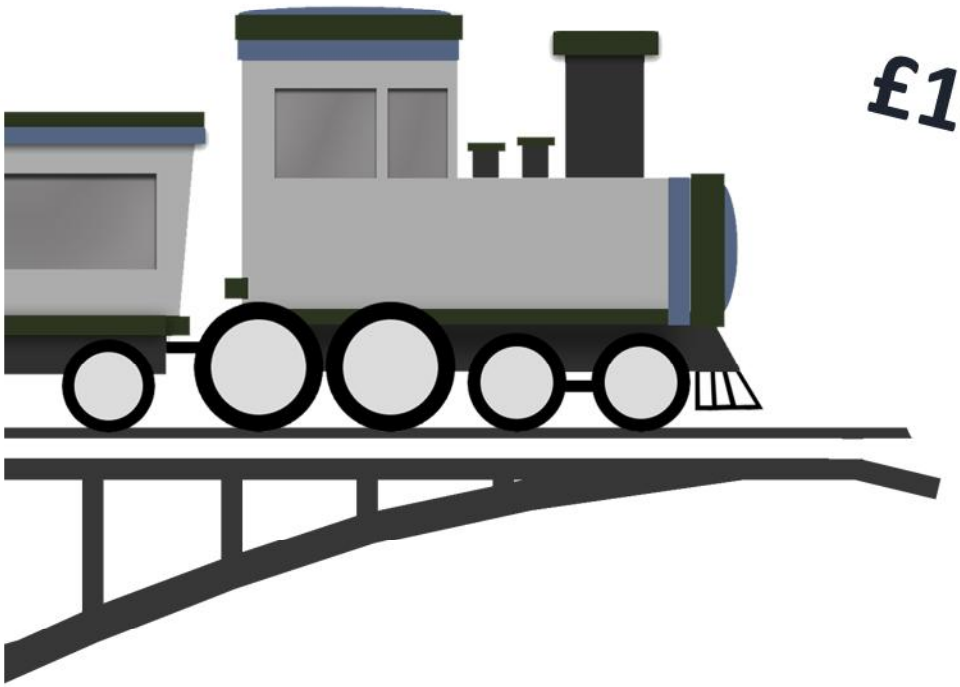
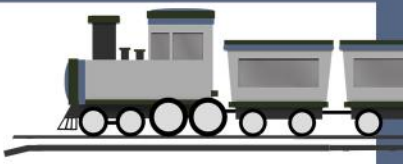
Privatising Network Rail:



A £10 billion ticket to disaster

A report by we own it and transport for quality of life



Report written by Lynn Sloman, director at Transport for Quality of Life
With support from We Own It
June 2016

We Own It is an independent organisation that campaigns for public services for people not profit. The evidence shows that privatisation is failing, while public ownership is supported by a majority of the British public. We believe in transparent, accountable public services that belong to all of us.

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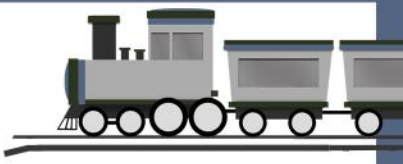

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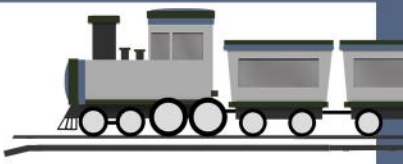


Executive Summary

Network Rail is currently in public ownership but the government is threatening to break up the network and sell off parts of the railway. This report explains how much the plan could cost us over the next ten years and makes the case that break up and sell off is short-sighted from a financial point of view.

The options being considered include Network Rail selling its largest railway stations, parts of the commercial estate, the power assets and the telecommunications assets. The government is also looking at options for private companies to manage the railway tracks on different parts of the network. Network Rail itself has agreed with the government to sell off some of its assets, and believes it can raise £1.8 billion from the sales. The plans being considered would make the railway worse, not better, for two reasons. Firstly, the assets being sold off have the potential to provide an ongoing source of income. Selling them off will mean we lose out on long term revenues into the future. Secondly, these assets are crucial to the operation of the railway and selling them off would be hugely complex, risky and in the long run, more expensive. This report analyses the financial consequences of the sell-offs being proposed.

Network Rail sell-offs would cost us £10 billion over ten years.

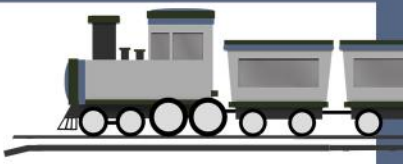
This includes:

- £1.1-£1.7 billion in one off set up costs (including financial advice, legal fees, under-valuation)
- £3.4-£3.8 billion over ten years in fragmentation and transaction costs (including higher interest payments, dividends to shareholders, sub-contractor profit margins, contractual arrangements, project cost over-runs)
- £3.9 billion over ten years in lost opportunities for income (revenue from stations, renting out commercial property and telecoms spare capacity)
- £1 billion or more of failure and exit costs (buying back commercial debt, administration costs)

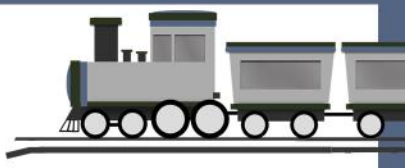
A better way to fund the railway

Network Rail has a funding problem, not a financing problem. All the financing ‘solutions’ on the table will cost more in the long run. This report suggests three ways to tackle Network Rail’s funding problem:

- Fair taxes – those who benefit from the railway would make a contribution to improving it. This could include rail improvements being financed by taxing the uplift in property value they produce, a payroll tax on employers close to railway stations and a tax for motorists who benefit from less congestion.
- Cutting wasteful expenditure – a unified, publicly owned railway (created over time as franchises are brought in-house) would save money (around £1.2 billion a year).
- Better accountability – channelling public funding via regions and cities to make sure they get the rail improvements they need for their economies to thrive.



