

Treasury Report: KiwiRail - advice on iReX project for meeting on 8 March 2021

Date:	3 March 2021	Report No:	T2021/442
		File Number:	SE-2-25-2

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson) Minister for State Owned Enterprises (Hon Dr David Clark)	Agree to the recommendations.	8 March 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Michael Moore	Principal Advisor, Commercial Performance [39]	[35]	✓
Ann Webster	Acting Manager, Commercial Performance		

Minister's Office actions

Return the signed report to Treasury

Note any feedback on the quality of the report

Enclosure: No

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Executive Summary

KiwiRail's shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises) are meeting with the Minister of Transport on 8 March 2021 to discuss KiwiRail's Budget 2021 bid for new interisland ferries (Project iReX). KiwiRail is seeking \$565 million in additional funding through Budget 2021. Project iReX has already had \$435 million appropriated through Budgets 2019 and 2020.

The meeting was called as a response to the Ministry of Transport briefing its Minister outlining its concerns with the increasing scale and cost of the iReX project (OC210034 refers). The Treasury largely shares these concerns. We note that the detailed iReX business case provided by KiwiRail for its Budget 2021 bid is still in draft form and has yet to be finalised by KiwiRail's Board.

We advise that the key matter to consider in the meeting is whether KiwiRail's iReX budget bid proceeds for further consideration as part of the overall Budget 2021 package, or if Ministers decide to defer the bid. The Minister of Finance will receive advice this week on the draft Budget 2021 package, including on transport initiatives.

Since the Budget 2020 bid, where \$400 million was appropriated, the following cost changes have occurred:

- a the cost of the two ferries have increased to [37]
- b portside costs, including to ensure Picton and Wellington can accommodate the larger ferries, have increased to over \$1 billion
- c KiwiRail's ability to debt-fund part of the cost has decreased from approximately \$700 million to \$320 million.

KiwiRail is currently undertaking detailed contract negotiations with a shipbuilder, with a view to signing a contract in mid-2021. Contract signing will effectively commit KiwiRail, and contributors to portside costs, to a project now estimated at \$1.76 billion. KiwiRail will require further Crown funding (ideally, in its view, through Budget 2021) to be able to enter into this contract in good faith.

If the Budget 2021 bid proceeds, and KiwiRail enters into this contract, there will be very limited ability to amend ship design. As a result, Ministers will likely be faced with limited options regarding portside infrastructure and face the associated costs and risks.

We recommend that you defer KiwiRail's 2021 iReX budget bid, and instruct officials to prepare a letter for you to send to KiwiRail advising them of this deferral. This recommendation aligns with Vote team advice in the draft Budget 2021 package. We recommend that next steps include a review of the iReX business case and governance arrangements.

Recommended Action

We recommend that you **agree** to defer the KiwiRail iReX Budget 2021 bid, and instruct officials to draft a letter to this effect for KiwiRail's shareholding Ministers to consider.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

Ann Webster
Acting Manager, Commercial Performance

Hon Grant Robertson
Minister of Finance

Hon Dr David Clark
Minister for State Owned Enterprises

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Purpose of Report

1. This briefing provides background information for your meeting on 8 March 2021 to discuss KiwiRail's replacement ferry budget bid. It outlines key matters that we recommend you consider during the meeting.

Background

2. KiwiRail's shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises) are scheduled to meet with the Minister of Transport on 8 March 2021.
3. The meeting was arranged by Ministers' offices in response to a briefing from the Ministry of Transport (OCU210034 refers) that discussed KiwiRail's interisland ferry replacement project (Project iReX). The Treasury was consulted in the preparation of this advice.
4. The briefing outlined the separation of roles and responsibilities, particularly around Budget processes, between KiwiRail's shareholding Ministers and the policy Minister (the Minister of Transport). It expressed concern that iReX costs are escalating; KiwiRail is seeking \$565 million through Budget 2021, in addition to \$435 million in funding appropriated through Budgets 2019 and 2020.
5. This briefing provides background information on the iReX project and outlines key matters that we recommend you consider during the meeting.
6. We advise that the key matter to determine during the meeting is whether KiwiRail's iReX budget bid continues to proceed through the Budget process or not. If you determine that it should not proceed, we recommend you advise KiwiRail as soon as practicable.
7. Please note that the Minister of Finance will also receive advice later this week on the draft Budget 2021 package, which will detail Vote team assessments of transport initiatives. The preliminary recommendation on the iReX Budget bid is for the bid to be deferred until a final Detailed Business Case can be considered.

