

Terms of Reference: a review of the entity form of KiwiRail Holdings Limited and the New Zealand Railways Corporation

Purpose of review

1. This Terms of Reference will guide work, the objective of which is to:
 - a. Review the extent to which the current entity form of KiwiRail Holdings Limited (KiwiRail) and the New Zealand Railways Corporation (NZRC) as two State-Owned Enterprises (SOEs) support Government objectives
 - b. Determine if any changes to the status quo would better enable KiwiRail and NZRC to achieve outcomes sought by Government, including making changes from the SOE form
 - c. Advise Ministers on the above two matters, and determine next steps following Ministerial consideration.

Context

Purpose of Rail

2. As part of the Future of Rail Review it was recognised that the Government was seeking a number of outcomes from the rail system and that a clear purpose needed to be articulated. A description of rail benefits was noted as:

“Rail contributes to national and regional economic growth, reductions in emissions and congestion, and has the potential to reduce road deaths and injuries, facilitate wider social benefits, and provide resilience and connection between communities¹.”

3. The New Zealand Rail Plan articulates the Government’s strategy for rail in New Zealand.

Entity form and activities

4. KiwiRail and the New Zealand Railway Corporation (NZRC) are SOEs, pursuant to the State-Owned Enterprises Act 1986 (the SOE Act).
5. Section four of the SOE Act states (in part):
 - (1) *The principal objective of every State enterprise shall be to operate as a successful business and, to this end, to be—*
 - (a) *as profitable and efficient as comparable businesses that are not owned by the Crown; and*
 - (b) *a good employer; and*
 - (c) *an organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so.*

¹ DEV-19-MIN-0123 refers.

6. NZRC's function is limited to holding designated Crown railway land and leasing it to KiwiRail, in the form of a multi-decade core lease. This is NZRC's only form of revenue other than management fees charged to KiwiRail.
7. KiwiRail is an integrated rail network operator. Its operations can be categorised as:
 - a. above-rail, predominantly commercial in nature, consisting of rail (freight and tourist) and ferry operations across the Cook Strait, and management of a commercial property portfolio with commercial tenants typically in the freight and logistics sectors
 - b. below-rail, predominantly a public benefit operation, consisting of the ownership, development and operation of the rail network itself, such as tracks, tunnels, bridges, track and train signals and associated infrastructure.
8. This distinction has been reinforced through the recently completed Future of Rail review, which has resulted in a funding framework that reflects:
 - a. above-rail investment and operational decisions should be made on a commercial basis (KiwiRail is currently implementing a multi-year 'Pathway to Profit' which seeks to transition KiwiRail's above-rail operations to a state of commercial self-sufficiency where no Crown equity funding is required from FY24/25 to maintain the current scope of operations)
 - b. below-rail operations are funded on a public benefit basis, largely through the National Land Transport Fund (NLTF) (in line with an agreed Rail Network Investment Programme and with the support of Crown contributions and track user charges paid by KiwiRail) and by access charges paid by metropolitan rail users and other users.
9. The reformed funding framework ensures that rail infrastructure investment decisions are made as part of an integrated land transport system. The Future of Rail review also recommended that KiwiRail operate separate above-rail and below-rail financial accounts to support transparent decision-making. However, the distinction between above- and below-rail functions is only for funding and transparency purposes. In practice KiwiRail operates as a single integrated entity.
10. In May 2020 Cabinet noted that there "will be no changes to KiwiRail's organisational form or structure at this time, and that KiwiRail will continue to operate as a vertically integrated SOE" [DEV-20-MIN-0082 refers]. Cabinet also noted "that a further review of KiwiRail's SOE status will be initiated in December 2020, and reported back to Ministers in October 2021". Ministers subsequently agreed that the start of the review would be deferred to mid-2021.
11. KiwiRail's shares are equally held, on behalf of the Crown, by the Minister of Finance and the Minister for SOEs (shareholding Ministers). Each of KiwiRail and NZRC have their own boards of directors, with recent convention being a common Chair across both entities.

Challenges arising from the status quo

12. The Future of Rail review explicitly acknowledges that the Government is seeking both commercial and public benefit outcomes from KiwiRail. As noted above, the review made a number of changes to improve transparency and funding decisions made in relation to KiwiRail. However, there is a desire to confirm that those changes are sufficient to achieve the outcomes the Government is seeking from KiwiRail and whether there are sufficient levers for the Government if KiwiRail remains in its SOE form.

13. There are also questions about KiwiRail's reliance on Crown funding (forecast to only be required for below-rail activities from FY24/25) and public benefit purpose, and the consistency with the objectives and accountabilities set under the SOE Act. The delivery of improved metro network infrastructure, and access to that network, is a particular area where the principal objective of the SOE Act "to operate as a successful business" may not be consistent with the rationale for Crown investment "to support the growth of commuter passenger services". As noted in paragraph 8 above, KiwiRail is looking to improve the commercial performance of its above-rail activities through a 'Pathway to Profit' initiative.
14. When considered from a combined above- and below-rail perspective, KiwiRail is not a viable commercial business as it generates only a portion of the cash required to fund its investment in above- and below-rail assets. The Crown's willingness to meet the funding gap is due, in large part, to the Crown's desire to purchase wider public benefits associated with rail, such as reduced road congestion and lower emissions. Under the Future of Rail, once certain above-rail 'catch-up' equity investments have been made, this funding gap will be met through the NLTF-funded below-rail RNIP (non-equity) funding stream (which the Crown also contributes operating funding to).
15. During the Future of Rail review, Cabinet requested that the Treasury and the Ministry of Transport jointly lead a review of KiwiRail's SOE status [DEV-20-MIN-0082 refers].