The proposed sell-offs are a short term fix. Although they would raise some cash up-front, the long-term effect would be to increase the complexity and cost of running the railway, and this additional cost would have to be paid by passengers and taxpayers. Network Rail as a publicly owned body has a responsibility to run the railway for the benefit of passengers and taxpayers, today and in the future. Breaking up the railway and selling off its profitable assets is a risky, costly experiment that we cannot afford.



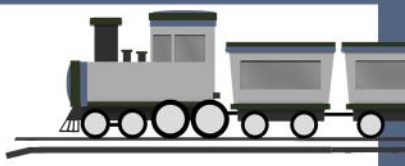
1. What is the Government planning to do to Network Rail?

Network Rail is the organisation that is in charge of Britain's railway infrastructure – the track, signalling, overhead wires, bridges, tunnels and stations that are needed for our train services to run.

Unlike train services (which were privatised in 1994), Network Rail is currently in public ownership. However, in the recent past it has been in the private sector (as Railtrack, between 1994 and 2002); and then a not-for-profit company (between 2002 and 2014).

The Government is now threatening to split Network Rail up and sell parts of it off again. All of the following are being considered:

- Selling Network Rail's electrical distribution and traction power assets: pylons, cables and 120 electricity sub-stations that provide and distribute the power to run the 50% of all rail traffic that is electrically powered [1] [2].
- Selling Network Rail's telecommunications assets: 20,000 km of fibre-optic cable, 18,000 km of hard cable, and 2,500 masts that form the 'nervous system' of the railway[3].
- Selling 18 of the largest railway stations to the private sector[4].
- Selling some of Network Rail's commercial estate of 7,500 properties, freight yards, depots and land[5].
- Selling 30-year 'concessions' to companies to manage and maintain the railway network in some parts of the country. The companies taking on the concessions would make a profit by charging 'track access charges' to the privatised passenger and freight train companies that used their track[6].
- Letting 'vertically integrated' franchises for some rail services, where the franchisee would be responsible for maintaining and enhancing the track as well as operating train services[7].



2. Why the sell-off?

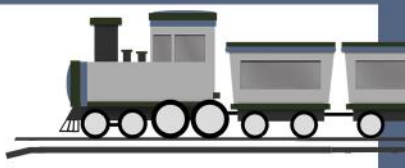
There are two motivations for the sell-off plans.

The first is that Network Rail has a funding shortfall for the enhancement projects it needs to deliver in the period from 2014/15 – 2018/19 (known as Control Period 5, or CP5 for short). In order to close the funding gap, it has agreed with the Government to sell off some of its assets. This is supposed to raise £1.8 billion. Details of which asset disposals will raise this money are very sketchy: so far, all we know is that it will come from sale of part of the commercial estate (including depots and retail units in some stations) and spare capacity on the telecoms network[8]. Raising money in this way is acknowledged by Network Rail as having adverse consequences for the future funding of the railway: the report by Network Rail Chair Peter Hendy which committed to the sell-offs says that:

"…there are clearly implications for the future funding of the railway. Less income from property means that more will have to come from elsewhere." [9]

So the sell-offs are a short-term fix, but they do not solve (and actually worsen) a much bigger underlying problem. This is that between 2002 and 2014, Network Rail borrowed substantial amounts of money in order to pay for rail infrastructure upgrades (known as 'enhancement projects'), so that it now has a debt of £41 billion[10]. The Government chose to ignore this growing debt while Network Rail was classified as a not-for-profit company – effectively, it could put the cost of rail enhancement projects on the Network Rail 'credit card', and pretend that it wasn't there. But in 2014 the Government was forced to re-classify the company as part of the public sector. This means that Network Rail's debt now appears on the Government balance sheet, and cannot be ignored any more. The Government does not want the debt to grow, because it would look bad in the Public Sector Net Debt statistics, but does not want to fund rail investment through taxation either. In desperation, it is trying to find another way of getting money up-front, through sell-offs, concessions or other financing 'solutions'.

Potentially, the sell-offs and concessions could raise billions of pounds – and kick the problem a few more years down the line. But money up-front will have to be paid back sooner or later. Worse still, these financing 'solutions' will increase the total cost of the railways, for a variety of reasons described in section 5.



3. The financial and operational case for not selling off Network Rail's assets

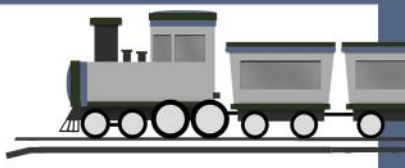
The sell-offs and concessions that are being considered will make the railway worse, not better:

- Some of the assets being considered for sell-off have the potential to provide an ongoing source of income, which could be used for long-term investment in our rail infrastructure. By selling assets, Network Rail may get an immediate injection of cash, but this is at the expense of long-term revenues.
- Other assets are crucial to Network Rail's operations. Selling them off (and then buying back a service from the new owner) is hugely complex, risky, and in the long run more expensive.

Table 1 summarises the main reasons why each of the sell-off options under consideration would be a bad idea.

