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From the General Manager Rail

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Mr J Clyne
Head of Financial Economics
Office of Rail Regulation
1 Waterhouse Square
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Dear Mr Clyne

POLICY FRAMEWORK FOR INVESTMENTS: AN INITIAL CONSULTATION

Background

This response to the above document is on behalf of BAA plc (BAA) the worlds leading airport company and its wholly owned subsidiaries. BAA owns and operates seven UK airports including Heathrow, Gatwick and Stansted. These airports form essential international gateway infrastructure supporting the UK economy. As international gateways they clearly need to be connected to the national rail network.

Appropriate rail access to our Airports is essential if they are to develop as required by the December 2003 White Paper 'The Future of Air Transport' (CM.6046) (referred to ATWP).

The ATWP requires BAA as developers of Airport capacity to pay the costs of upgrading or enhancing road, rail or other transport networks or services where these are needed to cope with additional passengers travelling to and from expanded or growing airports. The ATWP also states that where a scheme has a wider range of beneficiaries, the Government, along with devolved administrators, will consider the need for additional public funding through their investment programmes on a case-by-case basis.

BAA have already invested large sums of money in connecting our Airports to the network particularly at Heathrow where we constructed, funded and now operate the Heathrow Express service. We are currently looking at a number of other potential rail investments to support planned airport capacity expansion at airports such as Stansted.

At our major London Airports these rail investments are funded by adding them to our Regulated Asset Base providing it can be demonstrated clearly that the investment is for the benefit of the airport users. These investments decisions are carefully scrutinised by the Airline community.

We have recently signed a 5 year Framework Development Agreement with Network Rail to cover our involvement with them on a number of schemes. We are also about to agree an Implementation Agreement to cover the work necessary to extend the Heathrow Express service to Terminal 5 at Heathrow. If as a result of this ORR consultation, there is a change to the approach NR are required to take to third party funded enhancements we have an agreement with NR that our recently agreed Framework Development Agreement will be reviewed.

We continue to have a general concern about the extremely complex and uncertain nature of investing in connecting to the railway. When we received consent for T5 the Secretary of State made it a condition that the Heathrow Express operated to T5 on the day of opening. To achieve this we need to ensure that key milestones are achieved, this type of issue seems to be very difficult to contractualise and the programme risk appears to remain with BAA.

We work very closely with Network Rail on projects and in our opinion they are genuinely trying to improve how they work with third party investors such as BAA. However there are still a number of major challenges , such as reducing the cost of integrating new works into the existing railway and it is against this background we have responded to this consultation document.

General Comments

We welcome this consultation document and would be happy to discuss our views further and for our response to be made public. In this response we have commented on the issues that are particularly relevant to our interests rather than those which may have a wide rail industry perspective. We have used the paragraph numbers used in your document for ease of reference.

Introduction

- 1.2 We consider it is sensible to have a process to consider large capital expenditure projects that were not contemplated at the time of the periodic review.
- 1.5 It is our view that the nature of regulation should be that the market decides where to invest. We are not convinced that NRs wider industry ‘planning role’ is consistent with this principle. In the Aviation industry BAA is not responsible for the Airline Industry, this is the responsibility of the Civil Aviation Authority.
- 1.9 We find it helpful that the ORR is proposing to set out its role with respect to NR’s obligations.

Network Rail’s Role in Investments

- 2.4 We agree that NR should be expected to deliver schemes efficiently and in line with agreed timescales. This is a key issue for BAA where connection to the railway is a planning condition by a Local Authority or Government in respect of additional capacity we have developed and wish to bring into use. Although we can work very closely with NR to integrate the programmes for rail and airport works at the end of

the day we do need a framework where NR are fully incentivised to perform their obligations on time.

