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KiwiRail: Doomed to Fail?

Luke Malpass

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When the New Zealand rail system was nationalised in 2008 and renamed 'KiwiRail', Australians referred to it as the 'sale of the century.' The initial repurchase cost the taxpayer $690 million, and along with spending commitments and ongoing concessions to the previous owner, Toll Holdings, it has already cost the taxpayer around $1 billion. This was proclaimed at the time to be a purchase made on strategic, environmental and economic grounds. This rhetoric represented an idea about the 'failed policies of the past,' often peddled by former Prime Minister Helen Clark and former Minister of Finance Dr Michael Cullen as an explicit rejection of privatisation.

A year on from the renationalisation, it has become clear that the previous government's justifications for purchasing a hugely expensive, loss-making asset were driven more by ideology and political expediency than sound economic or social reasons. KiwiRail in its current form will never be more than a loss-making asset and is an open-ended fiscal risk.

This report argues that:

- The Labour government disregarded Treasury's oft-repeated advice that the acquisition of KiwiRail would not solve any of its underlying problems. Ongoing subsidies will always be required to run the current system regardless of ownership. There are too many kilometres of track and insufficient demand to reach commercial equilibrium.
- Treasury has subsequently valued the asset at $369 million, which is a financial loss of $321 million for the Crown. This represents a loss of almost $1 million per day for the last year in write-down costs alone. Further, this Optimised Depreciation Replacement Cost valuation is a 'public benefit entity' costing: in other words, KiwiRail is worthless as a business. The government requires a real return of 8 percent on its transport assets, whereas KiwiRail delivers a negative return.
- The environmental and strategic reasons given for the buyback are not compelling. Government ownership of Rail will not deliver net economic development benefits to New Zealand.
- KiwiRail will not deliver on the substantial greenhouse gas emission cuts promised. Arguments for state ownership of Rail on environmental grounds such as pollution reduction and road congestion are weak. These ideas represent cargo cult thinking more than reality.
- The only apparent reason for the buyback was an ideology regarding the desirability of state ownership. Rail has an old-world romantic appeal, and the purchase was widely advertised in the Labour Party's *Kiwibank, Kiwisaver, KiwiRail* election campaign. This ideology is at odds with the inexorable trend toward privatisation in New Zealand and around the world over the past 20 years.

Luke Malpass is a Policy Analyst with the New Zealand Policy Unit of the Centre for Independent Studies.

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- KiwiRail needs to be restructured and privatised in separate pieces. This way, the commercially viable parts can be privatised and certain lines sold to interesting parties like ports and companies such as Solid Energy and Fonterra. The unprofitable parts should be shut down by government and the land put to more valued use. Land could be set aside for public use, such as being part of the new national cycleway, or sold to private interests.

KiwiRail has a difficult future in its current form. With many fiscal pressures looming in the medium term for New Zealand, KiwiRail is becoming an increasing financial burden on the government's balance sheet. The reform, rationalisation and resale of KiwiRail should be a top priority for the government.

Introduction

> Transport touches the lives of all New Zealanders and contributes profoundly to the social, economic, environmental and cultural wellbeing of the nation.[1]
> — *New Zealand Transport Strategy 2008*

> A farmer wrote to me complaining that the Railways had lost his tractor … I asked the Railways to find the farmer's tractor. They said, 'Sorry minister, we know it left Hamilton but it failed to arrive at Taumaranui.'[2]
> — *Richard Prebble, Former Minister for Railways*

When the government bought back the NZ Rail system in 2008 and renamed it KiwiRail, it was supposed to herald a new era in integrated and sustainable transport strategies. Modern locomotives would wind their way across beautiful New Zealand vistas, carrying not only freight and people but the aspirations of a country boldly facing the future. Private sector ownership was out; public ownership of what the government called an important 'strategic asset' was in.

The buyback was offered as a response to the perceived failure of private sector involvement in Rail. Government investment and operation were thought to be the way forward. Treasury repeatedly advised that a change of ownership would not change the underlying problems with Rail. But the government disregarded this advice.

A year on from the renationalisation, it is time to examine the fallout from the purchase. KiwiRail cost the government $690 million.[3] This is more in real terms for a lesser asset[4] than the $400 million the government sold NZ Rail for in 1993.[5] Treasury recently valued the real sale value of the asset at $369 million.[6] This represents a financial loss of $320 million to the taxpayer for a poorly performing, depreciating and rundown asset.

Rail in New Zealand is largely unprofitable, and this is caused by several factors that the government cannot change.

