Balfour Beatty

The Shaw Report
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Balfour Beatty's submission to the Shaw Report's inquiry into Network Rail's structure and financing

1. Introduction

Balfour Beatty is a leading international infrastructure group. With 20,000 employees across the UK, we provide innovative and efficient infrastructure that underpins our daily lives, supports communities and enables economic growth. Our rail business, Balfour Beatty Rail, is one of the leading rail infrastructure suppliers in the UK. From feasibility studies, planning and design through to implementation and asset management, we provide multi-disciplinary rail infrastructure services across the lifecycle of rail assets. Our expertise covers electrification, track, power, civils, specialist rail plant, railway systems and asset management technologies.

We welcome the publication of the Shaw Review Scoping Report and the bold ideas it explores about how to achieve a more sustainable structure and financing model for our railways. It is imperative that our rail infrastructure is put onto secure financial footing, ensuring a strong pipeline of future investment.

Balfour Beatty also welcomes the publication of the Hendy and Bowe Reviews. We think it is right that the governance and day-to-day management of the processes for planning and overseeing rail enhancements are strengthened, and that clearer accountability is provided for associated costs and project management. And it is vital that the contracting community, Network Rail, the Office of Rail and Road (ORR) as regulator, and the Department for Transport (DfT), learn the lessons as to why the current enhancement schemes have exceeded their budgets and been delayed.

However, industry will want to see certainty following the multiple reviews that have been undertaken. Policy uncertainty is a major disincentive to infrastructure investment and will impact on the large number of projects in the pipeline.

Balfour Beatty has a constructive long-term relationship with Network Rail and view it as a valued customer. Managing the delivery of what are increasingly complex network enhancements and large value infrastructure projects while running a railway is a challenging task and we recognise that Network Rail is operating within a tight financial envelope. However, as with any large organisation, there are areas that could be improved. For example, in our experience, in Network Rail's case there is often over optimism on costs and timescales at the beginning of projects, inadequate early planning and changes in scope during development and delivery which adds cost and leads to delays. It is also the case, in our view, that some large projects, which Network Rail manages in a hub and spoke fashion, should be managed holistically.

We are keen to contribute to the debate and share our expertise in order to assist wherever possible. In this note, Balfour Beatty aims to set out its thoughts on some of the key areas, to help ensure that Network Rail is put on a sustainable footing.

2. Questions on greater power for Train Operating Companies (TOCs): 13, 14, 16, 18

The July 2015 Budget Red Book[1], sets out that Network Rail will devolve power to route manager directors, and that the government is changing the way it channels public money through the industry, directing it through the TOCs in the form of track access charges. Network Rail is also forming clearer regional divisions internally, and there is speculation that the organisation may be formally broken up into regional companies, or companies based around the franchises. In some cases, this would be formalising working relationships which are already close, for example, Chiltern Railways and c2c already work effectively at all levels with their Network Rail counterparts.

Channelling public money through private operators is an interesting move and could be seen as a step towards formally reuniting train operators and track in individual regional bodies with responsibility for everyday track maintenance and renewals.

Such a move could have significant potential to improve the way that the rail network operates. It could yield many benefits in terms of: the companies building a closer relationship with passengers; improved and faster decision making processes; individual companies taking on more responsibility for maintenance, renewals and enhancements; and the driving of efficiencies across the system, in that companies could be benchmarked against each other.

Similarly, we note that the ORR is considering the way regulation of Network Rail can help underpin devolution to eight routes[2]. This direction of travel could see eight regional businesses created within Network Rail, based on the eight key routes out of London. Each business would have its own profit and loss account, control over its assets and a license to operate. This would leave the national part of Network Rail to focus on the central function of co-ordinating timetables and so on.

A more radical option is for Network Rail to be broken up and concessioned to TOCs, financiers and infrastructure companies. This could allow infrastructure and maintenance costs to be compared across regions.

If any of these options were followed, Balfour Beatty would caution that there would need to be an overarching body to retain a strategic and system safety view of the whole network, whose remit would include how the different parts interact; and there should still be someone at a central level taking a holistic view of nationally important infrastructure. This could be set by value, for example, anything of £50m and over could be considered 'nationally important'.

Our own preference would be for a system that was vertically integrated on a geographical basis, with route Managing Directors responsible for all aspects of their routes, from maintenance, operations and renewals, to enhancements and stations. This would enable them to make decisions taking whole life costs into account. It is our experience that these decisions are either not being made at the moment, or are made sub-optimally.

