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Channel Tunnel Rail Link (Supplementary Provisions) Bill

Bill 4 of 2007-08

The aim of this Bill is to 'clarify the legislative and regulatory position' of the Channel Tunnel Rail Link (CTRL) ahead of a restructuring of London & Continental Railways. The Bill confirms that the Secretary of State is empowered to fund the CTRL and the trains that run on it. The Bill would also: amend the original 1996 Act as regards access agreements; repeal certain duties of the Office of Rail Regulation; allow the ORR to charge a fee for the exercise of its regulatory functions in relation to CTRL; and amend the definition of development agreement in the 1996 Act to include the word 'operation'.

The Bill is due to receive Second Reading on 20 November 2007.

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Summary of main points

The *Channel Tunnel Rail Link (Supplementary Provisions) Bill 2007-08* (HC Bill 4 of 2007-08) makes relatively minor changes and clarifications to the regulatory and financial regimes as they relate to the operation of the Channel Tunnel Rail Link (CTRL). The Bill would:

- confirm that the Secretary of State is empowered to fund the CTRL and the trains that run on it;
- amend the *Channel Tunnel Rail Link Act 1996* as regards track access agreements;
- repeal certain duties of the Office of Rail Regulation (ORR);
- allow the ORR to charge a fee for the exercise of its regulatory functions in relation to CTRL; and
- amend the definition of development agreement in the 1996 Act to include the word 'operation'.

London & Continental Railways (LCR) built the CTRL and owns the UK share in Eurostar UK Ltd. as well as significant pieces of property around the Eurostar terminals at St Pancras and Stratford. It was selected as the winning consortium to construct the CTRL under a PFI agreement in February 1996; however, in 1998 the Government announced that LCR had failed to find the necessary money for the project and consequently the deal was restructured into a public private partnership under which LCR raised capital to construct the entire new railway and to restructure its debt. More than half of the capital is underwritten by a Government guarantee, which substantially reduces the cost of borrowing. In return for financial support for the project, the Government has a 'stakeholder share' in LCR and will receive a share of LCR's cash flow after 2020.

In 2006 LCR was reclassified as a public sector company and there was talk of the company being sold off, though nothing came of this. As this Bill removes the ambiguities in the regulatory and financial regime around the CTRL, there is inevitably speculation that this is in preparation for selling off the company's constituent parts in the near future.

CONTENTS

I The Bill

The Bill contains six clauses, of which only five are substantive.[1]

Clause 1 would confirm the Secretary of State for Transport's power to fund the Channel Tunnel Rail Link (CTRL) and the trains that operate on it. It would appear there was "a sufficient level of uncertainty" as to whether the power to provide financial support[2] applied to the CTRL.[3] Currently, this support takes the form of:

- Capital funding, via loans, Government Guaranteed bonds, securitised bonds and other debt facilities; and
- Revenue funding for domestic services operating under a franchise.

Clause 2 aims to clarify the CTRL's exemption from the Office of Rail Regulation (ORR)'s regulatory framework by removing part of the relevant section in the 1996 Act that could indicate some ambiguity where, for example, domestic services are operating on the CTRL track.[4]

Clause 3 would amend the duties of the ORR in relation to the CTRL now that the construction phase of the CTRL is completed to remove those sections which are consequently irrelevant.

Clause 4 would allow the ORR to charge the operator of the CTRL for the performance of its duties on that route, mirroring to a large extent that power which it already possesses to charge Network Rail for the rest of the rail network. Such a fee would be levelled on an ad hoc basis, with the ORR allowed to decide how much is to be paid and on what timescale.

Clause 5 adds the term 'operation' into the development agreement that LCR entered into with the Government in 1996 to clarify the status of the agreement now that the construction phase of the link is complete.

II Comment

Most of the comment on the Bill has focused not on its specific provisions but on the long term aim behind the Bill – to allow for the further restructuring of London & Continental Railways (LCR).[5,6] For example, *The Times* reported that LCR may be headed for a "multibillion-pound privatisation next year":

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1 for a full description of the Bill, see the Explanatory Notes, available at: http://www.publications.parliament.uk/pa/pabills.htm

2 granted the Secretary of State by virtue of section 6(1) of the *Railways Act 2005*

3 Explanatory Notes, para 11

4 for an explanation of the current regulatory regime, see section IIIC, below

5 further to the reclassification of the CTRL as a public sector company by the Office for National Statistics and statements by the then Secretary of State for Transport in early 2006: HC Deb 14 February 2006, c104WS and HC Deb 20 March 2006, c111WS

6 the history of LCR and its involvement in the CTRL is given in section IIIB, below