Tracks have been built by governments over the years without regard to commercial imperatives, leaving much of the system unprofitable with little prospect of ever being so. This also leads to the next problem caused by demographic and technological change. Because rail is a static, long-lived asset, it is not well placed to respond to population changes and industrial freight flows. Nor is it well placed to respond to the greater flexibility offered by cars and trucks. Once a track has been laid, trains must travel there regardless of market forces—it is a totally sunk cost. New Zealand's population is too small and not concentrated enough to make our currently large rail network viable. This is nineteenth-century technology developed well before other forms of transportation became widely available; and while it still is good at transporting some freight, rail has severe limitations and is only economical in some areas. Rail's lack of commercial success reflects the fact that for the resources required to operate a rail system, relatively few customers find it an attractive transport prospect.

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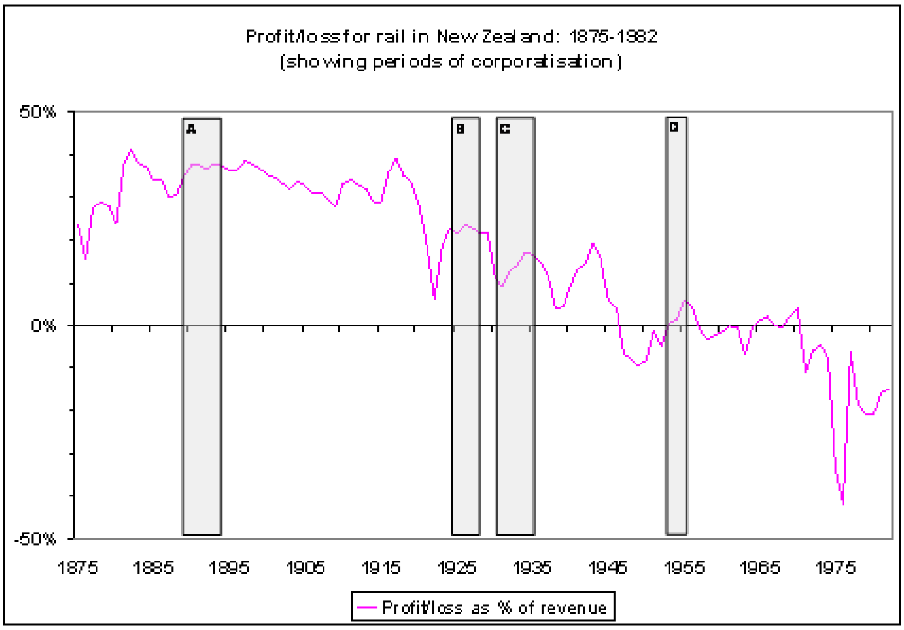
These factors make it necessary to consider a serious restructuring and downsizing of the rail network, followed by privatisation.

The NZ rail experiment: history repeated

Since public ownership of the NZ rail system in the 1870s, it has seen five sets of major reforms—all in response to poor performance and financial instability. The graph below shows the first four cycles, with the fifth beginning in 1983. Each of these restructurings was followed by short periods of growth in revenues but struggled again after only a few years.[7] The NZ Institute for the Study of Competition and Regulation (ISCR) has shown in a recent report that this profitability problem is endemic in rail in New Zealand. The country, geographically and size-wise, is simply not well suited to the expansive kind of rail infrastructure that has been built up over time.



Source: Dave Heatley. The Future of rail in New Zealand. NZ Institute for the Study of Competition and Regulation. ISCR February Seminar (19 February 2009)

Rail has been trying to combat the reality of New Zealand's geography in each of the four previous times it was restructured, and also the challenges of the nation's changing demographics.

Rail has been trying to combat the reality of New Zealand's geography in each of the four previous times it was restructured, and also the challenges of the nation's changing demographics from the 1950s to the 1980s. Rail did not respond well to these changes; indeed, it was never in a position to do so because railways rely on concentrations of people and goods over long distances to be economical. This is not the case in New Zealand where the population is small and dispersed. It also shows the limitations of nineteenth-century technology trying to respond to modern transport patterns, demands and expectations.

Recent history

Corporatisation

The NZ Rail Corporation was created in 1983, and was succeeded by NZ Rail Ltd in 1990. The corporatisation process turned the old Department of Railways into a government-owned corporation that was expected to have a 'core business focus'[8] and turn a profit for its sole shareholder, the government. This restructuring saw many workers laid off as Rail was compelled to commercialise and trim costs. The government had been using Rail as a state employment agency for some years and it was operating at a substantial loss. The corporatisation process attempted to make NZ Rail a going concern with a business model and chief executives with discretionary managerial powers that no longer needed signing off by a minister.

NZ Rail was transformed into a commercial entity that could be successfully privatised.

Privatisation

In 1993, the Crown wrote off $1.3 billion of debt in NZ Rail and sold it for $400 million (approximately $573 million today) to the consortium of Fay Richwhite & Company (via investment company Pacific Rail), Wisconsin Holdings (an American rail Company), and Berkshire Partners. The company was renamed Tranz Rail Holdings Ltd in 1995.

