

RESTRICTED – POLICY AND COMMERCIAL

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2. Secretary of State

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CENTRAL RAILWAY

Issue

1. How to respond to Central Railway's request for Government to promote a hybrid Bill to secure powers for their project, in the light of their latest advice on their ability to finance the project wholly privately.

Recommendation

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Timing

5. Routine. CR are keen to have an early steer on whether Ministers are likely to be able to support their scheme, since they need to raise further finance quickly if the project is to go forward. However there is no need from our perspective to rush into a decision.

Clearance

6. This submission has been cleared with Finance, Legal, Communications, Major Projects and Logistics Directorates. FD have advised that backing a hybrid Bill without greater certainty over the financeability of the project would present a real risk to the delivery of the Department's long-term programme. While CR's project is predicated on no public sector support, there is the possibility that in the event of problems Ministers might be compelled to make a contribution at some future date, for which it is extremely unlikely that we would be able to secure additional funding from HMT, and hence a need to defer or cancel something from our current long-term spending plans.

Consideration

Background

7. Central Railway's proposal is to build, finance, maintain and operate a 430 mile freight railway from northern France, via the Channel Tunnel, to Liverpool, by way of West London, Rugby, Sheffield and Manchester. From the Tunnel round to the north-western approaches to London, it would follow a new alignment alongside the M25 and existing rail lines; it would then follow the disused Great Central alignment as far as Rugby, from where a new line would run parallel with the M1 as far as Leicester, after which it would largely run over existing lines (outline map attached). CR's scheme is for a railway which would both carry continental-gauge freight trains and provide an extended shuttle service for HGVs and trailers. It would include links to the UK motorway network at several major new freight terminals. This would be a wholly privately funded scheme, with no Government support for construction or operation.

8. Having tried and failed to secure TWA powers a decade ago, because the principle of the scheme failed to secure Parliamentary approval (the proposal was overwhelmingly rejected, largely because of environmental concerns) the promoters have asked the Government to promote a hybrid Bill for the project, which they see (probably rightly) as the only way of obtaining the powers.

9. The SRA carried out a major review of the CR proposal last year, which was highly sceptical of the project's financeability, and of the cost and revenue estimates put forward by CR. The conclusions of their consultants

RESTRICTED – POLICY AND COMMERCIAL

suggested that the project cost which CR estimated at around £10bn (including financing) might be over £16bn, and that the likely revenue figures might be some 40% less than CR expected. The SRA's review also included a detailed evaluation of the effects of the project on the existing rail network, which resulted in a number of concerns about the impact of the scheme at some locations on the network. Subsequent discussions led to CR making significant revisions to their proposals, and the conclusion reached was that there were no "show-stoppers" as far as the present network is concerned. However, Richard Bowker's advice to Ministers remained firmly, and continues to be, that a hybrid Bill should not be offered.

10. In discussions with CR earlier this year, it was agreed that were such a Bill to be promoted it would have to stipulate that there would be no public funding of any kind for the project. However, it was also made clear to CR that the Secretary of State was not at that stage able to offer any support for their proposal, or to seek colleagues' agreement to the idea of a hybrid Bill. Before being able to consider doing so, he would need clear assurances about the funding of the project, going beyond mere expressions of interest or willingness to consider, although he recognised that it would not be possible at such an early stage to secure binding commitments from potential lenders and investors.

11. The Secretary of State also asked for more advice on the nature of the environmental issues which were likely to be encountered with the proposals, and evidence to assure him they would be resolved. In particular, he was looking for confirmation that serious discussions had taken place with both the Highways Agency and Network Rail and that there were no fundamental problems from either of their perspectives.

12. We have not undertaken a cost benefit appraisal of the project, or asked CR to do one. This approach was on the basis that this would be a commercially-driven, wholly privately funded initiative, with no public sector cost, and that it would be entirely for CR to justify their proposals in submitting them for Parliamentary approval.

Policy context

13. Beyond the specific issues which the SRA's review looked at last year, we have not evaluated in detail the impacts of the CR project on the road and rail networks. But in general terms it appears that it would significantly increase rail freight capacity and provide more effective competition with road haulage for international traffic. It would appear to fit in well with the sustainable development strategy, in terms of providing new freight hubs offering greater opportunity for road/rail interchange. It would free up capacity on existing rail routes, particularly the WCML, although it would add pressure at some locations in the Midlands and North-West. It would also free up capacity on some of the most densely trafficked parts of the motorway and trunk road network, again with some local exceptions. There is little prospect of substantial public funds being available to meet these objectives. The project could also generate valuable extra revenue for Eurotunnel, and help to

RESTRICTED – POLICY AND COMMERCIAL

address its impending financial problems. In principle, therefore, the project has considerable attraction in terms of transport policy and 10 Year Plan objectives. We know that No 10 are broadly supportive, for that reason.

