

Treasury Report: KiwiRail – advice on Project iReX

Date:	21 June 2021	Report No:	T2021/1279
		File Number:	SE-2-25-2

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	Agree to the recommendations Sign the letter attached as Annex Five, and the shareholder resolution attached as Annex Six	28 June 2021
Minister of Transport (Hon Michael Wood)	Agree to the recommendations (with the exception of recommendation e)	28 June 2021
Minister for State Owned Enterprises (Hon Dr David Clark)	Agree to the recommendations Sign the shareholder resolution attached as Annex Six	28 June 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Daniel Madley	Analyst, Commercial Performance	[35]	✓
Michael Moore	Principal Advisor, Commercial Performance		
Maureena van der Lem	Manager, Commercial Performance		

Minister's office actions

Return the signed report to the Treasury

Minister of Finance's office: once signed, **send** the letter, attached as Annex Five, and the shareholder resolution, attached as Annex Six, to KiwiRail

Note any feedback on the quality of the report

Enclosure:

- [Annex One: KiwiRail briefing on Project iReX \(Treasury:4475686v1\)](#)
- [Annex Two: Detailed Business Case - June 2021 \(Treasury:4473340v1\)](#)
- [Annex Three: Comment on Detailed Business Case \(Treasury:4475857v1\)](#)
- [Annex Four: Talking points for Cabinet on 28 June 2021 \(Treasury:4473345v1\)](#)
- [Annex Five: Letter to KiwiRail \(Treasury:4473346v1\)](#)
- [Annex Six: Shareholder resolution \(Treasury:4473347v1\)](#)

Executive summary

KiwiRail is currently engaged in Project iReX – the replacement of its aging ferry fleet and working with port stakeholders to develop the associated landside infrastructure. It has previously provided three iterative business cases to support budget bids, and \$435.1m in Crown equity has been appropriated through Budgets 2019 and 2020.

A Budget 2021 funding request was declined as a Detailed Business Case (DBC) had not been approved by KiwiRail's Board and costs remained relatively uncertain. In April 2021, you requested KiwiRail provide you with a Board-approved DBC and address other questions you had on the project's scope and funding arrangements.

KiwiRail provided a briefing, attached as **Annex One**, and other material on 3 June 2021, and asked you to respond by 30 June 2021. This is because KiwiRail has signed a Letter of Intent with a South Korean shipyard to build two large rail-enabled ferries in which KiwiRail has locked in relatively favourable terms; the letter expires on this date and KiwiRail wishes to sign a ship-building contract before the letter's expiration.

KiwiRail has asked you to “approve” the Detailed Business Case

The DBC is attached as **Annex Two**. It is not necessary for you to “approve” the DBC as responsibility for its accuracy remains with KiwiRail's Board.

Officials from the Treasury, the Ministry of Transport and Te Waihanga, the New Zealand Infrastructure Commission have assessed the DBC. The Ministry of Transport engaged AECOM as independent technical advisors. Our assessments were limited to meet KiwiRail's desired deadline. Partly because of this, we retain some key concerns:

- a [38] , and the National Land Transport Fund is already under pressure
- b commercial negotiations are yet to conclude with the ports in Picton and Wellington, [38]
- c a lack of external quality assurance for KiwiRail's forecasts, such as revenue growth and levels of on-board passenger spend
- d a lack of clearly measured benefits, including the lack of a Cost Benefit Analysis.

Further detail on the DBC's limitations are attached as **Annex Three**. Officials understand the need to replace the Interislander fleet and proceed with the project, in spite of these concerns. It is important that Ministers note these concerns when considering KiwiRail's other requests (discussed below), and that securing the relative cost certainty of the ships now heighten these risks (for mainly landside infrastructure).

KiwiRail has asked shareholding Ministers to approve Project iReX as a Major Transaction

KiwiRail forecasts that it will initially enter into transactions for Project iReX collectively valued at \$1.14b. This rises to [37] over 30 years. These transactions are in excess of 50 per cent of KiwiRail's total group assets as at 30 June 2020 (\$1.771b), and therefore represent a Major Transaction as defined by the Companies Act 1993. KiwiRail has confirmed that it requires approval from its shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises) to proceed.

A shareholder resolution is attached as **Annex Six**. We recommend shareholding Ministers sign it. The resolution has been drafted by the Treasury's Legal team, in consultation with KiwiRail. It has been drafted to maintain a degree of flexibility around future funding arrangements, in line with our advice below.

In response to Ministers' questions we also advise that a level of independent assurance and oversight is appropriate for Project iReX, given its scale. The assurance should be focused on assuring that KiwiRail is following good process and methodology as the project is progressed, and the assurance should be risk-based. If you agree with our assessment, we will work with KiwiRail to confirm assurance details and how these could work with the project, and report back to you.

KiwiRail has asked the Crown to provide a further \$257m in equity

KiwiRail has requested that Ministers approve \$257m of further Crown equity in order to meet the forecast capital costs of Project iReX. On 8 June 2021 Cabinet authorised you (collectively as joint Ministers) to draw down a tagged capital contingency of up to [37] subject to your satisfaction with the DBC and that the risks and trade-offs of contracting for the new ferries now can be mitigated and are otherwise acceptable. Cabinet has asked you to report back on your decision by 30 June 2021.

The key assessment for Ministers is, if you wish Project iReX to proceed, what level of funding certainty will satisfy KiwiRail's Board, who will want the shortfall to be addressed.

KiwiRail has proposed the Crown provide a further \$125m in Crown equity, and allow KiwiRail to repurpose \$132m of insurance proceeds from the Main North Line (MNL) reinstatement that KiwiRail currently holds. We advise that this funding should return to the centre, as originally intended by Cabinet, and any further Crown funding for Project iReX should come from the tagged contingency.

We considered the option of a Crown loan, however KiwiRail strongly rebutted this, noting that its Board and financiers will not accept further debt beyond the \$350m KiwiRail will raise against the ferries.

On balance, we advise that the Crown does not need to commit to providing further funding to Project iReX at this time. On the basis of the projections provided by KiwiRail, Project iReX does not face a funding shortfall until [37]

You can advise KiwiRail that Cabinet has agreed to the establishment of a tagged contingency, and delegated authority to you collectively as joint Ministers to draw down on it. Reserving the right to provide funding in an unspecified form in the future will likely result in you receiving better information upon which to make a decision. KiwiRail's intended debt of \$350m is appropriate as it also allows a Crown loan to be considered in the future.

Communicating your decisions to Cabinet and KiwiRail

Cabinet has asked you report back on your decisions by 30 June 2021. Talking points are attached to this briefing as **Annex Four**.

A letter to KiwiRail, communicating your decisions, is attached to this briefing as **Annex Five**. The shareholder resolution, approving Project iReX as a Major Transaction, is attached to this briefing as **Annex Six**, and can be sent to KiwiRail at the same time as the letter.