In 2003, Tranz Rail's share price collapsed and the company was separated and taken over by separate entities. The government bought the tracks for $1 and Toll Holdings bought the rest of the business. The government agreed to a $200 million 'funding injection.'[9] The transport Minister at the time, Paul Swain, said that if the government had not intervened, the trains would have stopped running within a week. Minister of Finance Dr Michael Cullen added that, 'Unlike the Telecom and Air New Zealand sales, the then National government did not insist on a Kiwi Share in Tranz Rail and did not put in place an effective alternative mechanism to enforce performance obligations.'[10]

In spite of Dr Cullen's assertion, it is unclear how the government enforcing performance obligations on a private company would aid commercial success. 'Performance obligations' in this case is a euphemism for 'government mandate' of compulsory freight levels on unprofitable and rarely used lines. These obligations also ignore market signals: if performance obligations are needed to compel a company to operate unprofitable services that consumers do not wish to use, it shows those services should not be supported by government subsidies.

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The buyback

> A modern rail system can lessen the carbon footprint of our wider transportation network, taking pressure off our roads and allowing our trucking and shipping businesses to operate more efficiently. Combined with an increase of almost 1,100 per cent in public transport investment since 1999, today's announcement marks a major step forward in building a truly sustainable transport network.[11]
> — *Prime Minister Helen Clark, 5 May 2008* [12]

> Note that the deep-seated problems with rail will remain regardless of ownership.
> — *Treasury Report, 5 September 2007* [13]

The 2008 buyback

In May 2008, the Labour government bought Toll Rail for $665 million (final price was $690 million) plus ongoing concessions for Toll New Zealand's freight forwarding and trucking operations. Dr Cullen's rationale for the buyback was Toll's inability or unwillingness to meet the terms of the National Rail Access Agreement (NRAA) under which the company was expected to contribute a certain amount of capital for tracks. However, Toll did not find it economical to pay for tracks, and the government was not prepared to subsidise track access costs. Instead, it decided that the easiest and most desirable way to resolve the situation was to purchase the business, resulting in the renationalisation of Toll New Zealand as KiwiRail.

This investment was met with mixed reaction in New Zealand, especially because the cost of the buyback was greater in real terms than what it was sold for in 1993. Moreover, Toll Holdings 'was not looking to sell the rail operating business.'[14] For an apparently failing rail system with no prospects of improvement, it was a hefty price to pay.

What reasons did the government give for the buyback? Just that there had been underinvestment in rail, that the government wasn't prepared to further subsidise private profits, and that New Zealand needed an extensive rail system.

Components of KiwiRail

- freight service
- suburban commuter service, and
- long-distance passenger service.

There are also tourist services such as the Tranzalpine service and the Interislander ferry car, rail and passenger services.

Note: **Long-distance passenger service is a small component of the rail network. The services referred to in this report are primarily freight and long-distance passenger**. The suburban Tranz Metro in Wellington, for example, faces a very different set of challenges to a freight line on the west coast.

KiwiRail at a glance

- **$12 billion**: total assets (an unrealistic sum)
- **3,300**: staff
- **4,000**: kilometres of track
- **18,000**: hectares of managed land
- **$614.3 million**: revenue in 2007–08
- **3**: passenger ferries (one owned, two leased)

The May 2009 Budget provided $258 million of new rail funding and $90 million of operating support for KiwiRail. The government also agreed to make a debt facility to KiwiRail, which included $115 million to fund the purchase of 20 new locomotives and provide KiwiRail access to working capital.[15] While less generous than the funding signalled by the previous government (but not made explicit), it still indicated that such spending would continue as long as the state owned rail.

Reasons for buyback

Treasury acted as the government's lead agency throughout the 2008 buyback process. Treasury papers in the two years leading up to the purchase indicate that the government acted despite Treasury repeatedly advising against the purchase, especially that '*regardless of ownership, some form of ongoing subsidy will be required to retain existing services*.'[16] [emphasis added]

The government acted despite Treasury repeatedly advising against the purchase, especially that 'regardless of ownership, some form of ongoing subsidy will be required to retain existing services.

However, this advice is contrary to the National-led government's aim to operate Rail 'as efficiently as possible, with strong commercial imperatives to provide the greatest benefit to the New Zealand economy and rail passengers.'[17] In other words, the aim is to provide a high quality, low cost service that is flexible to consumer demands. But as Treasury points out, state ownership in itself cannot provide this.

Renationalisation was treated and presented as a technical decision—based on the argument that the previous owner, Toll Holdings, could not (or would not) put up the investment necessary to reach the government's goal of making Rail a more widely used and profitable form of transportation.