Another point to consider is freight: government has a stated objective to increase the amount of freight which goes by rail. Rail freight has different needs from passenger services, as freight routinely operates across existing Network Rail geographical route boundaries. The review of the shape and financing of the infrastructure provider and its roles must ensure that planning and delivering 'cross- boundary' services is made easier.

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[1] Budget Red Book, July 2015, page 57-58

[2] Interview with Richard Price in Infrastructure Intelligence, 5 August 2015

Above all, we believe the rail network needs a stable, dynamic programme of investment in railway infrastructure, with Network Rail, or any successor organisation(s) being accountable and playing a strong part in developing a long-term vision for rail.

3. Questions on financing and private sector involvement

It is important to make the point upfront that Balfour Beatty has no ideological preference for private, public or hybrid finance. Our interest is in ensuring that the system works as well as possible.

Our view is that it should be about the most effective finance – be that private or public. And of course, the use of private sector finance and expertise to deliver national infrastructure assets is not new. The key point is that any model will need to secure political, social and industry consensus. If it does not, then it will not attract private investment.

While it is sensible to look at all options, we agree with the Scoping Report[3] that: *"public interest cannot be wholly met through the operation of a competitive market".* However, the report goes on to emphasise the role of more private sector input to *"facilitate risk transfer (albeit partial) away from government"*[4] and so reduce the upfront capital demands to the taxpayer.

Question 21: Do you have any views on whether the RAB remains a relevant concept for the railway, and, if not, what should replace it?

The RAB based approach (or similar concepts) used to set prices has successfully facilitated billions of pounds of private sector investments into UK regulated infrastructure whilst allowing the regulators to protect consumers against the risks associated with the market failures, such as poor safety, excessive tariffs and inadequate state of the infrastructure networks. The water, wastewater, utilities and aviation sectors in the UK can be named as examples. From this perspective, the usage of the RAB concept in the railway sector is relevant and can become one of the key drivers of the private investments in the UK railway infrastructure. The RAB is a well understood regulatory concept and provides a guaranteed and stable return to investors.

However, Network Rail's reclassification to the public sector, the return on investment accruing to the government (circularity of the cashflow) and the introduction of the cap on borrowing (instead of a RAB based risk buffer) means that the purpose of the RAB mechanism's utilisation under the current ownership and corporate structure of Network Rail is unclear.

Question 23: Do you have any views on how Britain's railway infrastructure should be funded in the future, regardless of corporate structure?

In our view, Britain's railway infrastructure should be funded by a combination of funds provided by the end users of the railway network, private sector investors and, to a lesser extent, the government. In particular, the activities related to operations, maintenance and renewals of the railway infrastructure could be funded by the money raised from the Access Charges, currently paid from the Train Operating Companies (TOCs) and the Freight Operating Companies (FOCs) to Network Rail and the Franchise Premiums, currently paid from the TOCs and FOCs to the DfT. The enhancement and expansion works of the railway network, which are capital intensive, could in turn be funded by private sector capital through the RAB concept, PPP/Concession type transactions and government support in the form of cash grants and/or funding guarantee schemes.

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[3] The future shape and financing of Network Rail *The scope*, November 2015, p13
[4] Ibid, p58

However, we agree that all options should be considered, for example:

I. ***Monetising non-core assets***, although, as the Scoping document highlights, these have not historically represented a significant source of funds for Network Rail. Indeed, according to its annual accounts[5], only 4% of its income is from commercial property. Network Rail has also recently announced that it will sell off up to £1.8 billion of non-core railway assets to meet the increased costs of its five-year programme of upgrades, thereby reducing how much could be raised via this route.

II. ***More local funding.*** More could be done to maximise the potential for partial funding by local authorities or devolved governments for specific local and regional projects – such as Pye Corner station in Newport, which cost £3.5 million and was jointly funded by the Welsh Government and DfT's new station fund[6]. This has the dual benefit of taking the pressure of Network Rail's finances and enabling local areas to bid for the schemes that are important for their local economies.

III. ***Greater private investment and management.*** Joint ventures and other forms of private-public sector partnerships could also be allowed to develop and build assets and then either operate them under concession for a number of years or transfer them to Network Rail. We believe that there is significant mileage in this solution. Of course, the private sector's involvement in the rail network goes back to its inception, when it was built with private money.

