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T/F Seldman.

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

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The Rt Hon John MacGregor OBE MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London
SW1

16 APR 1986

Dear John

DOCKLANDS LIGHT RAILWAY AND CANARY WHARF

At our meeting on 26 February we agreed on a set of principles which should govern further negotiations with the Canary Wharf Consortium on the financing of the £92M Bank extension to the Docklands Light Railway as a public sector project. In particular we agreed that

i. the initial payment from the Consortium should not be renumerated and it should be set at the highest possible figure above £45M.

ii. beyond that the possibility of further financial support should be pursued.

Negotiations with the Consortium have been conducted on this basis by my officials, assisted by yours, DOE's, and by Rothschilds. They have now reported back with what they believe to be the best deal obtainable.

Proposed deal with the Consortium

The main features of the proposed deal - which of course is subject to our agreement - are as follows:

a. LRT will provide an extension to Bank ultimately capable of carrying the traffic likely to be generated by the full 10 million sq ft development planned for Canary Wharf. LRT will retain the option of phasing the scheme; the initial phase would be sufficient to service a development of 5 million sq ft but LRT would undertake additional upgrading on receipt of a commitment by the Consortium to complete the later phases of their development.

b. the Consortium will contribute in total £71M in cash, £45M of which would be paid over the next four years during the construction of the extension, with a further annuity of £1.3M a year for the following twenty years. This is equivalent to a total contribution in present value terms of £45M discounted at 5% real.

c. the Consortium will undertake to guarantee the costs (£4.5M) of upgrading the initial railway should they withdraw from the project, since this work will have to be carried out now whether or not the extension finally goes ahead.

a. and b. above are of course subject to the signing of the Master Building Agreement which itself will be conditional on the successful passage of the present railway Bill through Parliament. I understand from Kenneth Baker that negotiations on the Master Building Agreement are proceeding between the LDDC and the Consortium, with the target of reaching agreement on points of principle during May, and that your officials are discussing with DOE an economic appraisal of the Canary Wharf scheme itself.

The attached paper which has been discussed with your officials describes the basis on which LRT are appraising the project and analyses the financial risks involved. Taking into account the costs and benefits of the project, including some non-financial transport benefits, the project shows a real rate of return in excess of 5%. This analysis is based on a set of assumptions as described in the attached paper, in particular revenue forecasts are based on a central assumption of a level of occupancy of 5 million sq ft at Canary Wharf. All the indications are that the Consortium will not proceed with the project if they cannot assure a level of occupancy of at least this amount.

Implications for public expenditure

The project will be carried out wholly in the public sector and a separate subsidiary of LRT will be established to build and operate the railway. It has been agreed with your officials that the Consortium's contributions will accrue to the project as revenues and will score as internal resources. Net of the Consortium's initial cash contribution of £45M during construction, LRT's share of the capital expenditure on the railway is expected to amount to some £60M (cash).

Expenditure in 1986/87 will be relatively small and we expect it to be accommodated within LRT's existing EFL. The project is expected to peak in 1987/88 when the public sector share of the outlay could be some £17-£18M, followed by some £15M in the next two years with some carry over into 1990/91. I propose to discuss with LRT how they might best finance this expenditure.

In subsequent years we can of course look forward to reductions in LRT's EFL and grant requirements when the Consortium's annual payments begin and operating surpluses build up to anticipated levels.

No provision has been made in LRT's planned investment programme nor in the planning figures for LRT's EFL to accommodate this additional expenditure. This is not a project that has been initiated by LRT. Nevertheless, I have Keith Bright's assurance that his Board will be prepared to submit an investment case to me but only on the basis of an assurance that LRT's EFLs for 1987/88 and beyond will accommodate this additional expenditure, without adversely affecting their planned investment programme. In the circumstances I think we are bound to accept this and I should like your agreement that we can do so.

Next steps

In my view the understanding we have now reached with the Consortium represents the best deal we could expect and would be a highly satisfactory outcome for the Government. It will provide a valuable addition to London's public transport infrastructure and a stimulus to Docklands as a whole as well as keeping open the prospect of the Canary Wharf development going ahead.

It will be for LRT to draw up the appropriate detailed agreement with the Consortium, the terms of which will be subject to my approval. I am not proposing any further publicity until such an agreement is completed.

I should be grateful for your agreement in principle that we should proceed with this project on the basis that I have described.

