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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT PERFORMANCE AUDIT REPORT

NEW ZEALAND SECOND RAILWAY PROJECT

(LOAN 725-NZ)

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Operations Evaluation Department

TABLE OF CONTENTS

Approximate Currency Equivalents (NZ$)

1971-72: US$ 1.20 = NZ$ 1.00
1973: US$ 1.43 = NZ$ 1.00

PROJECT PERFORMANCE AUDIT REPORT

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Introduction

This report presents the results of an audit of the New Zealand Second Railway Project, for which the Bank made a US$ 16 million equivalent loan (725-NZ) in March 1971. Some $10.5 million of the loan was subsequently cancelled in March 1973 after US$ 5.5 million had been disbursed. This review is based primarily on discussions with some of the Bank staff who were involved with the project and on relevant reports and materials from the Bank's files.

Background

In the late 1960s, the New Zealand Government became increasingly concerned with the country's balance of payments problems. These problems resulted from a projected slump of the main export commodities, the decision of Great Britain, New Zealand's largest market, to join the European Common Market, and the difficulties in obtaining credit due to a shortage of funds in international capital markets. These issues prompted the Government to request Bank financing for specific projects to ease the balance of payments crunch on the country's investment program.

Prior to coming to the Bank, New Zealand had approached the International Monetary Fund for balance of payments assistance. The Fund responded favorably, offering standby credit for one year with the possibility for renegotiation thereafter. However, New Zealand felt that a standby credit was too limited and too simplistic a solution for their particular case. First, they were anticipating that their balance of payments difficulties would extend over a period of up to five years. Secondly, the resolution of this problem would require some economic restructuring and production reorganization which would probably be a long-term process for which Bank support in certain areas would be desirable.

The Bank agreed to lend a total of US$ 40 million during the 1970-74 period. This commitment reflected the Bank's appreciation of the country's balance of payments difficulties, and investment requirements, and its interest in closer relations with New Zealand. The Bank hoped to increase New Zealand's participation in the Bank Group, particularly in the then forthcoming fourth IDA replenishment, although a formal link was never made between the proposed Bank loans and New Zealand's contribution to IDA.[1/] Two loans were finally made, the railway loan analyzed in this audit, and another to the New Zealand Development Finance Corporation.[2/] Both were subsequently partially cancelled.

The Railway project was finally selected for financing by the Bank because of its previous experience in New Zealand's transport sector,[3/] and because the high foreign exchange component of the project and the fast expected disbursement were particularly important to help the balance of payments. Furthermore, the Bank saw the strengthening of the transport sector, especially of the railways, as a prerequisite for future economic growth.

Another issue related to the project was the need for a national transport policy. Government regulation in New Zealand was inhibiting the efficient development of the transport system. The regulatory framework was very restrictive, particularly to the development of road transport, through the prohibition of commercial trucking service on routes exceeding 40 miles where railway service was already available. The difficulties engendered by overly constrictive regulations were becoming increasingly evident to transport authorities and users alike. The Government authorities and the Bank, therefore, agreed that it would be desirable to study the design of alternative transport policies.

Project Description

The project consisted of the first three years of the New Zealand Railways' 1970/71-1975/76 Investment Plan, and a national transport policy study. The Investment Plan, prepared by the Railways, comprised investments totalling US$ 160 million equivalent; of this amount, US$ 88 million was to be invested in the first three years. The 15-year Bank loan was expected to finance about 33% of the foreign exchange costs of the project, as follows:

1/ Subsequently, the New Zealand Government made a voluntary contribution to IDA of US$ 5 million equivalent.

2/ Loan 806-NZ for US$ 8 million made in March 1972.

3/ The first railway loan (438-NZ in 1965) provided US$ 42 million to help finance the Railways' 1965-70 Investment Plan.

New Zealand Railway Project
(US$ million equivalent)

	Appraisal Estimate			Actual (FY 1970-1973)	
	Total Cost	Foreign Cost	Loan Items	Total Cost	Loan Disbursements
Capital Expenditures	87.8	47.8	15.5	71.9	5.3
Consulting Services	0.7	0.5	0.5	n.a.	0.2
Total Project	88.5	48.3	16.0	71.9	5.5

Main project items were: (i) shunting and main line locomotives, (ii) rolling stock, including 1,100 freight wagons and parts for the manufacture of another 610 freight and 100 ballast wagons, 2 sets of passenger trains and 20 passenger cars, (iii) improvements to permanent ways, (iv) two ferries linking the north and south islands; and (v) workshop and track maintenance equipment.