Recommended action

We recommend that you:

Detailed Business Case

- a **note** that the KiwiRail Board has approved a Detailed Business Case for Project iReX (the replacement of KiwiRail's ferry fleet and development of landside infrastructure) and has submitted it to Ministers in accordance with Ministers' request on 8 April 2021
- b **note** that KiwiRail has requested a response on the Detailed Business Case and associated approvals by 30 June 2021 as it has a Letter of Intent to enter into a ship-building contract, on favourable terms, which expires on this date
- c **note** that officials retain concerns with Project iReX, specifically residual cost risk for landside infrastructure, the lack of external quality assurance for KiwiRail's forecasts and the lack of clearly measured benefits from the project

Major Transaction

- d **note** that Project iReX is a Major Transaction for KiwiRail, as defined by the Companies Act 1993, and KiwiRail requires approval from shareholding Ministers to proceed
- e **agree** to sign the shareholder resolution, attached as Annex Six to this briefing, approving KiwiRail to enter into a Major Transaction for the purposes of Project iReX, and that the signed resolution be sent to KiwiRail at the same time as the letter described in recommendation (o) below

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

Further Crown funding

- f **note** that KiwiRail has requested \$257m in Crown funding be provided to support Project iReX, comprised of \$125m in new Crown equity and Ministers agreeing to KiwiRail repurposing \$132m of Main North Line insurance proceeds that KiwiRail currently holds
- g **note** that Crown equity of \$435.1m has already been appropriated to support Project iReX
- h **note** that Cabinet has authorised you, collectively as joint Ministers, to draw down a tagged capital contingency of up to^[37] subject to your satisfaction with the Detailed Business Case and that the risks and trade-offs of contracting for the new ferries now can be mitigated and are otherwise acceptable
- i **note** that based on KiwiRail's 10-year above-rail financial forecasts, KiwiRail should not necessarily need further Crown equity funding for Project iReX, and that any funding shortfall is not expected until ^[37]
- j **agree** that no further Crown funding will be provided to support Project iReX at this time, but that collectively, as joint Ministers, you will consider providing further Crown support, in the form of equity, a Crown loan or otherwise, when KiwiRail has demonstrated a need for such funds being required

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for
State Owned Enterprises

- k **note** that, as a result of your agreement to recommendation (j) above, KiwiRail will return the \$132m in Main North Line insurance proceeds it currently holds to the centre, as originally intended by Cabinet

Assurance arrangements for Project iReX

- l **agree** to the proposed independent assurance arrangements proposed for Project iReX, focused on assuring that KiwiRail is following good process and methodology as the project is progressed, and to manage risks to delivery within the defined cost, schedule and outcomes

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for
State Owned Enterprises

- m **agree** that the Treasury and the Ministry of Transport will work with KiwiRail to confirm the assurance arrangements and report back to Ministers with further advice

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for
State Owned Enterprises

Report back to Cabinet and response to KiwiRail

- n **report back** to Cabinet on Monday 28 June 2021 to provide an oral update on the decisions you have taken in recommendations (e), (j), (l) and (m) above

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for
State Owned Enterprises

- o **agree** for the Minister of Finance to sign and send, on behalf of all three Ministers, the letter to KiwiRail attached as Annex Five to this briefing, outlining the decisions you have taken in recommendations (e), (j), (l) and (m) above.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Transport

Agree/disagree.
Minister for
State Owned Enterprises

Maureena van der Lem
Manager, Commercial Performance

Hon Grant Robertson
Minister of Finance

Hon Michael Wood
Minister of Transport

Hon Dr David Clark
**Minister for
State Owned Enterprises**

Treasury Report: KiwiRail – advice on Project iReX

Purpose

1. This report provides you with officials' advice on Project iReX. This is largely in response to a briefing, attached as **Annex One**, and Detailed Business Case (DBC), attached as **Annex Two**, that KiwiRail Holdings Limited (KiwiRail) submitted to Ministers on 3 June 2021. The briefing included a request for KiwiRail's shareholding Ministers to approve Project iReX as a Major Transaction for the purposes of the Companies Act 1993, and a request for further Crown equity funding.
2. KiwiRail has requested a response from you on these matters by 30 June 2021. We have previously advised you on this process and outlined our key areas of focus (T2021/1138, T2021/1405, and OC210034 from the Ministry of Transport, refer).

Background

KiwiRail is seeking to replace its aging ferry fleet and wrote to Ministers in early June 2021

3. The Cook Strait ferry connection is a key passenger, freight and lifeline link between the North Island and South Island. The Cook Strait is currently serviced by KiwiRail's 'Interislander' ferries, and StraitNZ's 'Bluebridge' ferries.
4. KiwiRail's current fleet of ferries are reaching the end of their economic and operational lives. As the ferries age, maintenance costs and the frequency of service outages will increase. There is an increased risk a ferry will lose its 'Safety of Life at Sea' (SOLAS) certification, which would force retirement. These risks increase as the ferries age and are likely to accelerate from 2025.
5. Procuring replacement ferries requires a multi-year lead time, so it is responsible asset management for KiwiRail to not delay replacement to ensure the ongoing resilience and reliability of the Cook Strait connection. KiwiRail has therefore been engaged in a multi-year project to replace its Cook Strait 'Interislander' ferry fleet, in addition to working with stakeholders on options to redevelop outdated landside infrastructure in Picton and Wellington to accommodate the new ferries. Collectively these interdependent work streams comprise Project iReX.
6. The 'Interislander' ferries are one part of KiwiRail's above-rail business and is generally profitable, contributing [37] operating surplus in FY20. They are commercial assets. To reflect this, consistent with KiwiRail's designation as a state-owned enterprise (SOE), Ministers have asked KiwiRail to fund as much of the project as possible on a commercial basis, including through private debt, but have accepted that some Crown funding may be required.
7. KiwiRail prepared three business cases to support funding bids for each of Budgets 2019, 2020 and 2021. KiwiRail received \$35m in Budget 2019 to undertake detailed design work on the ferries, and \$400.1m was appropriated in Budget 2020 for the full programme, on the understanding that this would be the final Crown contribution.
8. However, the projected capital costs for Project iReX increased between Budgets 2020 and 2021, primarily due to cost increases in the landside infrastructure. KiwiRail initially sought a further \$565m in Crown funding through Budget 2021 to meet this shortfall. KiwiRail subsequently tabled a revised Budget 2021 bid, seeking further Crown funding of \$257m based on an estimated total project capital cost of \$1.45b.

9. The table below outlines how the capital costs for the project have changed across the four business cases, three of which were for Budget bids.

Budget (\$m)	2019	2020	2021 initial	June 2021 DBC
Ships [37]				
KiwiRail delivered landside costs				
Terminals (CentrePort and Port Marlborough contribution)				
Total capital cost	775.0	1,389.5	1,759.0	1,450.0

10. KiwiRail's Budget 2021 bid was declined due to cost uncertainty and that the fact that the KiwiRail Board had yet to approve a final DBC. Because of these uncertainties, shareholding Ministers also declined a request by KiwiRail to draw down \$34.9m of appropriated iReX funding (T2021/441 refers). In declining the request, the Minister for State Owned Enterprises wrote to KiwiRail's Chair on 8 April 2021 to ask KiwiRail to:
- prioritise the finalisation, including Board sign-off, of the DBC
 - advise of the feasibility of reverting to a less-capital intensive option, such as two medium-sized ferries
 - provide further information on the extent to which costs can be met by other parties and whether these parties are supportive of the project
 - advise on its ability to take on further debt funding.

KiwiRail is seeking a response from Ministers by 30 June 2021 to enable the signing of the ship-building contract

- Based on the indicative business case of November 2018, and firmed up as the business cases developed, KiwiRail has settled on procuring two new, large, rail-enabled ferries. In December 2020, KiwiRail signed a Letter of Intent with Hyundai Mipo Dockyard (HMD) in South Korea. This Letter of Intent locked in key terms, including price, for two large rail-enabled ferries while a ship-building contract was negotiated. Crucially, the Letter of Intent expires on 30 June 2021.
- If the ship-building contract is not signed by 30 June 2021, KiwiRail will need to renegotiate terms and conditions for the ships and will very likely be subject to cost increases. KiwiRail estimates this could be in the order of [37] for the steel component of the ships alone. The arrival of the new ferries could also be delayed, which would drive increased maintenance and operational costs for the current fleet.
- The type and size of ferries that are selected influences the design and cost of landside infrastructure. Entering into the ship-building contract by 30 June 2021 would lock in favourable commercial terms for the new ferries but restrict optionality on landside infrastructure requirements – the full detail and costs of which remain uncertain.
- In the past few months, KiwiRail has finalised the DBC in line with Ministers' request of 8 April 2021. As part of this work, it has undertaken a series of value-engineering 'design sprints' to reduce capital costs for the landside infrastructure (the largest cost increases between Budgets 2020 and 2021). The outputs of these 'design sprints' and supporting information have been viewed by officials and AECOM, as an independent technical advisor.