> Alistair Darling, the Chancellor, and Ruth Kelly, the Transport Secretary, are expected to rule early next year on what happens to London & Continental Railways, two years after the Government shelved a quick sale that became mired in accusations of cronyism (…)
>
> The likely plan is that the company will be broken up into three parts: the railway lines, which would make money by charging Eurostar trains and local services to Kent; a share of Eurostar, the train operator; and land around King's Cross and Stratford.
>
> All or some of the three parts may then be auctioned off, with proceeds being returned to the Treasury, which has underwritten the private sector debt involved in the project to the extent of £6.1 billion (…)
>
> The sale is already sparking interest among overseas infrastructure funds and private equity groups, which have been monitoring the company's progress since a sale was put off last year. The likes of Macquarie, the Australian bank, Goldman Sachs and the sovereign funds of the Middle East and the Far East, could be potential bidders. [7]

The *Financial Times* reported that the CTRL is "set to be sold in Government-run auction":

> Rob Holden, chief executive of London & Continental Railways, said an auction could be held for the 110km High Speed One link between London and the Channel tunnel (…)
>
> Mr Holden told the FT that LCR had worked closely with the Department for Transport and the Treasury on a range of options. "That has been honed down to a point where we and the civil servants are in a position of going to ministers with some advice and recommendations," he said.
>
> An auction of High Speed One would pitch Network Rail - the owner of the mainline rail network - which manages the high-speed link and is known to be interested in buying it, against financial buyers such as infrastructure funds. "You can run a very effective competition to realise best value for government, with Network Rail and various other infrastructure funds competing to buy it," Mr Holden said.[8]

The Daily Telegraph subsequently reported that LCR has received "a number of break-up enquiries".[9]

III Background

This section gives an overview of the history of the CTRL, LCR's involvement, and the regulatory regime that applies to it.

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7 "Rail link provider is on track for privatisation", *The Times*, 2 November 2007

8 "High-speed rail line set to be sold in auction", *Financial Times*, 3 November 2007

9 "Infrastructure funds signal interest in builder of Channel Tunnel rail link", *The Daily Telegraph*, 6 November 2007

A. Channel Tunnel Rail Link Act 1996

The aim of the Channel Tunnel Rail Link (CTRL) was to double the railway capacity available for international services between Britain and Europe, with up to eight international trains per hour running in each direction between London and either Paris or Brussels. The cost of construction of the CTRL when plans were being drawn up in 1992 was estimated to be £2.7 billion at contemporary prices.

The *Channel Tunnel Rail Link Act 1996* provided for the construction of a high speed rail link between London and the Channel Tunnel. The CTRL would provide the capacity needed for the increase in international rail traffic via the Channel Tunnel and reduce international journey times. The Act provided for the rail link to be built, maintained and operated by a private sector promoter but with a public sector contribution. The Bill was a Hybrid Bill: it affected some individuals in their private capacity in a different way from others in the same class while proposing a project of national importance. Those persons directly affected by the Bill could, by means of petitions against it, present their views to select committees.[10]

Section 42 of the *Channel Tunnel Act 1987* stipulates that no Government grant or subsidy can be paid for international rail passenger services. The Government can, however, support domestic services run on a rail link. Section 31 of the 1996 Act allows the Secretary of State to give such financial assistance as he thinks fit to the nominated undertaker for construction work authorised by the legislation; section 32 allows him to make payments to the nominated undertaker in return for the right to use some of the capacity on the CTRL. Section 32 payments are payments for domestic services between Kent and London particularly in the peak periods.

B. London & Continental Railways

Information on LCR can be found on its website: http://www.lcrhq.co.uk/

1. Selection as the private sector promoter, 1996

On 29 February 1996 the then Secretary of State for Transport, Sir George Young, announced that London & Continental Railways (LCR) had been selected as the winning consortium to construct the link.[11] He also announced that an international station would be built at Stratford to be combined with the new domestic station which was being constructed for the Jubilee Line Extension (JLE). He said that London and Continental would construct a short length of new railway (‘the Link’) within the Kings Cross railway lands which would provide a direct twin-track connection between the CTRL and the West Coast Main Line (WCML). This was the modified developers' scheme preferred by the CTRL Select Committee which enabled direct and frequent international services to cities such as Birmingham and Manchester which would by-pass St Pancras and call at

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[10] information on Hybrid Bills and the relevant Parliamentary procedure is in House of Commons Factsheet L5 http://web.archive.org/web/20060321001858/http://www.parliament.uk/documents/upload/l05.pdf

[11] HC Deb 29 February 1996, cc999-1016; London & Continental was thought to have bid for nearly £500 million less subsidy from the Government than the rival consortium, Eurorail

Stratford. The new railway and the international station at Stratford would be promoted under the *Transport and Works Act 1992* (TWA) as the Bill itself provided only for the building of a 'long box' to accommodate a combined international and domestic station.

