

RE: CHARGING FRAMEWORK FOR THE HEATHROW SPUR

CONSULTATION RESPONSE BY HEATHROW AIRPORT LIMITED

I. Introduction & Summary

1. This is the response of Heathrow Airport Limited (“**HAL**”) to the consultation document *Charging Framework for the Heathrow Spur*, published by the Office of Rail and Road (“**ORR**”) on 11 February 2016 (the “**Consultation Document**”).
2. The Consultation Document concerns the basis on which HAL can charge third party rail operators for access to the Heathrow Spur – in particular whether access charges can be set taking into account the historical costs to HAL of constructing the railway infrastructure.
3. HAL is entitled to recover access charges that take account those long-term costs if the construction of the Heathrow Spur could not have been undertaken without the prospect of HAL being able to do so.
4. The Consultation Document sets out a provisional conclusion that “*HAL has not provided sufficient evidence to show that it should be able to levy charges relating to the historical costs of constructing the Heathrow Spur*”, in particular noting that “*there is no explicit evidence setting out the basis for the investment from the time when the investment decision was made*”.
5. In this consultation response HAL:
 - a. explains why the ORR’s approach in the Consultation Document is wrong as a matter of law; and
 - b. refers to new documentary evidence from 1993, which proves that the commercial decision by BAA plc to build the Heathrow Spur was taken on

the basis that the capital costs involved would be fully recovered from rail users and the investment would ultimately be “sold down”.

6. This new evidence shows the reasoning of BAA plc at the time of the decision to invest in constructing the Heathrow Spur. The evidence is summarised in Section IV below, by reference to five key documents. This is precisely the kind of contemporaneous, “*explicit evidence from the time of the planning and financing of the project*”, described in the ORR’s Consultation Document as “*the best evidence*”. It supersedes the ORR’s reasoning in the Consultation Document, which was based on inferences drawn from evidence post-dating the relevant commercial decisions.
7. The evidence directly meets the tests the ORR has laid down. It shows, beyond any doubt, that the investment decision by the Board of BAA plc (for which they would ultimately be responsible to shareholders) was based on – indeed was expressly subject to – BAA being able to recover the long-term costs of the construction project, plus a commercial rate of return, through levying charges on rail users.
8. In the light of this evidence the only decision lawfully open to the ORR is to conclude that HAL is entitled, pursuant to Schedule 3, paragraph 3(2)(b) of the Railways Infrastructure (Access and Management) Regulations 2005 (the “**Regulations**”), to set access charges that take into account the long-term costs of the project.

II. The Issue

9. HAL is the “*infrastructure manager*” for the Heathrow Spur, as defined in regulation 3 of the Regulations. Pursuant to regulation 12(2)(a), HAL must “*determine the fees to be charged for use of the [Heathrow Spur] in accordance with the charging framework, the specific charging rules, and the principles and exceptions set out in Schedule 3*”. Pursuant to regulation 12(1), the ORR “*must establish the charging framework and the specific charging rules governing the determination of the fees to be charged*” for use of railway infrastructure.

10. The issue of access charging for the Heathrow Spur has not previously arisen because until 2012/13 it was considered that the Regulations did not apply and, in any event, the only train services currently using the Spur to date have been the Heathrow Express and Heathrow Connect services, both of which are ultimately operated by HAL (in the case of Heathrow Connect, jointly with GWR). The issue arises now because Crossrail intends to seek access to the Heathrow Spur for the purposes of running the Crossrail train service between Reading and Shenfield, stopping at both Paddington Station and Heathrow Airport.

11. Schedule 3, paragraph 1(4) of the Regulations provides that “*charges for the minimum access package and track access to service facilities ... shall be set at the cost that is directly incurred as a result of operating the train service*”. By way of exception to that rule, Schedule 3, paragraph 3 provides that an infrastructure manager “*may set or continue to set higher [access] charges on the basis of the long-term costs of the project*” if three cumulative criteria are met (the “**Paragraph 3 Exemption**”):
 - a. **First Criterion:** The project has been completed since 15 March 1988 or since the coming into force of the Regulations (on 28 November 2005): paragraph 3(1);

 - b. **Second Criterion:** The project increases efficiency or cost effectiveness: paragraph 3(2)(a); and

 - c. **Third Criterion:** The project could not otherwise have been undertaken without the prospect of such higher charges: paragraph 3(2)(b).

12. The Consultation Document sets out the ORR’s proposed decision to establish a charging framework for the Heathrow Spur that specifically excludes the Historical Long-Term Costs of constructing the Spur.¹ The ORR’s provisional view is that:

¹ Consultation Document, §63

- a. the First and Second Criteria of the Paragraph 3 Exemption are met;² but
- b. the ORR is “*not satisfied that HAL has provided sufficient evidence to demonstrate that the project could not have gone [ahead] without the prospect of higher charges to users*”³ and, therefore, is not satisfied that the Third Criterion is met.

III. The ORR’s incorrect approach to the question

13. The correct application of the Paragraph 3 exemption is a matter of law. The ORR’s approach to the question of whether a project could or could not have been undertaken without the prospect of higher railway access charges must be reasonable and proportionate. That is particularly true in the present case, where the relevant investment decisions were taken over twenty years ago, before Directive 2001/14/EC and the Regulations existed. It would be unreasonable, in the circumstances, for the ORR to require unequivocal contemporaneous evidence explicitly addressing the question arising under the Regulations.
14. In the Consultation Document the ORR has indicated that:

“... an important factor in determining whether charges can be levied under the [Paragraph 3 Exemption] is the basis on which the investment was made (i.e. expected returns/traffic forecasts rather than the actual amount recovered)”⁴; and

that it is for HAL to show that: “when the decision was taken to approve the project, there was no realistic commercial possibility of the Project going ahead without the prospect of levying charges on rail users that contributed to Historical Long-Term Costs” (§35).

² Consultation Document, §§20-21

³ Consultation Document, §62

⁴ Consultation Document, §32

15. The ORR has accepted – rightly – that a “*realistic commercial standard*” should be applied to the evidence.⁵ The ORR has also indicated that the “*best evidence*” would be “*explicit evidence from the time of planning and financing of the Project*”, such as HAL Board papers approving the project contingent on the expectation of recovering higher charges.⁶
16. Until now HAL was unable to provide explicit evidence showing the basis for the investment decision in the Heathrow Spur. The ORR therefore provisionally concluded, from what it has referred to as “*the available evidence in the round*”, that the Third Criterion of the Paragraph 3 Exemption is not satisfied.⁷
17. We disagree with the ORR’s provisional view, and consider the approach to be legally wrong. The evidential burden that has been placed on HAL is, in the circumstances, unreasonable, and the ORR has failed to apply the “*realistic commercial standard*” referred to in the Consultation Document. In particular, the Consultation Document ignores a number of the points made in HAL’s initial submission, including the point that BAA was not free to, and had no incentive to, incur investment costs in providing surface access infrastructure without an expectation of recovering those long-term costs from users of the new infrastructure.
18. The ORR has also:
 - a. failed to take into account of the inherent unlikelihood of a company borrowing hundreds of millions of pounds at commercial rates to build a railway line on the basis that third party rail operators would be able to access and use that infrastructure without BAA being able to recoup its investment costs; and
 - b. wrongly placed weight on events post-dating the relevant investment decision, in particular the subsequent decision by the CAA to include the Heathrow Spur within the airport’s regulatory asset base (a concept that

⁵ Consultation Document, §35

⁶ Consultation Document, §§36-37

⁷ Consultation Document, §46

did not exist at the time of the investment decision and therefore could not have formed any part of the reasoning behind the investment decision).