This is true—Toll did not see it as viable to make new investments in Rail in the medium term, a conclusion that Treasury concurred with after having access to confidential commercial information.[18] This is because much of the rail network (loosely termed)[19] is simply not profitable and 'officials … have concluded that neither Toll, nor any other rail operator, can meet the full costs of the track.'[20]

Ideology of State ownership

> This week the government accomplished what might be a world first for the twenty-first century: the buy-back of a railway. In most parts of the world, the ideology of 'public ownership of the means of production, distribution and exchange' is long since dead.[21]
> — *Bernard Hickey, economic and financial commentator*

Dr Cullen stated in the press release announcing the Rail sale that 'the selling of our public rail system in the early 1990s and the running down of the asset afterward has been a painful lesson for New Zealand.' Helen Clark went on to say, 'Modernising our transport sector is central to transforming our economy and making it truly sustainable.'

It appears that the government purchased KiwiRail for non-commercial reasons. These reasons are primarily environmental: getting more traffic off roads, reducing carbon emissions, and promoting sustainability (although, what that means is unclear).

The difficulty is that the only politically sustainable way of delivering these goals is for KiwiRail to be profitable. The political will for subsidies might exist, and if this is the case then fulfilling social goals with Rail will not be a problem. The present government recognises subsidies as a necessity in the short term. However, in the longer term, a large subsidy is not a politically reliable or fiscally sustainable path to travel down. Over time, the subsidy will increase and previous issues associated with different government ownership structures will emerge. See box below.

Box. 2 Treasury on government ownership[22]

When the government was originally considering renationalising the rail system, it received the following advice from Treasury on possible models of Crown ownership:

1. **Single track and operations SOE, a return to the 1986–93 model.** It would not be viable on its own and there would be continuing disputes between Ministers and the SOEs around funding. TVNZ is the closest parallel.
2. **Single track and operations Crown Entity (CE).** This would remove a commercial focus and the nearest historic parallel would be rail pre 1980. The CE would require significant annual funding. Disputes between Ministers and the CE over funding would be commonplace.
3. **Separate SOEs for track and operation.** 'If the two SOEs behaved commercially, this would largely replicate the current set of disputes between Toll and Ontrack.'

'We have identified several key problems with the rail freight business in New Zealand: few routes are commercially viable; it faces fixed high costs and has difficulty competing with ships; it is not really a "network"; and investments in new rolling stock are uneconomic.'[23]

None of these options is desirable. All have effectively been tried and failed before. State ownership and subsidies are certainly not economically sensible and, regardless of political will, an ever-increasing subsidy is probably not politically sustainable. Most advice that has been released by Treasury suggested that a renationalisation would be fraught with difficulty.

According to Treasury calculations allowing the current network to 'reach commercial equilibrium' would require the length of track to be reduced from 4,000 kms to 2,300 kms.[24] There is no obvious reason why government ownership will make any difference to this situation. Nor is there any reason why social goals need to be delivered through state ownership of a rail company. Especially, ownership that would be 'in effect an open-ended fiscal risk.'[25]

Of course, there is nothing particularly ideological about including the rail system as part of an overall transport strategy in New Zealand. Renationalisation with the stated intention of reform, rationalisation and resale would have been understandable, if perhaps not the best way for the government to go about it. But repurchasing the network with the intention of keeping it in public hands for no appreciable gain allows only one substantial conclusion to be drawn—this purchase was driven by ideology, *an ideology that government ownership and operation of rail is inherently more desirable and more efficient than private ownership operation.*

Short-term political expediency may also have driven the purchase process. The government went into the last election with the campaign slogan of '*Kiwibank, Kiwisaver, KiwiRail—keep it Kiwi, Vote Labour*,' leveraging off the idea of positive public ownership of assets.

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The difficulty with this idea, however, is that organisations such as the World Bank consider that 'privatisation is now so widespread that it is hard to find countries not using this approach: North Korea, Cuba and perhaps Myanmar make up the shrunken universe of the resistant.'[26] Paradoxically, the buyback was in the words of Michael Cullen, 'an ideological burp.'[27]

The environmental argument

There has been an argument for Rail to play a more substantial strategic role in New Zealand's transport mix. In order to meet Kyoto obligations and reduce greenhouse emissions, the *New Zealand Transport Strategy* sets a target for 'Rail to carry 25% of all freight tonne kilometres'[28] (it carries approximately 15 percent at present) as a target to help reduce greenhouse emissions. This has been based on the assumption that the higher costs of Rail will be offset by the benefit of much lower emissions in the short term. It envisages that in the long term, Rail will be used more widely thus helping curb greenhouse emissions. It is assumed in New Zealand that 'Rail is four times better than trucking' in terms of emissions.