The following public sector assets were transferred to the winning consortium:[12]

Eurostar Rolling Stock: £318 million[1]

Manchester Longsight Depot: £5.9 million[2]

Waterloo International Terminal: £136 million[2]

Ashford International Station: £41 million[3]

North Poole Depot: £77.5 million[2]

King's Cross Railway Lands: £5.8 million—up to £10.6 million[4]

Stratford Railway Lands: £ 15.2 million—up to £ 12.5 million[5]

St. Pancras Station: £3.7 million[6]

[1]Seven of the Eurostar train sets and the night service stock are leased. Value shown is the written down value as at 31 March 1995 on an historical cost basis after taking into account leasing obligations.

[2]Value shown is the written down value as at 31 March 1995 on an historical cost basis.

[3]Value taken from EPS's 1994-95 annual report and accounts and based on the net present value of future leasing payments.

[4]The first value is the estimated existing use value based on rental income derived from the lands taken from a valuation of the lands carried out for the BR Property Board in March 1995. The second value is the estimated development value of those parts of the lands not ultimately required for the operation of the CTRL, taken from a valuation carried out for the DETR in November 1995.

[5]The first value is the estimated existing use value based on rental income derived from the lands, taken from a valuation of the lands carried out for the BR Property Board in March 1995. The second value is the estimated development value of those parts of the lands not ultimately required for the operation of the CTRL, taken from a valuation carried out for the DETR in May 1995.

[6]Existing use value taken from a valuation carried out for the BR Property Board in March 1995.

LCR set up a wholly-owned subsidiary called Eurostar (UK) Ltd (EUKL) and all these assets were transferred to that subsidiary in 1996. This was because they were already owned by British Rail's European Passenger Services (EPS) and it was this company which basically became EUKL. These assets could not be sold out of EUKL without the Government's agreement.

[12] HC Deb 4 February 1998, c650W

2. Government rescue and restructuring, 1998

At the end of 1997 it had become clear that overly optimistic forecasts for the operating performance of Eurostar UK had prevented LCR from raising all the money it needed from private investors to build the Link. The restructured deal retained the same route for the Link but split construction into two sections: section 1, from the Channel Tunnel to near Ebbsfleet on the outskirts of London and section 2, from near Ebbsfleet to St Pancras. Railtrack was brought in both to manage construction and, when it was completed, to purchase section 1.

On 28 January 1998 the then Deputy Prime Minister, John Prescott, announced that LCR had failed to find the necessary money for the project. Mr Prescott had rejected the company's request for a further £1.2 billion over the following ten years, in addition to the £1.8 billion (at 1997 prices) already agreed. On 3 June 1998 Mr Prescott announced a revised agreement for the funding and construction of the CTRL. It did not involve a material increase in the direct grants to be paid to LCR but it did involve a radical restructuring of the project and the role of LCR:

> Today, I signed with LCR and Railtrack a statement of principles which meets all our requirements and which fulfils the contract agreed by the previous Secretary of State, the right hon. Member for north-west Hampshire (Sir G. Young), who I see is in his place. Under this public-private partnership, LCR has been strengthened. A new management team is in place, and LCR has agreed to raise more equity to support the project. Railtrack has agreed to take a key role in building the link. It will manage construction for the railway to north Kent, and will commit to purchase it upon completion. Railtrack will have an option to build and buy the remainder of the link.
>
> LCR has secured a strong partner to operate Eurostar. Two very strong bids were considered--one from Virgin, the other from a consortium comprising British Airways, National Express and the national railways of France and Belgium. LCR today agreed to award the contract to the consortium. LCR has an obligation to build the entire 68 miles of railway from the channel tunnel to St. Pancras in London, via Ebbsfleet and Stratford, in accordance with the 1996 Act endorsed by the House.
>
> The link will be built to the same route, the same specification and the same high standards as before. There will be the same environmental and heritage safeguards, and the undertakings and assurances given during the passage of the 1996 Act remain (…)
>
> I have always made it clear that the Government required a fair deal for the taxpayer, consistent with the Government's existing obligations under the contract, and this deal most certainly achieves that. The basic grant remains at £1.8 billion. There will be no requirement for additional Government support before 2010. Moreover, following intensive negotiations, the extent of the Government's additional contribution will not be the £1.2 billion requested in January, nor the £700 million about which hon. Members may have read in the press this week. It will be £140 million. After 2020, our share in the benefits will probably more than compensate for the extra money that we are asked to provide in 2010.

