27 February 2012

Mr Geoff Lewis
New Zealand Productivity Commission
PO Box 8036
WELLINGTON 6143

Via email: freightinquiry@productivity.govt.nz

Dear Geoff

International Freight Transport Services Inquiry – Draft Report

Thank you for providing KiwiRail with the opportunity to respond to the Productivity Commission's draft report on International Freight Services. I commend the breadth of the review and the input from across the industry that has been considered.

In responding to the report, my focus is, understandably, on your observations regarding the rail industry and the related recommendations. As discussed below, it is difficult to see how some areas addressed in the report pertain to freight transport efficiency, and I question conclusions drawn on four themes which come through in the report.

i.) KiwiRail only partially competes with road and coastal shipping

The report notes that for much of New Zealand's domestic freight movements, KiwiRail does not effectively compete with road and coastal shipping (pages xvii, xxvii, 67, 119, 169, 204) and its ability to do so is impacted by poor incentives to improve performance and political pressure to keep open unviable lines (page 119).

Successful delivery of an integrated supply chain for New Zealand industry requires a high level of co-operation and partnership, as well as competition, between modal transport options to deliver the best solution to the market. Each modal option offers differing service speed, frequency and price points to meet market needs. Assuming the appropriate investment has been made for each mode to be relevant, rail's place in a country the size and shape of New Zealand is to provide backbone line haul capacity for the transport industry connecting major producers, ports and distribution centres.

There is no doubt KiwiRail requires shareholder support to put right the lack of investment in the past but this is not to be confused with a lack of competitiveness. We must perform as required by the State Owned Enterprises Act 1986 (SOE Act) and the expectations of the Board. This is no different to the expectations upon a private or publicly listed company. The Board has responsibility for all operational aspects of the company, including any decisions related to the commercial viability, or otherwise, of its rail lines.

ii.) There is a low expectation of KiwiRail's commercial performance compared to other freight modes

The report refers to rail's (pages xx, xxvi, 153) poor financial performance and multiple-objectives.

It is a mistake to judge rail on recent performance which is a result of long term neglect, not capability. There is clear evidence that the market wants rail as part of the transport solution and our economic modelling indicates that planned volume growth and optimal pricing will deliver a financially sustainable railway. The market has been very clear in their support for rail, with freight operators, large producers and ports all investing alongside our business.

Although COMU listed KiwiRail as a multiple-objective company in its 2010 Annual Report, it notes that the reason for this is due to the valuation of its assets having a distortive effect on the results of the SOE portfolio as a whole, not due to it undertaking non-commercial activities. We intend to address this issue through a restructure of KiwiRail's balance sheet by 30 June 2012 to more closely align the carrying value of its assets with their commercial value.

It may also be helpful to clarify several matters regarding Government appropriations in relation to rail:

- KiwiRail's "non-commercial activities" are limited to a relatively minor $3.2 million annual appropriation covering public rail safety, rail corridor beautification, sponsorships and rail heritage
- KiwiRail provides metropolitan train services in Wellington and network infrastructure access for metropolitan train services in Auckland and Wellington under contract to regional councils based on its operating costs, performance incentives, and a commercial return
- The major metropolitan developments in Wellington and Auckland have been carried out under a construction contract with the Government, not an operating subsidy. These projects are funded and managed separately from KiwiRail's commercial activities.

iia.) KiwiRail's low returns represent an effective subsidy, in addition to actual operating subsidies it receives

Reference is made to the funding and/or subsidies paid to KiwiRail, but the report does not give the reader a clear understanding of the purpose of those payments (pages xxvii, 18, 32, 67, 102, 105, 119, 153, 169, and 205).

KiwiRail has not received operating subsidies since 2009. The business generates positive operating cash flows to fund capital expenditure. KiwiRail is also receiving equity funding from the Crown under the Turnaround Plan to correct the historical under investment in rail and return the condition of rail infrastructure and rolling stock to a steady-state position. These payments are funding the replacement or upgrade of specific assets, and are not an operating subsidy. Subject to suitable performance, the Crown intends to invest $750m over the first three years of KiwiRail's turnaround.

Furthermore, we believe that references to the funding of metropolitan rail in a freight industry report are misleading:

- In 2009 the Government decided to spend $1.6 billion on upgrading the Auckland and Wellington metropolitan rail systems. KiwiRail was awarded contracts to electrify the Auckland network and complete other improvements to track infrastructure in Auckland and Wellington. These activities are funded through specific appropriations that are accounted for and managed separately from KiwiRail's commercial activities.
- As noted in point ii), various metro rail services are provided to the Auckland and Wellington regional councils based on a commercial contract, not an operating subsidy.

iii.) Performance expectations for the freight industry, including rail, should include appropriate levels of return on the investment as is expected in the private sector and by Economic Value Added (EVA) performance measures

The report supports the expectation that all freight investments should operate with the aim of achieving appropriate economic returns (pages xxii, xxviii, xxix, F8.3, R10.3 amongst others). KiwiRail supports the use of EVA as a long term measure of financial performance, but as with any measurement system there are pluses and minuses. Until KiwiRail reaches a normalised capital expenditure profile and the benefits of those investments are realised, EVA results will merely reflect the effect of many years of under investment in rail and the associated deterioration of service levels.

Furthermore EVA measures will not reflect the wider benefits to New Zealand that the Government is expecting from its equity investment in KiwiRail (e.g. savings in road construction costs, road safety, reduced greenhouse gas emissions, the option value of an alternate transport system, etc.).

iv.) KiwiRail acts on its own to determine the future of NZ rail without sufficient public accountability

There are some inconsistencies between the expectations (and related recommendations) of government accountability versus the SOE governance regime and that of stock exchange listed companies (pages xxii, 17, 131-2, 142, 147, 206, R9.1). While the report supports the SOE governance and performance expectation regime, it recommends that there be wider public scrutiny of the company's investments.

As an SOE, KiwiRail's operational responsibility sits with its Board, up to certain thresholds at which point the shareholder is required to give its approval (which applies equally to all companies). The KiwiRail TAP was approved by the Board and invested in by the Government. As shareholder, the Crown undertook its own wide ranging engineering and financial review of the TAP to satisfy itself of the efficacy of making additional investments in rail, including meeting with key customers to confirm their commitment to rail through additional volumes and complementary investments in rail served terminals. It is now the Board's responsibility to see that the TAP is successfully implemented.

KiwiRail believes the accountability expectations for the Board are just as they would be for a stock exchange listed company. Although KiwiRail is not accountable to a share price, it is required to report its performance publicly in its Annual Report, to provide an annual Statement of Corporate Intent, is monitored by the Crown Ownership Monitoring Unit which requires an NZX based continuous disclosure regime, and it has the same commercial obligations as a private company. KiwiRail has made a strong commitment to being open and accountable, but without jeopardising its commercial operations.

Other Points

Further to the items raised above, I also want to highlight some specific items that could be addressed:

- in many instances, referenced reports and data are many years old, up to 22 years in one instance (pages 60, 67, 105, 131, 168, 204).
- the KiwiRail TAP provides for the company to be fully self-funding, not just for rolling stock as referred to in page 67.
- I am unclear of the relevance of the comment on page 122 that Solid Energy and Port of Lyttleton were interested in acquiring the Midland line.

I look forward to meeting with you to discuss these matters further.

Yours sincerely

Jim Quinn
Chief Executive