

## Report 5: Outline Purchase Contract and Financial Model

To: Rail Development Group

From: William Peet [WITHHELD UNDER SECTION 9(2)(a) of the OFFICIAL INFORMATION ACT 1982]

Date: 21 August 2008

### Executive Summary

Ministers have directed that the Rail Development Group provide advice on rail industry issues and make recommendations to them for approval.

Report 2 recommends a contract between Ministers and KiwiRail for the purchase of non-commercial services.

The cost of provision of the services has been calculated as an annual operating subsidy for the business. This has been set at a level to produce a net present value for the forecast operating cash flows (including capital grants and all capital expenditure) equal to the opening debt i.e. a zero equity value.

The output of the modelling over the next 5 years is (\$m):

Item	2009	2010	2011	2012	2013
Commercial rail freight revenue	[WITHHELD UNDER SECTIONS 9(2)(b) and 9(2)(i) of the OFFICIAL INFORMATION ACT 1982]				
Crown operating subsidy revenue	90	92	95	97	99
Upgrades (growth + catchup but not metro)	92.9	153	206	161	151
Total subsidy	134	201	266	243	235
Operating subsidy % of total revenue	[WITHHELD UNDER SECTIONS 9(2)(b) and 9(2)(i) of the OFFICIAL INFORMATION ACT 1982]				
Total subsidy based on upgrades	[WITHHELD UNDER SECTIONS 9(2)(b) and 9(2)(i) of the OFFICIAL INFORMATION ACT 1982]				

### Recommended Action

I recommend that you:

- 1) **Note** this paper;
- 2) **Recommend to Ministers that they:**
  - a) **Note** the financial model underpinning the business plan; and
  - b) **Approve** a 5 year contract (average \$95m per year, total of 473m) to purchase non-commercial services from KiwiRail under Section 7 of the SOE Act, with an updated version to be submitted as part of the normal SCI and business planning process for 2008-9 and beyond.

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### Report: Purchase contract

#### Purpose of Report

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- 1) Ministers have directed that the Rail Development Group provide advice on rail industry issues and make recommendations to them for approval.
- 2) This report outlines the issues to consider regarding a contract to purchase non-commercial services from KiwiRail.

#### Background

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- 3) As covered in Report 2, it is proposed that the Government purchases non-commercial services from KiwiRail. This is based on the principle that without intervention, the commercial marketplace will gradually reshape the business until it provides adequate financial returns. The outcomes from this process are likely to be at odds to policy outcomes.

#### Outcomes from a commercial business plan

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- 4) The commercial business plan outlined first by Tranz Rail in its review of non-economic lines (“the pink bits”) in 2002 and by Toll with its “Plan B” would result in:
  - a) Abandonment of approximately 41% of lines, including:
    - All lines north of Helensville;
    - i) All track north of Oringi (including Napier – Gisborne);
    - ii) Stratford to Okahukura;
    - iii) Masterton to Woodville;
    - iv) Central part of North Island Main Trunk Line:
      - (1) Te Kuiti to Marton;
      - (2) Paraparaumu to Longburn;
  - b) Maintenance of over 80% of rail tonnage is maintained while approximately 50% of revenue is retained;
  - c) Rail would become predominantly a bulk operator of coal, forestry, milk and IMEX on limited routes. Most Intermodal traffic and nearly all domestic revenue would be exited; and
  - d) A coastal ship or road linehaul option would be run by Interisland Line to service limited domestic freight on Auckland to Christchurch.
- 5) The basis for this analysis is that every line segment must recover long run costs rather than a national network approach. If the same approach was applied to the roading network Transit would close a significant amount of our state highway network as road user charges applicable to many state highway would not cover the long run costs.
- 6) This also relies on being able to exit the costs for infrastructure without penalty, though under the lease and access right enjoyed by Tranz Rail and Toll they would remain liable for restitution. This is largely theoretical for such a large amount of track to be exited and would either trigger forgiveness of the obligation or default under the lease. Under the new regime the costs of closing line segments would also be significant as an obligation would continue to exist to ensure assets (e.g. bridges) remain safe until ownership transfers to someone else.

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- 7) Such draconian options are unlikely to be helpful when considering optimal outcomes as they place disproportionate incentive on gaming.

### Outcomes sought in addition to the commercial business plan

- 8) As described in Report 2, any intervention away from a pure commercial model has to drive towards different outcomes to those occurring in the absence of such intervention. From our experience and subject to feedback, the desired outcomes to be achieved appear to be:
- a) Freight:
    - i) Baseline
      - (1) A national network: all lines open with regular rail ferry services, most of the time;
      - (2) Services on all lines, at least weekly;
      - (3) Achieve modal shift to rail from road (as opposed to rail to and from coastal ship, other than at the margin), prioritised according to the value of taking incremental traffic off roads in various corridors (for example shifting NTKs to rail in Auckland-Tauranga are likely to be more valuable than NTKs in Southland in terms of avoided roading costs).
  - b) Passenger Metro:
    - i) Substantial increase in Auckland as per the Rail Development Plan from the ARC and ARTA, resulting in a reducing per head contribution from taxpayers;
    - ii) Moderate increase in Wellington as per the GWRC rail upgrade plan;
    - iii) Other commuter services as commercially justified or as supported by NZTA;
  - c) Long distance passenger:
    - i) Domestic and international tourist services on Christchurch – Greymouth, Christchurch – Picton and Wellington – Auckland;
    - ii) Other services as commercially justified;
    - iii) Non-scheduled heritage train services at a similar level to today at minimum cost;
  - d) Passenger, car and commercial vehicle movement across Cook Strait to continue to be purely commercial; and
  - e) State sector level of compliance – assets, processes and systems in proper state.
- 9) These will need to be further developed around specific service levels, such as level of self-insurance for major adverse events and these should be done by the establishment unit over the next 6 months.
- 10) There needs to be a forward commitment (recommended to be 5 years) to this subsidy to incentivise efficient decision making and implementation of initiatives. The State Highway funding guarantee process approved in 2007 provides a good benchmark.

### Financial summary

A detailed model by business unit has been developed based on the ONTRACK/PwC work in late 2007. It integrates the modelling done by both KiwiRail and ONTRACK as part of business planning this year and reflects the following assumptions:

[WITHHELD UNDER SECTIONS 9(2)(b) and 9(2)(i) of the OFFICIAL INFORMATION ACT 1982]

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- 11) Detailed assumptions are contained in the Appendix to this paper.
- 12) The model has been used to derive an annual operating subsidy for the business. This has been calculated at a level to produce a net present value for the forecast operating cash flows (including capital grants and all capital expenditure) equal to the opening debt i.e. a zero equity value.
- 13) The output of the modelling over the next 5 years is (\$m):

<b>Item</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
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**Appendix A: KiwiRail Forecast Assumptions**

[WITHHELD UNDER SECTIONS 9(2)(b) and 9(2)(i) of the OFFICIAL INFORMATION ACT 1982]