> All the parties have contributed to that improvement: LCR, Railtrack, the consortium and the Government. Recognising the unique features of the project and our commitment to strengthen international rail transport links, we have agreed that the Government's credit will stand behind £3.7 billion of bonds issued by LCR privately in the City to fund the project. [Hon. Members: "Who will pay?"] Hang on. That debt will be repaid out of the proceeds of the sale of the completed link. The risk of the Government incurring liability under the guarantees is therefore remote. The Government will support the financing package, which will allow this project to proceed now and at the minimum financing cost. It is a unique financing deal and I should like to express my appreciation to the Chancellor and the Treasury for having arrived at that agreement. The alternative would have been considerable delay and increased costs (…)
>
> The Government believe that, in a real public-private partnership, not only costs but benefits are shared. The Government are sharing the risk, so it is only right that the taxpayer should share the benefits. I have therefore agreed with the parties that the Government will take a public stakeholder share in LCR, yielding a 35 per cent. share of the company's pre-tax surplus after 2020. The Government will also have a 5 per cent. stake in the Eurostar management company. That will be a public-private partnership with strong public accountability. Moreover, if LCR decides to sell the business--it cannot do so without the Government's agreement, as we shall hold a golden share in the company--the taxpayer will share at least 35 per cent of the proceeds. [13]

The new agreement, described as a public private partnership (PPP), retained the original route and (with amendment) the CTRL Development Agreement concluded by the Conservative Government in February 1996. LCR would build the CTRL and for this, it would set up two subsidiaries, Union Railways (South) and Union Railways (North), each of which would be responsible for one of the two phases of construction. The construction project would be managed for LCR by Railtrack and Bechtel. Phase 1 would run from the Channel Tunnel to Fawkham Junction. Work began in late 1998 and was completed by 2003. Phase 2 consisted of the more technically difficult section of the route, from Fawkham Junction, via the new station at Ebbsfleet, and then running north of the Thames into St Pancras. Work began in 2001 and St Pancras opened for international services in November 2007. Railtrack and LCR agreed a target Cost for Phase 1 of £1.7 billion and a target Cost for Phase 2 of 2.5 billion (in January 1997 prices).

Railtrack was committed to acquire the Phase 1 infrastructure (on completion) for the actual cost of construction, less certain grant payments received by LCR, together with accrued interest. It had an option to acquire the Phase 2 assets by 2003 (and there were inbuilt incentives for it to do so). It was hoped that this would give rise to a purchase price for Phase 1 and Phase 2 of £1.5 billion and £1.8 billion respectively. Eurostar would pay access charges to Railtrack. LCR’s concession to operate the CTRL will expire in 2086 (previously 999 years), when the assets will return to the Government. Eurostar (UK) Ltd, owned by LCR, would run the trains on the CTRL, but will also return to public ownership in 2086. LCR contracted the management of Eurostar (UK) Ltd to a

[13] HC Deb 3 June 1998, cc367-370

consortium of National Express Group, British Airways, SNCF and SNCB. The contract would last initially until 2010.

The Government stated that it would not increase its grant support of £1.8 billion (net present value). It did, however, agree to guarantee £3.7 billion of privately raised debt funding (thereby reducing the cost of that finance for LCR). A further £2 billion of commercial debt would be raised without Government backing. The Government would take a ‘stakeholder’ share in LCR, entitling it to a proportion of the company’s cash flow (after 2020), and to a proportion of the sale of LCR or its assets.[14]

3. Financial arrangements following the restructuring, 1998-2001

The financing of the restructured project was fundamentally different to that envisaged in 1996, and so was the distribution of risks among the various parties now involved with the deal. In 1997 the estimated construction cost was £1.67 billion for Phase 1 and £2.5 billion for Phase 2.

The Government continued to be committed to provide grant support worth £1.8 billion (NPV) as agreed in the original Development Agreement. It would be split between the two phases, in a roughly one-third to two-thirds ratio. In addition, the Government agreed to stand behind the payment of track access charges in the event that these could not be met by Eurostar.

In addition, the project was to be financed by a combination of commercial debt and bonds totalling approximately £5.8 billion. The Government agreed to guarantee £3.75 billion of debt. The first element (£2.65 billion) was raised in February 1999 to ensure funding was available for both the financial and construction of Phase 1 and to cover forecast losses on Eurostar. The remaining £1.1 billion was to help fund the second phase.[15] The first of these ‘eurosterling’ bond issues, described as Government Guaranteed Bonds, was issued in mid-February 1999, with the longer bonds issued first, because of market conditions.[16] They were a hybrid between gilts and corporate eurobonds.

