

10 February 2021

OC210034

Hon Michael Wood
Minister of Transport

Action required by:
At your convenience

Advice requested on KiwiRail's iReX project (interisland ferry replacement)

Purpose

To respond to your request for further advice on your responsibilities, as Minister of Transport, key decision timeframes and decision-making rights for KiwiRail's iReX project (interisland ferry replacement). This follows advice from the Ministry of Transport regarding Budget 2021 transport sector initiatives.

Key points

- The decision on the type/size of vessels is a commercial decision for KiwiRail's Board. Decisions on port and landside infrastructure to accommodate the new, larger ferries are also commercial and subject to negotiations between KiwiRail, CentrePort in Wellington and Port Marlborough in Picton.
- Ministers have limited power to direct KiwiRail. However, Treasury has advised that KiwiRail will require approval of shareholding Ministers before signing a ship build contract. KiwiRail has submitted a 2021 budget bid seeking \$565 million; this is additional to the \$400.1 million provided for the ferries in Budget 2020.
- With regard to this project, your role as Minister for Transport is to consider implications for the transport system and how the project aligns with Government transport priorities, such as:
 - whether the proposed changes will provide the right transport service that is required across the Cook Strait
 - potential resilience implications for the transport system from the change
 - costs of reconfiguring the road and rail networks that connect to the ferry terminals, including how these may be funded
 - potential implications for competition across the Cook Strait and how that may impact on transport outcomes.
- The Ministry believes there are limited options for shareholding Ministers to respond to the proposed Budget bid from KiwiRail. In our view, shareholding Ministers either:

- agree to fund the full amount sought in Budget 2021. This choice commits the Crown to the programme in full, and potentially risks further requests for funding as landside costs become clearer.
- defer funding in Budget 2021 to allow more time to consider the commercial case and transport implications of the programme. This may include reconsidering other ferry design options that KiwiRail has previously discarded.
- The option to defer funding would raise significant concerns with KiwiRail given it has already undertaken the Request for Proposal to appoint the ship build contractor and is expecting to enter into a contract in June 2021. However, the Ministry does not think it is preferable to move forward with the proposed project at this time. Once ship-build contracts are signed for this particular design of ferry, this locks in the need for the significant terminal redesign and road/rail connections for the ferries. The implications and cost of this work is not yet known.
- We recommend you discuss the Ministry's concerns with shareholding Ministers to determine how they wish to proceed. We expect that shareholding Ministers may also seek further advice from the Treasury about the commercial case for the proposed ferry design.

Recommendations

We recommend you:

- | | | |
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| 1 | agree to discuss the various options with progressing the iRex budget bid with KiwiRail's shareholding Ministers, to confirm whether they endorse it proceeding through the Budget 2021 process in its current form. | Yes / No |
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Harriet Shelton
Manager, Supply Chain

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Hon Michael Wood
Minister of Transport

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- Minister's office to complete:**
- | | |
|--|---|
| <input type="checkbox"/> Approved | <input type="checkbox"/> Declined |
| <input type="checkbox"/> Seen by Minister | <input type="checkbox"/> Not seen by Minister |
| <input type="checkbox"/> Overtaken by events | |

Contacts

Name	Telephone	First contact
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Callum Gill, Adviser, Supply Chain		

Cabinet previously agreed to fund KiwiRail’s purchase of two large rail enabled ferries

- 1 Cabinet previously agreed to fund, through Budget 2020, KiwiRail’s purchase of two large rail enabled ferries to replace its current fleet of three ageing vessels, and the required landside facilities (KiwiRail’s Inter-Island Resilience Connection (iReX) project).
- 2 The principle of replacing the interisland ferry assets is part of the Government’s investment priorities in the New Zealand Rail Plan and the Future of Rail “resilient and reliable” investment scenario agreed to in principle by Cabinet.
- 3 However, the exact specifications of the ferries are a commercial matter on whose development KiwiRail has led. The Treasury, as the advisor to shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises), is also engaged in KiwiRail’s iReX programme.
- 4 In Budget 2020, Cabinet agreed to provide \$400.1 million towards the iReX project. As part of this funding, Cabinet also directed KiwiRail to provide regular reporting to you and its shareholding Ministers on progress of the ferry replacement project, including a full breakdown of financial performance and the impact of additional debt on KiwiRail and ability to repay that debt.
- 5 At that time, the expectation was the remainder of the capital expenditure for the project was to be funded through debt of approximately \$700 million. KiwiRail’s Budget 2021 bid notes that following a review of its capital structure by Ernst & Young, a more prudent ratio of debt to equity should be considered for the project (with a funding cap of \$320 million).
- 6 KiwiRail is now seeking an additional \$565 million for the project through Budget 2021. This is made up of reduced debt financing for the vessels due to the newly imposed debt funding cap (approximately [37] and increasing vessel and landside costs (approximately [37]