KiwiRail is seeking to replace its current aging ferry fleet

8. KiwiRail's current fleet of three Interisland ferries are approaching the end of their useful life. The cost to maintain the fleet and ensure they meet maritime standards will increase as they age.
9. To future-proof its ferry business, KiwiRail is in the process of procuring two larger, rail-enabled ferries, to enter service by the mid-2020s.
10. KiwiRail received \$35 million in Budget 2019 to undertake detailed design work on the ferries. A further \$400 million was appropriated in Budget 2020 to fund the ferries themselves. At the time, KiwiRail indicated that the balance of approximately \$700 million would be debt funded.
11. Ernst and Young subsequently reviewed KiwiRail's capital structure and recommended a debt ceiling of \$320 million. This reduction in debt funding, plus cost increases in the

past year, most notably for portside developments in Wellington and Picton, have led to KiwiRail submitting a Budget 2021 bid for a further \$565 million.

12. We note that at the end of 2020 KiwiRail signed a non-binding Letter of Intent with Hyundai Mipo Dockyard in South Korea. KiwiRail is currently undertaking more detailed contract negotiations with Hyundai Mipo, with the intention to sign a contract by mid-2021.
13. KiwiRail has released a number of press releases on iReX, most notably:
 - a 27 May 2020: Notification, following Budget 2020, that KiwiRail is planning to procure two new large ferries¹
 - b 16 December 2020: KiwiRail agreed to the proposal that the new ferry terminal be at Kaiwharawhara rather than Kings Wharf²
 - c 22 December 2020: Builder of the ferries, and a non-binding Letter of Intent announced³.
14. While these announcements may create a degree of public expectation, they are not, in any way, binding.
15. The size and specifications of the ferries are operational decisions for the Board of KiwiRail to make. However, as KiwiRail cannot fund the ferries from its own balance sheet, and has received Crown funding, and is seeking further Crown funding, shareholding Ministers have greater involvement in the ferry procurement process.
16. In October 2020, KiwiRail's shareholding Ministers wrote to KiwiRail stating their expectation that KiwiRail consult them and the Minister of Transport prior to KiwiRail signing an agreement with any prospective shipyard or for any significant portside infrastructure development. KiwiRail was also expected to provide the same Ministers with detailed progress against the programme, including a full breakdown of financial performance, additional debt that KiwiRail may be taking on and KiwiRail's ability to service that debt.
17. The Treasury has received further information from KiwiRail on its iReX programme, largely in relation to its 2021 Budget bid, but we still have concerns on the viability of the project.

Key matters for Ministers' consideration

18. Ministry of Transport's briefing to the Minister of Transport raised several concerns with the iReX budget bid, which the Treasury largely shares.
 - a the specifications of the proposed ferries go beyond the policy objectives of the Future of Rail review
 - b there are alignment risks between KiwiRail's preferred vessels and terminal infrastructure upgrades
 - c potential land transport costs for roading realignment required to support the project
 - d consideration of competition across the Cook Strait.

¹ <https://www.kiwirail.co.nz/media/next-step-for-new-generation-interislander-ferries/>

² <https://www.kiwirail.co.nz/media/kiwirail-focuses-on-new-ferry-terminal-at-kaiwharawhara/>

³ <https://www.kiwirail.co.nz/media/world-renowned-shipyard-chosen-to-build-new-interislander-ferries/>

19. Treasury shares the Ministry of Transport's concerns around the strength of the case for the two large rail-enabled ferries. A final draft detailed business case was delivered as part of KiwiRail's budget bid. However Treasury has had insufficient time to fully analyse it, and the business case has yet to be finalised and approved by the KiwiRail Board.
20. Through the Future of Rail review, Cabinet agreed in principle [DEV-19-MIN-0123 refers] to a resilient and reliable rail network that was estimated to require capital expenditure of [37] over 10 years. A component of this, ferry replacement, was estimated at [37]. The 2021 budget bid is seeking to extend the Crown contribution to this project to \$1 billion, out of a total forecast cost of \$1.758 billion. While the project cost estimate incorporates substantial contingencies for both Picton and Wellington ports, there remains risk that the portside cost could materially increase.