19. The Consultation Document also contains material errors. In particular, it is said that the “Newco” joint venture arrangements between HAL and the British Railways Board was not pursued and that “instead” the Heathrow Spur was included in the airport Regulatory Asset Base.⁸ In fact:
 - a. the “Newco” (Heathrow Express Operating Company Limited) was established on 11 January 1996 and its service agreement commenced on 1 April 1996; and
 - b. the BAA Board subsequently approved a decision to buy out the British Railways Board interest on 27 June 1996.
20. The Consultation Document accepts that “*had the Newco structure proceeded, the third criterion of the Paragraph 3 Test would very likely have been satisfied*”.⁹ The fact is that the Newco structure did proceed, and it was on the basis of that proposed structure that – three years earlier in 1993 – BAA invested in building the railway. BAA later decided to buy out the interest of its commercial partner, British Railways Board, and the buyout removed the need for a joint venture structure because the project was then 100% owned by members of the same group, namely BAA plc and Heathrow Airport Limited (a wholly owned subsidiary of BAA plc).
21. However, that could not alter the fact that the only realistic commercial source of income to contribute to the historic long-terms costs was revenue from rail users. The CAA only formally recognised the concept of the Regulatory Asset Base for Heathrow later, on 1 March 1997, several years after the relevant investment decisions (indeed Heathrow Express commenced operations on 25 May 1998).

⁸ Consultation Document, §51

⁹ Consultation Document, §51

IV. New Evidence relating to HAL's decision to invest in Heathrow Spur

22. Since publication of the Consultation Document, and in the light of the ORR's reference to the need for contemporaneous evidence, HAL has undertaken further extensive searches, including of older, microfiche records, for any documents relating to the Heathrow Spur. These further searches have uncovered contemporaneous documents concerning BAA's decision to invest in the Heathrow Spur, including minutes of the Board meetings at which key investment decisions were taken, and the papers presented to the Board in advance of those meetings.
23. As explained below, these documents show that the decision to invest in the Heathrow Spur was contingent on HAL being able to recover a commercial rate of return on its capital investment on the project through rail charges, including track fees imposed on other users of the line, specifically including CrossRail.
24. The Annexes to this consultation response include the key documents from the microfiche searches, which refer to the investment decisions taken in relation to the Heathrow Spur in 1993. The microfiche searches have also uncovered later documents, in particular relating to the 1995 tunnel collapse during construction of the Heathrow Spur, which are of less immediate relevance to the issue of Criterion 3 of the Paragraph 3 Test. However, HAL will provide these later documents to the ORR should the ORR wish to have them.
25. As explained above, HAL does not consider that the Consultation Document reflects a correct legal approach to the question arising under the Regulations. However, the newly available contemporaneous evidence supersedes the reasoning in the Consultation Document and is conclusive. The paragraphs below set out the timeline of BAA plc's decision to invest in the construction of the Heathrow Spur, by reference to five key documents.

(i) BAA plc Board Paper BAA 19/93 (March 1993)

26. BAA 19/93 is a paper for the BAA plc Board of Directors presented by the Group Technical Director, who, at the relevant time, was Michael P Maine.¹⁰ The paper is dated March 1993 and is titled *Heathrow Express – Approval of Joint Venture with British Rail Board*. The paper is provided at **Annex 1** to this consultation response.
27. Key extracts are as follows:

“INTRODUCTION

...

3. It is extremely important to maintain the exemption from the rules that will apply to services under privatization and, in particular, from the Regulator. This exemption will enable us to charge a track fee to other users of the line crossing Heathrow Airport, as fee that will compensate the Heathrow Express project for any loss of income generated by the introduction of other services on the line, including CrossRail. We have concluded, therefore, that we should not seek to change the basis of the access fee as it is spelt out in the Joint Venture Agreement.

...

5. In the circumstances, therefore, we recommend that the joint Venture Agreement is approved, as the best deal we can obtain...

...

FINANCIAL APPRAISAL

18. This project has been appraised on three bases, each assuming Heathrow is capped at 54 million passengers a year: -

[The various financial appraisals are set out. Financial appraisal on the first two bases shows a projected “IRR” (Investment Rate of Return) of 14.2% (as a project which would eventually be “sold down”) and 12.5% (as a stand-alone project), respectively. The second basis refers to increases in capital costs having a significant impact on the IRR.

Page 7 of the document is missing from the document recovered from the microfiche. It appears that the financial appraisal on the third basis (taking account of Heathrow’s overall development prior to the opening of Terminal 5) is set out on page 7 and continues on page 8. The total capital costs breakdown is included as Appendix 2 to the document.]

¹⁰ BAA 19/93 is initialed “M P M”.

RECOMMENDATION BY GROUP FINANCE

20. As a stand alone project the marginal returns and the extent of the downside make this an unattractive investment. In the context of Heathrow's development prior to the opening of T5, however, Heathrow Express is considered an essential part of the plan to accommodate growth in traffic. The returns which are forecast for this overall development programme are attractive, and on this basis Group Finance recommend approval".

[emphasis added]

28. BAA 19/93 is important for the purposes of the Third Criterion of the Paragraph 3 Exemption, for two reasons in particular:
- a. First, paragraphs 18 to 20 show that BAA plc was approaching approval of the Heathrow Spur construction project on the basis of an expected positive rate of return on its capital investment (IRR) – i.e. BAA plc was expecting not only to recover its capital investment, but also a commercial return on that investment, on a stand-alone basis;
 - b. Secondly, this and a number of other documents refer to the “exemption” of the Heathrow Spur from proposed rail regulation as “*essential to the financial viability of the project*”.¹¹ Paragraph 3 of BAA 19/93 explains how BAA plc understood the “exemption” would impact on economic viability – i.e. by enabling BAA plc to levy access charges on other Heathrow Spur users, specifically including CrossRail, in order to maintain BAA plc’s income, and the projected rate of return, from the Spur. The projected income (revenue) from the Spur was, of course, a critical component of BAA plc’s anticipated IRR.

(ii) BAA plc Board Meeting of 10 March 1993

29. BAA 19/93 was presented to the Board of Directors of BAA plc at a meeting on 10 March 1993 (the “**10 March Board Meeting**”). The minutes of that meeting

¹¹ The emphasis placed by the Board on the need to secure an exemption from the access arrangements under the Railways Bill in order to secure the project’s financial viability is also clear from document 8/93 (26 March 1993), a BAA Management Committee update, at paragraph 2.

are attached at **Annex 2**. Those minutes expressly refer to BAA 19/93 on the first page, immediately under “Apologies”.

30. The minutes of the 10 March Board Meeting show the BAA plc Board agreeing, *in principle*, to the joint venture with the British Railways Board to construct the Heathrow Spur (Resolution Point 1). The Board also agreed as follows:

“2. Before a final decision to proceed was made Mr. Maiden should review the revenue forecast in light of the underlying assumptions made by MVA and Coopers & Lybrand in their report;

3. Mr Maine would assess the risk of exemption from regulation not being obtained, clarify the timing of the Railways Bills becoming law and assess their impact on the commitment of further capital expenditure to the project...”

31. In relation to Point 3 above, the minutes of the 10 March Board Meeting state:

“Concern was expressed over the possibility of the Secretary of State being unable to grant exemption from regulation for the Heathrow Express branch until the Railways Bill had become law as this exemption was essential for the financial viability of the project”

[emphasis added]

32. This document demonstrates the Board’s agreement to proceed on the basis set out in BAA 19/93, subject, in particular, to examination of the risk of not obtaining exemption from regulation, which would preclude HAL from fully recovering its capital expenditure.

(iii) Board Paper BAA 30/93 (March 1993)

33. BAA 30/93 is a paper for the BAA plc Board of Directors presented by the Group Technical Director (Michael Maine), dated March 1993 and titled *Heathrow Express Update & Financial Approvals*. The paper is attached at **Annex 3**.
34. The paper was produced for a BAA plc Board meeting scheduled for 25 March 1993 – which meeting is identified as “30/93” at the end of the minutes of the 10 March Board Meeting.

35. The most relevant extracts from BAA 30/93 for the purposes of this consultation are as follows :

“PRESENT POSITION

3. Concern was expressed at the Board meeting [on 10 March 1993] that the Secretary of state was unable to grant exemption from regulation for the Heathrow Express branch line until the Railways Bill had become law and this exemption was essential for the financial viability of the project. At the time of the meeting, we were unsure when the Railways Bill would become law.

4. The Department for Transport has confirmed that the Railways Bill should receive Royal Assent in October 1993. It has also confirmed that Clause 17, the Clause that would give the Secretary of State the powers to grant exemption to specific lines from compulsory third party access, including the Heathrow Express, was not altered during the current committee stage and no attempt had been made to put forward any amendments to the clause... It is highly likely therefore that the Bill will become law in October and that the Secretary of State will take immediate action to grant the Heathrow Express exemption from compulsory third party access...

