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The Rt Hon John MacGregor, OBE, MP
Chief Secretary to the Treasury
Treasury Chambers
LONDON
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25 FEB 1986

Dear John

We are meeting at 10.30am tomorrow with George Young to discuss the latest position on the Docklands Light Railway. I am writing to set out briefly where negotiations stand with Mr Travelstead and to suggest how these should be taken forward.

Background

At the end of November, we reached an agreement with the Canary Wharf Consortium whereby London Regional Transport, at the Consortium's expense, would work up a detailed design for extending the Docklands Light Railway to Bank and take steps to promote the necessary Bill in Parliament. This they have done. A scheme has been devised with a projected capital cost of some £92M. Second Reading of the London Docklands Railways (City Extension) Bill is scheduled for 3 March.

In November we also agreed that we should jointly prepare a scheme for privatising the railway. The intention was that the Consortium would underwrite the funding of the extension and that the whole railway would be transferred into the private sector; the Consortium would be owners of last resort.

Despite a great deal of effort on all sides, the Consortium have now decided that they do not wish to go forward with a privatisation. They gave three main reasons for this:

1. The financial projections do not offer a sufficiently high and assured level of profitability to attract investment on normal commercial terms.

2. In the Consortium's view there were technical and legal problems about the transfer of the necessary assets and powers to the private sector which introduced unacceptable levels of uncertainty unless extensive warranties and indemnities were given by Government.

3. Both LRT and the Consortium have come to the conclusion that it could be extremely difficult to secure the passage of the Bill without imposing certain restrictions and obligations on the owners of the railway, for instance to provide a minimum level of service. This would be incompatible with the philosophy of privatisation and would compound the difficulty of securing genuine private sector risk capital.

New Proposal

In the absence of an agreed privatisation scheme, the Consortium have now offered to provide funding for the railway on a completely different basis. Under their new proposal they would guarantee to provide sums sufficient to enable the proposed extension to go ahead on the basis that LRT would build it and operate it. This would relieve the Consortium of the responsibilities associated with owning and operating the railway, relieve them of the risk of cost or time overruns on the contract and protect them from any subsequent operating losses.

We initially understood this offer to cover the whole projected capital cost (£92M) of the railway. However, we now have written proposals from them which restrict their payment to the sum required once projected operating profits from the railway have been taken into account.

The Consortium's contribution would consist of two elements. £45M of it would be in the form of a direct payment from the Consortium. The balance would be funded by LRT through borrowing and subsequently reimbursed by the Consortium from a sinking fund to which all tenants of the new development would contribute. This element could be paid either on a year by year basis or commuted to a single lump sum to be added to the initial £45M.

Problems With New Proposal

The size of the second element would depend crucially on what level of projected operating profits were agreed. If they were fixed at the fairly optimistic levels used in LRT's current base case the contribution from the sinking fund would be minimal. Agreeing to such a high level of projected profits would mean accepting potentially very high risks that income would fall substantially short of the borrowing costs incurred by the public sector. Revenues are heavily dependent on the success of Canary Wharf and the risks could be partially offset by negotiating a guarantee from the Consortium. While they seem prepared to consider guaranteeing a set level of development (say 5m sq ft) by a given date they are unwilling to guarantee traffic levels. The risks would therefore still be unacceptably high in both LRT's view and our own.

Shortfalls on operating profits are not the only risks confronting LRT if the scheme were to go ahead on this basis. Any cost overrun onthe contract would need to be borne by LRT. This could be a substantial risk given the nature of the project. Furthermore, the Consortium will doubtless want to impose fairly stiff conditions about completion dates: we may not be able to secure their contribution if there are serious delays.

Assessment

There has not been time to carry out a detailed financial appraisal of the project on the new basis. However, Rothschilds advise that Government should negotiate on the basis of securing an adequate lump sum from the Consortium to cover all the contingent capital and revenue risks borne by LRT, and should not negotiate on later phased payments based on projected operating profits: the risk on Canary Wharf patronage would remain unacceptably high (because of the Consortium's unwillingness to provide guarantees related to traffic/lettings as opposed to construction levels); fares to be charged in the public sector would remain in issue (the Consortium would press for premium levels as they proposed); and it would be technically difficult to frame an agreement to avoid future disputes (eg. over provisions for renewals etc).

On this basis, Rothschilds' preliminary figures of the additional capital sums needed from the Consortium over and above the £45M on offer, to minimise risks (ie. allowing for a 20% capital cost overrun and 20% shortfall in traffic relative to the presently optimistic forecasts) and to secure a 7% real rate of return are:

i) At LRT fare levels - £43M;

ii) At a premium of 10p on LRT fare levels - £28M;

iii) At a premium of 20p on LRT fare levels - £15M;

iv) At a premium of 30p on LRT fare levels - £7M.

The most difficult area is that of revenue risks. There is of course a possibility that, even if the Master Building Agreement for Canary Wharf is signed, the development will not go ahead, or will be on a much reduced scale. I have asked for further work to be put in hand urgently to determine the effect on traffic of completing the development up to different stages in order to try and quantify these risks further.