Table 1: Reasons why the sell-offs are a bad idea

	Loss of ongoing source of income	Complex (could lead to unsatisfactory outcomes)	Risky (could lead to crashes)	Makes running the railway more expensive
Sale of electrical power assets		■		■
Sale of telecoms assets	■	■	■	■
Sale of 18 largest stations	■	■		■
Sale of commercial estate	■			
30-year concessions		■	■	■
Vertically-integrated franchises		■	■	■



4. The sell-off plans in detail

4.1 Electrical power assets

Network Rail's electrical power assets could be sold to one of the privatised electricity companies, or to a global investor[11]. The buyer would operate, maintain and renew the power network, and could also raise finance (by taking on debt, or through equity) to pay for enhancements. They would receive payments from train operating companies who used the electricity to power their trains.

It is not clear whether the sale of electrical power assets will include everything from sub-stations right up to the overhead lines that provide power to the trains, or just part of the system.

The legal agreements between Network Rail, the new owner of the power network, and the train companies would be extremely complex. Costs would be higher because of this complexity, and because of dividend leakage. One expert rail industry commentator[12] has said that:

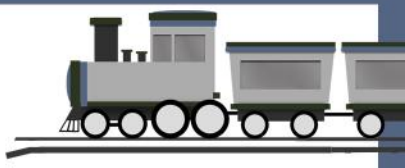
"…monetising the physical interface between power supply and trains would be a goldmine for lawyers and consultants."

4.2 Telecommunications network

Network Rail's telecommunications network is a core service for the operation of the railway: it enables train drivers to communicate with signallers and control centres; is essential for maintenance teams; provides wi-fi for passengers; and in future will enable trains to run more often on busy sections of the rail network by replacing traditional line-side signals with a continuous communication-based digital signalling system.

Network Rail has invested nearly £2 billion in its telecoms network in the last decade. The new state-of-the-art network has a lot of spare capacity. If this was rented to commercial telecommunications companies, it would provide a long-term revenue stream for Network Rail. Network Rail recognises this, and would prefer to rent its spare capacity to telecoms companies, rather than selling off the network in its entirety and then itself renting services back from the buyer[13]. However, the Government is still pushing for an outright sale or a joint venture[14].

There is a risk that a private telecoms company would have a poor understanding of the safety-critical aspects of the telecoms network.



4.3 Large railway stations

Most railway stations are owned by Network Rail but operated by one of the train operating companies. However, Network Rail itself runs the 18 largest railway stations, including ten in London and the main stations in Leeds, Edinburgh, Glasgow, Liverpool, Manchester, Bristol, Birmingham and Reading.
Network Rail has engaged investment bankers Citigroup to advise it on whether these 18 stations should be sold off, or offered as long-term concessions to property developers, shopping centre landlords, or train companies.

Under either option, commercial interests would take precedence over the wider public interest and the interests of passengers. For example, less-profitable but useful services such as left luggage facilities might be moved away from the station concourse; and station enhancements would be focussed on short-term profit rather than protecting and enhancing the station heritage for the long-term.

A sell-off would also remove a steady and growing source of income for Network Rail. In the five years 2014/15 – 2018/19, income at the 18 stations from retail, advertising, car parking, left luggage and other sources will be £938 million[15] [16] .

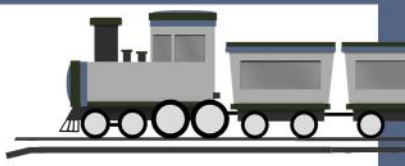
Network Rail's property arm is very successful, and a review of its forecasts by commercial property services company DTZ for the Office of Rail Regulation stated that the 18 stations were well-managed and outperformed reasonable benchmarks[17]. At the moment, all its profits are directly invested in the railway. If a property developer, shopping centre landlord or train company took over, they would want to take their 'cut', meaning less money over the long-term to invest in rail services.

4.4 Commercial estate

Network Rail also gets an income from letting commercial space and land, including space under railway arches. It has recently stepped up its programme of redevelopment of space under railway arches, to create higher value spaces which generate more rental income. It particularly develops spaces which are attractive to local independent businesses, including space for start-up local entrepreneurs at affordable rents.

Network Rail's portfolio of land around stations has the potential to generate substantial and ongoing income in the future, but only if Network Rail retains ownership. This means it makes more sense for land that is not needed to be developed through joint ventures, or directly by Network Rail's property arm, rather than being sold off to a developer.

As with the 18 largest stations, a sell-off of Network Rail's commercial estate would remove a steady and growing source of income for Network Rail. In the five years 2014/15 – 2018/19, its property rental income will be £665 million[18]. It is expecting its property income to grow by 67% during that period. All these profits are reinvested in the railway.



4.5 Thirty-year concessions

Initially, the railway network in two areas of the country (known in railway jargon as 'Routes') could be sold off. The Shaw Report, commissioned by the Government to make recommendations on the future shape and financing of Network Rail, suggests that the first areas to set up concessions should be the Wessex and Anglia 'Routes'. These two areas make up a significant proportion of our railways. The Wessex Route includes the lines between London Waterloo and Portsmouth, Southampton and Weymouth; it has over 2,000 kilometres of railway track. The Anglia Route covers the whole of East Anglia, including lines into London Liverpool Street and Fenchurch Street; it has nearly 2,300 kilometres of railway track. Between them, these two Routes make up about one-seventh of the railway in Britain[19].

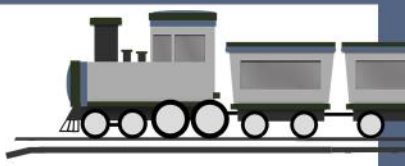
The contracts for the 30-year concessions would be very complex. Based on the contractual agreements that were needed when Railtrack was privatised, there would be contracts between the Wessex and Anglia concessionaires and Network Rail or the Government; track access agreements between the concessionaires and all the passenger and freight train operating companies that used their track; station access agreements; and leases of stations, light maintenance depots and other rail facilities. Contracts would also be needed with the companies that bought the electrical power assets and telecoms assets that are being considered for privatisation.