5. The risk of exemption not being granted therefore is very small, but clearly a risk still exists. The risk of there being a delay to the planned timing of the Bill becoming law is higher...

6. Since the last Board paper a number of other uncertainties related to the Bill have also been considered and the uncertainties and assurances given by the BAA Legal Department or by the Department for Transport, are dealt with in the following paragraphs.

7. There was uncertainty about how long the exemption would be granted for and what possibility there was of the exemption being withdrawn. The Department for Transport has confirmed in writing that the exemption is in perpetuity. Our Legal Department therefore confirms that once granted an exemption could not be withdrawn.

8. Concern has been expressed that if the Bill fails and is re-instated by the present Government it is possible that the exemption would not be granted under a new Bill. The Department for Transport has confirmed in writing that the commitment to exemption by the Secretary of State would be binding on him or his successor in these circumstances.

9. Concern was also expressed about what happens if the Government falls and there is no Bill. In this case it would be a private spur line and no other operator could have access to that line unless they complete a commercial

agreement with the Heathrow Express company. There would obviously be limitations under the present competition laws...

12. All of these uncertainties will disappear once the Bill becomes law and exemption is granted...

OPTIONS TO BE CONSIDERED BY THE BOARD

21. The Board needs to consider, having received all of the assurances that we are likely to receive from the Secretary of State about the granting of exemption from Regulation, and having given financial approval to the project, how much capital expenditure we should commit ourselves to until the uncertainties described above, have been removed.

22. The options open to us, although they are not exclusive, are as follows:

[Four options are listed. All provide for an initial financial commitment well below the £260 million estimated costs of the project (in 1992 prices). Option 1 provides for the highest financial commitment of £12.64 million expenditure up to 1 November 1993.]

QUESTIONS FOR THE BOARD

27. Does the Board agree that:

27.1 Approval should be given to the construction of the Heathrow Express at a costs of £260 million at January 1992 prices?

27.2 Option 1 should be accepted as the phasing of the project between now and November 1993?

27.3 Permission should be sought from the Board for further expenditure beyond the £12.64 million set out in this paper at the appropriate time?"

[emphasis added]

36. HAL has not been able to locate the minutes of the meeting at which the document BAA 30/93 was considered. However, the next document shows that the BAA plc Board committed only limited capital expenditure on the Heathrow Spur project prior to November 1993, in line with the proposals in BAA 30/93.
37. Paragraphs 14 to 17 of BAA 30/93 refer to a review by Mr Stan Maiden of the revenue forecasts, which was requested by the Board as its meeting on 10 March

1993, before a final decision to proceed would be taken. Passenger forecasts were a key element relevant to the profitability of the project as a standalone investment, since passengers were the source of the revenue the project would generate, enabling BAA to generate a return on the investment.

38. Mr Maiden is the former Forecast and Research Director of BAA. He has retired from Heathrow, however in the context of preparing this response we have been able to speak to Mr Maiden. He has confirmed that in 1993 he reviewed and subsequently validated the passenger forecasts undertaken by two independent consultancies, MVA and Coopers & Lybrand. Mr Maiden has said that he recalls his conclusion being as described in the attached paper, namely that *“their work produces robust and rational results which have revisited several times in the past by independent expert who are leaders in this field”*.

(iv) Paper for BAA plc Management Committee dated 9 November 1993

39. This paper is titled *Heathrow Express: Approval of Remaining Funds* and stated to be *“presented by the Group Technical Director”* (Mr. Maine). The paper is attached at **Annex 4**.
40. The key extracts from the paper for the purposes of this consultation are as follows:

“1. This paper seeks approval for the remaining £235.2 million at outturn costs required to complete the Heathrow Express project, together with £3 million capitalised management costs to support the development of the project.

BACKGROUND

...

4. BAA will arrange all of the debt. BAA is therefore required to source a total of £271.1 million at outturn prices (£244.7 million January 1992 prices) being the summation of debt and our own equity. The BAA Board has so far approved a total of £35.9 million at outturn, the latest approval being in July 1993 (BAA/80/93). Approval of the remaining £235.2 million of expenditure is sought.

5. The existing approvals provided sufficient expenditure for construction to proceed until the end of November 1993. It was agreed that at that time approval to proceed with the full scheme should be given only if the Board was satisfied that the powers to “ring fence” the Heathrow Express promised by the Secretary of State had been incorporated in the final version of the Railways Bill.

THE RAILWAYS BILL

6. This received Royal Assent on 4 November. Both BRB and we are satisfied that the Bill contains all the powers required by the Secretary of State to enable him to grant the agreed exemptions to the Heathrow Express.

7. The procedures he must follow mean that these will not finally be put in place until February next year, but no further parliamentary approval is required.

8. There is no reason to believe that the Secretary of State will not grant these exemptions and I recommend that the project continues on that basis.

...

FINANCIAL APPRAISAL

12. The rate of return to BAA is 10.1% is based on the current opening date, December 1997, and the current rules for calculating rates of return. This still gives a Net Present Cost of £41.1 million, but as described in BAA 19/93 (March 1993), taking into account the total Heathrow development before Terminal 5 there will be a return in excess of BAA's 13.25% hurdle rate.

QUESTIONS FOR THE MANAGEMENT COMMITTEE

13. Does the Committee approve the remaining £235.2 million to complete the Heathrow Express for a total cost of £285.7 million with £14.6 million of this latter figure having been provided by BRB?

...

15. Does the Committee agree that this paper should be submitted to the Board?"

[emphasis added]

(v) Extract of minutes from BAA plc Management Committee meeting

41. HAL has not been able to locate a copy of the full minutes of the BAA plc Management Committee meeting at which the aforementioned 9 November

Paper was considered. However, HAL has located on microfiche the relevant extracts of those minutes, which is attached at **Annex 5**.

42. The relevant extract is marked “ 396/93 - Heathrow Express: Approval of Remaining Funds” and indicates that the Management Committee agreed that the proposal to commit the remaining required funds for the Heathrow Spur project should be submitted for the approval of the Board.

(vi) Further BAA plc Board Meeting

43. HAL has also not been able to locate the minutes of the BAA plc Board Meeting at which the aforementioned 9 November Paper was considered. It can, however, be inferred from the fact that the Heathrow Spur Project went ahead that the BAA plc Board did approve the commitment of the full expenditure required.
44. The Railways Act 1993 – the “Railways Bill” referred to in the above Board papers and minutes - came into force on 24 December 1993. The relevant exemptions from the Act were then given effect in the Railways (Heathrow Express) (Exemptions) Order 1994.

V. The Third Criterion of the Paragraph 3 Test is satisfied

45. The contemporaneous documents described above show that BAA plc only committed the capital expenditure required to construct the Heathrow Spur on the basis that it would recover this capital expenditure – plus a commercial return – from revenue from rail users, including if necessary through charges levied on third party rail users, including CrossRail.
46. In particular:
 - a. The BAA plc Board viewed exemption from the sectoral regulation envisaged in the Railways Bill as “*essential to the financial viability of the project*”: see, e.g. Minutes of 10 March Board Meeting.