The main objectives of the project were to continue the Railways' modernization program, to prepare for containerization in external trade during the early 1970s, and to strengthen the Railways' position in individual markets such as steel, timber and paper. The Railways' commercial freight traffic was estimated to increase 6% per year from 1970 to 1976. Traffic in the base year of the program, 1969-70, was 1,676 million ton-miles. By 1972-73, actual traffic was 1,874 million ton-miles as against 2,014 million estimated at appraisal. However, by 1973-74, actual traffic was 2,218 million ton-miles as against an estimated 2,109. The consultant services included in the project were to assess the impact of transport regulation on road-rail competition and to develop policy principles through the preparation of a national transport policy study.

The first railway loan agreement in 1965 had stipulated progressive measures to improve the Railways' financial position and the Railways had met all their financial obligations during the implementation period of the first project. Nevertheless, the need for further financial improvements was evident when this second project was appraised. Substantial wage increases were expected during 1971; in order to provide the necessary funds to meet this, and at the same time improve the Railways' financial position, the Borrower and the Bank agreed on several specific measures. Thus, a 12% freight tariff increase on a selective basis and a 10% increase in passenger fares became effective over the course of 1971. Further tariff adjustments were planned for 1971 and 1972 but did not materialize.

The loan agreement also stipulated that the Government would direct the Railways to take all necessary measures (including, but not limited to, adjustment of the tariffs and rates): (i) to meet debt service obligations and working capital needs out of internally-generated resources and (ii) to finance a reasonable proportion of its capital expenditures. The loan agreement also stated that the Railways should break even in fiscal 1972 and earn rates of return on the net fixed assets in operations as follows: 3.5% in 1973, 4.0% in 1974 and 1975, and 5% in subsequent fiscal years.

Loan Cancellation

The loan was cancelled by mutual agreement between New Zealand and the Bank in May 1973 because fulfillment of the financial covenants of the loan was not compatible with the freezing of rail rates adopted,as part of its stabilization policy, by the Labor Government that had taken office in 1972. A very important background factor was the improved economic conditions in the country.

The tariff increases in 1971 were insufficient to meet debt service obligations or achieve the rates of return stipulated in the loan agreement. In 1972, a Labor Party Government was elected in New Zealand. The new administration responded to inflation problems with policies which prohibited increases in rates for public services, at least during the first term in office. Hence, rail tariffs remained the same, contrary to stipulations in the loan agreement, and the Labor Government was prepared to subsidize the expected losses. Thus, in 1972 and 1973, the railroads actually lost money -- in contrast to an expected loss in 1971 followed by a financial break-even in 1972 and a NZ$ 10 million net revenue in 1973 (see attached table). Net operating losses occurred during the period and new borrowing increased the debt/equity ratio from 10:90 to 19:81 between 1971 and 1973. Railway authorities anticipated that the losses would continue for several years. Although there were only slight differences between the actual and estimated revenues, actual expenses were greater than those estimated due to inflation and wage escalation. Thus, the Railway was in default of the Bank loan covenants since it had failed to increase its tariffs as stipulated, thereby incurring heavy losses.

In 1969, when the Loan was negotiated, the Government had projected imminent balance of payments deficits. Except for a short period in 1970, however, the country evidenced an economic boom and a strong balance of payments position which began to be reflected in the availability of ample foreign exchange reserves. The major economic problem was inflation, rather than balance of payments deficits. Furthermore, shortages in the international capital markets began to ease up after 1970 and credit was again available at relatively favorable terms.

The balance of payments situation changed from a deficit to a surplus for two major reasons. First, although Great Britain did join the Common Market, New Zealand was able to negotiate a short-term trade agreement in mid-1971 which assured her of the British markets for a while. Secondly, although the predicted slump in wool did occur, no slump occurred in meat. In fact, meat prices and total meat exports rose. The improvement of the balance of payments situation is reflected in the following figures (millions of US Dollars):1/

	1968	1970	1972
Total foreign exchange reserves at year-end	76	126	578
Balance of payments surplus (or deficit)	79	- 33	200

By the end of the first quarter of 1973, the reserves had grown to over one billion dollars. Thus it appears that the basic underlying reason for loan cancellation by the Borrower was that the balance of payments problem no longer existed, and alternative sources of funds were readily available. Furthermore, the structural changes in the economy were viewed as a long-term problem not requiring immediate action. Hence, Bank financing was no longer critical to the national investment program.

