AVIVA INVESTORS

HARNESSING PRIVATE FINANCE FOR UK RAIL TRANSFORMATION

JUNE 2018

The UK wants to attract private sector investment into its fragmented rail network, but the pathways for injecting capital are not yet clear.

The plan to use private capital as part of the drive to improve the UK rail network marks a new chapter in a complex tale. From privatisation in the 1990s when the network was split into parts - based on track, rolling stock and franchise operators - passenger numbers have more than doubled to record levels. There are now over 1.7 billion rail journeys made in the UK every year[1], some using systems that have barely changed for decades.

The government is committed to investing around £53 billion between 2019 and 2024[2], hoping that private sector investment alongside it will enhance and expand the rail network, delivering savings to the Treasury and improvements for customers. Although it is early days, there has been broad but qualified interest over a move that could challenge the monopoly of Network Rail in relation to infrastructure upgrades and enhancements.

History of private sector engagement

The recent changes were discussed by a diverse panel including representatives from the state-controlled operator Network Rail, investor developer Rock Rail, engineering and project management specialist Atkins, legal advisor DLA Piper and Japanese financial service company and major infrastructure lender SMBC, at a meeting led by Darryl Murphy, Aviva Investors' head of infrastructure debt.

The UK has an established history of using institutional capital on the railways, which has brought new rolling stock on-stream and financed franchise operators from as far afield as Hong Kong and Japan. The latest announcements relate to how capital might be used to finance the development of the network infrastructure itself, introducing greater competition and contestability. (It is important to note the difference between 'financing' and 'funding'. Financing involves providing the capital for an investment; funding covers the way in which the financing of the investment is repaid. In the rail sector, funding is typically from either the user or taxpayer. The newest initiatives are financing-oriented, as there is already a well-established framework for third-party funding where parties may benefit from rail improvements, such as services to port or airports, for example.)

Initial assessments suggest there are opportunities to finance digital railway enhancements, upgrading signalling systems and making it possible to run trains closer together. The changes have already begun on some lines, but are far from comprehensive. Other opportunities may include improving stations and train depots and even developing new lines such as the East–West Rail Link. Developing property around transport hubs may also be possible, to unlock value in convenient locations with heavy footfall.

However, the specific ways in which enhancements might be delivered are still evolving; the diversity of the assets mean that a single model is unlikely to fit all. Few heavy rail developments can be wholly funded from the fare box, for example, but there are many other classes of asset that could be developed or revitalised without using public funds.

In the IPFA discussions, a private sector contributor suggested that the Department for Transport (DfT) may be considering a public-private partnership (PPP) type-structure for the Western Rail Link, the new line to join Heathrow Airport with the Thames Valley, and a market-led proposal to upgrade the Brighton Mainline, linking London to the south coast via Gatwick Airport.

Recognising challenges

There are, however, real challenges for potential stakeholders, including a lack of development capital. The Hansford Review suggested creating an 'early development fund' to cover some initial bid costs to encourage more private capital into the industry; one is yet to emerge. Other issues raised by the panel included thorny boundary and interface issues, making it difficult to allocate responsibilities between counterparties. Timeliness may be an issue too, as each project will need to go through a detailed Treasury evaluation process.

[1] Rail statistics compendium 2016-2017. UK Office of Rail and Road.

[2] New £48 billion funding for Britain's railways. Gov.uk press release. 12 October 2017

There are also the inevitable practical issues that come with working on a live network with some of the heaviest usage in Europe. "It's a very complex industry, with a variety of drivers around passenger safety, service and delivery", highlighted Layth Irani, head of Infrastructure, Transportation and Islamic Finance at SMBC. "Anything on live railways is fraught. You have to get the possession and to do that you have to book a year ahead."

Other practical concerns expressed by Colin Wilson, head of UK Projects at DLA Piper, included the ability to assess the condition of the assets and the need for Network Rail to work effectively with third parties if the desire for more open competition is to become a reality.

Meanwhile, it seems that obsolescence risk is real, particularly with potential disruption from intelligent mobility. "Car companies are starting to look at different offerings. Ford launched Ford Chariot in London, which is its initial step towards autonomous vehicles. How will these things start to play together? They will start to eat away at the fringes of the railway," according to Chris Docker, Atkins' director of Strategy & Development.

Planning the route forward

With change on the cards, interested parties are being encouraged to engage widely with stakeholders including the DfT, Network Rail and its business development directors, local authorities and regional train operating companies.

A number of stakeholders highlighted the importance of establishing transparent revenue streams, whether wholly private or from a combination of private and public sources. There was an active dialogue on how this could be achieved, with panel members suggesting longer-term franchises might match asset lives more closely and be more appealing for commercial partners. Chiltern Railways' unique 20-year franchise for the line connecting Oxford and London was noted – a significantly longer term than the five to seven years envisaged in early privatisation proposals.

It should be noted that if track and train are vertically integrated (i.e. a single company were to manage both track and train) then margins may be higher than they currently are in the franchise model, reflecting the reward for taking on more risk. There are currently no vertically-integrated franchises, but the recently-renationalised London and North Eastern Railway is expected to re-emerge in that form.

Conclusion

The idea of bringing Victorian-type entrepreneurialism back to reinvigorate Britain's railways is clearly attractive from the perspective of a government seeking efficiency improvements, but there is still some way to go in finalising the framework for delivery. IPFA members have been advised to take part in the DfT's consultation process to help move the process forward.

"There will be a revolution around this," suggested Mark Swindell, CEO of Rock Rail. "It will be a different way of delivering a major enhancement project to the railways. The enhancement will not be done by Network Rail; it will be done by alternative risk-bearing, privately-financed owners."

"These new structures will work in compliance with the current regulatory environment and railway stakeholders' current roles and responsibilities," he added. "However, the new private-sector rail asset owners will work with all rail stakeholders to specify required outputs and will seek bankable supply and maintenance arrangements. These structures will need to be driven by the private sector and presented as solutions to the DFT and rail stakeholders as a new way of bringing funding into the railways."

ipfa | InternationalProjectFinance Association

J39198 RA18/ 0619/01052019