- b. The BAA plc Board deliberately delayed the decision to commit the full capital expenditure required for the Heathrow Spur until it could be confident that the Spur would be granted such an exemption: see, especially, BAA 30/93 and 9 November Paper for BAA plc Management Committee.
- c. BAA plc was only willing to proceed with full investment in the Heathrow Spur once the Board was confident that it would be granted an exemption from relevant sector regulation, and on the basis that BAA would be able to achieve the relevant rate of return from the project.
- d. From the perspective of the Board, the importance of such exemption lay in the fact that this would enable BAA plc (later HAL) to charge other operators using the Heathrow Spur for access so as to compensate for the loss of income the other operators' service may cause to the Heathrow Express: BAA 19/93, paragraph 3. In other words, the importance of the exemption is that it would allow HAL to maintain its projected incomes from the Spur (on which the IRR assumptions were based) in the event of use of by other operators.
- e. The projected incomes (revenues) for the Heathrow Spur were obviously a key component in BAA plc's calculation of its projected IRR – i.e. return on capital expenditure. This is why Mr Maiden was asked to conduct a further review of the forecasts, as they were critical to the likely profitability of the project and BAA's ability to recover the capital investment.
- f. It follows from (c) to (e) above that the BAA plc Board would not have proceeded with full investment in the Heathrow Spur – and, therefore, the Spur would not have been constructed – unless it was confident that it could (pursuant to the said exemption) levy charges on access operators

enabling BAA plc (later HAL) to recover its capital investment in construction, plus a commercial rate of return.¹²

47. In light of the above – and, particular, given the ORR’s express indication that contemporaneous documents attesting the initial investment decision are the “*best evidence*” in relation to Criterion 3 of the Paragraph 3 Test - the only finding that the ORR can lawfully reach on the evidence now available is that Criterion 3 is met in respect of the Heathrow Spur.
48. For the avoidance of doubt, HAL also continues to rely, as necessary, on its earlier submissions concerning the Joint Venture Agreement and the CAA’s treatment of the Heathrow Spur expenditure and revenues (referred to in the Consultation Document) as supporting the conclusion to be reached on Criterion 3 on the strength of the now available contemporaneous evidence.
49. It follows that, in accordance with the terms of Article 8(2) of Directive 2001/14/EC and the Regulations, HAL is entitled to set its access charges for third party operators taking into account the historical long term costs of the relevant infrastructure.

VI. Conclusion

50. HAL invites the ORR to reconsider and reverse its provisional conclusion on the application of the Paragraph 3 Test to the Heathrow Spur, in the light of the new evidence and the other matters set out above.
51. As the new documents must affect the ORR’s reasoning and decision, HAL would also invite the ORR to consider whether a further short consultation on any new provisional conclusion would be desirable.

¹² As set out in our previous submission, an article from the Japan Railways and Transport Review, March 1999 includes a section on “Financing” which notes, *inter alia*, that the Heathrow Express involved capital spending of more than £450m, that funding came from the company’s cash flow and from loans from the European Investment Bank and the Export-Import Bank of Japan, and that “*the surplus of revenue over operating costs is confidential, but it is expected to give shareholders an appropriate return on capital investment*”.

CONFIDENTIAL

Presented by the Group Technical Director

**BAA 19/93
March 1993**

**HEATHROW EXPRESS - APPROVAL OF JOINT VENTURE WITH
BRITISH RAIL BOARD**

INTRODUCTION

1. This paper seeks approval to a Joint Venture Agreement with the British Rail Board (BRB) for the building and operation of the Heathrow Express. The Chief Executive and I signed a Heads of Agreement with BRB, subject to Board approval, on 2 March 1993 and the BRB Board gave approval to that Agreement on 4 March.
2. The Chief Executive circulated to Board Members a copy of a letter he had sent to John MacGregor which sought help in a number of areas. We have subsequently received a reply from the Secretary of State and a draft of this letter, which was still being finalised when this paper was written, is attached at Appendix 1. We have also had a number of discussions with the Department of Transport.
3. It is extremely important to maintain the exemption from the rules that will apply to services under privatisation and, in particular, from the Regulator. This exemption will enable us to charge a track fee to other users of the line crossing Heathrow Airport, a fee that will compensate the Heathrow Express project for any loss of income generated by the introduction of other services on the line, including CrossRail. We have concluded, therefore, that we should not seek to change the basis of the access fee as it is spelt out in the Joint Venture Agreement.

4. We will take up the offer of help to obtain European Community funding, although it is unlikely that even if we did obtain a grant that this would be more than a token in the region of £1-5 million.
5. In the circumstances, therefore, we recommend that the Joint Venture Agreement is approved, as the best deal we can obtain. It will still need to be turned into a legal document before it is finally signed and the Heads of Agreement give a target date of 30 April 1993 for that to happen.
6. We had intended that this paper would come to the Board on 25 March, but the Government has requested that we give approval to it by the end of this week, and have indicated that the Treasury will give its approval by the same deadline, to enable the Agreement to be announced as part of the Budget Statement on Tuesday 16 March.

BACKGROUND

7. Royal Assent was obtained in May 1991 for the building of a fast rail link between Paddington and Heathrow under a Joint Venture Agreement between the BAA and BRB to construct and operate this railway. The uncertainty caused by BR's privatisation, together with their lack of funds prevented the continuation of this Agreement which lapsed in December 1991.
8. Since then the project has been reassessed and costs significantly reduced. After lengthy negotiations with BRB, a Heads of Agreement for a new Joint Venture provides for a total capital cost of £260 million at January 1992 prices.

THE SERVICE

9. The service will run every 15 minutes and use dedicated electric trains. The journey time to the new station in the Central Terminal Area will be 16 minutes

with an additional 6 minute journey to Terminal 4. The carriages will be designed specifically for airline passengers, providing a large amount of space for baggage incorporating passenger information displays.

10. The new stations in the CTA and Terminal 4 will both be served by escalators and lifts. Two dedicated platforms will be provided at Paddington Station.
11. The £260 million project cost, a breakdown of which is shown at Appendix 2, does not include the infrastructure required for baggage check-in at Paddington and the corresponding infrastructure to remove the bags at Heathrow. This facility will be added to the project provided airlines pre-commit to use the facility on terms that will recover the capital costs.
12. A further paper will be presented to the Board, requesting capital expenditure, when all agreements are in place. An operational date of Summer 1997 is still possible.

THE AGREEMENT

13. The project will be carried out as a 70:30 joint venture between BAA and BRB. To maximise tax benefits the project will initially be carried out as a HAL project, with the intention of incorporating the venture and introducing additional shareholders after the link has been completed. Key details of the Heads of Agreement are as follows:-

13.1 Both Heathrow Airport Limited and BRB will guarantee that their part of the works will be delivered on cost and on time. The respective costs are:-

Heathrow Works	£202 million
BRB Works	£ 53 million

Additionally a parliamentary undertaking requires the project to improve the roads around Paddington Station at a cost of £5 million. Any increase in that cost will be borne on a 50/50 basis by Heathrow Airport and BRB.

- 13.2 The notional accounts for the project will reflect a financial structure with £51 million of quasi-equity (£35.7 million from BAA and £15.3 million from BRB). The balance of funds will be in the form of a loan arranged and guaranteed by BAA. This loan will be lent to the project and BAA will charge a margin of 1.5% on its actual borrowing costs.
- 13.3 If the project is loss-making beyond a pre-determined cumulative level, BAA and BRB will put in an additional £25 million in cash, split 70:30 between BAA and BRB. It is unlikely that the Government will allow BRB to commit any further funds beyond their share of this £25 million; if losses continue, therefore, a failure by BRB to meet their share of the losses would result in their 'shareholding' being diluted.
- 13.4 Separately from the joint venture, BAA is also making a £16 million loan to BRB to fund part of the cost of electrifying the main line. This loan will be repaid, with interest plus a margin of 1½%, if and when an alternative operator wishes to use the main line.
- 13.5 An annual payment of £4½ million (indexed) has been agreed for the use of the existing Great Western main line and Paddington Station.
- 13.6 HAL will pay to the venture an annual subsidy of £2½ million (indexed) which will entitle passengers to transfer between the two Heathrow stations at no charge. As and when the project becomes more profitable and reaches agreed revenue thresholds the subsidy will reduce to £1 million and the track access fee will increase to £6 million.

- 13.7 Although the basis of the agreement is a 70:30 joint venture, BAA and BRB have agreed that no profits will be paid out until after the venture's incorporation as a separate company. In the meantime any cash surpluses will be used to reduce the outstanding balance on the BAA loan.
- 13.8 BAA has effective control over the venture, by means of a Management Committee in which we have a casting vote. There are certain minority protection provisions for BR, however. These are shown as Appendix 3.
- 13.9 It is the intention of both parties to incorporate the venture and sell down their shareholdings as soon as possible after Heathrow Express commences operation. BAA intends eventually to be a minority (circa 15%) shareholder in the project.