15. KiwiRail's Board approved the DBC, and it was provided to Ministers and officials on 3 June 2021. KiwiRail has asked you to respond on three matters:
 - a **Approve** the DBC for Project iReX, as Ministers have previously requested to be consulted – refer paragraphs 20 to 55
 - b KiwiRail's shareholding Ministers to **execute** a shareholder resolution, as required by the Companies Act 1993 – refer paragraphs 56 to 69
 - c **Approve** \$257m of new Crown equity funding, including asking Ministers to allow KiwiRail to repurpose \$132m of insurance proceeds it currently holds – refer paragraphs 70 to 97.
16. With respect to KiwiRail's request for further Crown funding (paragraph 15c), Cabinet delegated authority to all three Ministers on 8 June 2021 to draw down up to [37] as a tagged capital contingency [DEV-21-MIN-0110 refers]. You collectively sought this delegated authority to ensure that you had the best possible chance of responding to KiwiRail by 30 June 2021, including providing further Crown funding if required.

Officials have undertaken a limited assessment of the documents

17. Officials from the Treasury, the Ministry of Transport and Te Waihangā, the New Zealand Infrastructure Commission have worked together, over the past two-and-a-half weeks, to assess the DBC and associated documentation provided by KiwiRail on 3 June 2021. The Ministry of Transport also engaged engineering consulting firm AECOM as an independent advisor to assist with assessing technical aspects of the DBC. The scope and time available for this review has been limited and therefore this does not constitute a full assurance review of the DBC.
18. Our assessment has been compressed to meet KiwiRail's request for Ministers to respond prior to the Letter of Intent's expiration on 30 June 2021. KiwiRail has provided a large amount of information in response to many of our questions, and has made staff, including the Senior Leadership team, available at short notice, which has greatly assisted our assessment.
19. The Treasury's Commercial Performance team provides ownership and performance advice to KiwiRail's shareholding Ministers. It has prepared this briefing, in consultation with:
 - a the Treasury's National Infrastructure Unit, focusing on the strategic fit and value-for-money of potential further Crown funding
 - b the Treasury's Investment Management and Asset Performance team, who is responsible for oversight of the government's investment management system
 - c the Ministry of Transport, focusing on the transport policy implications of KiwiRail's proposal, and working with independent technical advisor AECOM
 - d Te Waihangā, the New Zealand Infrastructure Commission, focusing on the project's role within the wider strategic context of New Zealand's infrastructure plan.

Consideration of the Detailed Business Case

20. KiwiRail has asked Ministers to “approve” the DBC it provided on 3 June 2021 (attached as **Annex Two** to this briefing). Approving the DBC would imply that Ministers are completely comfortable with the quality of the document and the accuracy of its information. We advise that it would not be appropriate, or necessary, for Ministers to “approve” the document, as overall responsibility for the document remains with KiwiRail’s Board in line with s 5(2) of the State-Owned Enterprises Act 1986¹.
21. We recommend Ministers respond to KiwiRail (through the letter attached as **Annex Five** to this briefing) to acknowledge the material provided and to state your high-level support for the project.
22. It is important for Ministers to note that officials and AECOM continue to have several concerns with the information provided in the DBC. Overall, we understand the need to replace the ‘Interislander’ fleet and the rationale underpinning the decision to prefer two large rail-enabled ships. The consequence of this requires port, terminal, and other transport investments to make the ‘Interislander’ system operate effectively and the focus going forward should be on how to manage and mitigate the remaining risks in the project in relation to these investments.
23. The material provided by KiwiRail in response to matters we raised did not always fully address our queries. **Annex Three** provides further comment from the Ministry of Transport and AECOM on the DBC.
24. Our key outstanding concerns are as follows:
 - a [38] which is especially problematic as the National Land Transport Fund (NLTF) is already under pressure
 - b commercial negotiations are yet to conclude with the ports in Picton and Wellington, [38]
 - c a lack of external quality assurance for KiwiRail’s forecasts, such as revenue growth, levels of on-board passenger spend, expected mode shift and market share growth assumptions
 - d a lack of clearly measured benefits, including the lack of a Cost Benefit Analysis (CBA).
25. [38]
26. KiwiRail’s negotiations with HMD are well advanced. There is relative cost certainty (of [37] including contingency) for the ship component of Project iReX and favourable commercial terms on offer if the ship-building contract is confirmed by 30 June 2021.

¹ Section 5(2) of the State-Owned Enterprises Act 1986 states that “all decisions relating to the operation of a State enterprise shall be made by or pursuant to the authority of the board of the State enterprise in accordance with its statement of corporate intent.”

[38]

27. This uncertainty, [38] is largely comprised of:
- a a lack of consenting in Wellington (noting that consenting in Picton has been fast-tracked)
 - b [38]
28. In respect of the value-engineering and design work undertaken for the Wellington and Picton ports, AECOM has notified us of the following risks and limitations:
- a in terms of cost completeness, there are many sources of funding that need to be confirmed, and these agreements have not been completed
 - b [38]
 - c
 - d
29. [38]
30. AECOM notes that the cost-estimating methodology used in the 'design sprints' appear to be robust, however, this was based on a small sample due to time constraints. The design and cost estimation process appear to be robust based on the sampling undertaken.
31. AECOM notes that assuming no unforeseen risks arise which materially change the nature of the design, the minimum functional design option for the ports and terminals should be able to be delivered for the cost stated in the DBC. This is based on the level of design and cost methodology used.

Wider transport sector and system considerations

32. Given the strategic nature of the Cook Strait connection and the interface of the national rail network and State Highway One, the Ministry of Transport considers that the Government has an interest in ensuring that connected infrastructure is well provided for and fit-for-purpose.
33. As this connection essentially forms part of State Highway One, the Government needs to be satisfied that the connective infrastructure and terminal choice will be as resilient as the replacement vessels. Resilience of the network is as dependent on the landside infrastructure arrangements as it is with the choice of vessels.

34. It is critical that any implied trade-offs in the terminal design or cost sharing arrangements around the roading network do not result in impeded movement of people and goods.
35. The Ministry of Transport sought comment from NZ Transport Agency Waka Kotahi (Waka Kotahi) on the implications for the NLTF and the local and State Highway roading networks from the proposal.
36. Waka Kotahi noted that it is unable to provide certainty of funding from the NLTF, and that it does not have a clear view of the total impact and costs to the transport network as a result of the iReX programme.
37. Waka Kotahi also notes that it does not have a clear view of the programme level risk, that a risk-adjusted programme through to delivery is yet to be determined, and it is yet to agree with KiwiRail who pays for what infrastructure. Cost shares will be based on the beneficiary pays principle, and the split of costs between parties needs to reflect where the benefits sit.
38. In Wellington, Waka Kotahi is working with KiwiRail and other partners to understand the wider impacts for the Stage 1 and 2 developments required for the Multi-User Ferry Precinct, and improvements required to mitigate these impacts.
39. Officials note that Stage 1 is the minimum required investment to enable land transport connections to the single user ferry terminal at Kaiwharawhara. Stage 2 will require significantly more investment for land transport and wider transport system connections, the costs and funding shares of which are yet to be known.
40. In Picton, Waka Kotahi notes that there will likely be impacts on the Blenheim roading network, and that an integrated transport strategy is currently being completed which will provide more clarity.

Competition across the Cook Strait

41. The Crown has an enduring interest in maintaining a competitive freight market across the Cook Strait. Competition provides both resilience in multiple operators and efficiency benefits.^[37]
42. Further engagement with StraitNZ is required to understand the potential impacts on its operation and whether the Crown's investment will have on competition across the Cook Strait freight route.