However, Dave Heatley at the Institute for the Study of Competition and Regulation (ISCR) points out that comparable Australian case studies reveal far less compelling statistics.[29] Gaballa and Cranley calculated that distance is the main determinant for the level of greenhouse gases.[30] This is recorded over much longer distances than in New Zealand (making freight more efficient). In their study, intermodal transport (mainly train and a little road transport, a realistic and real-life mix) produced 61 percent of road-only emissions. As Heatley points out, the figures are less than two times road emissions levels and nowhere near the four times generally quoted in New Zealand. If carbon efficiency is a key driver behind Rail, then those estimates need serious revision.

There are two main problems with the environmental arguments for rail. The first is that the 'average' emissions profile is complex. Average emissions do not suddenly drop if goods at the margins transfer from road to railways. Rail is better at transporting certain goods (coal, for example) and roads do other things better (livestock, courier deliveries, and concrete, for example). Given that fuel is a substantial cost for both transport modes, the most efficient mode probably has already captured the business of what it can efficiently carry.

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The second problem with greenhouse gas arguments for state ownership of Rail is that an emissions trading scheme (ETS) or other mechanism (such as a carbon tax) internalises carbon costs. Under an ETS, Rail might gain an input cost advantage and can pass that onto customers. This would occur regardless of the ownership of Rail.

The cost-benefit analysis that has been offered to place Rail so squarely at the heart of the *New Zealand Transport Strategy* must be questioned, especially as shipping is more than twice as efficient as rail (in greenhouse terms), and competes along similar routes to rail. This ratio suggests that in order to get the same amount of carbon savings, the government has to compel a far greater share of freight to Rail to reach the same targets. Further, if an overall strategy of reducing congestion and greenhouse gases was so important, then why did the previous government not look at ways to actually support that by investigating deregulation and providing incentives for other transport modes? While Rail certainly is 'cleaner' than road transport, it is not as clean as shipping and the substantial environmental benefits claimed for it are dubious.

The strategic argument

Another argument made for state ownership of Rail is its strategic importance. Rail is supposed to be an important and integral part of the nation's infrastructure; it is important for our exporting sectors; and it can help provide an integrated planning approach. In essence, Rail ownership is supposedly in the 'national interest.'

At the time of the buyback, this argument was more implicit than explicit and revolved around price stability and predictability (petrol prices were high at the time). In a press release, Helen Clark said the purchase allowed the government 'to make strategic decisions.'[31] This is laid out in the strategy report produced by the Ministry of Transport.

Dr Cullen denied that the KiwiRail deal was in any way related to the idea behind the government's blocking of Auckland Airport sale to the Canadian Pension Plan.[32]

Preventing an airport part owned by Canadian Pension Fund was a matter of national strategic importance, but the acquisition of KiwiRail was not, at least according to the architect of the deal.

An argument about strategic importance has some merit—in the past, Rail has been something that taxpayers were prepared to keep because of a perception that it may become economical in the long term. However, it now seems that in the long run and in many places, it invariably hasn't been profitable. The public response to the idea of losing a rail system seems to be a stronger factor than any particular strategic concerns. For whatever reason, railways have a romantic appeal. It seems that for much of New Zealand, the *idea* of losing certain rail services is more powerful than the *reality* would actually be.

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Either way, if rail is a 'strategic asset, it is unclear *how much of it* is 'strategic' and how it is *more* strategic under state ownership. The government can only keep unprofitable lines going and if lines are extremely unprofitable, and therefore underused, how are they strategic?

It is also important to note that while a lot of railway lines were closed from the 1950s through to the 1980s, there is no evidence of adverse economic consequences or a large political constituency for their reopening (although a rather vocal one exists).

Moving forward

Privatising KiwiRail

Privatisation of KiwiRail should be seriously considered. The longer it remains in state hands, the longer taxpayers are exposed to risk and ever-rising costs. The government will almost certainly make a loss on this 'investment'[33] because the previous government paid far too high a price for a loss-making enterprise in the first place. A substantial loss may come despite an improved asset from the time of purchase.

The question from the perspective of citizens and government is: What exactly do we want Rail in New Zealand to provide? Many would say a profitable and sustainable rail network.

Once this question is answered, a privatisation procedure can be tailored to help ensure these goals can be met by the market.

Privatising assets is a good way to pay down debt, but in the case of KiwiRail it is unlikely in the short term that anyone will pay close to what was paid for it. As the Minister for Transport has said, 'sadly, nobody in their right mind would pay the sort of money for KiwiRail that the previous Labour Government paid.'[34] The manner in which the asset was bought from Toll Holdings would also act as a deterrent to any potential investors. The government may have trouble making any substantial money off the deal.

