Investing in the railway: a new approach?

Darren Fodey of law firm Stephenson Harwood LLP considers a new approach to funding for rail projects

Attracting investment to the railways has been a perennial woe. The Office of Rail and Road's (ORR) investment framework policy and guidelines date back to October 2010 – and in the past few years we have seen Sir Peter Hendy's review highlight the need for third parties to put their money where their mouths are.

Most recently, even the title of the Hansford review (Unlocking rail investment – building confidence, reducing costs) reiterated this, emphasising the need for a contestable rail market and the need to engage with third party investors – both funders and deliverers.

Potential investors regularly claim an interest in funding rail industry schemes. There is clearly appetite within the industry for that investment. Yet, to date, there has been little alignment between the 2 and little actual investment.

It is widely recognised that this needs to change. With the intention of attracting greater levels of investment and innovation from the private sector, as well as market-led delivery of railway projects, on March 20 2018 the Secretary of State for Transport published a call for enhancement proposals for the national railway network.

On the same day, new guidance was issued on what the Government wants from market-led proposals (or MLPs) and how the DfT will consider them, including the relevant governance processes. The ORR has also republished a series of existing guidance, including updates, on financing and delivering projects outside of the periodic review process.

Will this new approach result in a deeper and more lasting relationship between private investors and railway projects? Might existing mechanisms already achieve this?

The new framework

In essence, the new framework is a way for the DfT to review investor proposals – and can be divided into 2 categories:

Not requiring public funding – there will be a fast-track approval process which only enters the DfT's governance procedures once implemented – provided relevant approvals and authorisations have been obtained, such as from Network Rail and the ORR. It is also anticipated that the DfT could run an open competition for the design, build, finance and maintenance of such schemes.

Requiring public funding – where a proposed investment also requires public funding directly – such as grants from either local or central Government – or indirectly – such as through the franchise system – there will be a rigorous process to follow. This requires business cases to be prepared in accordance with DfT guidelines and a public procurement process to apply at various stages throughout the lifecycle of a project.

The second category is perhaps the most relevant: the key element investors look for is a revenue stream to pay back the investment and it seems likely that this – either directly or indirectly – will require public sector involvement.

Projects requiring public funding

Governments are known for being good at bureaucracy and processes, and this new guidance is no exception. Where a MLP involves public funding, as well as producing a 'compelling' 5 case business model – which will cover strategic, economic, commercial, financial and management pillars – the MLP will need to demonstrate how the DfT's 4 priorities for investment and action will be satisfied. These are, in no particular order:

- keeping people moving safely and smoothly
- delivering the benefits from programmes and projects already committed to
- new and better journeys, and opportunities for the future
- changing the way the rail sector works for the better.

The guidance highlights the role that private finance can play, with the DfT preferring 'off balance sheet' structures. For example, availability payments would necessitate an ongoing operations and maintenance role for the investor and rights to retain track access charge payments would need to be subject to reliability deductions. The guidance is also protectionist: respecting investments already made, which may include the franchising process.

Enhancements pipeline

The project lifecycle has been rebadged in an easy-to-understand way which mirrors Network Rail's guide to rail investment projects process. Beginning with Determine (output specification), it then moves through Develop (feasibility and option selection) and Design (outline and detailed design) and ends with Deliver (implementation) and Deploy (handback and close).

There will be a series of 'decision points' where the DfT must be presented with certain information in order to progress to the next stage. Many of the deliverables will be a familiar part of any project's development – and will already be necessary as part of the developer/investor's internal processes. However, the DfT does have wide discretion – and the breadth of information needed by the DfT may be wider. It will be important to ascertain what is needed – and when – to ensure a MLP is not unduly delayed.

Merits of the new approach

One of the advantages of the new process is the access it will give to relevant persons within both the DfT and Network Rail's system operator and business development functions. The principle of greater private sector involvement in the railway is a good one and could potentially deliver more benefits to the industry than the public sector is able to do alone.

This is to be encouraged. However, we can identify a number of potentially prohibitive disadvantages of the new guidance – which

may actually disincentivise that investment:
Bureaucracy: the significant bureaucracy which this brings will incur costs, meaning only the most sophisticated investors, with the prospect of large returns into which this administration can be priced, are likely to be interested.
Smaller schemes: some of the smaller MLPs – which could potentially drive greater passenger benefits – are not likely to be cost effective under this new approach.
Procurement: the public procurement process – at various stages of the enhancements pipeline – means that there is no certainty that the MLP will go ahead. Importantly, there will be no certainty that the investor (who may be providing expertise, such as design or construction work, with a view to recovering that investment in future) will be chosen to drive forward the MLP. In effect, the guidance gives carte blanche to take innovative ideas from one party and give them to someone else at each stage of the project, offering no incentive to provide innovation or investment.
Money vs control: unfortunately, one of the consequences of the new approach seems to be that the industry would very much like your money and your ideas to fund the initial stages of a MLP but wants to retain control over every element of the MLP – including whether you remain involved in it.

Encouraging investment

The launch of the new guidance created positive headlines, although perhaps a lukewarm reception from the industry. How can investment best be facilitated? We would suggest a number of top tips for those looking to invest in the rail industry:
Small steps: radical change does not happen in rail, change takes place in a series of incremental steps over time. The more successful schemes will be ones which use – or slightly develop – existing industry mechanisms. Imposing a complex PPP/PFI or other finance structure on a railway investment is not likely to be successful in the long-term.
Existing regulatory mechanisms: the ORR's re-published guidance is helpful at setting out what options already exist to facilitate rail investment. For example, HS1 and the Crossrail project have adopted an 'investment recovery charge' as a mechanism whereby investments can be recovered over time through a track access charge supplement. Planning for this at the outset of the project – and ensuring both the ORR and the DfT accept this approach – will be important to take advantage of this mechanism.
Existing franchise mechanisms: investing in the industry through a franchised train operator may also be an option. Ways of doing so will depend upon the period in which the investment is recovered.

While it has been criticised, the 'residual value mechanism' in the franchise agreement provides a way that a train operator can invest for the longer term, and an investor can consequently provide funding to the train operator. If an investment can be recovered during the franchise term, this may make it easier still – it will be key for potential investors to engage in the bidding process when train operators are preparing their strategy and initiatives. Again, depending on the proposal, the DfT may need to be involved in the process.

At the heart of all of this is the need for closer collaboration – and greater alignment of incentives – between the rail industry and potential investors. Whether introducing new processes and hurdles is the right approach is perhaps questionable, but the motivating factor for the new guidance is clearly welcome. It is right that we should be looking to bring together the appetite for investment with the appetite to invest and we can but hope that the result will be a buffet from which the industry – and the passenger – can benefit.

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