There would be a risk that the concessionaires would cut back on regular maintenance (which is what Railtrack did), in order to save money and be able to pay bigger dividends to their shareholders. This could lead to crashes, as happened repeatedly when rail infrastructure was last managed in the private sector.
This would be a much more expensive way of providing a rail service, because of the complex contractual arrangements between many different organisations; the leakage of money out of our railway service in dividends to shareholders; and the substantial costs of first setting up the new arrangements, and then, if they prove unworkable and ultimately fail (as is highly likely) 'picking up the pieces' about 5-10 years on.

4.6 Vertically integrated franchises

The Welsh Government wants to let what is known as a vertically integrated franchise on the South Wales Valleys lines. A consortium of private companies would maintain and enhance the infrastructure, and also operate the trains. This option is also being looked at for train services and railway track between Southend and London (Essex Thameside).

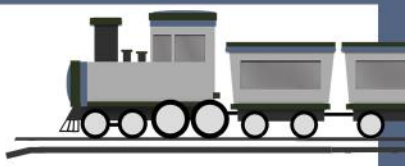
One idea is that the consortia who take over the infrastructure and train operations in these areas could



include manufacturers of digital signalling equipment: they would upgrade the lines and trains, with new equipment on all rail vehicles, beacons on the rail infrastructure, and new control systems[20]. The theory is that there would be an incentive for the consortium to do this well, as it would lead to more passengers travelling, and hence more profit for them.

But this is again hugely complex. In order to be attractive to the private sector, the contracts would need to be for a long time (e.g. 30 years). This would lock-in inflexible arrangements that would cease to be in the public interest as time passed.

The risks would be similar to those for a Route-based concession. The costs of providing a rail service through this type of vertically integrated franchise in the private sector would be higher than the costs of a vertically integrated service under public ownership and control, because of dividend leakage, consultancy fees at the outset, and costs of 'picking up the pieces' if the arrangement was unsuccessful.

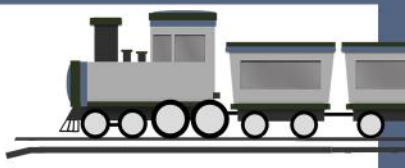


Past experience of privatising rail infrastructure

Privatisation of rail infrastructure has been tried before, with disastrous results.

Railtrack cut back on essential maintenance work in order to be able to pay bigger dividends to its shareholders, leading to a series of fatal crashes. Following the Hatfield crash, there was a near shutdown of the rail network, with widespread speed restrictions causing huge delays to train services across the whole country. Railtrack also mismanaged rail enhancement projects, including the modernisation of the flagship West Coast Main Line, where cost projections soared from £2.5 billion at the start to £14.5 billion four years later[21]. Eight years after it was set up, the company was taken into administration for bankruptcy. This led to the establishment of Network Rail, initially as a not-for-profit company (in a fudge designed to avoid its substantial debts having to appear in the Public Sector Net Debt economic statistics), and then as part of the public sector when this fudge became untenable. The re-classification of Network Rail's debt as public sector debt is one of the factors that is driving the Government's desire to privatise Network Rail again, despite the catastrophic outcome last time national rail infrastructure was privatised.

In London, the maintenance and renewal of the Underground was passed to two consortia of private companies, Tube Lines and Metronet, under contracts known as the 'public-private partnership' (PPP), in 2002 and 2003. The contracts were meant to be for 30 years[22]. The consortia borrowed substantial sums of money in order to fund infrastructure upgrades; they then received a monthly payment from London Underground called an infrastructure service charge, which varied according to how well the tube networks under the control of the consortia were performing. Metronet repeatedly failed to deliver projects on time and to budget. As costs rose, it repeatedly asked for more money from London Underground. Four years after the start of the Metronet contract, in 2007, an independent arbiter ruled that Metronet was not entitled to any more money. The Metronet consortium collapsed and went into administration; Transport for London had to take responsibility for most of its debts. A similar pattern occurred with Tube Lines: projects were delayed and costs rose; the consortium asked for higher payments from Transport for London; the independent arbiter ruled that they were not entitled to the payments they sought; and eventually in 2010, ten years after the start of the contract, Transport for London bought out the shares in Tube Lines, effectively taking over the company and bringing it back into public ownership[23].



5. What the sell-offs will cost

5.1 Summary of costs

Evidence from previous unsuccessful sell-offs of rail infrastructure suggests that the sale of Network Rail assets will be a very bad deal for us, the public. It will be much more expensive than an integrated railway under public ownership. This is for a number of reasons:

- Initiation costs: Even before anything is sold off, there will be a lot of costs. Financial advisers will make a great deal of money out of scoping the options for privatisation. Then there will be huge legal fees to draw up all the complex contracts for the different sales and concessions. From past evidence, it is also probable that the Government will sell off our rail infrastructure at less than its real value, in order to attract buyers.

- Fragmentation and transaction costs: Once electrical and telecoms assets and Route concessions are in private hands, it will cost more to achieve the same outcomes than it did under Network Rail. The money the private companies borrow to finance enhancements will incur higher interest rates than if it were borrowed by the Government; the private companies will pay dividends to their shareholders; there will be tiers of contractors and sub-contractors, with each one extracting a profit; the fragmentation into many organisations will introduce inefficiencies at every interface; and concessionaires may not be able to manage complex enhancement projects to budget, and will seek to pass back cost over-runs to the Government.