With the issue of the short term bonds, the Government announced on 17 February 1999 that the rescue package had been completed.[17] Mr Prescott forecast that, because of the success of the bond issue, the Government’s commitment to lend money to Eurostar might fall from the £140m estimate of June 1998, to less than £100 million. The loan would be repaid as part of the stake which the Government had taken in LCR. It was also announced that the Government had improved the terms of the June offer, so that if LCR were to be sold, ‘the vast majority’ of the proceeds would go to the Government. The Government share had previously been ‘up to 35 per cent’.

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14 DETR Memorandum, ‘Channel Tunnel Rail Link’, June 1998

15 HC Deb 19 May 1999, c354W

16 DETR press notice, “Prescott launches £1.65bn Channel Tunnel Rail Link bond”, 10 February 1999

17 DETR press notice, “Prescott announces completion of Channel Tunnel Rail Link rescue package”, 18 February 1998

The National Audit Office (NAO) published a report on the CTRL on 28 March 2001;[18] it was considered by the Public Accounts Committee the following year.[19] The Committee's key recommendations were addressed by the Government in its Treasury Minute issued in response to the report. This covered: forecasts of user numbers for new ventures; proper allocation of risk; the 1998 restructuring and taxpayer liability; and a lack on monetary value placed on economic regeneration.

> **PAC Recommendation**
> There is now ample evidence that even expert forecasts of user numbers for new ventures are subject to very great uncertainty. When negotiating deals the eventual success of which is heavily dependent on the number of users and the income generated, departments should examine a wide range of sensitivities around bidders' forecasts before signing a deal.
>
> **Treasury Minute**
> The Department of Transport, Local Government and the Regions (DTLR) accepts that the assessment of all new ventures should be subject to risk analysis. DTLR appraisal guidance makes clear that the key issues when assessing project risks are to consider a range of outcomes, to assess the probability of each outcome and to assess the interactions between different elements which affect outcomes. Revised Treasury appraisal guidance will set more stringent procedures for departments to follow for taking account of risk and uncertainty.
>
> A range of forecasts were prepared for the Channel Tunnel Rail Link during the various negotiations. However these did not encompass two independent events which have affected the performance of the Link and which could be argued would have attracted a low probability in the risk analysis prior to the occurrence of the events: the Channel Tunnel fire and the extraordinary success of European low cost airlines. In addition, the Link was serving a relatively new travel market for rail, which increased the uncertainty inherent in the forecasts. In essence all of these independent events have combined to produce a performance that was lower than originally envisaged for the CTRL.
>
> **PAC Recommendation**
> One of the functions of risk capital in a project is to secure the commitment of those who subscribe it by giving them something to lose if the project fails. In this case, the shareholders in London & Continental were insulated from that risk in two ways: they stood to gain, and did gain, from substantial contracts placed with them by London & Continental and, when the project came close to collapse, the Department felt obliged to keep the shareholders on board, with undiminished capital. Although the proportion of risk capital in a project is a matter for negotiation with bidders who will balance the amount of risk borne against the higher cost of servicing such capital, it is a false economy to proceed with a PPP in which too little risk capital has been subscribed by the private sector.
>
> **Treasury Minute**

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[18] NAO, *Channel Tunnel Rail Link* (session 2000-2001), HC 302, 28 March 2001: http://collections.europarchive.org/tna/20040722042150/http://www.nao.org.uk/publications/nao_reports/00-01/0001302es.pdf

[19] PAC, *Channel Tunnel Rail Link* (twenty-second report of session 2001-02), HC 630, 21 March 2002

The risk capital originally subscribed was the result of a competitive bidding process - the losing bidder offered less than London and Continental Railways (LCR).

One of the Department's aims of the first restructuring was to remove the existing shareholders from management control, but to require them to maintain an economic interest in the success of the project. As the shareholders received differing financial benefits from the restructured business, it was clear that the shareholders would need some additional incentive to approve the restructuring. It was therefore intended that the original shareholders would convert their entire equity into preference shares and new ordinary shareholders would be brought in to improve the management. In the event, new shareholders did not want to invest equity given the different risks. An alternative contractual structure was put in place to incentivise the new operator/ manager of Eurostar UK (…)

PAC Recommendation

In deciding to restructure the deal rather than pull the plug, the Department put in place complex arrangements that will expose the taxpayer to substantial risk for many years to come. For instance, some £4 billion of bonds were issued by London & Continental, subject to Government guarantees, and in addition it is likely that further substantial sums of taxpayer's money will have to be lent directly to the company to keep it afloat. The Department will need to ensure that the substantial risks to which the taxpayer remains exposed are monitored and managed carefully throughout the life of the project.