KiwiRail has advised of the following timeframes for the project

- 7 KiwiRail initiated its procurement process in March 2019, notifying the market of its intent to replace its ferries. In August 2019, KiwiRail provided prospective suppliers with its high-level ship requirements and received 28 responses. KiwiRail concluded its selection process by issuing a Letter of Intent to Hyundai Mipo Dockyard in late December 2020.
- 8 KiwiRail advises that the critical milestone is entering into the ship build contract in June 2021 with Hyundai, which is dependent on funding certainty through the Budget 2021 process. KiwiRail notes that without funding, it would delay the arrival of the new fleet and compromise the Interislander service. An outline of the key project milestones is given below.

Vessel replacement timeline

- December 2020: Signing of Letter of Intent with Hyundai Mipo Dockyard
- March to May 2021: Final technical and commercial negotiations with successful respondent
- June 2021: Entry into contract
- Early 2022: Complete basic design and received approval from classification society
- November 2022: Ship 1 construction underway
- November 2023: Ship 2 construction underway
- October 2025: Ship 1 delivered to NZ/then enters service
- June 2026: Ship 2 delivered to NZ/then enters service

Picton Terminal

- December 2020: Terminal concept design complete
- December 2020: Consents lodged under fast track
- January 2021: Fast Track consenting review process underway
- October 2021: Detailed design
- March 2022: Construction underway (ready by mid 2025)

Wellington Terminal:

- December 2020: Location decision (Kaiwharawhara)
- May 2021: Terminal concept design underway
- April 2022: Fast Track consenting underway
- September 2022: Detailed design underway
- June 2023: Construction underway (ready by August 2025)

9 Note that KiwiRail expect to replace its ferries in 2025/26. Beyond this point, the current fleet would require further capital investment (on top of what they are already receiving from 2021-24) to ensure that they stay in class and are serviceable until replacement vessels arrive.

Role and responsibilities for the iReX project

The decision on the type/size of vessels rests with KiwiRail's Board

10 The decision on the type/size of vessels and other detailed specifications is a commercial decision for KiwiRail and its Board. KiwiRail's proposed new interisland ferries will require bespoke terminal infrastructure in both Wellington and Picton upon arrival. Port and landside infrastructure decisions are also commercial in nature and subject to negotiations between KiwiRail, CentrePort in Wellington and Port Marlborough in Picton.

The role and responsibilities of KiwiRail's shareholding Ministers

- 11 KiwiRail's shareholding Ministers are responsible for subscribing to equity injections, as KiwiRail does not generate sufficient cash to cover its cash outflows for operations and/or its capital investment programme.
- 12 As the iReX project is largely a commercially driven investment, the expectation is that shareholding Ministers will consider funding the project largely based on its commercial benefits. Shareholding Ministers will also consider this alongside broader benefits, Cabinet decisions, and whether funding has already been provided for iReX in previous Crown appropriations. This means transport implications are also likely to be a key consideration.
- 13 The most direct levers that shareholding Ministers have available to influence KiwiRail's performance are through the annual business planning process, including the annual letter of expectations, decisions on the funding level of the organisation, and the appointment of Board members.
- 14 Under the State-Owned Enterprises Act 1986 (the SOE Act), shareholding Ministers have limited power to direct KiwiRail's Board. Investment decisions are the responsibility of the Board. However, given the significant value of the new ferries, it is likely to be defined as a major transaction under the Companies Act 1983 and would require the approval of shareholding Ministers, even if KiwiRail did not seek new Crown funds.
- 15 Alternatively, if KiwiRail seeks new Crown funding, as has been proposed through Budget 2021, these funds will be paid to KiwiRail through a shareholder equity injection which shareholding Ministers will need to sign-off and subscribe to.
- 16 So, while the KiwiRail Board has final responsibility for deciding the type/size and specifications of the vessels it will procure, KiwiRail's current financial situation means that it cannot proceed if shareholding Ministers do not support the proposal.
- 17 Shareholding Ministers have also told KiwiRail that they want to be consulted before any ship building contract and/or major infrastructure decisions in Wellington or Picton are entered into.