THE NEED CASE FOR THE HEATHROW EXPRESS

14. Ground access into Heathrow is already difficult and whilst some road improvements can be achieved the delays suffered by passengers will increase as passenger numbers rise reducing the attractiveness of Heathrow. London Underground which serves London commuter traffic as well as airline passengers is running at capacity during peak hours.
15. 7 million passengers are forecast to use Heathrow Express when Heathrow is handling 54 million passengers a year, providing relief to the roads. The project will provide a new alternative means of access into Heathrow and introduce further competition for existing services. The rail link forms a key part of Heathrow's Public Transport Policy Statement.
16. Counsel's advice is that the Heathrow Express is a key feature in the case for Terminal 5 and is reflected as such in the Environmental Assessment documents that have been published for the proposal.

17. The Heathrow Express is a key piece of infrastructure that is vital to enable Heathrow to maintain its market lead and grow its business in competition to other major European hubs. It will enable an additional 2 million passengers per annum to be handled by Heathrow Airport, although other work, for example the expansion of Terminal 1, is also required to provide that increased capacity.

FINANCIAL APPRAISAL

18. This project has been appraised on three bases, each assuming Heathrow is capped at 54 million passengers a year:-

18.1 As a project which would eventually be "sold down". A discounted cash flow (DCF) of the project shows an IRR of 14.2%.

18.2 As a stand alone project, but showing BAA's financial interest in the project, having regard to BAA's 70% share of the joint venture, the £16 million electrification contribution by BAA, the £2.5 million annual subsidy by BAA and the lending margin on the loan. This shows the following results:-

IRR	12.5%
NPV at 15% hurdle rate	(£30m)

Sensitivity tests show that fare revenues and capital cost overruns have the most impact on the IRR:-

	Effect on IRR
10% reduction in fare revenues	1.5%
10% increase in fare revenues	+1.4%
10% increase in capital costs	-1.0%
10% increase in operating costs	-0.5%

wider development programme for Heathrow. Based on the assumption that Heathrow's existing four terminals will handle 54 mppa prior to T5's opening, falling back to 50 mppa thereafter, the results of this global appraisal are as follows:-

(a)	IRR of Heathrow's development (without Heathrow Express)	21.2%
(b)	IRR of Heathrow's development (with Heathrow Express)	16.9%
(c)	As (b) but with Coopers & Lybrand revenue forecasts for Heathrow Express	13.8%

If the passenger numbers at Heathrow reached 60 mppa the IRR of Heathrow's development with the base forecasts for the Heathrow Express would rise from 16.9% to 24.4%, with the Coopers & Lybrand revenue forecast it would increase from 13.8% to 22.6%.

19. Except under very pessimistic assumptions, therefore, the overall development of Heathrow prior to T5 is likely to give a return in excess of BAA's 15% hurdle rate.

RECOMMENDATION BY GROUP FINANCE

20. As a stand alone project the marginal returns and the extent of the downside make this an unattractive investment. In the context of Heathrow's development prior to the opening of T5, however, Heathrow Express is considered an essential part of the plan to accommodate growth in traffic. The returns which are forecast for this overall development programme are attractive, and on this basis Group Finance recommend approval.

RECOMMENDATION

21. Despite the project rate of return being below the 15% hurdle rate, the Group Technical Director recommends that for the benefit of Heathrow's total business the Heathrow Express project should proceed as a joint venture with BRB as defined in the Heads of Agreement signed on 2 March 1993.

QUESTION

22. Does the Board approve the Joint Venture Agreement with BRB described in this paper?

M P M

DRAFT

APPENDIX 1

Sir John Egan
Chief Executive
BAA plc
120 Wilton Road
LONDON SW1V 1LQ

HEATHROW EXPRESS

Thank you for your letters of 1 and 2 March. I am very pleased that you have reached agreement with BR over your joint venture.

I am sorry to say, however, that I really cannot intervene over the question of the track access fee to be paid by Heathrow Express. We have already made major concessions in accepting that the access agreement with British Rail should run for as long as 25 years and even more so in agreeing that, subject to Parliament, the new spur into Heathrow should be exempt from the regime which is to apply to domestic passenger services under the Railways Bill. If, as you seek, the basis of the access fee were to change then I for my part would find it difficult to sustain the argument for the exemption which gives the spur a considerable benefit. No doubt in these circumstances British Rail would also have to reconsider the length of the access agreement.

As for European Community funding, the present position is that current arrangements make it impossible to fund construction costs. These arrangements are due to be rolled over for a further two years or until the Network funds envisaged in the Maastricht Treaty are agreed. Obviously I cannot say what the criteria for funding under any Network programme will be. But if Heathrow Express is eligible then we shall certainly give what support we can to an application for assistance.

APPENDIX 2**TOTAL BREAKDOWN OF CAPITAL COST**

	CURRENT
	£M
LAND ACQUISITION	6.0
ENABLING WORKS	7.0
TUNNELLING AND CIVIL WORK	69.0
STATIONS	
- BUILDINGS AND FIT-OUTS	18.0
- M & E	24.0
SETTLEMENT MONITORING AND PROTECTION	3.0
SIGNALLING AND ELECTRIFICATION	6.0
TRACK BED AND RAIL	6.0
ROLLING STOCK	28.5
ROLLING STOCK SPARES	2.5
PROJECT INSURANCE	3.0
DESIGN AND SUPERVISION	29.0
HEATHROW WORKS - TOTAL	<hr/> 202.0
BR WORKS - SIGNALLING/TRACK ALTERNATIONS/ ELECTRIFICATION/IMPROVEMENTS AT PADDINGTON	
BR WORKS - TOTAL	53.0
PADDINGTON ROADWORKS	5.0
TOTAL	<hr/> 260.0

MINORITY PROTECTION PROVISIONS

During Stage I (prior to the formation of Newco), BRB's rights will be based upon those which a 30% shareholder would enjoy as if the Project was being undertaken by a limited company and BRB were a 30 per cent. ordinary shareholder in that company.

In addition to the above, the following subjects will require the unanimous agreement of the Management Committee:-

1. Any significant modification to the scope of the Project.
2. Integration and compatibility of the HAL and BRB works including signalling and electrification.
3. Provision of facilities at Paddington which would affect Heathrow Express.
4. Acquisition, sale or disposal of material assets other than in accordance with the agreed scope of the Project.
5. Arrangements for stabling, maintenance and cleaning in so far as they could affect the operational integrity of the Great Western main line.
6. Arrangements in respect of safety and emergency situations.
7. Deviation from the commercial objectives set out in the Joint Venture.
8. Additional significant capital or legal obligations (other than in accordance with the guidelines set out in the Heads of Agreement).

CONFIDENTIAL

BAA plc

**MINUTES OF A MEETING OF THE BOARD OF DIRECTORS OF THE COMPANY
HELD AT CORPORATE OFFICE, 130 WILTON ROAD, LONDON SW1
ON WEDNESDAY 10 MARCH 1993 AT 1700 HOURS**

Present:	Dr N B Smith	-	Chairman
	H G Ashton		
	Sir John Egan	-	Chief Executive
	R L Everitt		
	M S Hodgkinson		
	M P Maine		
	Sir Patrick Wright		
In Attendance:	J Grice	-	Company Secretary
	C Barlow	-	Senior Development Manager
	P Jones	-	Group Capital Planning Manager
	T Morgan	-	Director, Corporate Communications

Apologies:

Apologies for absence were received from Mr J E Boyd, Sir John Drinkwater QC, Mr G G Edington, Mr N G Ellis, Mr J M B Gibson, Mr P J Middleton and Mr L M Urquhart

29/93

**Heathrow Express - Approval of Joint Venture with British Rail Board
BAA 19/93**

The Chairman explained that it had been necessary to convene a meeting at short notice to obtain the Board's approval to the proposed joint venture agreement with the British Rail Board ("BRB") for the building and operation of the Heathrow Express to enable the agreement to be announced by the Government as part of the Budget Statement on Tuesday 16 March.

Mr Maine reported that Sir John Egan and he had signed heads of agreement with BRB, subject to Board approval, on 2 March 1993 and the BRB Board had given approval to the agreement on 4 March.

Sir John Egan had written to the Secretary of State for Transport on 2 March seeking that:-

1. the track fee would be reduced to the general level of track fees on the Great Western line should they become substantially lower than included in the heads of agreement;

2. the £4.5m track fee be reduced to £2m per annum until the project was profitable, thereafter rising to £6m per annum as proposed in the heads of agreement; and
3. that the Secretary of State would assist BAA in applying for a grant from the European Community for the project.