- Lost future revenue: Network Rail makes a profit out of the commercial property it manages (such as business premises under railway arches, and retail space at its stations). In the future, it could also make a profit out of renting the spare capacity on its telecoms network. Once these assets are sold off, it will be the private buyers who will make money out of them, and that will mean less money for investment in our railway.

- Failure and exit costs: It is very likely that this latest experiment in privatising rail infrastructure will fail, as previous experiments have failed. But like the banks, the railways are too important to fail, and so the Government will incur more costs, in settling the debts of bankrupt companies, paying off shareholders, and paying for administrators to manage the companies while they are legally bankrupt.

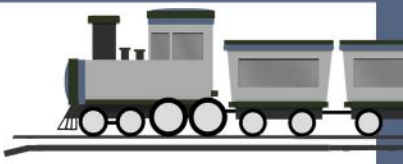


Table 2 (see page 16) summarises the estimated costs of the proposed sell-offs, under one possible scenario in which the power and telecoms assets are sold off; the 18 largest stations and commercial property portfolio are also sold off; and two of Network Rail's Routes are offered to the private sector as concessions. Under this scenario, one-off initiation costs could be £1.1 - 1.7 billion. Fragmentation and transaction costs could reach £3.4 - 3.8 billion over ten years. Opportunity costs would be at least £3.9 billion over ten years. Failure and exit costs could be £1 billion or more. This means that the total cost of the partial break-up and sell-off of Network Rail could be of the order of £9.5 - £10.4 billion over ten years. Large as this number is, it is still a conservative estimate of what the disaggregation and sell-off of Network Rail could cost. In particular, if the Government decided to offer 30-year concessions on more than two Routes, the cost would be very much higher.

No allowance has been made in Table 2 for the (unknown) up-front payment that Network Rail would receive from the sale of its telecoms and power assets, commercial property and stations, and this would partially offset the £3.9 billion lost future revenue. However, most of the costs in Table 2 would arise because the railway system was being run in a less efficient way (that is, with a higher cost base because of inefficiencies caused by fragmentation and transaction costs), so that, no matter what payment was made to Network Rail by private buyers, the net effect would be negative.

The following sections give more detail on the costs.

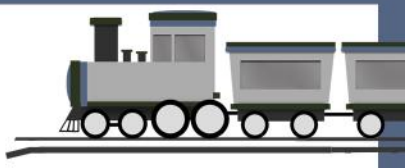
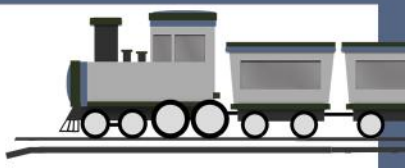


Table 2: Costs of proposed Network Rail sell-offs: ten year period

	One-off costs (£ million)	Annual costs or income foregone (£ million)	*Ten year period: cumulative costs or income foregone (£ million)*
Initiation costs	**1,139 – 1,739**		
(a) Financial advice from consultants and bankers about how to split up Network Rail	*130*		*130*
(b) Legal fees to draw up complex contracts	*609*		*609*
(c) Under-valuation at flotation	*400 - 1,000*		*400 - 1,000*
Fragmentation / transaction costs			**3,418 – 3,751**
(d) Excess interest payments on debt		*12 - 18*	*666 - 999*
(e) Dividend payments		*180*	*1800*
(f) Sub-contractors' operating margins		*47*	*470*
(g) Costs of interfaces		*48*	*482*
(h) Cost over-runs on infrastructure enhancement		*[not known; could be large]*	*[not known; could be large]*
Lost future revenue			**3,940**
(i) Lost income from rental of telecoms spare capacity		*[not known; could be large]*	*[not known; could be large]*
(j) Lost income from commercial property rental		*167*	*1670*
(k) Lost income from 18 largest stations		*227*	*2270*
Failure and exit costs	**1,000**		
(l) Buying back commercial debt + administration costs	*1,000*		*1,000*
TOTAL			**9,497 – 10,430**



5.2 Initiation costs

(a) Financial advice from consultants and bankers about how to split up Network Rail

Splitting up Network Rail to sell it off is already proving a very lucrative business for consultants and bankers. So far, Network Rail is paying investment bankers Rothschild to advise on the sell-off of its commercial estate; Citigroup to advise on the sell-off of major stations; KPMG to advise on selling electrical assets; and Deloitte to advise on options for freight yards[24] [25]. Network Rail is expecting to spend £130 million on getting advice about the sell-offs from these, and possibly other, firms[26].

(b) Legal fees to draw up complex contracts

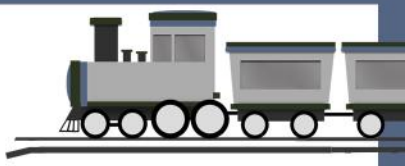
The London Underground PPP required enormously complex contracts between the private consortia and London Underground. There were 135 separate contract documents, more than 2,800 pages of contract terms, and 2 million words[27]. The costs incurred simply to close the PPP deals were a colossal £455 million[28] (£609 million in today's prices) – before a single escalator had been fixed.

Selling off 30-year concessions to manage and maintain the national railway network would be at least as complex, and possibly more so. The cost of negotiating the many contract documents for two Routes could be of the same order as the cost for the London Underground PPP, that is, £609 million in today's prices. There would also be substantial costs to negotiate the sell-off of electrical power assets and telecommunications assets, and stations, so this is a conservative estimate.