Discussions held between the Borrower and the Bank indicated that the New Zealand Administration was prepared to cancel the loan. In a letter to the Borrower, the Bank noted that the Railways were in default of the covenants and stated that unless the Government and Railways could present an alternative program to improve the Railways' financial position, the remainder of the loan would be cancelled.

1/ Source: IMF. International Financial Statistics, Vol. XXVII No. 4, Washington, D. C., April 1974.

Although the Bank offered the Borrower the option of developing alternative financial plans, the Borrower chose to cancel the loan. Apparently, the Bank issued the letter mentioned above because the Railway was not adhering to the loan covenants. In fact, the Borrower used the letter as a "trigger" to cancel the loan, as was previously arranged in discussion with the Bank.

Yet, the discussions leading up to the cancellation also reflected concern within the Bank for any loan to a relatively prosperous country, and for projects with railways which required Government subsidies to operate. However, the main reason for the Bank's decision to accept the loan cancellation was that one of the original purposes of the loan, assisting New Zealand with its balance of payments difficulties, had become obsolete.

Although the loan was officially cancelled in May 1973, it was agreed that the Bank would continue to provide advice to the transport policy study team.

Use of Loan Funds

The total amount of the loan disbursed prior to cancellation was US$ 5.5 million. These funds were used to partially finance parts which were later assembled into rolling stock (approximately 1,700 wagons), workshop equipment and signalling devices, and approximately one-third of the foreign exchange cost of the transport policy study.

The precise amount and nature of total project expenditures are not known since loan cancellation terminated borrower reporting. However, during the three fiscal years from 1970 to 1973, the New Zealand Railways' capital expenditures were approximately US$ 71.9 million equivalent, representing 81% of the expenditures planned at appraisal. This amount (US$ 71.9 million) was financed by (i) New Zealand's own resources (US$ 48.8 million), partly self-generated by the Railways and partly provided by the Government in interest-free loans, (ii) supplier credits (US$ 16.9 million) and (iii) IBRD loan funds (US$ 6.2 million), of which US$ 2.8 million represented drawings under Loan 438-NZ and US$ 3.4 million drawings under Loan 725-NZ. The balance of drawings under Loan 725-NZ was made in the financial year ending March 31, 1974.

Project implementation prior to cancellation proceeded without major difficulties. The equipment purchasing was somewhat behind schedule, but the transport policy study was carried out satisfactorily.

Transport Policy Study

The transport study was included in the project at the Bank's suggestion. The Bank had concluded that such a study was needed in New Zealand and that it would be locally supported, in light of the increasing recognition by the Government authorities of the problems caused by the existing regulatory framework. No institutional problems were foreseen in executing the study since the appropriate professional expertise was available in the country. The Bank utilized its wide experience to help in the design of the study, assisted the Government in identifying appropriate consultants, critically evaluated the progress of the study during its execution, and is at present analyzing the final report. It is not implied that the study would not have been made without Bank intervention. However, at a minimum, the Bank hastened the initiation and completion of the study and contributed transport model experience not available in New Zealand.

Although it is still premature to assess the impact of the study, three areas of accomplishments can be identified. First, in transport policy, the objective of the study was to recommend measures that would result in better transport coordination. This objective is being met: transport policy recommendations and policy papers have been prepared. Moreover, the recommendations appear to be reasonable; for example, the proposed abandonment of the 40-mile trucking restriction previously referred to.

Second, although an independent consulting firm completed the study, the Government organized a counterpart team of economists to work with the consultants. Today, this team has become the nucleus of an economic analysis division within the Ministry of Transport. Prior to this study, the economic group consisted only of seven persons with limited functions. Today there are 20 economists, some of whom are doing original work in transport modeling and econometrics. The group has been useful, not only to the Ministry of Transport, but also to other Government agencies, by providing analytical ability as well as information on various economic problems related to transportation.

Finally, a computer-based system of transport models was developed to evaluate intermodal policies and served as the basis for the study. The New Zealand transport model is another example of the Bank's continuing support in developing methodology in transport sector policy analysis. Previously, the Bank had supported the development of a transport model in Colombia with the participation of Harvard University. The Bank is currently analyzing the methodological progress made in the development of the New Zealand transport model and is preparing an evaluation of the policy implications of the study. These analyses are expected to be completed in the near future.