Scope

16. In order to achieve its objective, the review will consider:
 - a. the extent to which the Government is seeking commercial-for-profit business outcomes from KiwiRail as opposed to non-commercial public benefit outcomes, including the purpose of rail as articulated in the Future of Rail review
 - b. how KiwiRail's performance continues to be measured given its focus on a mix of commercial and non-commercial outcomes, including the roles and responsibilities of monitoring outcomes
 - c. whether Ministers have sufficient transparency and appropriate levers following the changes being implemented under the Future of Rail review to enable the Government to achieve the public benefit outcomes expected from KiwiRail
 - d. how the funding principles recommended under the Future of Rail are operationalised to ensure that KiwiRail's Board, shareholding Ministers and Policy Ministers all have the ability to take the decisions they are expected, or are legally required, to take
 - e. the extent to which the status quo creates challenges around the roles and responsibilities of KiwiRail and NZRC's Directors, Ministers and officials
 - f. the benefits and disbenefits associated with entity form alternatives, including in attracting the right skills required for KiwiRail and enabling the right culture considering the mix of both public benefits and commercial outcomes sought
 - g. progress made to separate KiwiRail's above- and below-rail financial reporting, and the benefits and disbenefits that could arise from further internal functional separation, including the consideration of subsidiary company structures
 - h. if, under the current status, KiwiRail's incentives and performance measures for optimising asset management and investment prioritisation align with Government expectations

- i. whether the status quo or any proposed alternative creates any issues in terms of restricting competition or access to the rail network, including through the role of NZRC
 - j. the costs and benefits of bringing KiwiRail closer to Ministerial direction.
- 17. The pros and cons of any change that could be made to the status quo to better enable KiwiRail and NZRC to achieve outcomes sought by Government, including the practicality of any change and how changes could be made in a way that mitigates risk and minimises disruption to the sector, need to be considered carefully in the review. On the basis of previous experience on structural change, it is acknowledged that there is a high bar for changes to an entity form and that consideration should also be given to achieving the Government's outcomes in the current SOE form.
- 18. The Ministry of Transport is also currently undertaking a review of the system issues that may have contributed to the rolling contact fatigue in Auckland. Following this, it intends to initiate a review of the metropolitan rail operating model, which may have interdependencies or implications for this review.

Out of scope

- 19. The review will not consider:
 - a. a change of ownership of KiwiRail and/or NZRC, including, for example, the privatisation of assets or functions
 - b. structural separation of KiwiRail away from its current vertical-integration model of an "above-rail" business and a "below-rail" operator of rail track asset management.

Participants and engagement

Project structure, governance and communications

- 20. The review will be jointly led by officials from the Treasury and the Ministry of Transport.
- 21. A Steering Group will be established with overall accountability for the delivery of the review to Ministers. The Steering Group will be comprised of one representative from each of:
 - a. The Treasury
 - b. The Ministry of Transport.
- 22. The Steering Group may invite other organisations, including KiwiRail and the Public Service Commission, to attend and/or present at its meetings.
- 23. A Working Group will be established to progress the review and report to the Steering Group. This group will consist of representatives from the Treasury, the Ministry of Transport, the Public Service Commission and KiwiRail.
- 24. Given its responsibility for reviewing the governance and structures of government, the Public Service Commission will be a key participant in the review. Likewise, KiwiRail will also contribute crucial sector expertise to the review.

25. Membership of the Working Group will not bind organisations to provide separate advice to Ministers if they deem it necessary.
26. The review will also be able to seek external input outside of the working group, for example, through interviews with key participants in the rail and freight system, KiwiRail and NZRC Board members (past and present) and relevant Ministers. External input of this nature will be determined by the Steering Group as required.
27. Expert input or resource may also be contracted by respective organisations as required.
28. The organisations that are members of the Working Group will work openly and collaboratively together on this review. To that end, Working Group members agree to consult other members of the Working Group prior to making any public comment, such as a media statement, in regard to this review.

Timeframes and engagement with Ministers

29. The Steering Group will report to shareholding Ministers and the Minister of Transport, copying in the Minister for the Public Service, where any significant decisions are required.
30. Shareholding Ministers and the Minister of Transport will be provided with advice on the matters outlined in the scope of the review by no later than 30 June 2022. This advice will be copied to the Minister for the Public Service.
31. The Steering Group will be responsible for determining and co-ordinating internal timeframes to ensure the timely delivery of advice.
32. Following the delivery of this advice, the next steps will be determined on the basis of decisions made by Ministers, and wider Ministerial consultation, if required.