Treasury Minute

We agree that this is a very important part of the project risk management process, and have put in place the necessary rigorous procedures in order to monitor the project throughout its life.

DTLR does not consider that there is substantial risk associated with the bonds issued to LCR; these are expected to be repaid through project cashflows. In addition, under the terms of the restructuring the amount of support available to LCR is capped. In the event that this cap is reached (or expected to be reached), Government would have the option to terminate the arrangements with LCR.

PAC Recommendation

The Department's economic justification for the project depended heavily on the monetary value placed on economic regeneration which it expected to result from the Link. Without a monetary value for economic regeneration, the justification for proceeding relied on wider policy benefits, such as national prestige, which are inherently unquantifiable. Decisions to proceed with major projects should be based on a comprehensive assessment of expected benefits as well as costs. We look to the Department to monitor the realisation of these regeneration benefits after the Link has been completed.

Treasury Minute

The decision to proceed with the CTRL project was based on an extensive assessment of expected benefits and costs undertaken in consultation with industry experts and advisors. As the committee notes, not all of these could be quantified (…)[20]

4. Railtrack in administration, 2001

The organisation of the railway changed considerably between 2002 and 2004, the major catalyst being that the private company that owned and operated the rail infrastructure – Railtrack – went into administration and was replaced by a company limited by guarantee (CLG), run on commercial lines but without shareholders – Network Rail. Railtrack's share of the CTRL was brought by LCR.

On 7 October 2001, the then Secretary of State for Transport, Stephen Byers, petitioned the High Court to put Railtrack plc into administration under section 60 of the *Railways Act 1993*.[21] On 15 October 2001, the Secretary of State said:

> If we can ensure that the channel tunnel rail link section 1 continues on time, on schedule and on budget, we will do so. There will need to be detailed negotiations about any value that the project might have, and there are differing views about that value … Section 2 will be completed.[22]

In June 2002 the then Secretary of State, Alistair Darling, gave a further statement setting out how Network Rail would assume Railtrack's responsibilities for the CTRL:

> Railtrack Group and Network Rail have now concluded a sale and purchase agreement to acquire Railtrack plc. I would like to set out in some detail the terms of that agreement. In line with its original offer, Network Rail will pay £500 million—of which £300 million will be provided by the Government—as well as taking over Railtrack's debt, which now stands at £7.1 billion. This includes loans from the European investment bank and the German bank, KfW, totalling just over £1 billion, which Network Rail plans to assume.
>
> In parallel, London and Continental Railways is acquiring from Railtrack its interest in the first phase of the channel tunnel rail link for £295 million. At a cost of £80 million, Network Rail will acquire the right to operate, manage and maintain the channel tunnel rail link and the concession to manage St. Pancras station. (…)[23]

5. Recent performance, 2005-06

In July 2005 the National Audit Office (NAO) published a progress report on the CTRL. The report found that:

> …London & Continental Railways (LCR) successfully completed the construction of Section 1 of the Channel Tunnel Rail Link (CTRL) on time and at a cost slightly below the target set in the 1998 restructuring. Drawing on the reasons for this

[20] *Treasury Minute*, Cmnd 5512, 1 May 2002
[21] DfT press notice, "Railtrack placed in administration", 8 October 2001
[22] HC Deb 15 October 2001, cc965-971
[23] HC Deb 27 June 2002, cc971-989

achievement, the NAO report highlights lessons for other projects, including the importance of:

- appropriate contractual provisions and incentives between the client, the project manager and contractors;
- stability of designs and continuity of management personnel before and during construction; and
- carefully working out the risk allowance, setting aside money for that and releasing the money if associated costs do arise rather than hoping to avoid them.

Section 2 is over 80 per cent complete in cost terms, and it has to date met all its construction milestones in a programme aimed at completing the new railway in the spring of 2007. LCR expects that the final cost of Section 2 will exceed the target cost by a few percentage points, allowing for railway-related inflation.

