

Chair
Cabinet Economic Development Committee

DELEGATED AUTHORITY FOR POTENTIAL FURTHER CROWN IREX FUNDING

Proposal

1. We propose that Cabinet delegate authority to us, the Minister of Finance, the Minister of Transport, and the Minister for State Owned Enterprises, to approve up to ^[37] in further Crown funding, to be allocated, if we are satisfied, towards Project iReX (the replacement of KiwiRail's Cook Strait ferries and the associated landside infrastructure).

Executive Summary

2. The Government has previously signalled the importance of a resilient and reliable rail system [DEV-19-MIN-0123 refers]. This included the replacement of KiwiRail's Cook Strait ferry assets. The ferries are commercial assets and should generate a commercial return over time. However, the Crown needs to invest capital to replace the assets due to historic underinvestment in KiwiRail.
3. Connections across Cook Strait provide vital transport links for people and freight. KiwiRail is one of two providers of ferries across Cook Strait. Its ferries are reaching the end of their economic lives, and KiwiRail is currently procuring two new, larger rail-enabled ferries, as part of Project iReX. The project also involves the replacement and upgrade of landside infrastructure in Picton and Wellington.
4. The total capital cost of Project iReX is not yet finalised. The most recent estimate is a total of \$1.45 billion. The Crown has already provided \$435.1 million in funding for Project iReX through Budgets 2019 and 2020, and further Crown funding is likely to be sought by KiwiRail.
5. A request for \$565 million in Budget 2021 was declined, primarily because the costs are not yet finalised and remain uncertain. KiwiRail is expected to provide us with a Detailed Business Case (DBC) in early June 2021 that addresses a range of concerns and clarifies the amount of further Crown funding required. The current estimated funding gap is \$257 million, and KiwiRail is exploring options to reduce this.
6. We will need to respond to KiwiRail's DBC. KiwiRail has asked Ministers to respond to the DBC by 30 June 2021. This is because KiwiRail has signed a Letter of Intent with a shipyard for the two new ferries which expires on 30 June 2021. The Letter of

Intent has locked in key terms and prices so that KiwiRail and the shipyard can progress detailed contractual negotiations.

7. If the Letter of Intent expires before KiwiRail signs a contract for the ships, the shipyard will be able to renegotiate terms and price. Mainly due to the increase in steel prices, the cost of the ships would likely increase by up to ^[37] . The delivery dates for the ships may be delayed, which would increase KiwiRail's maintenance costs for the existing fleet.
8. Further Crown funding requires Cabinet's approval. It will not be possible to fully assess the DBC, seek Cabinet approval for further Crown funding, if required, and respond to KiwiRail's DBC, all in the month of June 2021.
9. To ensure that we retain the ability to respond to KiwiRail's DBC by 30 June 2021, we ask that Cabinet delegate authority to us to approve up to ^[37] in further Crown funding, if required, towards Project iReX. This delegated authority would only be used if we are satisfied with KiwiRail's DBC. This funding would be charged against the multi-year capital allowance.
10. It is important to note that there remains a large number of outstanding risks with Project iReX that will need to be considered as part of the decision to provide further Crown funding.
11. KiwiRail and the ports in Picton and Wellington remain in negotiations over the scope, cost and design of landside infrastructure. Once the ferries have been contracted for, the options for landside infrastructure will be limited. The Crown may be asked to contribute to any landside cost increases.
12. We also need to consider how robust the costs for the road and rail connections are, and how those might be funded, including potential impacts on the National Land Transport Fund, which is already under significant pressure.
13. The Treasury, the Ministry of Transport and the Infrastructure Commission will analyse the DBC and provide us with advice in late June 2021, before any decision to exercise delegated authority will be undertaken.

Relation to government priorities

14. The Government has signalled its commitment to infrastructure, including rail, in the Speech from the Throne 2020, through the Future of Rail programme, and through the New Zealand Rail Plan released on 6 May 2021.

Background

KiwiRail is currently procuring new ferries to service Cook Strait

15. As part of the Future of Rail review, Cabinet agreed in principle to a resilient and reliable rail system that would deliver on the Government's desired outcomes for transport, and wider benefits, such as increased resilience [DEV-19-MIN-0123 refers]. This included replacing KiwiRail's Cook Strait ferry assets.