(c) Under-valuation at flotation

When public assets are privatised, the Government often under-values them because it wants the stock market flotation to be a 'success' – that is, for there to be heavy demand for the shares. When Railtrack was floated on the stock market, the Government valued it at less than a third of the real value of the assets (£1.9 billion, compared to the last proper assessment of the assets under British Rail, which had put them at £6.5 billion)[29]. It also wrote off debts of £1.5 billion, and transferred liability for the upkeep of 1,000 bridges to local government[30]. The National Audit Office concluded that the Government could have raised an extra £600 million - £1.5 billion from the sale.

Network Rail's electrical distribution and power assets are reportedly now worth an estimated £2 billion[31]. Network Rail's telecoms assets are worth at least as much as this, since there has been substantial investment of almost £2 billion in renewing the entire system in the last decade[32] [33]. If these assets are hived off, and then floated on the stock market, it is likely that they will be under-valued at flotation in a similar way to Railtrack, resulting in a loss to the public purse of £400 million - £1 billion or more.



5.3 Fragmentation and transaction costs

(d) Excess interest payments on debt

Network Rail is able to borrow money to pay for rail enhancements at low interest rates via the Government. A private company borrowing money to pay for rail enhancements would have to pay a higher interest rate. Although interest rates are currently low, research for the Office of Rail Regulation found that the premium for commercial borrowers (compared to the rates paid by the Government) is about 1.0 -1.5% (100-150 basis points)[34].

Network Rail's debt increased by £4.2 billion between 2013/14 and 2014/15. Within this, net debt for the Anglia and Wessex Routes increased by £229 million and £267 million respectively[35]. Enhancements of electrical and telecoms assets, which will have been funded by borrowing, cost £580 million (excluding enhancements in Anglia and Wessex Routes to avoid double counting)[36]. Enhancement schemes at some of the 18 largest stations (Reading, Birmingham New Street and London Waterloo) cost £133 million[37]. Enhancement (electrification) of the Wales Valley Lines cost £2 million. This means that over a quarter (29%) of the increase in Network Rail debt in 2014/15 was due to investment in the parts of Network Rail that are being considered for privatisation.

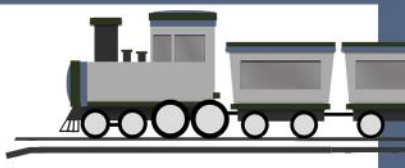
To estimate the excess interest payments on commercial debt incurred after privatisation, we assume that enhancements in the parts of Network Rail being considered for privatisation will continue at the same rate in future; that the premium incurred for commercial borrowing, relative to Government borrowing, will remain at the same low level as at present; and that excess costs will accumulate each year for 10 years (that is, the debt will not be paid off).

Under these assumptions, the excess interest payments on new debt would be £12 - 18 million in each year, but because debt will accumulate, and interest payments therefore grow, the cumulative excess interest payments over ten years would be £666 - 999 million.

(e) Dividend payments

Railtrack paid out dividends totalling £709 million (equivalent to £1,027 million in today's prices) in the six years between 1995/96 and 2000/01[38].

The private companies that take a slice of Network Rail will similarly pay dividends to their shareholders. Over time, annual dividends will probably average about 5% of the price they pay to buy the Network Rail assets. (For comparison, annual accounts show that the average annual dividends paid to Railtrack shareholders



during the six years the company was in business were 6.2% of Railtrack's sale price; and more recently the average annual dividends paid to shareholders in HS1 over the last three years were 4.3% of HS1's sale price).

Network Rail's accounts show that the asset value of the Anglia Route is £4.2 billion, and the asset value of the Wessex Route is £4.1 billion (as measured by the Regulatory Asset Base)[39]. As noted above, the electrical power and telecoms assets are together worth at least another £4 billion. Taken together, these assets therefore have a value of £12.3 billion. However, the actual price paid for the assets will probably be much less than this, because of under-valuation by the Government. If the concessions / sell-offs are under-valued by the same amount as Railtrack was, the combined sale price would only be £3.6 billion, and average annual dividends at 5% would be £180 million. The total over ten years would be £1.8 billion.

(f) Sub-contractors' operating margins

Network Rail made a decision in 2003 to bring track maintenance work in-house. It had previously been outsourced to contractors. Bringing maintenance in-house resulted in substantial savings, put by Iain Coucher, then Chief Executive of Network Rail, at £264 million per year[40] in 2006, equivalent to £334 million in today's prices.

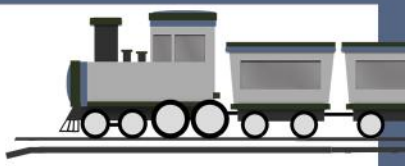
Assuming Anglia and Wessex concessionaires would revert to sub-contracting track maintenance work, the additional annual cost would be one-seventh of the Network Rail total, or £47 million. The total over ten years would be £470 million.

(g) Cost of interfaces

The more that the railway is fragmented into separate organisations, each one interacting with the others through complex and often adversarial contractual arrangements, the more costs rise. Every extra 'interface' in the system creates extra costs.

Research by consultancy Oxera for a review of rail value-for-money found that the cost of interfaces between different parts of the rail industry was substantial. For train operating companies, Oxera put the cost at about 5% of their net costs[41].

Although the Oxera estimate was for train operating companies, the same logic applies to infrastructure companies. A privatised company that was responsible for maintaining, renewing, and enhancing Network Rail's electric power and distribution assets would require extensive contractual agreements with Network Rail and each of the train companies, and all sides would need to employ people whose job would be to ensure they did not lose out financially from the way these agreements were implemented on a day-to-day



basis (e.g. deciding what compensation was payable to whom if line 'possessions' to carry out maintenance of overhead wires took longer than expected and trains had to be cancelled).