Your role as the Minister of Transport

- 18 As you know, your responsibilities relate to considering the impacts of KiwiRail's commercial investment decisions on the transport system. This means considering issues such as whether there are sufficient transport services across the Cook Strait (which is often considered an extension of State Highway One), and how the choices by commercial operators may impact on the landside connections (road and rail) that may require funding from the National Land Transport Fund (NLTF).
- 19 You are also responsible for Vote Transport, through which KiwiRail is funded. In this context, your role is to consider the nature and levels of funding for rail through Vote Transport, and how this funding contributes to government transport outcomes. However, it is important that shareholding Ministers endorse the iReX bid if it is to proceed, given the commercial nature of the project.

- 20 Treasury will provide commercial advice to shareholding Ministers on the project. The Ministry's role is limited to considering and advising on the transport implications of the project.
- 21 Through the Future of Rail review, funding principles were agreed to delineate between commercially-focussed investment decisions for KiwiRail and broader transport investment decisions for the rail system.

The Ministry has some concerns about the transport implications of the project

- 22 The Ministry received the updated draft iReX business case on 28 January 2021. KiwiRail's Board has not yet approved the business case. The Ministry and the Treasury have not had sufficient time to review the business case at the time of writing this briefing.
- 23 However, the Ministry continues to have concerns with the process and the potential transport implications of the project.

Proposed ferries go beyond Future of Rail intentions

- 24 The intention of the reliable and resilient investment scenario was to replace KiwiRail's aging assets, including the interisland ferries, with like-for-like assets. Cabinet did not agree to proceed with a growth scenario.
- 25 The Ministry considers that the current proposal for the ferries have extended beyond the intended reliable and resilient investment scenario.
- 26 The expectation was also that above rail assets were considered on the basis of their commercial investment case. We are aware that further advice needs to be sought on the commercial case from the Treasury.

Alignment of terminal infrastructure

- 27 As you are aware, KiwiRail's preferred vessels are dependent on upgraded terminal and berthing infrastructure at Wellington and Picton. KiwiRail anticipates construction of the Wellington terminal to commence in late 2022/early 2023 to be ready for use for the arrival of the first new ship in late 2025 and be completed in 2026.
- 28 The publicly available programme business case (PBC), published by the Wellington Future Port Forum, set up to determine the location of the Wellington Terminal, indicated terminal infrastructure in Wellington would not be completed until late 2028. This was prior to the recent challenges with the commercial negotiations between KiwiRail and CentrePort over the preferred location of the terminal, further delaying this timeline by over six months.
- 29 We are concerned that the required terminal infrastructure will be locked in once contracts for ship-build are signed. Given the nature of the process to date, we are concerned that the terminal costs estimates may not be robust at this time and that there is a high risk of continued cost escalation.

Funding of land transport infrastructure

- 30 The Ministry has similar concerns about costings for land transport infrastructure, and the potential implications for the NLTF. Waka Kotahi NZ Transport Agency (Waka Kotahi) will be responsible for considering funding for any road realignment required to support the project. The costs of rail realignment will also need to be considered through either the NLTF or Crown processes. These realignments will need to be considered in both Wellington and Picton.
- 31 The Ministry considers that these costs need to be factored into the overall financial and economic viability of the proposal in the business case.

Consideration of competition across the Cook Strait

- 32 Two commercial inter-island ferry operators currently service the Cook Strait route; KiwiRail's Interislander service, and the StraitNZ-owned and operated Bluebridge service. Bluebridge, which currently provides over 40 percent of the capacity across the Cook Strait on a per lane-metre basis, is a privately owned commercial operator, and does not receive any Crown funding.
- 33 Competition on the Cook Strait route is an important commercial driver. The impact of the Crown's investment in the iReX project on competition requires investigation and consideration. We want to avoid a situation where Bluebridge is crowded out of the market by KiwiRail's proposed two large vessels, potentially leading to a monopolistic market.