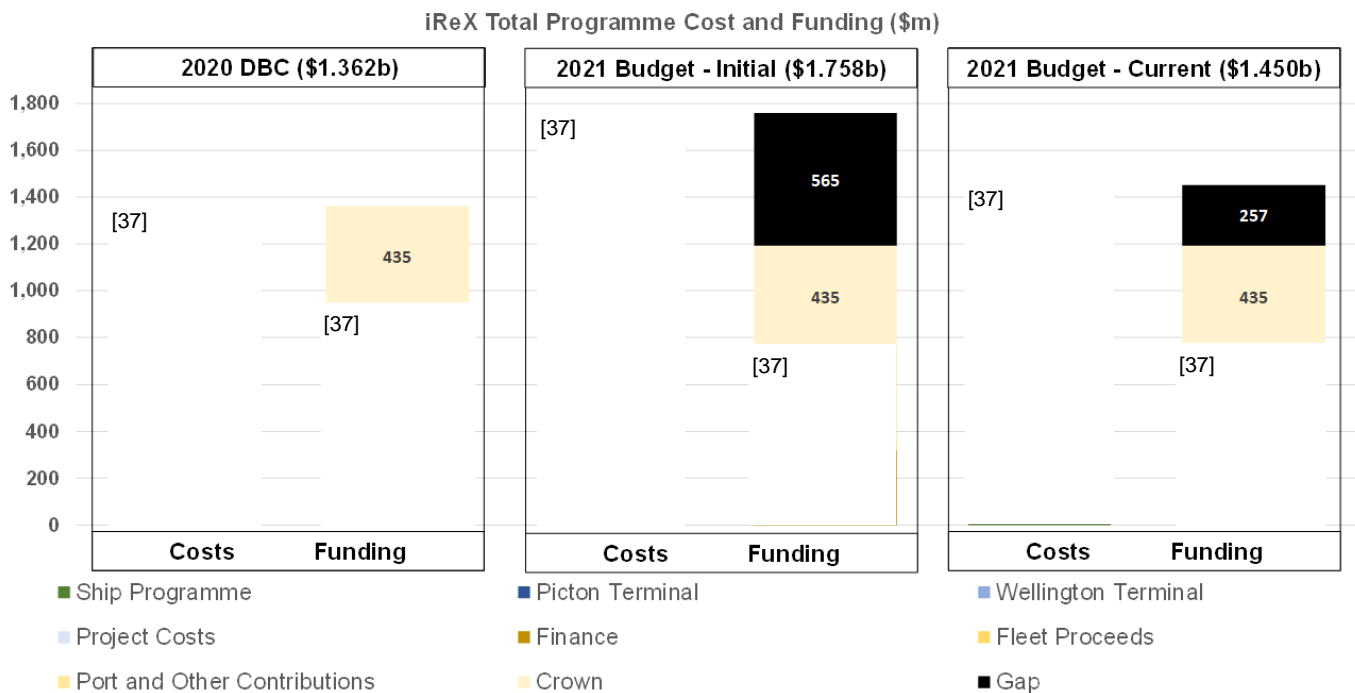
16. Connections across Cook Strait are important for New Zealand's economy and transport system, and provide a vital link for people and freight between the North and South Island.
17. KiwiRail is a State-Owned Enterprise (SOE), which operates a national rail network and ferries across Cook Strait, for both freight and passengers. As an SOE, KiwiRail is expected to operate as a successful business. KiwiRail's ferries are considered commercial assets and, as a result, should generate revenue sufficient to meet its costs over time. However, due to historic underinvestment in the overall rail network, initial capital does need to be provided to KiwiRail for this project.
18. KiwiRail's existing fleet of three ferries are reaching the end of their economic life. KiwiRail has initiated Project iReX to procure new ferries, and work with stakeholders, most notably the port owners in Picton and Wellington, to upgrade the required landside infrastructure to accommodate new ferries. The new ferries and port infrastructure are scheduled to be in place by approximately 2025/26. Following a procurement process, KiwiRail is in detailed contractual negotiations with Hyundai Mipo Dockyard (HMD) in South Korea. A Letter of Intent, locking in key terms and prices, has been signed and expires on 30 June 2021.
19. We have reiterated to KiwiRail that we expect Project iReX to be undertaken on a commercial basis, in that the benefits of the project will exceed the costs, and involved parties will fund as much of the project as possible. KiwiRail is expecting to take on commercial debt to assist with the financing of Project iReX, but Crown funding and contributions from other stakeholders, most notably the port owners, are also required.
20. KiwiRail received \$35 million through Budget 2019 to undertake detailed ferry design, and a further \$400.1 million through Budget 2020 to fund the ferries themselves [CAB-19-MIN-0174.41; CAB-20-MIN-0155.34 refer].