14. There is also a substantial strategic attraction in trying, notwithstanding the difficulties, to establish some form of capacity in the UK and overseas (especially US) markets to support the financing of transport infrastructure in this country without direct or indirect Government support. This would achieve genuine risk transfer and provide a downward pressure on construction costs.

15. Against these arguments, however, there are the risks (described more fully later) that CR may not be able to raise the finance, or that it might fail during construction, and the inevitable environmental concerns. We also need to bear in mind that there is a limited capacity at any time for major infrastructure development, whether in the financial markets, in the construction industry, in the railway industry, or in Parliament. On that basis, this might not be our first choice of project to go forward. It would certainly not be the SRA's choice. But then there is nothing else like CR on the agenda.

Financeability

16. CR have now written to the Secretary of State – text of letter attached at Annex A – with a report on where they have got to in drumming up potential financial support. They have held fairly detailed discussions with a substantial number of banks and other institutions and secured a fair number of letters of support from them.

17. CR have also emphasised that to try to minimise any risk of financial exposure to Government or the risk of CR being unable to complete the project, it should be a condition laid down in the Bill that the powers should not be granted until all the finance has been committed. Drafting of these provisions would need some care. They would be likely to require some form of judgement by the Secretary of State at that time as to the adequacy of the finance. This then creates the risk that if the project subsequently ran into problems it might then be more difficult to resist pressure to support it.

18. I attach at Annex B a commentary prepared by our Commercial Adviser which discusses the financeability of CR's business plan proposals, the issues which remain to be resolved, and the level of confidence to be attached to the project being privately financeable.

19. In essence, our view is that CR's business plan is challenging, and one which would test the present limits of the financial markets, but that without evidence, either of equity sponsors on the one hand, or of investors rejecting the business case on the other, that it is difficult to be definitive either way as to whether it could be delivered in practice. A substantial number of banks and financial institutions have looked at CR's proposals, and a good proportion have been willing to write letters of support; this is in itself quite a step forward.

RESTRICTED – POLICY AND COMMERCIAL

20. The financiers (with the exception of MBIA) have made it clear, however, in their letters and in discussions with us, that they have not yet sought seriously to probe CR's assumptions for costs and revenues. (Even MBIA have said they would need to do a lot more work before they could be confident that the project could secure investment grade status.) What the financiers have said, in effect, is that if CR's numbers stack up, if CR can underpin their finances with a healthy equity stake, and if the ratings agencies can be persuaded to give the project an adequate investment grade rating, then they would be willing to participate in the financing. All those are important caveats: and at this stage there is a significant risk that any or all of them could not be met.

21. It should be noted that the letter from CR in Annex A states "...it is clear that the letters are more than generalised expressions of interest – in particular by expressing a view on the project financeability and robustness.. " The discussions and materials received from CR leads us to feel this is overstating the case, perhaps with the exception of MBIA. In addition the EIB, as CR's proposed "foundation lender" is taking a very cautious stance. The evidence falls short of the "assurance on funding " that the Secretary of State was looking for.

Government financial support?

22. Unsurprisingly, some of the financial institutions have indicated that if the project was backed at least to some degree by Government they would be willing to look more favourably at it. Clearly, the risks to a successful financing would be dramatically reduced if Government was contributing to the finances or providing some form of underwriting. This is though something which has been expressly ruled out by both CR and ourselves. Indeed, CR have said to us that they do not want Government backing because they feel this would make it harder for them to secure a good deal with their contractors.

23. Nonetheless, were you minded to do so, there could be an argument for examining the scope for a Government contribution. This could be based on the direct financial benefits which could be expected to accrue to the public sector in terms of the reduced costs of maintaining and operating existing road and rail networks, the reduced need for future capacity enhancements, and possibly regeneration benefits at strategic locations.

24. A Government-backed project would be a very different proposition from that currently on the table. It would raise obvious questions about the scale and nature of that support, its affordability, and what priority the Government would want to give to this as against other spending areas. There would also be a need for a substantially revised governance structure in order to protect the Government's interests and to try to limit our exposure to the (large) costs and risks of this project. There would also be state aid and competition issues.