Privatisation: the forbidden concept

> The Government is now the owner of a business which probably has no value, in fact negative value, having just eight months ago paid almost a billion dollars for it.
> — *Bill English, Minister of Finance*[35]

Politically, any question of privatisation is difficult to address. The previous government pledged to halt privatisation, and the current government has promised to do the same in its first term. This suggests that public support for privatisation of assets is low.[36] Private provision of services (i.e. funded by the government, operated by the private sector) is received more favourably[37] but is still not particularly popular. This is the case around the world despite the fact that services are generally better, cheaper, and more suited to the market and consumer preferences when owned by private hands. This argument is not a blind adherence to an idea that private ownership is always substantially better than public but that 'on average and over time, the private sector is better at running businesses than politicians.'[38] It also means that governments are not gambling with taxpayer money and can avoid moral hazard issues involving public ownership.

Equally, those opposed to privatisation could claim the same moral hazard exists with potentially failing privatised businesses being bailed out or supported, especially if they receive subsidies, such as Toll. This is a fair criticism but ignores the benefits of privatisation accrue on average and over time, and that ultimately any government that bails out or supports an industry is not coerced into it but chooses to do so.

Different country, same challenges: lessons from Victoria

IN 1999, the Victorian government led by Premier Jeff Kennett privatised Victorian Railway services. Learning from privatisation experiences in the United Kingdom and to a certain extent New Zealand, the Victorians undertook to find a suitable ownership structure that could reflect the government's aspirations for Rail. Then, as now in Victoria, an ongoing level of subsidy was required to keep commuter rail running.[39]

The key issue in designing a privatisation was how to acceptably allocate risk and control the government subsidies received by private operators. This had to sufficiently incentivise certain levels of investment in capital and rolling stock and to prepare for the eventuality that a private rail operator might go bankrupt or walk away from its commitments.

Given these considerations, the government did not wish to sell the rail outright as there would be problems if the owners walked away from an unprofitable business. Nor did it wish to tender out long-term leases as this would not sufficiently align the incentives for private operators to make real gains in the efficiency required to improve services and increase profitability—which would be important over time if the subsidy was to be decreased or removed.

In the end, the Victorian government split the rail network into rural freight, long-distance commuter, suburban trams, and commuter trains before sale. For the urban commuter modes, it settled on a franchise model[40] (with fixed terms) as the best way of delivering value for money for the commuter subsidy. It tendered the parts off separately. The only outright privatisation was of the long-distance freight section of the rail.

Despite its different model, the Victorian government has since experienced similar problems that beset the New Zealand government's agreements with Toll. Private companies have had significant political leverage when renegotiating the terms of track access and maintenance. The companies paid substantial sums for the rail business expecting a speedy upturn in patronage and profitability. For various reasons, these did not eventuate as expected, resulting in companies unilaterally pulling out of the privatised market and an increase of subsidy for those who have remained.

Although the privatisation has not cost the taxpayer less, it certainly has not cost more and has led to a great increase in reliability, punctuality, and customer focus. Though there has been a buyback of the rural rail network, the Labor government of Victoria is still committed to its privatisation model.

Rather than highlighting a failure of privatisation, this story highlights the extreme difficulties with governments setting subsidy levels (to balance fiscal prudence with desired outcomes) and achieving a socially desirable rail system while satisfying political imperatives. This situation is another example of the difficulties with even partial government involvement.

Most objections to privatisation are made on ideological grounds. The argument is that some services and assets 'should' be owned by the state and all New Zealanders. State ownership is needed, so it goes, because certain services need to be affordable, accessible for everyone and complement an integrated planning approach. Where a case cannot be made on this basis, public ownership is justified on the grounds that the private sector would not be willing to provide what was 'needed' or that profits would be sucked offshore.

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While it is certainly true that there are some public goods that only the government has a real interest in providing,[41] there is little obvious reason why any of the services privatised in New Zealand during the 1980s and 1990s would have been better in public hands. Even a company like Telecom, whose customers still gripe over price, technology and customer service, delivers better service than when it was in public ownership. As other players enter the market, service will continue to improve. There is anecdotal evidence about people who, after moving house, had to get their local MP to contact Telecom and intercede on their behalf to receive a telephone in less than a few months.[42] Richard Prebble has written that 'it took six months in those days (early to mid 1980s) to get a business connection in the capital ... it also took three weeks to have it repaired if it went wrong.'[43]

The paradox of public ownership structures is that they tend to have difficulty efficiently delivering the services they mean to provide. Without competition and the disciplines imposed by the marketplace, businesses run by the state are often bureaucratic, inefficient, and not especially good at delivering the intended goods and services. This prevents creation of any substantial profits for appropriation. Another reason for this, which will become more relevant in the coming years, especially with regard to KiwiRail, is that public businesses are often expected to serve more than one goal.