Commercial negotiations are yet to conclude with the ports

43. KiwiRail continues to undertake commercial negotiations with both Port Marlborough and CentrePort regarding commercial asset returns, capital cost shares, and the overall investment in the project.

44. ^[38]

45.

46. [38]

47. We note that on 15 June 2021 the Mayor of Marlborough District Council wrote to KiwiRail's shareholding Ministers regarding Project iReX. We advise that a response to the Mayor can be considered separately to this report and will provide shareholding Ministers with further advice on this matter in the next week.

KiwiRail has not undertaken an external review on some of its financial forecasts

48. The DBC presents a positive Net Present Value (NPV) estimate of \$207m. This represents the net financial value in present day terms of undertaking the project. Future cash flows are discounted at a rate of 5 per cent per annum.

49. However, the estimate is underpinned by a range of assumptions that have not been subject to external review. [37]

50. While this does not necessarily invalidate the NPV analysis, in the absence of external review it casts doubt on the reliability of the financial analysis. KiwiRail's view is that its assumptions are conservative.

51. The Minister for State Owned Enterprises has asked officials to consider what the implications and flow-on costs may be if KiwiRail's inter-island freight projections are met, i.e. increased need for rolling stock funding. KiwiRail has advised that the freight demand growth to support the Interislander fleet is manageable within the rolling stock renewal programme.

It is difficult or not possible to measure some of the project's benefits against their costs

52. KiwiRail has not undertaken a full CBA for Project iReX as it states that this is typically only done for non-commercial investment decisions, such as roads. While we can understand this to some degree, KiwiRail has requested, through three consecutive Budgets, significant levels of Crown funding to support Project iReX to proceed.

53. While the NPV assessment provides analysis on the *commercial* value of the investment (notwithstanding the areas of concern that remain in relation to the assumptions used in this assessment), KiwiRail also references broader economic, social and environmental benefits of the investment, which are of interest from the Crown's perspective.

54. Without a CBA it is not possible to measure these benefits, meaning we are unable to fully understand the total economic value of the project and whether Crown investment in the project provides good public value. There may also be broader economic, social and environmental *disbenefits* which would have surfaced through a CBA.

55. The advantage of the CBAX tool is that it makes assumptions explicit, and values different types of costs and benefits in a consistent way. This provides the basis for more informed choices between different options, namely the Crown's ability to compare a Benefit Cost Ratio for Project iReX against competing needs for investment in the wider Transport area and other calls on Crown investment.

Execution of a Major Transaction – agreement by shareholding Ministers

56. KiwiRail has advised, in its briefing provided as **Annex One**, that the ship-build contract (as the first step of Project iReX) triggers a Major Transaction². Approval from KiwiRail's shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises) is, therefore, required for KiwiRail to proceed with the ship-build contract and the consequent transactions that comprise Project iReX.
57. KiwiRail forecasts that it will invest \$1.14b towards Project iReX's capital costs, spread across the ships, the Picton and Wellington terminals and programme costs. In addition, KiwiRail estimates that leases in Picton and Wellington required to secure ports' capital contributions will cost [37] over 30 years, and ongoing capex for the ships, such as dry docking and regular ship maintenance, will be a further [37]. This forecast investment and capex totals [37] over the 30-year life of the project.
58. KiwiRail's total group assets, audited as of 30 June 2020, are \$1.771b³. Given that the forecast investment represents considerably more than half of the value of KiwiRail's assets, it constitutes a Major Transaction. We note that the individual elements of Project iReX would *not* represent a Major Transaction in and of themselves, but advise that it is prudent to consider them in their entirety as related transactions.
59. Shareholding Ministers can approve KiwiRail entering into a Major Transaction for the purposes of Project iReX by signing a shareholder resolution, attached to this briefing as **Annex Six**. This document has been prepared by the Treasury's Legal team, in consultation with KiwiRail.
60. The resolution sets out estimates for individual transactions, however, does not commit to precise funding arrangements for the transaction. The Treasury advises that the resolution should maintain a degree of flexibility around future funding arrangements. We advise in paragraphs 89 to 90 below on how a degree of comfort can be provided to KiwiRail's Directors.
61. On balance, the Treasury's Commercial Performance team recommends that KiwiRail's shareholding Ministers sign the shareholder resolution attached as **Annex Six**. As discussed in paragraph 12, there are considerable costs associated with delaying the ship build. Notwithstanding the shortcomings in the DBC, in approving this Major Transaction, there are options to mitigate risks and improve your level of confidence in the delivery and cost of Project iReX, as outlined below.

Assurance arrangements for Project iReX

62. You have asked for advice on whether a level of independent assurance and oversight would be appropriate for Project iReX, given its scale.
63. We are supportive of strengthening independent assurance, including governance arrangements, for the project, and recommend this is based on the following remit:
 - a Given the overall scope of the project is reasonably clear (the ship-build and associated landside infrastructure), independent assurance should be focused on assuring that KiwiRail is following good process and methodology as the project is progressed, to manage risks to delivery within the defined cost, schedule, and outcomes (e.g. assurance of approach to cost estimation and refinement)

² Section 129(2)(c) of the Companies Act 1993 defines a major transaction as "a transaction that has or is likely to have the effect of the company acquiring rights or interests or incurring obligations or liabilities, including contingent liabilities, the value of which is more than half the value of the company's assets before the transaction".

³ We note KiwiRail's total group assets, unaudited, as at 31 December 2020, are \$2.214b. The project, as a group of transactions, would still constitute a Major Transaction using these unaudited accounts.

- b Assurance should be risk-based (e.g. focused on the areas where there is most uncertainty and risk).
64. Based on where we have identified risk, we recommend assurance is initially focused on the process and methodology to confirm the details and specifications for the terminal infrastructure development, as well as ensuring co-ordination across the overall programme (given the multiple partners involved, and commercial arrangements yet to be confirmed).
 65. Cabinet Office Circular (19) 6 (Investment Management and Asset Performance in the State Services) (CO (19) 6) gives effect to Cabinet's intention to make the best investment choices for current and future generations, ensure there is active stewardship of government resources, and maintain a strong alignment between individual investments and the government's long-term priorities.
 66. As an SOE, KiwiRail is not required to comply with CO (19) 6. However, given the significant levels of Crown funding that has been provided to KiwiRail through recent Budgets, including \$435m to date for Project iReX, there may be elements of CO (19) 6 that can be usefully integrated into Project iReX to ensure the Crown's investment in KiwiRail provides good public value.
 67. We propose to work with KiwiRail on this, including providing risk profile assessments for all significant investments and being subject to Gateway review, and on ensuring that there is appropriate Crown visibility across governance arrangements.
 68. If you agree with the above approach, the Treasury and the Ministry of Transport will work with KiwiRail to confirm assurance details and how these could work with the project, and report back to you.
 69. Please note that, as drafted, the approval for the Major Transaction (attached as **Annex Six**) is based on the expectation that KiwiRail will work with the Crown to improve assurance arrangements.

Consideration of further Crown funding

70. KiwiRail has requested that Ministers approve \$257m of further Crown equity in order to meet the forecast capital costs of Project iReX. \$435.1m of Crown funding, in the form of equity, has already been appropriated through Budgets 2019 and 2020.
71. Ministers' response on this matter will determine if KiwiRail's Board has the confidence to enter into the ship-building contract by 30 June 2021. Under section 136 of the Companies Act 1993, Directors must not agree to the company incurring an obligation unless they reasonably believe that the obligation (in this case payment) can be met.
72. The estimated capital cost of Project iReX is \$1.45b. Existing Crown funding, the sale of the current fleet, private debt KiwiRail will raise against the new ships, and port contributions total an estimated [37] leaving a shortfall of [37].
73. Of this [37], KiwiRail has committed to meeting [37] through an "enterprise stretch". This can be through efforts such as outperforming current performance targets, reducing contingencies as designs are further developed and achieving more favourable commercial arrangements with the ports. There is a risk that KiwiRail is not completely successful in these efforts and part of the [37] remains unfunded, but it is important that the right incentives are in place for KiwiRail to manage the project on a commercial basis.
74. A balance of \$257m remains to be funded. Previously, Cabinet delegated authority to all three Ministers on 8 June 2021 to draw down up to [37] as a tagged capital contingency.

