The Risks and Financing of the Mersey Gateway Bridge

by Chris Castles and David Parish

A report for the North-West Transport Roundtable and Campaign for Better Transport

Campaign for Better Transport

Transport Activists' Roundtable
North West

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Foreward

Stephen Joseph, Chief Executive of Campaign for Better Transport

A new Mersey Gateway Bridge has been promoted by Halton Borough Council as a privately financed project part-financed by tolls. The project has received high level political support, with a specific mention by the Chancellor in his speech announcing the Comprehensive Spending Review in October 2010. The Department for Transport has placed it in a list of projects to be supported, and a final decision to grant PFI credits and funding is due shortly. While rejecting general road pricing, ministers have raised the possibility of more toll road schemes (for example on the A14 in Cambridgeshire and the Kingskerswell bypass in South Devon) so this project could be seen as a pathfinder for others.

Campaign for Better Transport and the regional group North West Transport Roundtable asked consultants experienced in private finance projects to look at the Mersey Gateway project to see what the risks were. We think their findings ought to concern anyone interested in safeguarding value for public money. The consultants point out the risk that traffic and therefore income may fall short of forecasts and that bidders will try to transfer this risk to the council and the Government. The risk of shortfall is stronger because Halton Borough Council has proposed discounts for local residents, yet their data shows that 90% of traffic on the bridge is expected to be local. The Council has also suggested that tolls should be comparable with the Mersey Tunnels; this again will impact on traffic and income.

As a result, the consultants say that it is unlikely that toll income will cover the cost of the bridge, especially since the cost of private finance is now much higher since the banking crisis. They highlight the danger that these risks will be glossed over if, as happened with the M25 widening private finance deal, the process is driven by advisers keen to get a deal agreed, and they recommend an independent “due diligence” review once bids for the concession have been received and before any final agreement is reached.

This has implications away from Merseyside. If the Government is successful in getting more toll roads up and running, these issues of risk, financing and tolls will be raised everywhere. The record is not encouraging – this report draws on the National Audit Office’s criticism of the M25 widening PFI scheme, while our own research on the M6 Toll published last year [footnote] showed that it had worsened rather than solved local traffic problems and had lost money. We hope the Government will look at these issues before encouraging more such schemes. There is good evidence that other local transport investment offers better value for money in terms of dealing with transport problems, and we would like the Government to follow this evidence rather than encourage the pursuit of risky toll road schemes.

Stephen Joseph
January 2011
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Introduction
We were asked to report on the risks and financing issues associated with the proposed Mersey Gateway Bridge. It has been proposed that the bridge will be constructed and operated under Private Finance Initiative (PFI) arrangements and ultimately paid for by a combination of tolls on the bridge and public funds through PFI credits. A Public Inquiry on the project was completed in July 2009 and the Inspector’s Report, together with the decisions of the Secretaries of State for Transport and for Communities and Local Government, was published on 20 December 2010. As a result, the project now has all the formal approvals necessary in order to proceed. However, there are a number of important further steps before construction can commence. Halton Borough Council (HBC), as promoter of the scheme, will have to select a concessionaire to manage the project and to agree a financing package with the concessionaire and financiers which will enable the work to proceed. It must also agree with the Government the grants and PFI credits to support the project. But most importantly, both HBC and the Government must be convinced that the project constitutes good value for money, based on the terms on which it can be financed.

Private Financing: assessing the risks
There are various financing and management structures under PFI for a project of this sort. Some structures, for example the toll section of the M6 motorway, transfer substantial risk to the private sector. Other structures, for example the sale of a link that has already been constructed, such as the Dartford crossing, transfers little risk and are essentially means of reducing public debt.

In deciding the structure there are six major categories of risk to be considered:-

(a) Construction and maintenance costs
(b) Length of construction period
(c) Length of concession period
(d) Traffic forecasts
(e) Tolls
(f) Financing

At one extreme, government could put forward a proposed scheme for tolls and invite bids against the toll structure to build and operate the bridge. But this is not the approach that has been adopted and such a model is anyway unlikely to be successful in current conditions in financial markets. The challenge for HBC will now be to ensure, in this climate of tightened availability of debt finance, that in designing the competitive process and negotiating the concession agreement they achieve an appropriate level of risk transfer to the private sector and do not pay excessively high rates for debt and equity finance. Both Government and HBC should be prepared to walk away from any deal that does not achieve these objectives.