Since the opening of Section 1, demand for Eurostar has grown rapidly, but passenger revenues still remain well below forecasts. In addition to a direct grant of just over £2 billion, the Department for Transport expects to lend LCR about £260 million to cover the shortfall between cash requirements and income through to 2051, within a range between 0 and £400 million. Despite worse than expected revenue forecasts, the expected loan is not much more than the amount estimated in 1998 as LCR successfully secured savings through lowering the interest costs on its debt. Following Railtrack Group's departure from the project, LCR was able cut the cost of capital from 8.9 per cent to a more favourable interest rate of just above five per cent.[24]

The NAO was of the view that the taxpayer was still likely to be called upon to fund a shortfall in LCR's cash flow and the economic justification for the link remained marginal. In particular, the NAO took the view that the justification for proceeding with Phase 2 would depend on wider benefits and uncalculated transport benefits.[25]

The House of Commons Public Accounts Committee followed up with a report of its own in May 2006. The Committee found that:

In bidding for the project in 1996, LCR forecast that passenger numbers using Eurostar would reach 21.4 million in 2004 but actual passenger numbers for 2004 were only 7.3 million. Where future income from passengers is expected to provide a major element of the revenue needed to repay the cost of constructing transport infrastructure, it is crucial that realistic forecasts are prepared from the start. Downside risks need to be given due weight, drawing on both UK and international experience, in considering future projects.

The economic case for the Link remains marginal. On passenger traffic alone the Link is not justified, so regeneration benefits are required to make the project value for money. The Department's assessment of regeneration benefits of the Link should be rigorous, and should separate out clearly those attributable to

24 NAO press notice, "Progress on the Channel Tunnel Rail Link", 21 July 2005
25 NAO, *Progress on the Channel Tunnel Rail Link* (session 2005-06), HC 77, 21 July 2005, p38

> other major infrastructure projects close to the Link, including in due course the impact of the 2012 Olympics.
>
> **The initial aim was to transfer a high level of commercial risk to a private sector consortium, which did not however have the financial strength or equity capital to sustain that risk if things went wrong.** As risks materialised, the Department had to provide more and more support, while trying to ensure that private sector disciplines were maintained. In considering such major projects in future, Departments need to satisfy themselves that there is reasonable consistency between the degree of risk transfer and the extent of investors' equity stake in the project.
>
> **The Department thought the Cost Overrun Protection Programme, though expensive, was a way of maintaining private sector disciplines without extra direct support from the taxpayer.** After Railtrack Group withdrew from the project in 2001, the arrangements made by the Department and LCR included placing layers of cost overrun risk with commercial insurers, as well as the project managers. The value for money of such complex arrangements is difficult to judge, and there would have been less need for them if the private sector had, from the outset, the necessary financial strength to carry the risk allocated to it.
>
> **There remains uncertainty over the future call on the taxpayer.** Even though the major construction risks have passed, under the terms of the restructured deal the taxpayer remains exposed to the financial consequences of Eurostar underperforming against forecast passenger volumes. The Department should actively manage the size and timing of LCR's call on the Access Charge Loan facility, so as not to weaken the incentive for LCR and Eurostar to maximise passenger revenues. Any future changes to the structure or ownership of LCR will need to protect the interests of the taxpayer.
>
> **High levels of inflation on construction projects which drove up the costs of Section 2 of the Link will continue to be a problem for the South East.** There are a number of further major infrastructure projects planned, for example, the Olympics, widening of the M25, Thameslink 2000 and the Thames Gateway, creating substantial additional demand for limited resources. The Treasury and Office of Government Commerce, together with public bodies planning major projects, should aim to schedule the construction phases of such projects so as to manage the risks to cost, time and quality from any unplanned surge in demand.[26]

On the conclusion regarding the possible future call on the taxpayer, the Treasury Minutes, published in response to the report said:

> The Department agrees with this conclusion. The Department is considering a number of options for restructuring LCR. The Secretary of State said earlier this year the best way of protecting the taxpayer's interest would be for there to be an open, competitive and transparent process before the sale of LCR, probably once

[26] PAC, *Channel Tunnel Rail Link* (thirty-eighth report of session 2005-06), HC 727, 4 May 2006, p4

> the Channel Tunnel Rail Link has been commissioned, which we expect to be in 2007. This is something the Department is taking forward with LCR.[27]

C. Regulatory regime

The Office of Rail Regulation (ORR) has a range of statutory powers under the *Railways Act 1993* (as amended by the *Transport Act 2000*). Using these powers, it sets the contractual and financial framework within which Network Rail operates the network, ensuring that the company carries out its activities efficiently and well, and that it is appropriately funded. The powers of the ORR were further increased by the changes announced in the 2004 rail White Paper[28] and subsequently legislated for in the *Railways Act 2005*. The ORR became both the economic and safety regulator for the rail industry on 1 April 2006 when it took over the safety regulation responsibilities of the HSE.