75. KiwiRail has proposed that \$125m in new Crown equity be provided, and that Ministers agree to repurpose \$132m in insurance proceeds that KiwiRail currently holds.

We advise that the Main North Line insurance proceeds should be returned to the centre

76. KiwiRail received insurance proceeds following reinstatement of the Main North Line (MNL) which was heavily damaged in the 2016 Kaikoura earthquake. The Crown provided \$285m in funding to contribute to the reinstatement of the MNL, on the basis that any insurance proceeds received by KiwiRail would be returned to the Crown [DEV-18-MIN-0003 refers].
77. Reinstatement of the MNL was an investment in the below-rail section of KiwiRail's activities, such as maintenance of track, signals, tunnels and bridges. Repurposing it to contribute towards Project iReX would see the funding applied to KiwiRail's above-rail activities, such as its freight and ferries, which are expected to be undertaken on a commercial basis. As part of the Future of Rail review, Cabinet agreed [DEV-20-MIN-0082] that KiwiRail should implement financial reporting separation of above- and below-rail activities within its current structure to improve the transparency of costs, funding and revenues of these business units and to support future funding decisions.
78. We advise that agreeing to repurpose these MNL funds to Project iReX would be inconsistent with the financial reporting separation of KiwiRail's above- and below-rail activities. Additionally, the Crown has already made provision in its accounts for the return of this funding to the centre.
79. We advise that KiwiRail should return these funds to the Crown as originally intended. However, if you agree to repurpose the MNL insurance proceeds as KiwiRail has requested, we will need to make a corresponding write-off for the receivable on the Crown's accounts and account for an increase in equity in KiwiRail.

Consideration of providing a Crown loan

80. We advise that the provision of any further Crown funding for Project iReX should come from the tagged capital contingency referenced in paragraph 16 above.
81. We have considered the merits of providing KiwiRail with \$257m in the form of a Crown loan rather than as equity. There are several reasons why funding in the form of a Crown loan may be more appropriate than funding in the form of Crown equity as KiwiRail has requested:
- a On the basis of the DBC provided by KiwiRail, the project is NPV positive (\$207m). A Crown loan imposes stronger disciplines on financial performance, which is consistent with KiwiRail's status as an SOE and Ministers' desire for KiwiRail to undertake Project iReX on a commercial basis.
 - b KiwiRail's 10-year above-rail financial forecast has in excess of [37] in free cash flows in [37]. This suggests there is capacity in the above-rail balance sheet, and that the \$257m short-fall is primarily a cash flow timing issue.
 - c Excessive equity funding from the Crown distorts the market for provision of services across Cook Strait.
 - d The Crown has already appropriated \$435.1m for Project iReX in the form of equity and it is not unreasonable to have a funding blend to limit the Crown's risk, especially given the potential for the Crown to need to meet increased landside infrastructure costs.

82. [37]

83. Any Crown loan provided to KiwiRail would need to be made in the genuine belief that KiwiRail would be able to repay the loan. We note that in Budget 2021, a Crown loan to KiwiRail of \$174.25m was converted to equity at its request, and that KiwiRail had been unable to pay down the principal on the loan.
84. KiwiRail has strongly rebutted our questions concerning the feasibility of a Crown loan. KiwiRail noted that it has increased the amount of private debt it will take on against the ferries to \$350m (up from \$320m), that its debt carrying capacity has been assessed by EY, and that its Board will not accept any further debt. KiwiRail has also noted that the terms on which it has negotiated to raise \$350m of private debt have been based on financiers' understanding that this loan facility would be the only debt raised by KiwiRail.
85. KiwiRail has advised that, if a Crown loan were provided, there would be insufficient time for it to reengage with its financiers, and it would damage KiwiRail's reputation in the financial markets. We accept that this is a legitimate risk.
86. We note the Crown set a precedent prior to the COVID-19 lockdown on the strong commercial terms by which it established a loan facility of up to \$900m for Air New Zealand Ltd to draw down. Given the weaker financial position of KiwiRail, if any Crown loan was to be established, it would likely need to be provided on more generous terms.

We advise that no commitment to provide further Crown equity is required at this time

87. We have analysed the financial material provided by KiwiRail for Project iReX and across its wider business, including its 'Pathway to Profit' 10-year financial forecasts.
88. On the basis of the projections provided by KiwiRail, Project iReX does not face a funding shortfall until [37]
89. The key assessment for Ministers is, if you wish for Project iReX to proceed, what level of funding certainty will satisfy the KiwiRail Board, who will want to ensure that the \$257m shortfall is addressed.
90. If the decision is made to not provide KiwiRail with further Crown funding now, you can advise KiwiRail that Cabinet has agreed to the establishment of a tagged contingency, and delegated authority to you collectively as joint Ministers to drawdown on it. We recommend you use the letter, attached to this briefing as **Annex Five**, to communicate this to KiwiRail.
91. This option allows joint Ministers to consider further information on the funding shortfall closer to the time that it will be required. If you decide that improved assurance arrangements are required, as discussed in paragraphs 62 to 69, this option will ensure that KiwiRail is further incentivised to engage with Ministers and officials. You will be better placed to make decisions on the amount and type of funding to be provided, as the negotiations with the port companies will likely be complete, and the nature of potential cost escalations better understood.
92. The tagged contingency will automatically expire, and the funding returned to the centre, if it is not drawn down by 1 February 2022. Joint Ministers can agree to extend the tagged contingency at any time before it expires; we will advise you on this as required.
93. If you decide that some, or all, of the further funding should be provided in the form of a Crown loan, KiwiRail will have time to engage with its financiers. KiwiRail's ability to

perform to its financial forecasts and 'Pathway to Profit' will also determine its ability to service further debt, including a Crown loan.

94. In short, joint Ministers reserving the right to provide funding in an unspecified form in the future will likely result in Ministers receiving better information and KiwiRail having greater incentives to undertake the project.
95. The Minister of Finance has asked for the Treasury's assessment on whether the \$350m of private debt KiwiRail will take on is appropriate, or if it could service higher private debt. We advise that \$350m is appropriate; it has been assessed by EY and it preserves the option value of joint Ministers considering a Crown loan in the future.

Drawing down the tagged contingency

96. As noted in paragraph 16 above, Cabinet agreed to establish a tagged capital contingency of up to [37] to provide further Crown funding to Project iReX, if required, and delegated draw down authority to you, as joint Ministers [DEV-21-MIN-0110 refers]. The tagged capital contingency was charged against the Multi-Year Capital Allowance and could support either a Crown loan or a Crown equity injection.
97. KiwiRail does not require further Crown funds before 30 June 2021 in order to enter into the ship-building contract. It has sufficient funds to meet the deposit payment for the ships. If you decide to provide KiwiRail with further Crown funding, now or in the future, we will provide you with separate advice on how to facilitate this.

Risks

98. This briefing highlights that there are a number of residual risks in Project iReX, and that there are risk trade-offs associated with decisions asked of Ministers at this time.
99. A key risk relates to KiwiRail's reaction to the Crown's response regarding funding. There is potential that the response does not satisfy KiwiRail's Board sufficiently for it to sign the ship-build contract. KiwiRail's Board is likely to advise Ministers of its view before making any decision regarding the ship-build contract. The letter attached as Annex Five is drafted to provide an indication that further Crown support may be forthcoming, and Ministers' expectations of KiwiRail with respect to any further funding.
100. Aligned to this, there is a reputational risk for KiwiRail with financiers, shipyards and the wider market if it had to amend the proposal and go back out to tender for ships.
101. [38]

For this

reason, we propose strengthened project governance arrangements to mitigate these risks.