The Secretary of State had replied on 9 March that he could not intervene over the question of the track access fee particularly as major concessions had been made by the Department in accepting that the access agreement with British Rail should run for as long as 25 years and that access to the new spur into Heathrow should be exempt from the regulatory regime which would apply to domestic passenger services under the Railways Bill. He was, however, prepared to agree that, if European Community funding became available and Heathrow Express was eligible, the Department would provide what support it could to an application for assistance.

Sir John Egan said that, despite the somewhat onerous terms of the heads of agreement, the principal benefits to BAA would be:-

1. rail access to Heathrow;
2. control of the track access to Heathrow; and
3. freedom for the joint venture to agree the level of fares which it was envisaged would not be subject to regulation under the Railways Bill.

Sir John said that it was still the intention to sell down part of BAA's shareholding in the Heathrow Express company to both institutional investors and interested parties like British Airways and CP Rail. This was unlikely to happen until the service had been in operation for about two years. Eventually it would be BAA's intention to retain a minority interest in the project of c15%.

Mr Maine stressed that although heads of agreement had been signed there were still a number of important issues to be decided before the joint venture agreement was concluded. These included the provision of the infrastructure required at Paddington for baggage check in and the corresponding infrastructure to remove the bags at Heathrow both of which were considered to be essential. This facility was estimated to cost between £5m and £10m and would be added to the project provided airlines were willing to commit to use the facility on terms that would recover the capital cost.

Mr Maine said that the project would be carried out as a 70/30 joint venture between BAA and BRB on the basis set out in the Board paper which included a £16m loan from BAA to BRB to fund part of the costs of electrifying the main line. This loan would be repaid with interest plus a margin of 1.5% if and when another electric service used the main line.

Mr Maine said that, despite the project rate of return being below the 15% hurdle rate, he recommended that for the benefit of Heathrow's total business the Heathrow Express project should proceed as a joint venture with BRB on the terms set out in the heads of agreement signed on 2 March 1993. Based on the returns which were forecast for the overall development programme of Heathrow prior to Terminal 5 the Group Finance Department also endorsed the project.

Concern was expressed over the possibility of the Secretary of State being unable to grant exemption from regulation for the Heathrow Express branch line until the Railways Bill had become law as this exemption was essential for the financial viability of the project.

Mr Maine said that he had discussed the proposed joint venture with each of the Directors who had been unable to attend the meeting except for Mr Ellis, Sir John Drinkwater and Mr Middleton who were all abroad and uncontactable. Mr Boyd, Mr Urquhart and Mr Edington, had all confirmed their support for the joint venture project.

IT WAS RESOLVED THAT:-

1. the joint venture agreement for the Heathrow Express between the Company and British Rail Board be and it is hereby agreed in principle on the terms set out in Board paper BAA 19/93;
2. before a final decision to proceed was made Mr Maiden should review the revenue forecast in the light of the underlying assumptions made by MVA and Coopers & Lybrand in their report;
3. Mr Maine would assess the risk of exemption from regulation not being obtained, clarify the timing of the Railways Bills becoming law and assess its impact on the commitment of further capital expenditure on the project; and
4. Mr Hodgkinson would ensure that the CAA, who were expecting the project to be completed in the summer of 1997, were informed of the current position.

30/93

Date of Next Meeting

Thursday 25 March 1993

Board Room

Corporate Office

130 Wilton Road

London, SW1

1000 hours

There being no further business the meeting ended at 1820 hours.

Dr N B Smith
Chairman

CONFIDENTIAL

Presented by the Group Technical Director

**BAA 30/93
March 1993**

Heathrow Express Update & Financial Approvals

INTRODUCTION

1. At the Board meeting on 10 March 1993 (BAA 19/93) the Board approved the Heads of Agreement which had been signed with British Rail as the basis for the Joint Venture for the Heathrow Express.
2. This paper updates the Board on developments since that meeting and seeks approval for expenditure needed to keep the project on an acceptable timescale.

PRESENT POSITION

3. Concern was expressed at the Board meeting that the Secretary of state was unable to grant exemption from Regulation for the Heathrow Express branch line until the Railways Bill had become law and this exemption was essential for the financial viability of the project. At the time of the Board meeting we were unsure when the Railways Bill was likely to become law.
4. The Department of Transport has confirmed that the Railways Bill should receive Royal Assent in October 1993. It has also confirmed that Clause 17, the Clause that would give the Secretary of State powers to grant exemption to

specific lines from compulsory third party access, including the Heathrow Express, was not altered during the current committee stage and no attempt had been made to put forward any amendments to the clause. The Department also confirmed that the Government would fight very hard to retain the clause unaltered because it would be impractical to regulate every private line in the UK. It is highly likely therefore that the Bill will become law in October and that the Secretary of State will take immediate action to grant the Heathrow Express exemption from compulsory third party access. This exemption is likely to be effective two months after the Bill becomes law.

5. The risk of exemption not being granted therefore is very small, but clearly a risk still exists. The risk of there being a delay to the planned timing of the Bill becoming law is higher, although the Department of Transport and the Chairman of British Rail believe such delay to be very unlikely.
6. Since the last Board paper a number of other uncertainties related to the Bill have been considered and the uncertainties and assurances given by the BAA Legal Department or by the Department of Transport, are dealt with in the following paragraphs.
7. There was uncertainty about how long the exemption would be granted for and what possibility there was of the exemption being withdrawn. The Department of Transport has confirmed in writing that the exemption is in perpetuity. Our Legal Department therefore confirms that once granted an exemption could not be withdrawn.
8. Concern has been expressed that if the Bill falls and is re-instated by the present Government it is possible that the exemption would not be granted under a new Bill. The Department of Transport has confirmed in writing that the commitment to exemption by the Secretary of State would be binding on him or his successor in those circumstances.

9. Concern was also expressed about what happens if the Government falls and there is no Bill. In this case it would be a private spur line and no other operator could have access to that line unless they complete a commercial agreement with the Heathrow Express company. There would obviously be limitations under the present Competition Laws.
10. Concern was also expressed that if the Bill did not become law but at some stage, say in ten years time, another Government introduced another Privatisation Bill with no exemption then the Heathrow Express could have a problem. It is, of course, not possible to consider all future changes in legislation either related to railway privatisation or anything else. However, the Department of Transport confirmed that in their view the Heathrow Express could charge any other services coming into Heathrow for the use of its private stations. They also expressed the view that BAA could charge passengers for coming onto its private land, but did not feel that they were in a position to give assurances on that point. Our Legal Department says that any such charges would be taken into account by the CAA in setting the airport charges formula.
11. We clearly cannot cover all eventualities, but I believe we have considered all the major possibilities that might affect the project and have concluded that we are protected as much as we possibly can be and can take no further action to increase that protection.
12. All of these uncertainties will disappear once the Bill becomes law and exemption is granted.
13. There is a risk that the negotiations with BR, to enable the Heads of Agreement to be converted into a legally binding agreement, will either be delayed or could become so difficult that the agreement will never be implemented. As the Government, BR and BAA has announced that agreement has been reached so

publicly however this must be unlikely. It is more likely that there will be some delay before the legal agreement is signed. The recommendation in this paper assumes that we will not go ahead with major expenditure until the agreement is legally binding. However, ongoing expenditure to maintain the existing Heathrow Express team in being, and essential expenditure on off-site manufacture of items which are on the critical path, amount to about £200,000 a month.

FINANCIAL APPROVAL

14. The financial appraisal and the recommendations by Group Finance about the project were set out in BAA/19/93 and nothing has changed since then. I have therefore not repeated the appraisal in this paper. There was, however, discussion at the Board meeting about the revenue forecasts and the review of the work undertaken by MVA and Coopers & Lybrand which underlay these forecasts. The Board requested Stan Maiden to review the forecasts before a final decision to proceed was made.
15. Following the Coopers & Lybrand report, and since the Board Meeting, Stan Maiden has further considered the forecasts based on the MVA model. He believes that their work produces robust and rational results which have been revisited several times in the past by independent experts who are leaders in this field.
16. He says that there is an inherent risk in any traffic forecast for a new form of transport and it was this risk which has been highlighted by Coopers & Lybrand. They accept that the revenue figures produced by using one of the sensitivity examples they use are extremely pessimistic and the example was not based on any figures produced from either empirical or deduced evidence. In addition, Stan Maiden points out that the MVA work made use of 1987 CAA surveys of origins and destinations at UK airports, and the 1991 report has recently been

published which further confirms the validity of the MVA model.