The project has faced portside challenges

21. The portside activities are significant challenges in the overall programme. The current port facilities at both Picton and Wellington are aging and have limited remaining economic life. Irrespective of iReX, they will both require infrastructure investment soon. The question is how much investment, and to serve which type of vessels.
22. For Wellington, the main issue was whether to site the terminal facilities at Kings Wharf or Kaiwharawhara. This received significant media attention. KiwiRail strongly preferred King's Wharf, while other parties (CentrePort, Greater Wellington Regional Council, and Wellington City Council) preferred continued operations at Kaiwharawhara.
23. In December 2020, KiwiRail conceded that it is best to focus on the Kaiwharawhara site, although warned that this may be at some cost, particularly given seismic considerations. There are still several challenges to manage at Kaiwharawhara with current plans for construction to commence in late 2022/early 2023 to be ready for the arrival of the first new ship in late 2025 and completed in 2026.
24. [33] and [38]
25. Irrespective of the nature of current issues facing portside developments, there is clearly a need for tight management of the programme and close alignment between the parties involved. This raises the question around overall project governance arrangements for the programme, which the Ministry of Transport also notes in its briefing. We also believe that a review of project governance arrangements is timely.

Estimated costs have increased considerably, including costs for the ships and portside

26. It is not clear from the information provided what the cost premium is for portside facilities for larger ferries relative to continuing to operate with ferries similar in size to the current fleet. Officials are seeking clarity on this.
27. Portside costs have escalated significantly since the November 2018 decision around ferry options. At that time, the total portside costs were estimated at \$260 million. The latest estimate, on which the 2021 Budget bid was calculated, is in excess of \$1 billion.
28. In addition, there has been some cost escalation around the ships (from [37] in November 2018 to [37] in 2021 Budget bid). The overall pattern of cost escalation for the iReX programme from the time of the November 2018 preferred ferry decision (\$775 million) to Budget 2020 (\$1.36 billion) to Budget 2021 (\$1.76 billion) is

concerning. This supports the need for further work before committing to further funding for the project.

The iReX project has an impending critical commitment point in June 2021

29. The iReX project is well-advanced in that KiwiRail has a non-binding Letter of Intent with Hyundai Mipo to build two large rail-enabled ferries. Discussions are progressing with a view to enter into a formal contract in June/July 2021.
30. KiwiRail is scheduled to draw down another \$34 million for the project later this month, bringing the drawdown total to approximately \$100 million. The contract, as currently scoped, will effectively commit KiwiRail, and contributors to portside costs such as the port-owning councils, to the full programme cost of \$1.76 billion.
31. These imminent commitment points underscore our recommendation that you communicate with KiwiRail as soon as practicable, especially if the 2021 iReX budget bid should not be advanced.

We support the preferred option proposed in the Ministry of Transport briefing and recommend that KiwiRail is advised as soon as practicable that the budget bid is deferred

32. The briefing from the Ministry of Transport outlined two options for Ministers:
 - Option 1: Agree to the \$565 million funding bid
 - Option 2: Defer the bid and commission an external review of the business case.
33. Treasury supports the option of deferring the bid. There are too many uncertainties to support additional funding at this stage and further work should be undertaken to review the business case and explore funding options other than those proposed by KiwiRail in its Budget bid.
34. A review could be undertaken by the Treasury and the Ministry of Transport. Alternatively, an external review could be undertaken. As noted above, iReX governance arrangements could also be considered as part of any review.
35. We note that Ministers could also place the \$565 million funding (or part thereof) in contingency as part of Budget 2021 until further analysis is completed and Ministers are satisfied that the current risks have been adequately addressed.

Risks

36. As noted in paragraphs 29 to 31 above, KiwiRail is approaching a critical commitment point in mid-2021. If the Budget 2021 bid proceeds, and KiwiRail enters into this contract, there will be very limited ability to amend the ship design. As a result, Ministers will likely be faced with limited options regarding portside infrastructure and the associated costs and risks.
37. Deferring the Budget bid also carries some risks:
 - a Costs associated with delay (should the large two ferry option still prove viable), including project costs and the extended operation of the existing ferry fleet with associated higher maintenance costs
 - b Loss of momentum on the project, including ability to retain Hyundai Mipo, and the potential for having to re-enter into a complex and costly procurement process.

Next steps

38. Shareholding Ministers are meeting with the Minister of Transport regarding concerns relating to the iReX project on Monday, 8 March 2021 at 5:30pm.
39. Should Ministers agree that there be a deferral to the Budget bid of \$565 million for the project, we recommend Ministers instruct officials to draft a letter advising KiwiRail of the decision and to outline the approach to reviewing the iReX project, including the need for a full review of the business case. This would include consideration of the next viable alternative of smaller ferries with different specifications.
40. Irrespective of whether the Budget bid proceeds or not, officials intend to initiate a full review of the detailed business case once it has been finalised and provided by KiwiRail.