- 2.10 We are not sure why the Government has to be involved in deciding whether an investment scheme can be ‘logged up’.
- 2.12 We welcome the plans to enable NR to take forward minor discretionary investment schemes of up to £50m per annum. We would like to understand more on how NR will decide which schemes are implemented.
- 2.19 We remain concerned that the ORR does not expect NR to bear all the liabilities relating to the accuracy of information it provides. We feel that we should be able to rely upon the accuracy of the information provided. However we accept there will be circumstances where it is necessary for us to carry out our own surveys or commission NR to collect the information.
- 2.21 We fully support the ORR view that NR should be required to put in place efficient delivery arrangements and to take on those risks which it is in the best position to manage. The real issue is how as a third party investor in the railway, we can judge whether NR are providing efficient delivery arrangements in a reasonable timescale.
- 2.25 We fully support the ORR’s expectation as set out in this clause and confirm we would only expect to pay the incremental direct costs for these Network Operator services.
- 2.48 We agree that NR will be incentivised to deliver schemes at a lower price than agreed with the customer when a price is agreed in advance. The difficulty is how to agree an efficient fixed price, without competition from any other supplier in a timescale that meets our requirements.
- 2.50 We agree that following the Rail Review NR now has a reputational incentive to facilitate and deliver investments. The issue for BAA is, is this incentive sufficient for NR to meet our required delivery milestones or should there be some financial incentive included in the template agreements

The terms on which Network Rail should carry out investments:

- 3.1 We welcome this section of the document and would comment generally that remuneration on investment, like access conditions, should be non-discriminatory in their effect.
- 3.4 We would prefer to work on a target price estimate agreed in advance with a pain/gain share mechanism which shares both downside and upside risks between stakeholders. However, we are not sure that NR is sufficiently motivated by such arrangements given that they are a not for profit organisation. Where there is insufficient time to agree a target in advance we are willing to work on our emerging cost basis providing sufficient transparency or costs can be provided.
- 3.6 We fully support the ORR principles on risk allocation.

- 3.7 We welcome the proposal to introduce a default allocation of key risks.
- 3.8 Network Operations risks i.e. those due to the provision of network operations services are the most difficult for an organisation such as BAA to manage and therefore we conclude that these risks should in all but exceptional circumstances be borne by NR.
- 3.13 We agree that the Demand Risk should in most circumstances be taken by the customer funder.
- 3.15 We agree with ORR's proposal in this clause.
- 3.18 We support a single rate of return for all capital expenditure and therefore we agree with ORR's expectations.
- 3.21 We do not agree that the maximum contingency should be directly linked in any way to the cost of the scheme. We do not understand why a more expensive scheme should have a higher contingency risk. The CAA only allowed BAA 15% of the £4.2bn. T5 project which was a very complex project. We would expect NR to be able to work to similar levels of contingency.
- 3.23 We consider the maximum contingency should be 15 % but this does depend on how the scheme has been estimated and the proposed contractual relationship for the supply chain.
- 3.38 We fully support the OOR suggestion that for major schemes the ORR should review the efficiency of arrangements in advance (ex ante).
- 3.47 We would support the suggestion that Government should be allowed to add requested expenditure to the RAB.
- 3.51 We agree that risks should be allocated to the party best able to manage them and that it is important risk aversion does not hold up projects. We agree with NR that most liabilities should be capped (for both customers and NR) and that establishment of the two funds is a possible way forward. We are concerned that applying a NR fee could provide a perverse form of incentive to charge higher costs. Where an experienced investor/funder as worked with NR to implement a proper risk mitigation strategy they should see some financial gain from a lower fee.
- 3.55/ 3.57 We would like further information on the Industry Risk Fund and what are the low probability high impact industry risks. We are unclear as to whether 2% is the correct level and to what extent NR is already funded to cover some of these risks. We are concerned that setting a standard fee will penalise those investors who ensure that their scheme is well managed and carried out with proper risk mitigation. We would expect NR like all other companies to bear the risks that result from changes in law and Government regulations. If it is proposed that they are protected from this type of risk we assume that this is reflected in the cost of capital.
- 3.62 We agree that the level of liability caps for both customers and NR contained within the templates should be examined further by ORR to establish an appropriate level.

Should you wish to discuss the content of this submission please do not hesitate to contact us.

Yours sincerely

M A Noakes
General Manager Rail Projects