IV. ***Longer franchises***. A more fundamental way to involve private sector operators and private capital is by extending franchising contracts. The way we treat franchises at the moment in the UK is as contracts to provide an exclusive right to operate defined train services for a period of between five and ten years (though some franchise contracts are being written for longer periods, following recommendations from the Brown Report[7]), with some provision of infrastructure or railway operations services. Longer-term concessioning has been used in other parts of Europe, Latin America, Africa, and in many other parts of the world, with generally positive results, and it is our view that significant benefits could arise from the UK following suit.

    Concession contracts that include rail infrastructure are typically 25 to 40 years to allow the concession operator to invest in long-term assets to improve its performance, and infrastructure concessions are exclusive — the concession operator has the exclusive right to invest, maintain, and operate the infrastructure. It is our understanding that the maximum length of rail franchises is mandated by European law which outlines that initially, a franchise may be awarded for 15 years, but may be extended for a further 7.5 years in certain circumstances: a total of 22.5 years[8].

V. ***Local business levies.*** Building on the model of the Crossrail Business Rate Supplement (BRS), whereby London businesses are contributing £4.1bn to the costs of building Crossrail, more could be done in terms of businesses contributing to infrastructure costs through levies. Another example is the Battersea Nine Elms development. Very little public money has gone into this development. Levies on private developers are paying for the infrastructure necessary to support the change from industrial land to residential and commercial, including new

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[5] Network Rail Limited, Annual report and accounts 2015, p19
[6] https://www.gov.uk/government/news/new-35-million-railway-station-to-be-built-in-the-ebbw-valley
[7] The Brown Report into franchising, January 2013
[8] House of Commons Library, Railways: franchising policy, September 2014

schools, drainage systems, a park and green spaces. The devolution of business rates, for example, would give some metropolitan areas a capped power to increase rates to fund infrastructure, meaning local businesses could step in.

This point is an important one, and we agree with the Scoping document that one of the challenges Network Rail faces is in working with city regions to help rebalance the economy. We believe that there is a case for closer alignment between the way the railways operate and the way in which transport decision making is being devolved. Through Rail North and West Midlands Rail, city regions are in the process of taking on more responsibilities for local and inter-regional services while at the same time, wider transport strategies are being delivered by pan-regional bodies like Midlands Connect and Transport for the North. In our view, this increasing devolution is a further reason for supporting the devolution of power in Network Rail on a geographical basis.

We would also be supportive of the Transport for London model being replicated in Transport for the North as a pilot for the same powers being devolved to other bodies across the country, although we recognise that this is outside the scope of the Shaw Review. Balfour Beatty has a productive and valued working relationship with Transport for London and London Underground. Our experience has been that it is easier to introduce innovation and drive down unit costs in track renewals for London Underground (as compared to Network rail). We believe that this is because the entire system is integrated and under the full control (ultimately) of TfL. When making decisions the interests of all stakeholders can be more quickly aligned to find optimised solutions which ultimately benefit the fare paying passengers.

Question 24: What positive case studies are there (e.g. international examples in the railway sector, other sectors internationally/in the UK), where more affordable and sustainable funding and financing structures have been implemented, with or without private sector capital input? And how do you think the lessons learnt could be applicable to Britain's railway infrastructure?

One of the interesting cases worth studying is railway infrastructure in Japan. The key characteristic of the railway network in this country is that, unlike in most European countries, it is partially owned by private sector. The state agency Japan National Railway (JNR) began the process of staged privatisation in 1987, when it was devolved into six regional passenger companies (known as the JRs) and one nationwide freight company (JR Freight). These six vertically integrated companies (note that the companies generally own their rolling stock as well as the infrastructure on which they operate) currently operate in different regions across Japan.

The three JR companies inside of Tokyo-Nagoya-Osaka (high passenger traffic) are now fully privatised and listed on the Tokyo Stock Exchange. Up to one third of the shares in them are held by foreign bodies (all decisions related to financial issues, business development and CEO selection are made autonomously and free from any public sector interference). These three privatised rail companies receive no state subsidies.

The state has retained ownership in the other three but these public enterprises nonetheless act as private operators and seek to earn a profit. However, none of the three companies is profitable and they require government financial support to fund their operations.