RESTRICTED – POLICY AND COMMERCIAL

25. Overall, given also the severe funding constraints we are already facing, and CR's own views, we do not recommend that we offer any Government financial support.

Operational and environmental issues

26. CR's latest letter also outlines briefly where there are on these fronts. In essence, they have now established proper contact with the Highways Agency and Network Rail, with whom they have held reasonably constructive discussions. Their letter says that they have identified the issues to be addressed to take the project forward, and that the agencies have not identified any issues that should stand in the way of the Bill proceeding.

27. Detailed correspondence we have seen from HA and NR to CR is rather less upbeat in tone, though it is fair to stress that no show-stoppers appear to have emerged. HA have said to CR that more work will be needed to identify sections of motorways where CR's proposal would increase traffic – eg near to terminals – and the impact of this, and to work up designs for the proposed access arrangements to assess their feasibility, both during construction and in operation. NR have similarly identified a number of areas where more work is needed on the design of the rail proposals and the operational impacts. NR have made it clear that this would need to be paid for by CR and that the scale of work involved means it would have to be prioritised alongside their other planned activities.

28. More generally, CR say they are well placed with the various environmental agencies to pick up from previous discussions and to update the material as necessary.

29. Although not covered in the letter, CR have now asked whether the later timing of a Crossrail Bill might affect their position in the pecking order for hybrid Bills. They have previously stated that they could introduce a Bill next spring, though with the passage of time feel that this is now looking rather demanding. From our perspective we could not see a Bill possibly being ready before November 2004 at the earliest, so unless there was an unforeseen delay or problem with the Crossrail proposal, we assume, given the relative political priorities, that Ministers would conclude that Central would have to take a later turn.

Discussion

30. There is still a great deal to do to develop this project to the point where a Bill could be introduced. However, other than on financing, CR have a reasonable story to tell, and the further work they have done has not identified any fundamental flaws.

31. On financeability, CR have made useful progress since the spring in demonstrating that they have a business plan which could be made to work. However, even if all their assumptions prove to be robust, which is far from certain, the financing would still be an ambitious one which would test the

RESTRICTED – POLICY AND COMMERCIAL

capacity of the markets. It seems unlikely that CR will be able to produce any more definitive evidence of financeability on debt financing at this stage, or a commitment from a serious equity backer, in the absence of any indications of Government support for a hybrid Bill.

32. CR have put forward a structure which would as far as reasonably practicable isolate the project from Government financially. And if we were to promote a hybrid Bill it would be on an arm's length basis as possible, with CR taking responsibility for their project. Nonetheless there would still be a significant political risk in being seen to support, and take up a substantial amount of Parliamentary time with, proposals which on environmental grounds are likely to be very unpopular in many parts of southern and central England, although they have support in the north and north-west. Those concerns would be still greater if the project was seen as having little realistic chance of being financed. And, whatever we might now say, if CR went bust part-way through construction, the Government of the day might find it very difficult to avoid being sucked into some sort of rescue package, with the costs and risks which that might entail.

Options

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RESTRICTED - POLICY AND COMMERCIAL

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Presentation and handling

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RESTRICTED - POLICY AND COMMERCIAL

Conclusions

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copy to:

TEXT OF CENTRAL RAILWAY LETTER TO SOS

Rt Hon Alistair Darling MP
Secretary of State for Transport
Department for Transport
Great Minster House
76 Marsham Street
London, SW1E 5DU

10th July 2003

Since our meeting in March, we have been engaged in discussions with banks and potential investor in Central Railway with a view to securing expressions of interest in the financing of the project. In addition we have, as you requested, held a further round of discussions with the Highways Agency, the statutory environment agencies and Network Rail to ensure that there were no outstanding operational issues.

I am pleased to say that both sets of discussions have proceeded very successfully and have confirmed our view that the project is both practicable and financeable.

Financeability

Since our meeting we have met several leading global investment banks which could act as lead arrangers of the financing and with strategic partners and other potential investors covering each of the elements of the plan of finance.

These discussions have been helpful not only in providing general confidence in the financeability of the project but also in giving feedback from banks and other institutions on detailed aspects of the Company's proposed financing plan, allowing us to adapt the plan in some respects to make it even more robust. They have also provided a sound basis for the next stage of discussions on the financing of the project, and one consequence of this is that if you do decide to support the project you can have a degree of confidence that the fundamental groundwork for the financing has been laid.