102. Within the business case itself, there are optimism bias risks around assumptions underpinning financial performance, which could result in less profitable outcomes, which will in turn place the commercially sustainable above-rail business at risk. While such risks are difficult to mitigate, close monitoring of performance against the business case projections will create an environment whereby early decisions can be made to adjust the business model if necessary.

Consultation

103. This report has been prepared by the Treasury's Commercial Performance team, in consultation with:
- a the Treasury's National Infrastructure Unit
 - b the Treasury's Investment Management and Asset Performance team
 - c the Ministry of Transport
 - d Te Waihanga, the New Zealand Infrastructure Commission
 - e AECOM (independent technical advisors to the Ministry of Transport).
104. All of the consulted parties support the recommendations made in this report.

Next steps

105. Cabinet has requested that you report back by the end of June 2021 on the decisions that you have taken, with respect to receiving delegated authority to provide KiwiRail with up to [37] in further Crown funding.
106. We recommend that you provide an oral update at Cabinet on Monday 28 June 2021. Talking points, consistent with the recommendations in this paper, are attached as **Annex Four** for this purpose. The talking points reference a separate document that the Minister of Finance requested on the ferries' convertibility to alternative energy sources, which KiwiRail has prepared separately.
107. If you agree with our advice, we recommend that the Minister of Finance signs, on behalf of the Minister of Transport and the Minister for State Owned Enterprises, the letter to the Chair of KiwiRail, attached as **Annex Five**.
108. We recommend that KiwiRail's shareholding Ministers (the Minister of Finance and the Minister for State Owned Enterprises) sign the shareholder resolution attached as **Annex Six**, and that this document is also provided to KiwiRail with the letter described above.
109. We recommend that these two documents be provided to KiwiRail on Monday 28 June 2021, to provide a small time buffer before the ship-building contract is due to be signed on Wednesday 30 June 2021.
110. KiwiRail's Chair may be in contact with Ministers between these dates, as the KiwiRail Board establishes whether it has the confidence to enter into the ship-building contract. Officials will support Ministers in these discussions as required.
111. If you agree to our recommendations regarding assurance arrangements for Project iReX, officials will provide you with separate advice on how this can be implemented.
112. We will provide shareholding Ministers with separate advice on the letter you received from the Mayor of the Marlborough District Council.

Annex Three – Ministry of Transport / AECOM (independent technical advisor) comments on iReX Detailed Business Case

Issue Area	Assessment undertaken and caveats / limitations	Comment and issues identified <i>General qualitative comment about the adequacy of the aspect of the business case – key questions, comments on the approach taken, information gaps and obvious risks to the Crown. Include observations about business case argument and approach.</i>	Risks and limitations <i>High level judgement of the issue area and residual cost risk to the Crown or adequacy of coverage of issue in business case</i>
Investment perspective	Reviewed Detailed Business Case (DBC) (June 2021), discussions with KiwiRail team.	<p>The DBC largely presents the investment from a KiwiRail perspective, in that it is assumed the current Interislander service should continue, and therefore the DBC presents the consequential port, terminal, and other transport investments needed to provide an improved ferry transport system that meets 30-year forecast demands. As a result, the DBC primarily focuses on the whole of life Net Present Value (NPV) cost to get their ships loaded, sailing and unloaded quickly, which suits KiwiRail’s commercial model of getting people to spend money on the ships rather than at the ports and local businesses.</p> <p>There is a funding gap identified between committed and required funding (DBC Table 1, page 3). This could be filled through the Crown investment as requested or through debt or other revenue streams.</p>	<p>Opportunities for investment in co-benefits may be lost, e.g. the ports and terminals could fulfil more than just a ship boarding / alighting function.</p> <p>We understand the KiwiRail port and terminal design excludes any opportunities for other commercial operators, e.g. café’s, retail etc. that the Ports or others could leverage.</p>
Strategic case	Reviewed DBC (June 2021), and Indicative Business Case (IBC) (Nov 2018), discussions with KiwiRail team.	<p>The DBC uses the IBC conclusion of two large rail-enabled ships as a starting point. The DBC then presents the consequential port, terminal, and other transport investments needed to make the Interislander system work on a ‘minimum functional specification’ considering all relevant standards etc. The logic flows from the ships outwards: 2 x large ships > Ports > Terminals > supporting road and rail investments. The DBC proposed investment is not presented as an integrated system, and compared to other possible system solutions.</p> <p>The DBC investment story (DBC Section 2) could be strengthened by including some of the IBC arguments for investment, including outlining what would happen in terms of outcomes (delays through breakdowns, high emissions etc.) if this proposed DBC investment is not made. This could extend to an NPV analysis (DBC Section 3.3) which would presumably show large costs to maintain the existing ships into the future and ensure investors understand the need and urgency of investing in the proposal.</p> <p>Investment objectives for the project were developed in the IBC, along with Key Performance Indicators (KPIs) and measures (IBC Table 3, page 12). The DBC re-defines the investment objectives (DBC Table 3, page 30), but these appear to be qualitative, and do not reference desired investment outcomes through KPIs and measures. Quantitative assessment of investment KPIs would be expected in a DBC to ensure that the investor is able to understand what outcomes they are receiving for their money. The investment objectives (IBC Table 3, page 30) are highly KiwiRail specific, and do not relate to benefits to the NZ Inc that would usually be cited in applications for Crown funding.</p>	<p>We can not be sure that another system solution at these port locations or others, or using different ship combinations may not have provided better value for money outcomes.</p> <p>Providing quantified outcomes of the investment (e.g. carbon emissions, frequency and duration of breakdowns/outages etc.) for the current and proposed option would enable the investor to better understand what they are buying for their money.</p>
Options analysis	Reviewed DBC (June 2021), discussions with KiwiRail team.	<p>The confirmation analysis of the ship configuration as presented in Figure 2 (DBC, page 31) provides scoring on a -3 to +3 scale against investment objectives, which appears to be qualitative with no supporting commentary on why each score was given. Quantitative outcomes, in terms of passenger capacity, speed of loading etc. are not presented, which along with costs, risks etc would greatly assist to understand the trade-offs being made in the investment decision on ships.</p> <p>The ports and terminal facilities in Picton and Wellington appear to have been designed to a ‘minimum functional specification’ through a series of ‘design sprints’ focused on refining scope and costs. No comparative assessments have been undertaken to understand the merits of different port or terminal options, the outcomes they provide, and their relative costs and benefits.</p>	<p>Investors cannot see the benefits / outcomes they are trading-off against costs in both the ships and the ports and terminals. Therefore we cannot be sure that the DBC is proposing the best balance of outcomes for Crown money spent.</p>
Value for money assessment	Reviewed DBC (June 2021), discussions with KiwiRail team.	<p>As above, the DBC largely focuses on the whole of life NPV cost to get their ships loaded, sailing and unloaded quickly. Little focus appears to have been given to the customer experience prior to boarding and after disembarkation to address the issues raised in DBC Section 2.6 (pages 24-25), or to any potential wider macroeconomic benefits to NZ Inc from the requested public investment.</p>	<p>The absence of comparative assessment of different options, particularly for the ports and terminals, does not allow a robust assessment of value for money through a traditional benefit / cost ratio assessment. Or</p>