I am copying this letter to the Prime Minister, to the Lord Privy Seal, the Chancellor of the Duchy, the Secretary of State for Employment, the Secretary of State for the Environment, the Chief Whip, and Sir George Young, and to Sir Robert Armstrong.

Yours ever

Nicholas

NICHOLAS RIDLEY

15.4.86

DOCKLANDS LIGHT RAILWAY - BANK EXTENSION

NOTE ON INVESTMENT APPRAISAL

1. This note describes the outline investment appraisal made of the Docklands Light Railway (DLR) City Extension project. It is based on data produced by Rothschilds and agreed during the negotiations with the Consortium. The capital and operating costs and revenues were estimated by London Regional Transport (LRT). A more detailed appraisal is now being made by LRT, but there is no reason to suppose that its results will be substantially different from those outlined here.

Criterion

2. The objective of the appraisal is to ensure that the project satisfies normal public sector investment criteria. Transport projects are normally appraised against a test discount rate of 7% (representing a 2% premium on the required rate of return) in order to cover project risks and appraisal optimism. Treasury officials agreed that it would be more appropriate to appraise this project against the required rate of return of 5%. The special factors leading to this conclusion are that a high proportion of the income from the project is being guaranteed by the Consortium; and the residual risks have been explicitly examined. The investment is represented as the capital cost of the project including an appropriate contingency element. The financial returns to the public sector have been taken to comprise the Consortium's contribution, plus net operating profits. In addition non-financial benefits, notably the net time savings to passengers not travelling to and from Canary Wharf, have been appraised.

Assumptions

3. The following key assumptions were made:

i) capital cost - estimated by LRT as £92M at January 1986 prices, for a railway capable of accommodating a full 10 million sq ft occupancy of Canary Wharf, and including a £10M contingency allowance. The cost of a first phase capable of dealing with 5 million sq ft occupancy is currently estimated at some £85M.

ii) operating costs - agreed by LRT and the Consortium to be £5M pa initially, rising to £5.8M at full capacity.

iii) revenues - the Consortium have accepted LRT's revenue model. Traffic levels are dependent on the scale of development at Canary Wharf. The fares are assumed to be at standard Underground levels.

iv) inflation has been taken to remain at 5% throughout the appraisal period.

The Financial Return on Investment and the Consortium's Contribution

4. On the basis of the cost and revenue assumptions set out above, Rothschild's analysis showed that if 100% occupancy of the full 10 million sq ft development were achieved then the net present cost of the project would be some £48M. This would represent the contribution needed from the Consortium at that level of occupancy to achieve the required rate of return in purely financial terms. However, LRT would be exposed to the risk that development might stop short of 10 million sq ft. We asked Rothschilds to look at this risk. They confirmed the Consortium's contention it would not be profitable for them to proceed unless they were confident of letting at least 5 million sq ft. On this basis the central assumption adopted in our negotiations was the achievement of 50% occupancy by 1991. This increased the net present cost of the project to £59M on the basis of a £92M railway.

The Consortium's initial offer was limited to £30M in cash. They progressively increased this to their present offer of £45M in present value terms made up of cash payments of £45M pari passu with LRT's contributions as the railway is built, together with an annual payment of £1.3M for 20 years after completion. In addition they have dropped their requirement that they should participate in any profits from the railway and have guaranteed to meet any abortive costs on the upgrading of the Initial Railway in the event that they decide not to go ahead with their development.

Scope for Phasing of Capital Expenditure

6. Since the analysis assumes as a central case that 5 million sq ft rather than the full 10 million sq ft of development will take place we considered the capital savings which could be achieved by providing a railway initially with capacity to service a 5 million sq ft development with the option of improving it later to cope with the full 10 million sq ft of development.

7. Preliminary estimates show that in this way savings worth at least £6M in NPV terms could be made on the initial capital cost. It would, of course, cost rather more to reinstate these costs at a later stage than to include them in the initial contract. But the extra revenue generated by the extra 5 million sq ft of development is estimated to be worth £11M in NPV terms. On this basis phasing looks the most sensible approach.

8. On the basis of phasing the capital expenditure the Consortium's present offer of £45M in present value terms falls short of the reduced net present cost of the project by some £8M.