I should emphasise that these discussions have been based on an examination of the business and financial case as set out in the Company's Project Information Memorandum and other documents. Many institutions have devoted considerable management time and resources to the exercise so as to ensure that the opinions they express are as soundly based as is possible in the circumstances. They will of course wish to conduct their own further due diligence in advance of any binding commitment, but it is clear that the letters are much more than generalised expressions of interest - in particular by expressing a view on the project financeability and

RESTRICTED – POLICY AND COMMERCIAL

robustness and in many cases indicating the level of involvement they would be prepared to consider.

Among the letters we have received to date are:

- Major banking groups **Citigroup, UBS Warburg, Deutsche Bank, Commerzbank and Barclays Capital**
- Strategic partners **Parsons, Jarvis, Balfour Beatty and Bombardier**
- The leading US monoline insurer **MBIA** and **Marsh** the largest insurance broker, confirm the scope for a syndicate of insurers to offer guarantees on most of the project's bonds and much of the bank debt. Marsh also indicate that insurance markets could provide some form of construction cost overrun insurance
- Equity and/or mezzanine funds **Investec European Capital, CIT and 3i**
- The European Investment Bank (**EIB**)

We expect to receive further letters as our discussions progress. As you will know, SNCF is already a partner in the project and we have signed a joint MoU to implement it.

The letters we have received and our discussions with financial institutions reinforce our confidence that the project can be financed successfully on a commercial basis. Moreover, we believe that the letters and the degree of support for the project from banks and others are significantly more than could normally be expected for a commercial financing which still lies three years in the future.

Protections for Government

I am conscious, nevertheless, that the Government will wish to ensure that it is protected against any risk of financial exposure either because, in the event, the finance could not be raised or because the project subsequently ran into financial difficulties. We believe that the Company and the Government have a shared interest in ensuring that proper financial disciplines apply to the project. We have therefore set out in our discussions with your officials our proposals for ensuring that a commitment that the company will not receive financial subsidy or guarantees is made effective.

Crucially, we propose that it should be a condition of the Bill that the powers in it are not granted until all the finances are fully committed. As discussed with your officials, we also expect that at the time of making a decision in principle you may wish to set out certain conditions to be met before the Bill is submitted which we hope would be the subject of discussions with the Company prior to announcement; we would expect that amongst those preconditions would be further progress on the financing having been made.

We believe that these protections for Government are unlikely in practice to need to be exercised (indeed their existence should hopefully preclude the need to use them). But it is important that they are clearly in place as part of a framework of financial discipline on project costs and the proper allocation of commercial risk.

RESTRICTED – POLICY AND COMMERCIAL

The Highways Agency, Environmental Agencies and Network Rail

When we met in March you also asked us to have a further round of discussions with the Highways Agency, the environmental agencies and Network Rail to ensure that there are no outstanding operational issues.

I should emphasise that we have already had outline and in some cases more detailed discussions with these organisations including, in the case of the statutory environmental agencies, a MOU signed in 2000.

Our recent meetings have, nevertheless, served to ensure that we have as far as possible identified the principal issues that will need to be addressed and the further work that will be required to resolve or mitigate them. We have been pleased with the degree of agreement that we have reached with the agencies in our discussions and the recognition of the benefits that the project will bring as well as the specific issues to be addressed. Clearly there is a considerable amount of work to be done before the submission of a Bill and we have proposed a framework for cooperation with each agency to deal with the issues at the appropriate stage. None of the agencies have said there are any issues that should stand in the way of the project proceeding to the preparation of a hybrid Bill.

Conclusion

Both sets of discussions build on the extensive work conducted by Central Railway in developing the project. Taken together, this work confirms that the project is practicable and financeable on a commercial basis.

The positive benefits of the project for the country in terms of helping to ease congestion on motorways, providing additional freight transport capacity, contributing to regional economic competitiveness and reducing environmental damage are already widely recognised. We believe that continued developments in transport policy, motorway congestion and the economic environment for the project only serve to reinforce that positive case.

I look forward to discussing this further with you.