The same would apply for a privatised company that was responsible for maintaining, renewing and enhancing Network Rail's telecoms assets.

In 2014/15, the net cost of operations, maintenance, renewals and enhancement projects related to electricity supply and distribution was £796 million (not including the cost of electricity itself). The equivalent cost for telecoms was £168 million[42]. Using the Oxera estimate, this suggests that if these two parts of Network Rail were privatised, the combined interface costs would be about £48 million per year, or £480 million over ten years.

(h) Cost over-runs on infrastructure enhancement projects

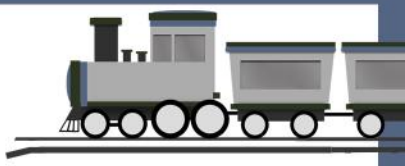
Network Rail has recently been criticised for cost over-runs on some major enhancement projects (such as the electrification of the Great Western Main Line from London to Cardiff). The Government commissioned an inquiry into the cost over-runs (the Bowe Review), which found that part of the reason was the fact that until 2014, any increases in costs could simply be added to Network Rail's commercial debt[43]. The Review said that there was:

"a previous reliance by all parties on access to financing that was off government balance sheet as a means of managing financial overruns".

Once Network Rail was re-classified as part of the public sector, this was no longer an option. The signs following the Bowe Review and another review (the Hendy Review by Network Rail's new Chair, Peter Hendy) are that enhancement projects at Network Rail will be much more tightly controlled now that cost increases cannot be simply added to the Network Rail 'credit card'.

However, the plans to set up the Wessex and Anglia Routes as concessions are designed to provide access to financing that is off the government balance sheet again. This means that privatisation is likely to result in more, not fewer, cost over-runs.

This is consistent with the evidence last time rail infrastructure was in the private sector. Railtrack's upgrade of the West Coast Main Line was very badly managed with huge cost over-runs (as summarised in the Box above). Metronet and Tube Lines were responsible for spiralling costs under the London Underground PPP: for example, Tube Lines was supposed to deliver the Jubilee Line upgrade at a cost of £285 million, but by



2010 they had spent £614 million and still not completed the work, leading to Transport for London taking back control and finishing the project itself. A year later, with the project having been completed by Transport for London, the London Underground Managing Director Mike Brown said that[44]:

"The final Jubilee Line upgrade cost completely vindicates our decision to end the waste and inefficiency of the PPP and transfer the work to TfL. Now we are free of the absurd constraints of the PPP contracts, we are able to ensure that future upgrades including the Northern Line are delivered in a much more efficient and economic way, and with far less disruption to Londoners and businesses….Since we took control last year we have completed the work that the PPP failed to deliver and overall reliability on the Jubilee Line – and on the Tube network as a whole – is now improving."

It is difficult to estimate how much costs may rise if PPP-style concessionaires are made responsible for infrastructure enhancement on the Anglia and Wessex Routes. For the immediate future, these two Routes have little forecast enhancement activity[45], but over the 30-year timescale of a concession, this could change. However, experience from past privatisations is that the concessionaires would pass back any cost over-runs to the Government. This is therefore an unknown but potentially large cost.

5.4 Lost future revenue

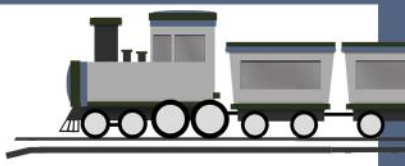
(i) Lost income from rental of telecoms spare capacity

Network Rail wants to rent some of the spare capacity on its fibre optic telecommunications network to telecoms companies. It is not known how much income this could provide, but it could be large. There is rumoured to be a lot of interest from companies including Vodafone, Virgin Media and TalkTalk[46]. The spare capacity could potentially be used to improve the availability of high-speed broadband in rural areas[47].

(j) Lost income from commercial property rental

Network Rail is expecting to receive £167 million in rent from its commercial properties in 2018/19[48]. Income from rental of commercial property is on a growing trend, so this represents a minimum figure for annual income foregone beyond 2018/19. Thus if the entire commercial property portfolio were sold, the lost income over ten years would be £1.7 billion.

The Office of Rail and Road (the organisation responsible for regulating the railway industry) has recently pointed out that "planned asset sales…would reduce future income streams (e.g. from property rents)" over Control Period 6 [2019-2024] and that this, together with the shift of some rail enhancement projects from



CP5 to CP6, "may imply some tough choices"[49]. In other words, selling commercial property now will mean less money for investing in the railway in future.

(k) Lost income from 18 largest stations

Network Rail is expecting to receive £227 million in income from its 18 largest stations in 2018/19[50]. Most of this is in the form of income from retail outlets (£163 million), but there is also income from advertising (£34 million), left luggage and car parking concessions (£23 million) and other sources (£7 million). Income from these sources is on a growing trend, so this represents a minimum figure for annual income foregone beyond 2018/19. If all 18 stations were sold, the lost income over ten years would be £2.3 billion.

5.5 Failure and shut-down costs

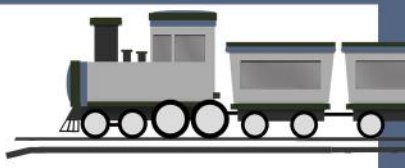
(l) Buying back commercial debt, plus administration costs

Following the collapse of Railtrack, it was operated under 'railway administration' for a year. During that time, the administrators, Ernst and Young, charged £755,000 per week. The Government then paid £1.3 billion to Railtrack's parent company (which ultimately went to Railtrack's shareholders) in order to bring the rail infrastructure out of administration and give control to Network Rail.