Analysis and key risks

The total project costs are not yet finalised

21. KiwiRail initially sought \$565 million in further Crown funding through Budget 2021, and submitted a draft business case to support this. At the time, the total cost of Project iReX was forecast at \$1.758 billion, an increase of 29 per cent on the \$1.362 billion forecast on which the Budget 2020 decision was based. This change was largely driven by increases in landside infrastructure.
22. As part of the Budget 2021 process, KiwiRail has subsequently worked to refine the scope and cost of Project iReX. The changes to the project's forecast capital costs over time, and the intended funding sources, are detailed in table one.

Table one: Forecast total programme costs and funding for Project iReX



23. KiwiRail’s current estimate of the total capital cost for the project is \$1.45 billion. KiwiRail’s Budget 2021 request was unsuccessful, on the basis that costs were not finalised and that further work was required on the DBC. At this time we asked KiwiRail to:
 - 23.1. prioritise the finalisation of its Detailed Business Case (DBC);
 - 23.2. advise the feasibility of reverting to two smaller ferries than currently intended, and as a result reduce overall project costs;
 - 23.3. provide further information on engagement with ports and their ownership councils, including the financial commitments provided by these parties;
 - 23.4. test its ability to increase debt funding in relation to the project; and
 - 23.5. confirm that the project’s whole of life costs have been considered, including all landside costs.

24. The DBC is expected to be approved by KiwiRail’s Board in early June 2021. We have communicated to KiwiRail that we expect the DBC to address our requests as outlined in paragraph 23. However, there is a tight deadline between Ministers and officials receiving the DBC in early June 2021, and KiwiRail’s Letter of Intent with HMD expiring on 30 June 2021.

25. The Letter of Intent locks in key terms and a price for the two new ferries, while KiwiRail undertakes more detailed negotiations with HMD. If a contract is not signed by the expiration of the Letter, KiwiRail, and the Crown as KiwiRail’s owner, will be

exposed to risk as HMD will be able to renegotiate the terms of the contract. This includes:

- 25.1. a likely increase in ship costs of between [37], noting that the price of steel alone has increased by 50 per cent since December 2020; and
 - 25.2. HMD will also be able to renegotiate the build slots. This could see the delivery of the new ferries delayed by years, and require the working life of the existing ferry fleet to be extended. KiwiRail has advised that maintenance of its existing ferry fleet would cost [37] per annum from 2025. If a ferry lost its compliance to carry passengers, this would reduce KiwiRail's return on its passenger service by [37] per annum, and KiwiRail would consider leasing a ship at an estimated [37] per annum to maintain services and market share.
26. At the current estimate of \$1.45 billion, there remains a funding gap estimate of \$257 million. We expect that the funding gap will reduce from \$257 million. It will not be known until June 2021 what the quantum of this funding gap will be and we expect the DBC to set out a cost range. KiwiRail is expected to formally seek Crown funding to cover this shortfall when the DBC is submitted in early June 2021.
 27. If Ministers are supportive of the DBC, we will need to respond with a commitment of Crown funding in order for KiwiRail's Board to have the comfort to sign the contracts for the new ferries by 30 June 2021. We are advised that a Letter of Comfort from Ministers will not suffice. We have impressed on KiwiRail that we expect it to debt fund as much of the project as possible, and work with the port owners on the extent to which project costs can be met by these parties.
 28. The provision of any further Crown funding requires Cabinet approval. Given normal Cabinet consultation timeframes, we are advised it will not be easy to seek Cabinet approval for further Crown funding after the DBC has been submitted and assessed in June 2021.
 29. We are therefore seeking a tagged capital contingency of up to [37], with authority to draw down delegated to joint Ministers. As KiwiRail is not yet able to provide certainty on what the funding gap will be, we recommend the maximum amount be [37]. However, it is our expectation that any further Crown funding sought would be materially below [37]