Yours sincerely

AD Gritten
Chairman

DRAFT

Central Railways – DfT commentary on financeability

B1. The question of whether Central Railways' business plan is financeable is difficult to be definitive about. However it is clear it will be very challenging for a wide range of reasons:

- The European Capital markets are unaccustomed to projects of this size without Governmental financial support.
- The closest precedent is Eurotunnel which has been a difficult experience for capital providers.(EIB says "we still bear the scars of Eurotunnel"). In addition we are aware that the MUC ending in 2005/06 suggests further writedowns are possible which will spillover into sentiment for projects of this kind.
- Conversations with banks on this project to date suggest that for both debt and equity and some of the sub categories within each of those, Central Railways would be really testing the current limits of market capacity, which suggests you need a favourable wind behind you on several different fronts to achieve the financing required.
- Competing demands on the capital markets from other major transport projects, including potentially Crossrail, may impact market capacity for Central Railways.

B2. Central Railways has received a range of letters from debt providers/arrangers expressing interest in principle to participate. Whilst it is commendable that these letters have been received, you have to remember banks' motivation when significant potential underwriting fees are at stake and they are not committing themselves to anything at this stage. I do not accept that there are significant reputational issues at stake in writing these. In addition it is worth noting the tone from the financial institutions is a lot less positive off the record than in written form and in general, the sense they have given me of the work they have done to date is not as rigorous as the plan suggests. I would separate MBIA from the rest here.

B3. If one takes the debt providers' letters as a whole, they say, they have looked at the PIM, and if the debt is capable of being rated at an investment grade level, then the debt is broadly financeable. In doing this:

- None of them have done due diligence on the numbers
- Most of them have not commented upon the PIM's assumptions or tested their economic robustness

And therefore, in coming to this conclusion, they have taken as a given:

- The robustness of the business case; and
- The plan has an appropriate amount and form of equity and that the equity has been successfully raised

I agree with their conclusion, but these are two very significant caveats.

RESTRICTED – POLICY AND COMMERCIAL

B4 On the question of investment grade rating, ICAP, (John Kramer himself) has opined on the investment grade nature of the plan. MBIA have done some desktop analysis, aided by their knowledge of Eurotunnel, but said they would need to do a lot more work to test market and price risk to get comfortable with investment grade status. The other banks I have spoken to have not performed this kind of analysis.

B5. On the question of equity, - £830m of pure equity is envisaged as well as a further £830m of subordinated debt and £415m of "standby subordinated loan". CR have also broken down where the equity would come from: strategic partners, private equity houses; public markets (IPO); quasi equity finance.

B6. CR has letters of in principle interest from Parsons, Balfour Beatty and Jarvis as strategic equity investors. None of them comment on the business and financial assumptions, i.e. the equity story. In addition CR have a few letters from mezz/subordinated debt providers which show an in principle interest. We had a helpful conversation with CIT, who have invested in the Birmingham relief road. CIT was positive (in front of CR) but said they were looking for too much subordinated debt relative to market capacity. He suggested European market capacity was £100-200m and if you get the story right (including a sense of stable UK transport policy) you could access US investors too which might take you up to £400m – Central Railways has pencilled in £830m in the latest version of their plan.

B7. Therefore our visibility on the equity is still low and it feels extremely challenging from the perspective of scale required and anecdotal evidence I have on the ability of raising equity finance in other transport projects. In addition some categories of equity such as £20m from lead arrangers, and £25m from private individuals have little useful precedent in the UK or on the scale envisaged.

B8. Several banks, including EIB, felt this project would have a much higher degree of success with some kind of partnership with government. They questioned whether freeing up Network Rail capacity by taking freight on to the new line or relieving congestion on motorways was worth some economic value to government which could be used to support the overall transaction.

B9. In summary, the letters and discussions with banks have been helpful in understanding what work has been done to date to assess financeability. There is certainly a lot of in principle interest. However, without government support the scale of this project and the precedent make this immensely challenging and therefore the risk of success, given the material I have seen to date, is very real.

B10. To be able to say it is financeable, we have to test the assumptions the banks have made: the investment grade rating and the ability to raise equity. These will both require an analysis of the robustness of the business case as well as the appropriateness of the capital structure. Neither of these will be

RESTRICTED – POLICY AND COMMERCIAL

that easy to get given the early stage of this project. However getting an independent assessment for the rating point would be very helpful. Getting a strong industry partner to put in a significant amount of equity (say £200 - 300m) would send a strong signal that someone with relevant experience has bought into the equity case. These are the sorts of things one needs to think about before we can talk about financeability with a greater degree of confidence.