17. His view therefore is that using the MVA assumptions for the base forecasts is sound and that the reduction in revenue produced by the work carried out by Coopers & Lybrand was extremely pessimistic.
18. Another cause for concern about the financial viability of the project must be the risk of the capital cost of the project being exceeded. The total cost is estimated to be £260 million at January 1992 prices with the cost split as follows :

BAA Works	£202 million
British Rail Works	£53 million
Paddington Roadworks	£5 million
TOTAL	£260 million

A detailed breakdown of the cost is given at Appendix 1.

19. These costs have been subject to a number of reviews both internally, with the help of Value Management studies, and externally through the Construction Manager, Taylor Woodrow, independent reviews by Balfour Beatty, Bovis & CP Rail, and a detailed review by an independent cost consultant, Currie & Brown. We are therefore very confident about their validity, although the checks have been based on the work being carried out according to the current programme and any significant delay to that programme could give rise to increases in cost if the construction industry and, in particular, the tunnelling industry, were to pick up. These judgements about cost increases are, however, necessarily subjective.
20. Corporate Finance and I recommend therefore that financial approval should be given to the expenditure of £260 million at January 1992 price levels of which BR has already spent just over £15 million and BAA £21.5 million.

OPTIONS TO BE CONSIDERED BY THE BOARD

21. The Board needs to consider, having received all the assurances that we are likely to receive from the Secretary of State about the granting of exemption from Regulation, and having given financial approval to the project, how much capital expenditure we should commit ourselves to until the uncertainties, described above, have been removed.

22. The options open to us, although they are not exclusive, are as follows :

	Commitment	Expenditure up to 1.11.93
Option 1 :		
Existing programme as shown on Appendix 2, with completion August 1997	£23.34 million	£12.64 million
Option 2 :		
Slow down initial expenditure, but keep to same completion date, but removes programme float	£11.87 million	£ 9.29 million
Option 3 :		
Defer major expenditure until January 1994, with programme completion December 1997	£ 8.07 million	£ 3.07 million
Option 4 :		
Defer major expenditure until April 1994, with programme completion April 1998	£ 2.5 million	£ 2.12 million

The differences between these options are shown at Appendix 3. The main differences are that in option 2 the cut and cover work, where we are ready to award the contract immediately at a very favourable price, is slowed down and some land acquisition is delayed. Whilst we believe that the completion in August 1997 could still be maintained we have removed almost all of the time contingencies that were included in the existing programme. Option 3 is significantly different because we delay all land acquisition and delay all the cut and cover work until the Bill is law and cut out most of the preparation work except those like the National Grid cable where we will have great difficulty in re-instating the programme with the National Grid at a time that would be acceptable to any future programme. We have also assumed that we agree with British Rail that they would carry out no work. This in itself is likely to increase the total cost because almost certainly they will refuse to honour their commitment to keep their costs within £53 million. In addition, we believe that the tender for the cut and cover work, which we have already held at the same price for 44 weeks, will either have to be retendered or renegotiated and on the basis that the second bid was £2 million higher than the bid we wish to accept, it is possible that at least £2 million could be added to the cost. Option 4 takes this one stage further with almost no work continuing, but the project management team still being kept together.

23. Whilst it is difficult to estimate the additional cost that options 2, 3 and 4 would add to the project, we estimate that the additional cost of option 2 is about £4 million, of option 3 about £7 million and option 4 about £10 million. We already know that some raw material prices, such as steel and cement, have recently increased by about 13%, but that companies are for the time being holding their prices because of the state of the industry. We are making the judgement that they will not hold their prices for very long.
24. In considering these options the following issues need to be considered :

- 24.1 The CAA, our Regulator, is expecting completion in the Summer of 1997. This was a key factor in achieving our current regulatory regime. The Board of CAA will be extremely concerned if there is any significant delay to the start of the service and this could seriously affect our currently very good relationship with the CAA.
- 24.2 Any of the options would be acceptable for the Terminal 5 case because whichever option was chosen substantial work would have started before the commencement of the Public Inquiry in October 1994.
- 24.3 As already stated, there is cause for concern that the total cost of the project would increase if significant delays to the existing programme occurred. This is referred to in paragraph 24. We may also receive a claim from British Rail because any delay to their works might invalidate their £53 million guarantee of the cost of their works.
- 25.4 One of the reasons for optimism about the financial viability of the Heathrow Express is the assumption that Heathrow might handle 60 million passengers per annum before Terminal 5 comes on stream, rather than the 54 million in the base case. One of the factors that would limit this growth is surface access to Heathrow and the earlier the Heathrow Express comes into service the better.

CONCLUSION

- 26 It is clearly difficult to be precise about which of these four options is the best option for BAA to adopt. The Management Committee has discussed these options in detail and on the basis that the risk of the Railways Bill not becoming law is small, they concluded that we should adopt option 1. The Committee came to this conclusion partly because of the issue of regulation and partly

because of the difficulty in holding the price level for the project if there is any significant further delay. I therefore recommend that we proceed with option 1. I also recommend that we return to the Board at the end of 1993 to seek further approval for expenditure beyond the £12.64 million which will by then have been spent. If we adopt option 1 we will have committed £23 million, but will be able to stop further work by paying penalties. The estimated cost of these penalties has been included in the expenditure figures shown in Appendix 3.

QUESTIONS FOR THE BOARD

27. Does the Board agree that :

27.1 Approval should be given to the construction of the Heathrow Express at a cost of £260 million at January 1992 prices?

27.2 Option 1 should be accepted as the phasing of the project between now and November 1993?

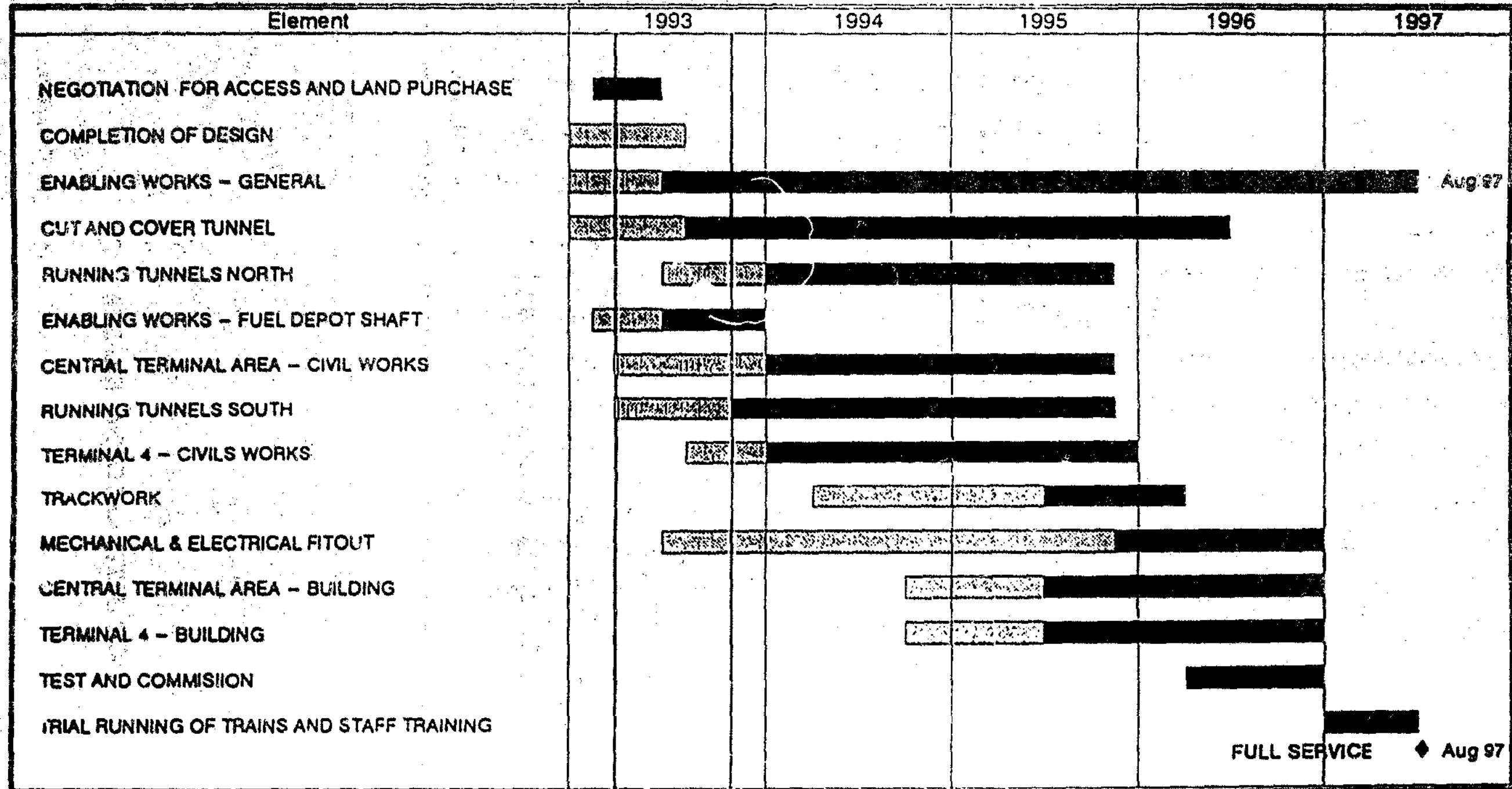
27.3 Permission should be sought from the Board for further expenditure beyond the £12.64 million set out in this paper at the appropriate time?