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Instead of seeking to provide quality service at a good price (i.e. that determined by the market), KiwiRail has been purchased to serve other social objectives, however loosely defined they may be.

There is substantial evidence provided by economists[44] and policy experts around the world that privatisation is preferable to public ownership in the long run. A study by Phil Barry found that realised gains to the economy out of New Zealand's privatisation process were positive; the privatised entities achieved greater productivity gains but acknowledged that not all privatised companies had succeeded. As Barry points out, 'Sometimes companies get it right and sometimes they get it wrong. The case for privatisation is not based on the claim that private enterprise is somehow always right and public enterprise is always wrong. Rather, it is a question of which form of ownership is likely to be most efficient over time.'[45]

Further, the global trend toward privatisation is undeniable. The World Bank notes that in 2006, '48 developing countries carried out 249 privatisation transactions valued at a record USD$104.9 billion.'[46] These are developing countries trying to increase their wealth and prosperity; while this is not proof that privatisation is more efficient, it certainly suggests that it is widely believed to be 'best practice.' Most nations in the world have pursued privatisation programmes in the past two decades.

The OECD's recent economic survey of New Zealand recommended privatising anything that is not core government provision, especially government-run businesses. It also notes that moves by the previous government contrary to this policy appeared to have more to do with ideological disposition than good policy. 'There is no fundamental economic rationale for government ownership in these sectors [air, rail, and banking] beyond perhaps a transitory phase.'[47]

The renationalisation of KiwiRail was a flawed decision; all of its previous problems remain but now at the taxpayers' expense. As the OECD suggested, government ownership can have some economic rationale on a transitory basis. Although KiwiRail is already a sink hole, many New Zealanders for whatever reason want a rail system. Privatisation could help maintain a viable rail by following these broad strategies.

Rationalise and properly corporatise KiwiRail

KiwiRail is covered by two pertinent Acts: the *State Owned Enterprises Act 1986* and the *NZ Railways Corporation Act 1981*. It is a statutory corporation under the latter Act. This arrangement is described as 'anachronistic' in background papers supplied to Finance Minister Bill English[48] because it does not give the company the independence required to function as an SOE. KiwiRail can only borrow with the Finance Minister's permission, and any equity injection must be approved via an order in council.

KiwiRail's situation must be amended as soon as possible, and a proper legislative form such as a total SOE, must be set up to allow KiwiRail to focus as a proper independent business.

KiwiRail must also close or mothball its increasingly unprofitable and unnecessary lines. Treasury estimates that to meet 'commercial equilibrium'[49] (to break even) on current form, the serviced track distance will have to shrink from 4,000 kms to approximately 2,300 kms. To achieve this, extensive track closure is required.

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Alternatively, unprofitable lines could be decommissioned and the land sold, some of which may be very valuable. This would mean the land under unprofitable tracks could be put to more valuable use and, therefore, be of greater benefit to the communities they are located in. The funds raised could be used by government for other worthwhile projects.

Box 3: Rail Trails

Any lines that have no prospect of being profitable in the long term could be decommissioned and turned into part of any future national cycleway. So called 'rail trails' have proved popular in the country and attract many tourists, both domestic and international. For relatively little cost, these have brought great benefits to rural communities and businesses. This usage of the old lines would add value to New Zealand and be cheap tourism infrastructure. If the national cycleway planned out of the jobs summit ever goes ahead, the government should ideally be looking at synergies between track closure and decommissioning and further cycle ways.

An economic impact report prepared for the Rail Trail Charitable trust by Carla Jellum and Arianne Reis of the University of Otago suggests that the rail trail has had positive economic impacts for communities and businesses in the area.[50] Given that trails in Central Otago have to shut during the winter because of adverse and sometimes dangerous weather, it is difficult not to see greater impact in other parts of the country with more generous weather year around. This could add another string to New Zealand's tourism bow and reinforce the '100% Pure' campaign.

If it is a choice between a cheap and diverse tourist attraction and subsidising a loss-making rail line, it seems an obvious choice. The dormant track land could be part of Prime Minister John Key's national cycleway.

This is not an economic panacea, but it does represent better use of capital on unprofitable lines and can be justified as a public service.

Keeping the profitable, putting down the dogs

Before any privatisation occurs, the government would be best to split the freight, long-distance, and suburban passenger parts of KiwiRail. These three systems are vastly different and serve different purposes. There is no reason why a rail system should not have a future in Wellington as 29 percent of the population work in the CBD (suburban commuter rail is best at moving large amounts of people into central cities). Perhaps some sort of localised subsidy formula is most appropriate in this case.

It would be best if KiwiRail were split into different businesses: freight, Wellington Tranz Metro, Auckland Metro, long-distance commuter (such as Tranz Alpine, Tranz Scenic), and the Interislander ferry services.