When Metronet collapsed, the Government paid £1.7 billion to settle its debts, and a further £300 million in administration costs. When Tube Lines was transferred to Transport for London, TfL took over what it described as 'an overly complex and expensive £1.6 billion debt structure', which it then progressively re-financed using cheaper loans.

Sell-offs of telecoms networks have also been tried before – and failed. The Financial Times recently reported that *"British Rail's telecoms unit was sold to Racal, a British Telecoms company, in 1996, which in turn sold it to a US company that went into Chapter 11 bankruptcy protection…A similar pattern saw Germany and France eventually buy their railway telecoms systems back in-house."*[51]

If the Wessex and Anglia Routes, the privatised electric power and distribution assets and the privatised telecoms assets all collapse, the combined failure and shut-down costs would be similarly high. Based on the evidence from Railtrack and Metronet in particular, the cost could easily be £1 billion or more.



6. What is really needed

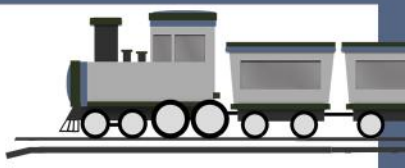
At root, the problem faced by Network Rail is a funding problem, not a financing problem. There is really no such thing as a financing solution to a funding problem: all the financing 'solutions' currently on the table will cost more in the long run.

We do need reform to our railways, but the proposed privatisations are not the reform that is needed. Instead, we need to identify new sources of funding that will be sustainable for the long term; cut wasteful expenditure; and make the bodies running our railways more accountable to the people they are there to serve.

- **New sources of funding:** At present, many beneficiaries of the railway in the UK are not making a fair contribution to improving it. Land and property owners benefit from rises in the value of their land or property in places where there are rail improvements. Many countries capture some of this windfall profit through what's called tax increment financing: the government issues bonds to finance the rail improvement, which are then repaid using the uplift in property taxes. Employers close to railway stations benefit from having a bigger pool of employees to choose from, as more people can reach their offices or factory by train. Most French cities therefore levy a payroll tax on employers, which part-funds the public transport network. Motorists benefit from less congested roads thanks to the railway, and in parts of the USA and other countries they therefore pay charges that support public transport, including rail. Once all these wider beneficiaries (landowners, businesses, motorists) start making a contribution, as well as passengers and the Government, the funding becomes sufficient to invest in a better railway.

- **Cutting wasteful expenditure:** We could greatly reduce the cost of running our rail network if, instead of selling bits of it off, we put track and privatised train services back together, under the control of a single publicly-owned body. This could be done gradually over time, as train franchises expire. A unified railway would be more efficient: there would no longer be all the fragmentation costs; dividend leakage from the train companies and rolling stock companies; costs of running franchise competitions; and costs of picking up the pieces when train operators fail (as has happened repeatedly).

- **Better accountability:** Network Rail plans to devolve power and responsibility to the 'Route' level, and this makes sense: it will make it easier for the organisation to work with, and be more accountable to, our regions and cities. The next logical step is for public funding for the railway to be channelled via the regions and cities, putting them in a strong position to negotiate with Network Rail to get the rail improvements they most need in order for their economies to thrive. This would mean that the funds that are available get spent more wisely than if all decisions are made in London.



Conclusion

As this report makes clear, the privatisation of Network Rail's assets will make the railway more costly for the UK public. Although Network Rail could improve its cash flow in the short term through selling its assets, it will lose permanent long-term income. In addition, the fragmentation of Network Rail into separate companies and concessions will create substantial added costs, so that the whole system will be more expensive to run. The combination of these two factors means that passengers will face higher fares, and government and taxpayers will have to plug an even bigger hole in Network Rail's accounts. This is a one-way ticket to disaster.

We Own It therefore calls on the government and Network Rail to reconsider these plans. Selling off our railway doesn't make economic sense.

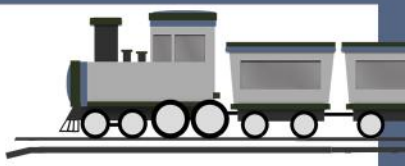
Specifically, we call on the government to:

- Put a moratorium on the sale of Network Rail assets, so that the long term benefits can be considered and the views of the public can be sought in light of the evidence presented in this report.

- Consider alternative funding arrangements to guarantee the long term success of our railway and the best deal for the public. The current plans kick problems down the line, rather than offering genuine long term solutions. The railways needs funding, rather than 'financing solutions' that mask the funding problem. This could be done in two ways. Firstly, the government should consider new sources of funding. This could include, as in many other parts of the world, looking at taxes on local businesses that benefit from rail investment, or using windfalls from increases in property taxes to fund investment. Secondly, Network Rail should cut wasteful expenditure. Rather than breaking up Network Rail, we could unify the railway as a public owned body. Previous research has shown this would save at least £1.2 billion a year[52]. Thirdly, Network Rail could maximise the economic benefits of the railway to cities and regions by working with them to decide on investment.

Polling shows that the public does not support the privatisation of Network Rail[53] and wants to see our railway in public ownership, working for all of us[54].

We need an organisation running our railway that is 100% focussed on the important task of delivering a vital public service – an organisation run by people who are proud to act in the public interest, and who care passionately about doing that. The current plans for Network Rail are taking us along the wrong track, and it's crucial that we turn the signals to red before it's too late.



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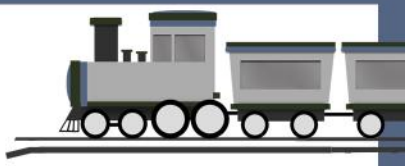

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