that it reduces value leakage by enabling the entity to contract and operate more efficiently. Our recommendations are therefore:

<u>1st Preference:</u>

In the absence of any appetite to further assess possible major down-sizing, provide a three year multi-year appropriation of *[s9(2)(b)(ii)]* on the basis that the company needs certainty to manage its business and investment programme accordingly, and enter into more favourable contractual terms with suppliers.

<u>2nd Preference:</u>

In the event that a three year multi-year appropriation is unaffordable in Budget 2015, provide one year's funding of $209.6 million (representing funding of $194.6 million + $15 million contingency[3]), plus an 'in-principle' commitment[4] for years two and three *[s9(2)(b)(ii)]* (taking the three year total to *[s9(2)(b)(ii)]* – the amount being sought by KiwiRail in its review).

Ant Shaw, Senior Analyst, Commercial Operations - Governance and Performance, 04 917 6160
Fiona Chan, Manager, Commercial Operations - Governance and Performance, 04 917 6103

3 Contingency funding is recommended because KiwiRail should continue to invest in its assets and business on the basis that the Government is making a medium-term commitment to retain the business, and deferral of investment is only a short-term fix. Deferral of capital expenditure is not always possible, with some investment spanning across multiple financial years.

4 An 'in-principle' commitment was applied at the start of the Turnaround Plan in 2010 when a $250 million appropriation was made in Budget 2010, with an 'in-principle' commitment to provide a further $500 million in Budgets 2011 and 2012.

IN-CONFIDENCE

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2015/945 SE-2-13-1

Date: 5 May 2015

To: Minister of Finance (Hon Bill English)

Deadline: 5 May 2015

Aide Memoire: Briefing for KiwiRail Discussion

This aide memoire provides overview and background material for a discussion on KiwiRail. Specifically it discusses the benefits of multi-year funding KiwiRail as opposed to a single year appropriation, the cost savings associated with proposed [Withheld under s9(2)(b)(ii)] and KiwiRail's ability to defer capital expenditure (capex).

Benefits from Multi-year Funding

For projects that will be substantially contracted out to third parties and span over a number of financial years, multi-year funding certainty enables KiwiRail's suppliers to price contracts in ways that allow them to recover substantial up-front resourcing / establishment costs and deliver economies of scale. The significant multi-year projects that KiwiRail intends to contract out over the next 3 years include:

[Witheld under s9(2)(b)(ii)]

KiwiRail estimate total efficiencies of between *[Witheld under s9(2)(b)(ii)]* over the next three years from having certainty of funding over that period and being able to contract and operate more efficiently as a result. These savings are summarised in the table over page.

We note that the Government is considering only a two year funding commitment to KiwiRail. As such not all of these savings will be achievable. In order to realise maximum savings, verbal commitment to the Board to fund beyond two years is recommended.

[Witheld under s9(2)(b)(ii)]

KiwiRail's Estimated Capex Savings from Multi-Year Funding

3 Year Totals	Total Investment ($ millions)	Forecast Efficiencies ($ millions)	% Efficiencies
Significant 'contracted-out' projects	*[Witheld under s9(2)(b)(ii)]*		
Rolling stock procurement			
Other Capital expenditure			
Total			

We have discussed KiwiRail's assumptions with AECOM[2] who believe KiwiRail's estimates of efficiencies are conservative for what could be achieved.

[Withheld under s9(2)(f)(iv) and s9(2)(b)(ii)]

2 AECOM is an engineering consultancy firm with rail experience. Feedback from them on KiwiRail's assumptions was based on an informal discussion with them. AECOM is currently undertaking a more detailed assessment of KiwiRail's assumptions, but this was not available in the timeframe required.

[Withheld under s9(2)(f)(iv) and s9(2)(b)(ii)]

[Withheld under s9(2)(f)(iv) and s9(2)(b)(ii)]

KiwiRail's Ability to Defer Capital Expenditure

Presented below is KiwiRail's assessment of its ability to defer capex. Their analysis assumes that any deferred capex must be caught up the following year. Some deferral is possible for the first two years, but by FY18 the deferred capex catches up.

<u>Summary of KiwiRail's ability to Defer Capex</u>

$m	FY16	FY17	FY18

[Witheld under s9(2)(b)(ii)]

Source: KiwiRail

However in KiwiRail's Commercial Review it is noted that reducing capex will gradually reduce KiwiRail's operational earnings. It has a negative impact through increased network failure and reactive maintenance expenses, which ultimately reduce operational cashflows available for reinvestment into the business.

Enhanced KiwiRail Monitoring Regime

We will include in the draft KiwiRail Letter of Expectation specific mention of the Government's expectation that KiwiRail will facilitate an enhanced monitoring regime alongside Treasury. One of the key objectives of the enhanced monitoring regime is to provide greater visibility and comfort to Cabinet on KiwiRail's framework for planning and prioritising capital expenditure.

James Forsberg, Senior Analyst, Commercial Operations – Governance and Performance, 04 917 6240

Fiona Chan, Manager, Commercial Operations – Governance and Performance, 04 917 6103

Pages 4-5 withheld under s9(2)(f)(iv) and s9(2)(b)(ii)