		The outcomes and benefits of the investment are not presented, as the premise of the DBC is to provide the infrastructure at the least NPV cost to enable the two large rail-enabled ships to operate. The DBC does not present any analysis of benefits / KPI's / measures, or a benefit / cost ratio. The NPV assessment (DBC Section 3.3) indicates a positive return from the investment, indicating that the costs are covered by the revenues over the lifetime of the assets. This should not be considered as 'value for money' as no benefits or BCRs are presented.	the assessment of outcomes delivered by different options. Crown investors are not able to compare the value for money of this investment with other competing investments, to consider where they would like to invest.
Resilience	Discussions with KiwiRail team.	The desire to drive down the construction costs in the ports and terminals may lead to a less than optimal resilience outcome. This could relate to the resilience of the land side infrastructure to the impact of natural events and outages for planned maintenance. There is also the risk that the value engineering removes too much resilience or redundancy in the design, meaning that upon further developing the design, changes need to be made resulting in increased cost or use of any contingency. For example, if seismic standards or stakeholder needs for the ports and terminals changed, this would require substantial redesign that has not been allowed for.	The approach to develop a minimum viable product to deliver cost savings may result in resilience issues being embedded in the project that impact either the operations of the service or the whole of life costs of the landside maintenance and operation. The amount of value engineering at this early stage of the design can embed cost risk of needing to revisit design decisions upon learning new information, or to address any unforeseen changes. This could put the amount of contingency required at risk.
Future proofing and interdependencies	Reviewed DBC (June 2021), discussions with KiwiRail team.	The DBC identifies several items that are required to enable the full effectiveness of the iReX investment. These include capital investment from both CentrePort and Port of Marlborough, both of which have not finalised funding agreements as noted in 'principal risks' (DBC pages 12-13). Crown funding is also being sought through the National Land Transport Programme for upgrades to the local and State Highway network, with co-funding by Waka Kotahi. The co-funding elements needed to deliver the successfully Interislander project are not presented in the project costs, and their funding is being sought through independent business cases, which at this point are not confirmed.	There are many sources of funding needing to be confirmed, and these agreements have not been completed.
Terminals and connecting infrastructure – cost completeness	Discussion with KiwiRail team, review of a couple of design packs for pricing, and sample from CANDY and ARM.	The port infrastructure designs are at about the 15 per cent stage of the design process, and the process appears to be robust from the sampling undertaken: 1. A design pricing pack is produced (containing the design of an element, staging requirements and construction methodology) 2. The design is then priced from first principals using CANDY (rates and quantities have not been checked in this review exercise) 3. Overheads and other non-direct costs items are added to the base costs as percentages, checked by an independent industry expert and seem appropriate.	The estimating methodology appears robust, however only a small sample was viewed due to time constraints for this review.
Terminals and connecting infrastructure – residual cost risk and cost estimation process	Discussion with KiwiRail team, review of a couple of design packs for pricing, and sample from CANDY and ARM.	ARM is being used to estimate the quantitative value of the risks defined by a series of risk workshops undertaken by the wider KiwiRail team. The risk identified at date are large "big picture" items and some are quite generic, as would be expected at the 15 per cent design phase. The ARM outputs largely support the business case value of risk and sit just under 30 per cent of the total cost for each of the two ports and terminals. Discussion with the KiwiRail risk manager gave confidence that the process being followed would lead to many of the larger risks being designed out by the 30 per cent design phase and that the residual risks would be more specific and engineering/construction focused.	There is a risk that the desire to drive down the port and terminal construction costs may result in unforeseen capital costs as the designs are progressed (i.e. the cost-saving innovations are unable to be realised), and increased whole of life costs for the assets.
Governance	Reviewed DBC (June 2021), Management Case, Section 6	From the review of the DBC Management Case, Section 6, it appears that: 1. Thresholds for escalation from one governance group to another have not been stated 2. The governance forum chair and members (even by role) have not been stated 3. The role of the shareholding Ministers has not been stated, and 4. The Programme will be subject to KiwiRail standard governance arrangements with some tailoring in the form of the Joint iReX and IIL Programme Control Group.	There are remaining risks that shareholding Ministers are inadequately represented in decision-making, decision-making is not subject to sufficient rigour, and that Board members are not clear on their remit / role / delegations.

Annex Four – talking points for Cabinet on 28 June 2021

1. I wish to accept Cabinet's invitation on 8 June 2021 to report back on decisions taken by ourselves, the Minister of Finance, the Minister of Transport and the Minister for State Owned Enterprises, as joint Ministers, with respect to Project iReX.
2. Project iReX involves the replacement of KiwiRail's Cook Strait ferries and the development of associated landside infrastructure.
3. On 8 June 2021, Cabinet agreed to establish a tagged contingency of ^[37] and delegated authority to joint Ministers to draw down on this contingency to provide further Crown funding for Project iReX if:
 - a. we were satisfied with the Detailed Business Case provided by KiwiRail, and
 - b. that the risks and trade-offs of contracting for the new ferries now can be mitigated and are otherwise acceptable.

Consideration of further Crown funding

4. KiwiRail is seeking a further \$257m in Crown equity funding by 30 June 2021 so that it can enter into a ship-building contract on favourable terms.
5. We have decided not to draw down any funding from the tagged contingency at this time. We have received advice that the funding shortfall in the project is not forecast to occur until ^[37]
6. We will be open to considering further Crown support, in the form of equity, a Crown loan or otherwise, when KiwiRail has demonstrated a need for such funds being required.
7. There are a number of outstanding risks in the project, namely:
 - a. ^[38] the National Land Transport Fund is already under pressure
 - b. commercial negotiations are yet to conclude with the ports in Picton and Wellington, ^[38]
 - c. a lack of external quality assurance for KiwiRail's forecasts, such as revenue growth and levels of on-board passenger spend
 - d. a lack of clearly measured benefits, including the lack of a Cost Benefit Analysis.
8. By reserving the right to provide funding in an unspecified form in the future we will likely receive better information on how these risks are being addressed upon which to make a decision.

9. We will update Cabinet if we decide to draw down on the tagged contingency in the future.

Assurance arrangements

10. Given the risks involved, we will be asking officials to engage with KiwiRail on improving the assurance and oversight arrangements for the project. This assurance will be focused on KiwiRail following good process and methodology as the project is progressed, and will be risk-based.

Major Transaction

11. KiwiRail's shareholding Ministers have approved Project iReX as a Major Transaction for KiwiRail, in accordance with the Companies Act 1993.
12. This has been approved on the basis of, among other matters, KiwiRail's Board favourably assessing the business case and contractual arrangements, the information provided by KiwiRail and KiwiRail's responses to officials' questions.

Responding to Cabinet's questions on electrification

13. We have also received further information from KiwiRail regarding the ability of the ferries to be converted to electricity or renewable sources. KiwiRail has advised that the ferries will be run on hybrid technology with electrical propulsion from generators fuelled by diesel and electrical shore power. This will result a 40 per cent reduction in emissions from 2027. Battery capacity will be progressively increased to fill future-proofed deck space as technology and prices improve.
14. In making all of our decisions we have considered advice from officials at the Treasury, the Ministry of Transport and Te Waihangā, the New Zealand Infrastructure Commission. AECOM was also engaged by the Ministry of Transport as independent technical advisors.

Hon Grant Robertson

MP for Wellington Central

Deputy Prime Minister

Minister of Finance

Minister for Infrastructure

Minister for Sport and Recreation

Minister for Racing



Sue McCormack
Acting Chair
KiwiRail Holdings Limited
[23]

Dear Sue

PROJECT IREX – BUSINESS CASE FOR INTERISLANDER FERRIES AND TERMINALS

Thank you for the Project iReX detailed business case and cover briefing of 3 June 2021. Ministers are aware of the importance of the iReX project given the pivotal role of the Cook Strait connection in the New Zealand transport system and the aging status of KiwiRail's ferry fleet.

We have reviewed the business case and would like to acknowledge the significant work that has gone into the project to date and into the completion of the business case. We also acknowledge the challenges and dynamic environment facing the board in assessing options to address the aging ferry fleet.