Conclusions

The underlying justification for this project was to help New Zealand overcome what at the time were considered to be serious balance of payments difficulties. Thus, it is understandable that, when those difficulties disappeared, the Borrower and the Bank agreed that the loan should be cancelled. However, the cancellation has to be properly interpreted: under normal conditions, the Bank would probably not take such an extreme step because the balance of payments position of a country improved or, as in this case, because some of the loan covenants were not being fulfilled. The decision to cancel the loan was taken because of the marginal nature of New Zealand as a Bank borrower. Because of its high level of development, the country qualified for Bank lending only under extraordinary circumstances; when the loan was cancelled most of those circumstances had disappeared. Thus, in retrospect, the decision appears to be correct.

In spite of the particular evolution of this project, the Bank did manage to make a positive contribution to the development of transport in the country. Its promotion of the transport policy study, including the application of a transport planning model, has been instrumental in triggering a long-overdue reappraisal of the Government's regulatory policies of the sector, and has helped bring into being the nucleus of a group that is now capable of carrying out a permanent review of transport policies in New Zealand.

NEW ZEALAND RAILWAYS

SUMMARY FINANCIAL STATEMENTS: 1970/71-1972/73
(NZ $ Millions)

	1970/71		1971/72		1972/73	
I. Summary Income Statement	Est.	Act.	Est.	Act.	Est.	Act.
Total operating revenue	104.5	102.9	120.1	120.9	136.8	133.3
Operating expenses (excl. depreciation)	100.3	103.9	106.9	117.4	112.3	128.2
Depreciation expenses	8.9	8.9	10.3	9.3	11.7	10.1
Total operating expenses	109.2	112.8	117.2	126.7	124.0	138.3
Net operating revenue	(4.7)	(9.9)	2.9	(5.8)	12.8	(5.0)
Non-operating revenue		2.3		1.5		1.7
Net revenue before fixed charges	(4.7)	(7.6)	2.9	(4.3)	12.8	(3.3)
Interest	2.1	2.1	2.1	2.5	2.8	2.6
Net income	(6.8)	(9.7)	0.2	(6.8)	10.0	(5.9)
Operating ratio (%)	104.5	109.6	97.6	104.8	90.6	103.8
Rate of return on net fixed assets (%)	—	—	0.9	—	3.6	—
II. Summary Cash Flow Statement						
Cash Required						
Investments in fixed assets	16.6	15.2	31.0	23.3	30.8	22.7
Interest on debts	2.1	2.0	2.7	2.4	2.8	2.7
Repayment of debts	2.5		3.0	2.9	3.9	4.2
Other		7.7		5.4		1.9
Total cash required	21.2	24.9	36.7	34.0	37.5	31.5
Cash Available						
Cash available at beginning of year	21.4	21.5	9.0	0.6	4.8	0.2
Net operating revenue before interest (loss)	(4.7)	(7.6)	2.9	(4.0)	12.8	(3.0)
Depreciation	9.0	8.9	10.3	9.3	11.7	10.1
External sources	5.0	2.4	18.2	28.0	14.5	26.7
Others (loss)	(0.5)	0.3	1.1	0.3	(1.6)	0.1
Total cash available	30.2	25.5	41.5	34.2	42.2	34.1
Cash position at end of year	9.0	0.6	4.8	0.2	4.7	2.6
III. Summary Balance Sheet						
Assets:						
Current	28.2	22.3	23.3	26.5	23.6	29.4
Fixed (net)	332.9	331.4	353.6	342.7	372.7	354.3
Others	0.1	5.0	0.1	0.1	0.1	0.1
Accumulated operational losses				6.8		12.4
Total assets	361.2	358.7	377.0	376.1	396.4	396.2
Liabilities:						
Current	8.7	6.1	8.9	8.2	7.6	6.7
Long-term	36.2	34.7	44.3	52.8	53.3	72.8
Others	0.1		0.1		0.1	
Equity	316.2	317.9	323.7	315.1	335.4	316.7
Total liabilities and equity	361.2	358.7	377.0	376.1	396.4	396.2
Debt/Equity Ratio	0.14	0.13	0.16	0.19	0.18	0.25
Current Ratio	3.2	3.7	2.6	3.2	3.1	4.4