We do not yet have LRT's own assessment of the revenue risks, or indeed of the project as a whole. The LRT Board must themselves be satisfied that the project is one that they can justify, and it is they who must reach agreement with the Consortium (with our approval). Among other matters, they will have to negotiate satisfactory arrangements for the Consortium to finance the cost of upgrading the initial railway.

Implications for Public Expenditure

The Consortium have indicated as their negotiating stance that they would want their initial capital investment of £45M remunerated if the projected operating profits on the railway exceeded the level necessary to service LRT's loans for the balance of the capital investment. If this were conceded all money provided by the Consortium would score as external finance and count against LRT's EFL. In this case LRT in order to justify the whole of the expenditure on this project would have to be able to demonstrate non-financial benefits sufficient to yield a 7% real rate of return on capital employed. For this reason and because LRT would be bearing the whole of the commercial risk, this negotiating condition of the Consortium is unacceptable.

On the other hand, provided the Consortium had no rights to any return on their initial capital payment it, and any further payments made out of their sinking fund, would count as internal resources and would not score against LRT's EFL. The balance of the costs of the scheme would count as public expenditure, scoring against the EFL, in the years incurred and would be offset in future years by any subsequent payments by the Consortium. Unless the Consortium agreed to a single lump sum payment, instead of phased payments, additional resources would have to be earmarked during the 3-year construction period. The project would remain to be justified on the basis of a financial appraisal requiring a 7% rate of return on capital taking into account the stream of revenues from the Consortium and the railway itself.

The forward provision for LRT makes no allowance for public sector investment in the DLR extension. Any extra call for external finance would have to be accepted as an additional bid in the coming public expenditure round.

Other Issues Relevant to the Negotiations

Originally it appeared that the Consortium were making the DLR the only absolute transport infrastructure stipulation. The Consortium are now seeking detailed commitments about the provision of roads as part of the Master Building Agreement, being negotiated between LDDC and the Consortium. This will specify the infrastructure and construction works apportioning detailed responsibility between the Consortium and LDDC. They are presently aiming to agree a final draft of the Agreement by 31 March, although it will not be signed until after the DLR Bill has received Royal Assent.

The public sector commitment being sought would be £25M of direct infrastructure costs (including £15M on roads) together with £33M of additional (or at least greatly accelerated) expenditure on associated roads. This includes proposals for the Docklands Northern Relief Road.

We need to take account of this additional demand from the Consortium in taking an overall view of the Canary Wharf negotiations.

Point for Decision

The first question is whether we should proceed with the extension of the railway as a public sector project. Given the difficulty of privatising the railway and the implications for Canary Wharf we believe we should provided:

i. we do not concede remuneration of the Consortium's capital because of the adverse public expenditure consequences implied by that;

ii. agreement can be secured to an appropriate figure which both minimises the risks and secures an adequate return on capital.

The second question concerns our negotiating stance with the Consortium over the railway. The Consortium have sensed the importance of Canary Wharf to Government and we are in danger of being pushed firmly back on the railway. We must stick out for the best terms. This means pushing back towards the initial position of the Consortium that they would cover all capital costs (indexed) and a return on capital borrowed without substantial income offsets because of the revenue risks being borne by the public sector. We are unlikely, however, to be able to hold to that position. We should therefore aim, at the minimum, to reach agreement on a sufficiently large lump sum from the Consortium as advised by Rothschilds. Their present analysis suggests that we should open by demanding an additional sum of about £43M since this reasonably minimises construction risks to LRT and would give reasonable assurance that the balance could be found from revenues at realistic public transport fare levels. (It may not however adequately cover risks that the Canary Wharf development does not go ahead as currently planned, and we need to do some further work on this and to have LRT's assessment of the risks involved).

The final question concerns the timing of Second Reading of the City Extension Bill. The Consortium believe that with Second Reading impending on 3 March they can force the Government to quick decisions this week. It would be to our advantage to slow the process down - for which the Consortium can be blamed because of their volte face - leaving more time to reach a sensible and considered response to their position and to secure agreement with LRT (whose board will now have to agree to accept responsibility for this as a public sector project and to accept responsibility for the capital and revenue risks involved) and subsequently with the Consortium. I therefore propose to defer Second Reading, although there may be difficulties in finding an alternative date before Easter.

Conclusion

George Young and I are to meet you on Wednesday 26 February to discuss this. I hope we can then agree that:

i. we proceed with the extension of the railway as a public sector project provided we can negotiate an acceptable financial contribution for the Consortium to the capital costs;

ii. we should seek a contribution which will in total produce an acceptable financial return at LRT fare levels. Initial calculations suggest that this would imply a contribution of some £88M in total from the Consortium.

iii. the LRT Board must reach their own view of an acceptable contribution based on their assessment of capital and revenue risks. We should back the LRT Board in reaching agreement on this basis.

iv. we should delay Second Reading beyond 3 March. There are however problems in finding an alternative date before Easter.

I am copying this letter to the Prime Minister, Kenneth Baker, George Young, John Biffen, John Wakeham, Norman Tebbit and to Sir Robert Armstrong.

Yours ever

Nicholas

NICHOLAS RIDLEY