Officials will provide us with further advice on the viability, risks and trade-offs of the project before delegated authority is used to commit further Crown funding

30. Before exercising this delegated authority, the Treasury, the Ministry of Transport and the Infrastructure Commission will undertake an analysis of the DBC and provide advice to us by 21 June 2021. This analysis and advice will include:
 - 30.1. whether the project is able to be undertaken on a commercial basis;
 - 30.2. an analysis of whole-of-life costs for the project;
 - 30.3. how the project aligns with the Government's wider transport priorities;
 - 30.4. KiwiRail's ability to comply with its lifeline obligations in an emergency event;

- 30.5. costs of reconfiguring the road and rail networks that connect to the ferry terminals, and implications for the National Land Transport Fund (NLTF); and
- 30.6. potential implications for competition across Cook Strait, and how that may impact on transport outcomes or create risks to the Crown.
- 31. There are a number of key outstanding risks and issues with Project iReX that we will need to consider as part of any further funding for the project. We need to weigh up the costs of delaying the ship-build contract, and whether delay will help us resolve these uncertainties and manage potential future funding risks to the Crown.
- 32. Once contracts are signed, the terminal infrastructure will need to be designed and built to support the ships. We are aware that uncertainty remains in regard to the costs to upgrade landside infrastructure at both the Wellington and Picton terminals and negotiations with ports are still ongoing. Once the ferries have been contracted for, alternative options for landside infrastructure will be limited. The Crown may be asked to contribute to any landside cost increases.
- 33. We also need to consider how robust the costs for the road and rail connections are, and how those might be funded, including potential impacts on the NLTF, which is already under significant pressure.
- 34. We will also need to consider other stakeholder views, for example the impacts on other port users, and the respective councils' plans.
- 35. As a result of these considerations, we may decline to provide KiwiRail with further Crown funding, and the delegated authority may not be used.

Financial Implications

- 36. This paper seeks agreement from Cabinet to establish a tagged capital contingency of up to ¹³⁷¹ in Vote Transport for further Crown funding towards the total cost of Project iReX.
- 37. It also seeks delegated authority to the Minister of Finance, Minister of Transport, and Minister for State Owned Enterprises to jointly draw down the tagged capital contingency, subject to satisfaction with KiwiRail's DBC and that the risks and trade-offs of contracting for the ferries can be mitigated and are otherwise acceptable.
- 38. This tagged capital contingency would be charged against the multi-year capital allowance.

Legislative Implications

- 39. There are no legislative implications associated with this paper.

Impact Analysis

Regulatory Impact Statement

- 40. No Regulatory Impact Statement is required for this paper.

Climate Implications of Policy Assessment

41. KiwiRail's new ferries are designed to emit less carbon than its current fleet, predominately due to the optimised hull design, utilisation of more efficient technology and the larger ferries needing to make fewer crossings. The two ferries are forecast to produce a total of 65,921 tons of carbon emissions each year; a 40 per cent reduction in the Interislander's carbon footprint when measured against a base year of 2012.
42. The ferries use hybrid technology to run on both diesel (for main propulsion), and electrical power generated by batteries and shore power (for entering into port, manoeuvring and when docked in port). It is expected that, in a typical three-hour crossing, the ferries will be powered by batteries approximately 30 per cent of the time. Overall, it is expected that the two new ships will use 36 per cent less fuel than the current fleet of three ships.
43. KiwiRail considered other types of main fuel in addition to diesel, namely LNG and methanol, however both were discounted as further costs would be required and they remain fossil fuels. Hydrogen fuel was also considered and discounted as an initial power system as, in KiwiRail's assessment, it is not yet suitable for large-scale application. However, the ferries' design and engines are future proofed in that the engines can accommodate alternative fuel sources, such as hydrogen, as they become available and reliable. This is in addition to increasing the capacity of batteries over time.
44. Any delay to the procurement of the new ferries, for example the missing of build slots as outlined in paragraph 25 above, will require KiwiRail to operate its existing ferry fleet for a longer period, and extend the transition period for moving to more efficient ferries. We note that KiwiRail is already looking to transition its current fleet away from marine-grade heavy fuel oil to a more efficient diesel oil, by the end of 2021.