The CTRL is regulated under a different regime, set out in the 1996 Act. This allows LCR (or any 'nominated undertaker' specified by the Secretary of State) to operate the CTRL for the purposes of providing infrastructure services, and use them for the purpose of providing services for the carriage of passengers or goods. The Impact Assessment to the Bill states that:

> ORR does not have the power to require an operator using any part of the CTRL network to hold a licence or to impose conditions in relation to CTRL on companies who also happen to hold licences under the national regime – this will apply to domestic TOCs [train operating companies]. International TOCs must hold European licences which ORR does have the power to monitor, suspend and revoke although these requirements do not apply to the network operator. ORR also cannot direct the owner of CTRL to agree access contracts and cannot carry out access charge reviews, although it does maintain safety responsibilities. The development agreement replaces these provisions. All of these exclusions to the national railway regulatory regime were made in the 1996 Act to give investors comfort that an independent body such as ORR would not be able to change income streams which were expected to be fixed.[29]

CTRL is also subject (along with the rest of the mainline rail network) to EU Directives on rail regulation, transposed into UK law by two sets of 2005 Regulations.[30]

D. Statistics

Eurostar passenger numbers and revenue

After starting in 1994 the number of passengers on Eurostar services increased to just over 7 million in 2000.[31] Numbers fell over each of the following three years to around

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27 *Treasury Minutes to 34th and 36-39th reports of the Public Accounts Committee*, Cm 6863, June 2006, p22

28 DfT, *The future of rail*, Cm 6233, July 2004

29 DfT, *Impact Assessment of Channel Tunnel Rail Link (Supplementary Provisions) Bill*, November 2007, p9

30 *Railway (Licensing of Railway Undertakings) Regulations 2005* (SI 2005/3050); *Railways Infrastructure (Access and Management) Regulations 2005* (SI 2005/3049)

31 *Progress on the Channel Tunnel Rail Link*, HC 77 2005-06, National Audit Office

6.3 million in 2003. The main reason for this decline is thought to be competition from low cost airlines. There was an increase in the final quarter of 2003 after the opening of the first phase of the CTRL. This continued into 2004 when numbers were up to 7.3 million. There were further increases in 2005 and in 2006 when the total reached 7.85 million. Growth continued in the first half of 2007. Total passenger revenue has followed a similar trend. It fell from £440 million in 2000 to around £380 million in 2003. By 2006 it has increased to £518 million and there was a 13.6 per cent increase in the first half of 2007.[32]

Passenger numbers were still below those forecast in the Government's 1998 projections. Their 'Downside case' was for just over nine million passengers in 2006. Revised projections were made for the Government in 2001 and even the 'Low Case' in 2006 was for more than eight million passengers.[33]

Total passenger and freight volumes using the Channel Tunnel

The number of passengers on the Passenger Shuttle service is 'long term decline'.[34] The fall in passengers in this market in 2006 was broadly equivalent to the increase seen in Eurostar passengers in the same year.[35] The total number of passengers travelling through the Channel Tunnel on either service peaked at 18.4 million in 1998 and despite some increases in 2003 and 2004 was around 15.5 million in 2005 and 2006.[36]

The number of goods vehicles using truck shuttles has generally increased over time other than in the years affected by the service suspension following the November 1996 fire. Increases have slowed more recently and total numbers have remained around 1.3 million a year since 2004. Rail freight through the tunnel fell from a peak of 3.1 million tonnes in 1998 to 1.6 million tonnes in 2006.[37] [38]

Capital grants

The value of capital grants from the Government to the CTRL was agreed at £1.8 billion in 1997 present values.[39] This is the value discounted for inflation and the Treasury's (then) discount rate of six per cent. This is standard practice for capital expenditure. Actual payments in cash values over the period 2001-07 are given opposite. These totaled £3.5 billion in cash terms and £3.7 in 2006-07 prices.[40]

CTRL capital grant

£ million cash

2001-02	185
2002-03	374
2003-04	222
2004-05	312
2005-06	1,382
2006-07	1,066
Total	**3,541**

Source: National Rail Trends Yearbook 2006-07, ORR

[32] Eurostar press notices: *"Busiest ever Christmas and New Year period helps Eurostar to a record 2004"*, 5 January 2005; *"Record year for Eurostar as business travellers switch from airlines"*, 16 January 2006; *"Record year for Eurostar as more travellers switch from airlines"*, 11 January 2007; and "Eurostar revenues rise as travellers go for greener high-speed rail", 18 July 2007

[33] op cit., *Progress on the Channel Tunnel Rail Link*

[34] Eurotunnel press notice, "Eurotunnel Traffic and Revenue in 2006", 17 January 2007

[35] assumes average occupancy of 2.52 for cars and 38.75 for coaches

[36] DfT, *Transport statistics Great Britain 2007*, table 6.8

[37] ibid.

[38] op cit., "Eurotunnel Traffic and Revenue in 2006"

[39] HC Deb 27 March 1998, c295-296W

[40] values converted to 2006-07 prices using October 2007 GDP deflators