TOTAL BREAKDOWN OF CAPITAL COST

	CURRENT £M
Land Acquisition	6.0
Enabling Works	7.0
Tunnelling & Civil Work	69.0
Stations	
- Buildings & Fit Outs	18.0
- M & E	24.0
Settlement Monitoring & Protection	3.0
Signalling & Electrification	6.0
Track Bed & Rail	6.0
Rolling Stock	28.5
Rolling Stock Spares	2.5
Project Insurance	3.0
Design & Supervision	29.0
HEATHROW WORKS : TOTAL	202.0
BR Works - Signalling/Track Alternations/ Electrification/Improvements at Paddington	
BR WORKS : TOTAL	53.0
Paddington Roadworks	5.0
TOTAL	260.0

HEATHROW EXPRESS RAIL LINK

Summary Construction Programme



██████████ PROCUREMENT AND MOBILISATION
 ▨▨▨▨▨▨▨▨ CONSTRUCTION, FITOUT & COMMISSION

▶ Royal Assent
 ▶ Time Now

FULL SERVICE ◆ Aug 97

APPENDIX 2

Presented by the Group Technical Director

9 November 1993

HEATHROW EXPRESS : APPROVAL OF REMAINING FUNDS

SUMMARY

1. This paper seeks approval to commit the remaining £235.2 million at outturn costs required to complete the Heathrow Express project, together with £3 million capitalised management costs to support the development of the project.

BACKGROUND

2. The Board approved the signing of a Joint Venture with BRB on a 70:30 basis to build and operate Heathrow Express at a total project cost of £285.7 million in outturn prices (£260 million at January 1992 prices). The Joint Venture requires both parties to guarantee to provide their works at an agreed cost. Any over spend will be borne by the partner responsible. Specifically:-

	(1992 PRICES)	OUTTURN
BAA will guarantee the costs of the branch line to Heathrow and the rolling stock	£202.6 m	£223.2 m
BRB will guarantee their works on the existing main line and works inside Paddington Station	£ 52.4 m	£ 56.1 m
Roadworks outside Paddington Station (guaranteed on a 50:50 basis)	£ 5.0 m	£ 6.4 m
TOTAL PROJECT COST	£260.0 m	£285.7 m

3. This project cost is funded under the Joint Venture as follows: -

	JAN 1992 PRICES	OUTTURN PRICES	BAA SOURCED FUNDS
BRB equity	£ 15.3 m	£ 14.6 m	-
BAA equity	£ 35.7 m	£ 34.8 m	£ 34.8 m
Debt*	£209 m	£236.3 m	£236.3 m
TOTAL PROJECT COST	£260 million	£285.7 million	£271.1 million

* (Debt figures exclude capitalised interest - approximately £40 million)

4. BAA will arrange all of the debt. BAA is therefore required to source a total of £271.1 million at outturn prices (£244.7 million January 1992 prices) being the summation of the debt and our own equity. The BAA Board has so far approved a total of £35.9 million at outturn, the latest approval being in July 1993 (BAA/80/93). Approval of the remaining £235.2 million of expenditure is sought.
5. The existing approvals provided sufficient expenditure for construction to proceed until the end of November 1993. It was agreed that at that time approval to proceed with the full scheme should be given only if the Board was satisfied that the powers to "ring fence" the Heathrow Express promised by the Secretary of State had been incorporated in the final version of the Railways Bill.

THE RAILWAYS BILL

6. This received Royal Assent on 4 November. Both BRB and we are satisfied that the Bill contains all the powers required by the Secretary of State to enable him to grant the agreed exemptions to the Heathrow Express.

7. The procedures he must follow mean that these will not finally be put in place until February next year, but no further parliamentary approval is required.
8. There is no reason to believe that the Secretary of State will not grant these exemptions and I recommend that the project continues on that basis. I will report progress to the Board every six months.

CAPITALISED HEAD OFFICE COSTS

9. Corporate Finance have advised that the Corporate costs of Heathrow Express should be capitalised in the project at a total of £3 million. These costs were originally classed as BAA corporate overheads and as such included in the cost of capital.

PHASING OF COSTS

10. The phasing of the project costs and the Heathrow Express head office costs is as follows at outturn prices:-

COSTS AT OUTTURN	PROJECT COSTS	HEAD OFFICE COSTS
Pre 1993	21.4m	
1993/94	22.2m	0.3m
1994/95	59.1m	0.7m
1995/96	86.5m	0.7m
1996/97	67.8m	0.8m
1997/98	10.8m	0.5m
1998/99	3.3m	
TOTALS	271.1M	3.0M
BRB Equity	14.6M	
TOTAL PROJECT COST	285.7M	

PROJECT COSTS

11. The Joint Venture requires BAA to provide its part of the project, namely the branch line to Heathrow and the rolling stock for a sum of £223.2 million at outturn (£202.6 million at January 1992 prices). Current estimates indicate a possible overspend of £15 million but we are taking the necessary action to get back to the approved cost level.

FINANCIAL APPRAISAL

12. The rate of return to BAA is 10.1% based on the current opening date, December 1997, and the current rules for calculating rates of return. This still gives a Net Present Cost of £41.1 million, but as described in BAA 19/93 (March 1993), taking into account the total Heathrow development before Terminal 5 there will be a return in excess of BAA's 13.25% hurdle rate.

QUESTIONS FOR THE MANAGEMENT COMMITTEE

13. Does the Committee approve the remaining £235.2 million to complete the Heathrow Express for a total cost of £285.7 million with £14.6 million of this latter figure having been provided by BRB?
14. Does the Committee approve the capitalisation of £3 million of Heathrow Express head office costs?
15. Does the Committee agree that this paper should be submitted to the Board?

extract. Management Committee - 16.11.93 (1 of 3).

396/93

Heathrow Express : Approval of Remaining Funds

ACTION

Chris Barlow reported that the Railways Bill had received Royal Assent on 4 November and contained all the powers required by the Secretary of State to grant the licensing and regulation exemptions required for the Heathrow Express service. Expenditure of £12.64m had already been authorised and approval was now sought for the remaining £235.2m.

IT WAS AGREED THAT the proposal to commit the remaining £235.2m to complete the Heathrow Express project be submitted to the Board for approval **AND THAT** the estimated £3m head office costs should be capitalised.

Michael
Maine/
Chris
Barlow

At this point Chris Barlow left the meeting.

397/93

Date of Next Meeting

Tuesday 16 November 1993
Board Room
Corporate Office
130 Wilton Road, London SW1
1415 hours

The meeting ended at 1805 hours.