Next steps

- 34 As you are aware, Budget 2021 bids, including the iReX bid, were submitted to the Treasury as part of Budget 2021. An updated business case has been submitted for the iReX programme.
- 35 At a minimum, we recommend you discuss risks and transport implications with shareholding Ministers to confirm whether they endorse the project proceeding through the Budget 2021 process in its current form.
- 36 Depending on this outcome, the Ministry only sees two viable options for Ministers to consider when proceeding with the iReX Budget bid – to accept the risks and fund the full amount sought (subject to further advice from Treasury), or defer the project to get greater comfort with the direction of travel.
- 37 We have considered whether there is a middle ground option to maintain momentum for the ship procurement process, but see these two options as the only viable pathways forward.

Option 1: Agree to fund KiwiRail's Budget bid for the full \$565 million to deliver both the ferries and required landside facilities

- 38 To ensure there are no delays in delivery for either the ferries or the landside facilities, Ministers could agree to provide KiwiRail with \$565 million, noting that KiwiRail has stated it expects to bring those costs down through further financing and other work. By how far costs may be reduced is not clear in the business case.

- 39 Shareholding Ministers may wish to put in place stage gates for the project with expectations that KiwiRail report back as that work is completed and prior to entering into contracts.
- 40 The Ministry of Transport does not support this option, as we believe that more work is required to determine the accuracy of the costings and timelines provided. Given the business case by KiwiRail has not been reviewed in-depth, there is a risk that further funding will be required from the Crown if the costs provided were too low, which is a particular risk for the landside costs. The late decision to move back to Kaiwharawhara also means that the costings have not had much time to be revised or examined.
- 41 We consider that these issues, as well as the commercial case for investment, need to be examined in more detail by the Treasury.

Option 2: Defer funding the iReX bid as part of Budget 2021 and commission external experts to review the KiwiRail business case

- 42 If shareholding Ministers decide to not support the iReX bid in its current form, further work needs to be done to consider the viable alternative options. This will involve KiwiRail and the Treasury reconsidering the options and the commercial case for those options. We also expect that the Treasury will seek the Ministry's input on the transport implications of the proposals.
- 43 It is possible that the Treasury may want to engage with external experts to assist with their work, given the scale and specific nature of the business case.
- 44 There are a number of areas that we consider require further consideration before a decision is taken. Such areas could include:
- Seeking further advice on the potential financing options KiwiRail is still considering, and its plans to manage these costs. We would expect that the road/rail costs would be factored into the Net Present Value (NPV) for the project.
 - Exploring the commercial case of the current proposal while seeking further advice from KiwiRail on the NPV of the alternative options that KiwiRail previously discarded (for example three medium sized ships, road enabled only ferries).
 - Exploring the transport implications, including seeking input from Waka Kotahi on the road/rail connections. This would also need to consider any competition implications with the Bluebridge service, and to what extent the new KiwiRail ferries would impact on this private operation.
 - Exploring whether there is a need for a revised governance structure for the project, and how all relevant stakeholders' input is considered as part of the process. We would anticipate that that relevant parties would include GWRC, Centreport, Port Marlborough, Marlborough District Council, Waka Kotahi, Bluebridge, the Treasury, Ministry of Transport, and the Infrastructure Commission.

Implications for KiwiRail if the Crown defers funding

- 45 If, through Budget 2021, the Crown decides no additional funding or a sum that is less than what KiwiRail is seeking is available for the programme, there are implications for its existing fleet, which is expected to retire in 2025.
- 46 KiwiRail is separately seeking \$26-32 million per year from 2021-24 to maintain the current ferry assets. We could assume that if there is a delay in the iReX project, which currently expects new ships in late 2025, that KiwiRail may seek further funding to continue the maintenance of the current ships.
- 47 Delaying would also have other consequences, including delaying increased revenues for KiwiRail, damaging KiwiRail's reputation with the Hyundai Mipo Dockyard which is expecting to sign a contract in June 2021, and potentially increasing the overall costs for the ferries due to foreign exchange risks. In addition, the 40 percent carbon emissions reduction that is expected from the new ferries will not be realised in the time anticipated.
- 48 We expect Treasury would need to seek further input from KiwiRail to fully understand the consequences of deferral.
- 49 The Ministry also recommends that, if Ministers agree to deferring funding, they inform KiwiRail of this decision as soon as practicable. This will allow KiwiRail to consider the implications of this on the business and reconsider their available options. It also means they can stop or slow down negotiations with their selected supplier before anything formal is agreed.