By breaking up the rail network, its various parts could be sold to the main users of those lines. For example, Solid Energy could buy the Midland line, and Fonterra could invest in the lines that service its milk plants. Ports may also be interested in owning hinterland links for strategic reasons.

Isolating the profitable parts of the rail system from the failures would help stem the flow of losses and help give re-privatised parts of the system the best chance of success.

Progressively close down unprofitable tracks and sell land

As there is a large amount of cross-subsidisation within the rail system, continued government operation should certainly mean some line closures, but these will almost certainly be deliberately insubstantial so as to minimise negative political impact. The government will almost certainly have to close some routes in the short term, but large-scale closures are a tacit admission that rail will decline in the long term. Governments are not good at making these decisions, so it would be best if they were made in the private sector, which are not subject to the same winds of political change. All unprofitable routes should be abandoned; this policy could fit well with planning a countrywide bike network as a bike track could be created where some of the old rail tracks were. This is not a politically attractive option because trains carry considerably more prestige than bicycles.

By breaking up the rail network, its various parts could be sold to the main users of those lines.

Ontrack, the government agency in charge of land ownership and track maintenance, values its assets at $12 billion.[51] This is a misleading way to calculate the assets as it considers the realised value of assets (land especially) that would only be worth close to that sum if they were no longer used for rail and sold for other purposes. Selling a lot of this land or putting it to more profitable or public good usage would be an excellent way to free up some capital to invest in worthy parts of the track to prepare it for sale.

Two options are worth considering:

1. Selling rail including the land to private owners. The new owner could then make the best use of each line. It would be up to the private owner to choose between operating a railway, selling land, or putting the land to a different non-rail usage.
2. By splitting the network into a set of viable core businesses, the government could retain public ownership of the land in those lines (as was done when sold in 1993), and a government agency could be in charge of closing down the rest and putting the land to its most profitable use. This could be public or private.

Tendering the tracks

If option 2 is chosen, the government could go through a tender process, outlining its objectives for various parts of KiwiRail, and sell the business for $1 (or a suitably 'peppercorn' price) to the bidder with the best medium- and long-term vision for the company, including capital injection, upgrades, and everything else that might go with it. Instead of tendering on offers solely on price, the government could tender on investment intention and service, and create a property right so that intentions not reasonably fulfilled the company could return to state ownership to try again.

The flexibility in this arrangement is advantageous as different conditions would be formulated for the very different parts of rail in New Zealand. It also means that as any interested parties would not have to pay to buy the business, they would be able to invest greater levels of capital. Although the taxpayer would lose significantly on these transactions, it would cut future taxpayer liability.

It also means that the government can work at getting the incentives right for any company that wishes to get involved in the private provision of rail for the long term. The best way to do this is not by setting stringent conditions on companies and ensuring certain rates of freight on selected lines. The new system would have to be structured in such a way that Rail for the first time (one might argue) could actually organically and sustainably develop. This might mean growth in some areas, and almost certainly shrinkage in others. Whatever the outcome may be, investment and development would be based on modern freighting needs and traffic flows.

Finance Minister Bill English rightly describes KiwiRail 'just about worthless.'

Conclusion

All this paints a bleak picture. KiwiRail was purchased from an operator that did not want to sell, at a price far higher than should have been paid or the real value of the company. This was done by a government against repeated advice from its own Treasury.[52] However undesirable subsidising a private operator might be, bringing it into Crown ownership was never going to remedy this situation. Instead it exposed the taxpayer to substantial costs and losses. Running the business of Rail has already become politicised and is set to become more so. Finance Minister Bill English rightly describes KiwiRail as 'just about worthless.'[53]

In its rather difficult history, NZ Rail has confronted the same fundamental difficulty—running as a commercially viable enterprise when it was not built to be one. Government ownership will not make rail profitable or break even because it was partly bought to fulfil other social, economic and environmental goals. Any enterprise is bound to fail when it serves more than just the profit motive. The question then is whether the other goals that Rail ownership fulfils are worth the yearly subsidy that will be needed to keep KiwiRail afloat? This question can only be answered in concert with the government's priorities and rigorous cost-benefit analysis.

Government ownership cannot and will not 'fix' rail in New Zealand. KiwiRail should not continue in its current form; it will become a soak hole for cash. The best thing government can do is get KiwiRail off its books and move towards a sustainable rail system for New Zealand.

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The Centre for Independent Studies
| PO Box 5529, Lambton Quay, Wellington 6145 New Zealand | p: +64 4 499 5861 | f: +64 4 499 5940 | cis@cis.org.nz
| PO Box 92, St Leonards, NSW 1590 Australia | p: +61 2 9438 4377 | f: +61 2 9439 7310 | cis@cis.org.au