The Japanese approach when privatising JNR was based on a number of distinguished features:

- Geographical separation (or regional subdivision) of JNR into six separate "stand alone" regional businesses with an aim to progressively transfer the ownership into "private hands".

Each company gained control over decisions about which lines to operate and which lines to close, hence removing any potential political interference;

- Continued government subsidies and support for low density and unprofitable routes protecting the consumers against adverse effects of market forces on the provision of railway services across the country;

- Focus on core rail track activities and disposal of non-core assets;

- Coordination and resolution of any interface issues between the newly created companies is dealt with by an overarching Regulatory Body; and

- Restructuring of the debt liabilities accrued on the JNR' Balance Sheet. About 60% of the total debt was transferred to a state owned agency (albeit with the JNR owned real estate and stocks) with the remaining 40% of the long term debt allocated to potentially profitable main passenger JRs. The remaining JRs were exempted from the debt liabilities because their profitability was uncertain given the small size of their markets and lower population density.

Question 25 and 26: What are your views on the enabling factors facilitating a sustainable and affordable capital structure for Britain's railway? What factors would be required specifically for private sector capital introduction? What types of investors may be interested in investing in Network Rail, any of its functions, or in select parts of it?

In our opinion, the enabling factors facilitating a sustainable and affordable capital structure for Britain's railway are connected to a) clear, stable and predictable regulatory environment, b) organisational structure and specific roles allocated to various industry participants including the network operator(s), network users, regulatory and safety bodies, etc and c) risk allocation and level of remuneration for investors. Prior to introducing the private sector capital into the Network Rail, it might be worthwhile to consider the following:

- Clarity on asset condition risk transfer - Network Rail would need to have in place adequate systems, processes and procedures to enable any potential investor to make an informed judgement on the state and condition of the infrastructure. The availability of up to date and accurate asset condition data is vital to avoid expensive risk pricing; clearly, creating such a robust system is also expensive. If this approach cannot be achieved then some alternative protection measures should be included that encourage the private sector to price the residual risk at a low level. Such mechanisms could be similar to the exceptional events mechanisms on OFTO assets.

- Corporate and organisational structure - the devolution options discussed in the Scoping Report are more likely to generate benefits if they involved creation of businesses/companies with their own P&L accounts, balance sheets, control over assets, unrestrictive ownership transfers, ability to raise debt and charge the users of the network adequate access charges (including, the franchise premiums).

- Functional role - focus on the core functions including the coordination of the timetables, life cycle management and development of the network. It would make sense for Network Rail to focus on core rail track activities and dispose of its non-core assets such as property, unused depots, land under railway arches, retail spaces, etc and use the proceeds to strengthen the balance sheet;

- Overarching regulatory body – acting as a strategic rail authority controlling the rail operations including economic regulation, health & safety and environmental aspects, etc. The role and areas of its intervention will need to be carefully thought through and clearly identified. This regulatory body should be mainly responsible for cross country coordination activities, mitigation of the interface risks and implementation of investment planning decisions;

- Debt issuance programme – outstanding borrowings under the £40 billion Senior Secured Multicurrency Note Program and the £4 billion CP Program managed through the Network Rail Infrastructure Finance PLC should continue to benefit from the direct and explicit guarantee from the UK Government. The proceeds from potential privatisation of Network Rail could be used, for example, to repay the debt liabilities held by the government in order to remove/reduce the burden on the taxpayers;

The above measures will bring the railway infrastructure closer to the other regulated industries in the UK and facilitate the flow of private investments through the usage of, for example, the RAB based mechanism. A competitive tendering model could also be used for specific lines (for example, parts of HS2) providing the platform for a pool of private sector investors who seek higher returns and can take bigger risks including construction and volume.

The type of investors that could be interested in investing in Network Rail will largely depend on the risks allocation model used and returns offered. For example, under the UK regulatory regimes with significant private capital presence (such as airports, power transmission, utilities and water) the investors earn low but stable inflation linked yields and do not typically take construction and direct demand risks. A similar model for Network Rail is likely to attract investors such as the rail industry specialists, insurance companies, pension, sovereign wealth, debt and equity infrastructure funds. Amongst the key attractions of investing in Network Rail, we would highlight the long-term nature of railway infrastructure business, resistance to economic cycles, opportunity to grow and expand and regulatory nature of the asset base (potentially low risk/stable inflation linked returns for investors).

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