Risks

9. i) Capital cost overruns

The capital cost has been based on careful estimates by LRT. As already stated, to reduce the risks the estimate includes a contingency allowance of £10M. This makes special provision for the risks associated with tunnelling and even setting that element aside the provision is very much more generous than the contingencies allowed for on the initial railway which are proving adequate.

ii) Operating costs

The DLR is a capital intensive railway using proven technology. There is therefore a sound basis for estimating operating costs. The railway will be run by a separate new subsidiary company which will permit the negotiation independently of the Underground of separate agreements on wages and working practices. LRT were sufficiently confident of their operating cost estimates to be prepared to operate the railway on a fixed price contract in the context of the previous privatisation proposal.

iii) Revenue risks

Traffic forecasts are crucially dependent on the level of development at Canary Wharf. The Consortium have said they will not proceed unless they are confident of letting 5 million sq ft although the current draft of the Master Building Agreement only specifies a minimum of 2 million sq ft. It may be possible to secure an increase in the guaranteed minimum level of development but we cannot count on this at present. The effect on the NPV of the project and the development stopping at 2 million sq ft would be a reduction of some £10M. Revenue forecasts also depend on assumptions about fares. The estimates are based on the assumption that LRT will not be able to charge a premium over and above their general level of fares.

Scope for Raising Fares

10. We have legal advice which suggests that when LRT

or a subsidiary run the DLR they could be challenged under section 8 of the LRT Act if they sought to charge significant premium fares. However there may be some scope within a general revision of fare zones and structures for securing a limited premium fare: a 5p premium would improve the NPV by £14M.

Non-financial Benefits of Investment

11. The financial appraisal does not take account of economic benefits conferred by the extension and not reflected in revenues. A major element in these is the time saved by travellers to and from Docklands. In the case of travellers to and from Canary Wharf it could be argued that the Consortium are paying through their contribution for the increased accessibility to their development. However there are many other, non-Canary Wharf travellers who will benefit from reduced journey times. In assessing the value of these benefits separate values have been allocated to time spent on work and leisure trips. An allowance has been made for the disbenefits resulting from the possible closure of Tower Gateway station.

12. The estimated value of non-Canary Wharf time saving benefits is about £15M NPV. This figures includes no allowance for any additional development benefits for Docklands, nor any allowance for reduced road congestion, vehicle operating costs and accidents.

Conclusion

13. On the basis of a strict financial appraisal the project would fall short of achieving a 5% real rate of return. If the development only reaches 5 million sq ft the financial shortfall in NPV terms is some £8M; if the development proceeds to the full 10 million sq the shortfall is reduced to around £3M. Time saving benefits to non-Canary Wharf users of the railway are alone worth £15M in NPV terms. Thus the project achieves a 5% real rate of return with the proposed contribution from the Consortium after taking account of the phasing of capital costs and these wider transport

benefits. The main risk (though still a small one if the development is to proceed at all) is that the development does not achieve the 5 million sq ft occupancy that the Consortium say is the minimum they will build.

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London
SW1P 3EB

21st April 1986

Dear Nicholas,

**DOCKLANDS LIGHT RAILWAY AND CANARY WHARF**

Thank you for your letter of 16 April. – with ON.

The outcome of the negotiations seems indeed to have been in line with the conclusions we reached when we and George Young met on 26 February. I would be content for agreement in principle to be given to the project.

At the meeting we deliberately set to one side the public expenditure implications of the proposal and the question of offsetting savings. These give rise to costs to LRT in each of the 3 years of the coming IFR round. In agreeing to this project I do not think that it would be right to give to LRT an assurance in the terms you mention in your letter. The fact that the DLR extension was not a proposal from LRT does not imply that we must agree now to the whole of LRT's own investment plans as well as to the DLR. We have not yet discussed, as we shall need to do in the IFR, LRT's planned investment programme, nor their revenue prospects as they are now seen. Whilst I do not wish to use agreement to the DLR extension as a tool for an arbitrary squeeze on LRT's investment plans, I do not feel able to agree in advance of the IFR to increase LRT's EFL by the full amount of the net costs of the DLR extension.

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

Yours ever,

JM

**JOHN MacGREGOR**

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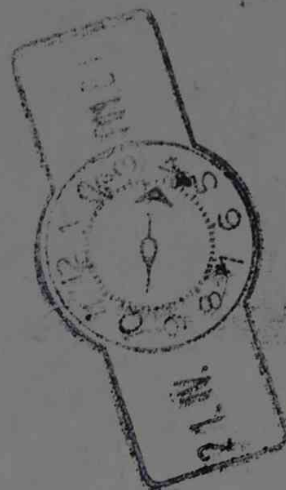
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