Population Implications and Human Rights

45. There are no human rights issues or implications, or population implications associated with this paper.

Consultation

46. The Treasury and the Ministry of Transport have prepared this paper.
47. The Ministry of Transport notes that there continues to be significant uncertainty with landside costs. Negotiations continue with both Port Marlborough and CentrePort over the respective share of costs (and the total costs of landside infrastructure). While there will be costs to KiwiRail from delaying the ship-build contracts, there are also equally important financial and legal risks to the Crown associated with committing to the ship-build without certainty regarding landside costs and shares. As noted in the paper, these will need to be carefully considered before Ministers take final decisions to support KiwiRail to enter into the ship-build contract. Once decisions are taken on the ship-build contracts, the options for land-side assets will be limited.

48. The Ministry also notes that there may also be potential implications for the NLTF in terms of funding road and rail connections. The NLTF is already under significant pressure and this will need to be considered when the final DBC is received.

Communications

49. It is expected that there will be press announcements when KiwiRail enters into a contract for the new ferries. If further Crown funding is provided, it would be announced at this time.

Proactive Release

50. We intend to proactively release this Cabinet paper following any announcement of KiwiRail entering into a contract for new ferries. If the Cabinet paper were to be released before this time it would likely jeopardise KiwiRail's commercial negotiations with HMD.

Recommendations

We recommend that the Committee:

1. **note** that KiwiRail is currently undertaking Project iReX, which involves the procurement of new ferries to service Cook Strait, and working with stakeholders to upgrade landside infrastructure to accommodate the new ferries;
2. **note** that the scope and costs of Project iReX have not yet been finalised, and that risks and trade-offs remain, primarily as options for landside infrastructure will be limited once new ferries are contracted for, the Crown may be asked to contribute further if the landside costs increase and that there may be implications for the National Land Transport Fund;
3. **note** that KiwiRail has signed a Letter of Intent with Hyundai Mipo Dockyard for the delivery of two new ferries, and that if a contract is not signed by the Letter of Intent's expiration on 30 June 2021, KiwiRail and the Crown will be exposed to risks, most notably cost increases to the ferry build and a likely deferred build slot that will delay the delivery of the ferries, and that cumulatively these risks, if realised, are likely to cost in excess of [37]
4. **note** that KiwiRail is likely to seek further Crown funding towards the total cost of delivering Project iReX, and the amount of this funding request will not be known until KiwiRail delivers a Detailed Business Case in early June 2021;
5. **note** that there will be insufficient time to fully assess the Detailed Business Case and receive Cabinet approval for further Crown funding, if required, between the Detailed Business Case's delivery in early June 2021 and the Letter of Intent's expiration on 30 June 2021;
6. **agree** to provide further Crown funding of up to [37] to Project iReX, subject to the Ministers specified in recommendation 8 below being satisfied with KiwiRail's Detailed Business Case and that the risks and trade-offs of contracting for the ferries can be mitigated and are otherwise acceptable;

7. **agree** to establish a tagged capital contingency of up to the amounts as follows in Vote Transport, to provide for further Crown funding towards the total costs of Project iReX;

	\$m – increase/(decrease)				
	2020/21	2021/22	2022/23	2023/24	2024/25 & Outyears
Project iReX – Tagged Capital Contingency	-	[37]	-	-	-

8. **authorise** the Minister of Finance, Minister of Transport, and Minister for State Owned Enterprises (together, joint Ministers) jointly to draw down the tagged capital contingency funding in recommendation 7 above (establishing any new appropriations as necessary), subject to their satisfaction as outlined in recommendation 6 above;
9. **invite** delegated Ministers to report back to Cabinet before the end of June 2021 on their decisions described in recommendation 8 above;
10. **agree** that the tagged capital contingency in recommendation 7 above be charged against the multi-year capital allowance.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Michael Wood
Minister of Transport

Hon Dr David Clark
Minister for State
Owned Enterprises