We note that there remain significant risks with the project and that elements of the business case fall short of expectations. Our officials have concerns around the lack of a full cost benefit analysis, whether risks are fully acknowledged – in particular relating to landside developments – and the absence of independent review of core assumptions that underpin revenue and cost estimates. Notwithstanding this, we are conscious of the pressing need to replace an aging fleet and the deadline of 30 June 2021 with respect to the letter of intent with Hyundai Mipo Dockyard (HMD) which, we are advised, offers favourable terms for new ferries.

Despite its shortcomings, the business case is clear in its preference for a two large rail-enabled ferry option, and we are advised of the costs associated with any delay, even though early commitment may increase risks in other areas of the project. The later, we believe, can be mitigated through strong project management practice. Accordingly, on balance we are supportive of the detailed business case in principle, conditional upon the following expectations being met:

- That areas identified in the detailed business case requiring further work (as noted above) are addressed, and that Ministers are kept apprised of any material changes. Treasury officials will engage separately on this matter.
- That you work with officials to review project governance arrangements to ensure good practice and an appropriate level of involvement by the Crown as a significant funder of the project. This may include KiwiRail considering project disciplines consistent with those set out in Cabinet Office Circular CO (19) 6 ([Investment Management and Asset Performance in the State Services](#)).

- That total project capital costs do not exceed \$1,450m, and that there be a transparent, and consultative, approach to the management of contingencies within this amount.

In the context of the above expectations, please find attached a signed copy of the Special Resolution approving KiwiRail Holdings Limited (KiwiRail) to enter into Project iReX transactions. This Special Resolution is to be held to our order and released only with effect from the date on which KiwiRail's Project iReX Board approval is not subject to any conditions (other than receipt of the Special Resolution).

The attached resolution is approved by shareholding Ministers based on:

- the Board's favourable assessment of the business case and contractual arrangements with HMD and our understanding that the Board has taken all reasonable steps to assure itself of the credibility of the business case, as well as our expectation that the Board will implement and maintain oversight of rigorous processes to manage risks to the project in the future;
- the information provided in the business case and cover briefing; and
- KiwiRail's responses to officials' questions on the business case and the iReX transactions.

We understand that the KiwiRail Board has approved the progression of Project iReX on the basis that KiwiRail will receive equity funding from the Crown to fund a shortfall of \$257m. Shareholding Ministers are of a view that it is too early to give a commitment to fund the shortfall through equity. This is based on the positive NPV of the overall project, KiwiRail's own projections of free cash flow in the above-rail business in the years [37] and that the funding shortfall is not forecast to occur until [37]

These factors suggest that there may be more capacity for KiwiRail to fund more of the project through debt – potentially Crown debt if no other avenues are available. However, we are also aware that there is insufficient time to gain certainty around this option in the time before a decision is required on the ship-build contract. For this reason, we can advise you that Cabinet has agreed to establish a tagged contingency that covers the amount of your forecast shortfall, that we as joint Ministers have been delegated authority to draw down upon. On that basis further Crown support can be provided, in the form of equity, a Crown loan or otherwise, when KiwiRail has demonstrated a need for such funds being required. At this point it remains our expectation, however, that KiwiRail seeks ways of funding the shortfall off its balance sheet consistent with its transition, through the 'pathway to profit,' to a commercially sustainable above-rail business.

We also advise that we do not support repurposing the MNL insurance money, which relates to your below-rail business. We therefore advise that KiwiRail should return these funds to the Crown as originally intended.

We are aware of the significant work that has gone into this project, and the challenges of working with so many stakeholders. However, we are disappointed that Ministers were given such a short timeframe between the receipt of the final detailed business case and the requirement to approve a Major Transaction based on that information.

Notwithstanding the above, thank you for your efforts in meeting the requests outlined in the letter of 8 April 2021, and we look forward to being kept apprised in a timely fashion as the project moves forward.

Yours sincerely

Hon Grant Robertson

Minister of Finance

On behalf of shareholding Ministers and the Minister of Transport

cc Minister of Transport, Hon Michael Wood
Minister for State Owned Enterprises, Hon Dr David Clark
Greg Miller, KiwiRail Group Chief Executive, [23]

Encl Special Resolution

KIWIRAIL HOLDINGS LIMITED
(the “Company”)

Special Resolution – Major Transaction

section 129 of the Companies Act 1993 (the “Act”)

BACKGROUND

- A. Project iReX involves material investment by the Company and its wholly owned subsidiary, KiwiRail Limited, for the replacement of ships and landside facilities to provide a vital secure and resilient economic and social transport link between the North and South Islands of New Zealand. Project iReX comprises entry into the transactions described in the Schedule to this resolution (the “**Project iReX Transactions**”).
- B. As a series of linked transactions the Project iReX Transactions may involve the Company acquiring rights or interests or incurring obligations or liabilities, including contingent liabilities, the value of which are more than half the value of the Company’s assets before the transactions.
- C. The Project iReX Transactions may therefore comprise a major transaction for the purposes of section 129(2)(c) of the Act, requiring the approval of the Company’s shareholders by special resolution.
- D. All dollar amounts in this resolution are New Zealand Dollars, unless stated otherwise.

RESOLVED, as a special resolution in accordance with section 122 of the Act, that:

- To the extent that the Project iReX Transactions constitute a major transaction, the Company’s entry into, execution and performance of the Project iReX Transactions is approved for the purposes of section 129 of the Act.

This resolution may be executed in any number of counterparts (including by facsimile or PDF transmission of a signed counterparty copy of this resolution) each of which shall be deemed an original, but all of which together shall constitute the same instrument.

SIGNED for and on behalf of all of the shareholders of KiwiRail Holdings Limited

Hon. Grant Robertson, Minister of Finance

Date: 2021

Hon. Dr David Clark, Minister for State Owned Enterprises

Date: 2021

SCHEDULE: PROJECT IREX TRANSACTIONS

The Project iReX Transactions comprise the following transactions, together with the entry into and execution of documents approved by the Company's board to record such transactions:

- (1) The purchase of two rail-enabled roll-on/roll-off and passenger ferries (the "**Ships**") from Hyundai Mipo Dockyard ("**HMD**") at an estimated cost of USD \$184.6m per Ship in accordance with:
 - a. each Shipbuilding Contract between KiwiRail Limited and HMD dated on or about the date of this resolution ("**Shipbuilding Contracts**"); and
 - b. each Refund Guarantee issued by the Industrial Bank of Korea guaranteeing the obligations of HMD under each Shipbuilding Contract to refund advance payments made to HMD prior to delivery of the relevant Ship ("**Refund Guarantee**");
- (2) Development by the Company of certain rail infrastructure and ferry terminal assets to be owned by the Company at Picton, at an estimated cost of ^[37] (including contingency and escalation);
- (3) Development by the Company of certain rail infrastructure and ferry terminal assets to be owned by the company at Kaiwharawhara, Wellington, at an estimated cost of ^[37] (including contingency and escalation);
- (4) The long-term lease by the Company of certain wharf and terminal assets to be owned by Port Marlborough New Zealand Limited ("**PoM**") in accordance with a Development Agreement and a Lease and Licence Agreement to be entered between the Company and PoM;
- (5) The long-term lease by the Company of certain wharf and terminal assets to be owned by CentrePort Limited ("**CentrePort**") in accordance with a Development Agreement to be entered between the Company and CentrePort;
- (6) Project management, design, engineering, consenting, build monitoring and other costs and professional services expenses reasonably incurred by the Company in delivering and monitoring project expenditure relating to Project iReX, at an estimated cost of ^[37] ;
- (7) Entry into loan facilities (including the granting of security) and the issue of shares in order for the Company and KiwiRail Limited to fund its entry into the transactions described above;
- (8) The sale by the Company of the ships *Aratere*, *Kaitaki*, and *Kaiarahi* at such times, on such terms and to such persons as the Company may determine, at an estimated aggregate price (less costs of sale) of ^[37] and
- (9) Any other material transaction, in consultation with Shareholders, that is ancillary to, or necessary to give effect to, the transactions described above.