Construction and maintenance costs and the duration of the construction process are the key areas of risk that the PFI should aim to transfer to the private sector. This is consistent with the approach of the Highways Agency which adopted a target to use private finance for 25 per cent of its road programme. It identified that projects likely to deliver savings were ones that include a large element of capital expenditure, spread over an extended period, and in which the relatively high costs of tendering are proportional to the value of the contract. The Mersey Gateway Bridge project would meet all these criteria. The length of the concession period is likely to be thirty years from the start of construction of the bridge. Longer concession periods give longer for the concessionaire to recover costs and hence should lead to lower tolls. But financing is unlikely to be available beyond a term of thirty years and this is typically the maximum length of PFI highway projects.

Tolls: setting the levels and local discounts
The Mersey Gateway Bridge (MGB) is an estuarial crossing and as such is suitable for tolls. It is planned to fund the construction and operating costs mainly through tolls on both the new bridge and, on the assumption that HBC will be a party to the concession arrangements, also on the existing Silver Jubilee...
Bridge (SJB) In addition, some funding support will be provided from Government in the form of a grant plus PFI credits. Reliance on toll revenue introduces an additional source of risk compared with the outsourcing of a road construction and maintenance project. The traffic demand over the two crossings and the level of the tolls charged will be the key determinants of toll revenue and hence the viability of the scheme could depend on the reliability of the traffic and revenue forecasts. These were questioned at the inquiry by expert witnesses, but the Inspector seems to have been satisfied that HBC had adequately established the commercial case for the project.

The availability of alternative routes via the M6, Warrington or the Mersey Tunnels and the level of tolls charged for the Mersey Tunnels will provide some market constraint on the level of tolls on the MGB and SJB. Nevertheless, the extent of risks carried by the private sector operator will depend on the extent of freedom given to the operator to set the level of tolls on MGB and SJB. Here there may well be local constraints: Halton BC have indicated that the level of tolls ‘are likely to be similar to the cost of travelling through the Mersey Tunnels (currently £1.40 for a car)’. The Mersey Crossing Group have also recommended that there should be ‘substantial discounts for local cars and light vehicles and a frequent user discount for HGVs’. However, it is not clear that these are firm commitments that will be written into the concession contract. HBC faces a difficult conflict of interest here in that the harder it presses for discount arrangements in the concession agreement the more difficult it will be to raise finance for the project. The concessionaire will probably press for HBC and Government to underwrite the costs of any discount scheme. But the risks for HBC would be high. Government is unlikely to wish to make an open-ended commitment to finance local discounts which would run contrary to its policy decision to fund most of the scheme costs through tolls.

The design of the process for the competition for the concession giving the right to construct and operate the MGB, and the process of negotiating the details and the financing for the scheme, will be critical in determining the extent of risk taken on by the private sector. It may be reasonable to place limits on those risks that the private sector cannot control, such as changes in the overall level of regional transport demand. However, it is important that the private sector is not allowed, during the bidding and negotiation process, to shift the risks of cost and time overruns during construction, or of maintenance and operating costs failures, back to the public sector or to users by seeking to recoup such costs overruns through increases in the level of tolls or public sector financial support.

The report by KPMG on the financing of the MGB, in which some of these issues may have been addressed, has not been placed in the public domain, for reasons of commercial confidentiality. The traffic report prepared by Mott MacDonald does not present sensitivity tests to different levels of tolls for the level of traffic and revenue on the crossings, which would have informed some of these issues. The traffic report does, however, indicate that the proportion of traffic generated within the local area is quite high. According to the Mott MacDonald report, almost 90% of the traffic on the route originates in Widnes, Runcorn, Warrington, Liverpool, Birkenhead, South Knowsley, Ellesmere Port, Wirral, Wales, St Helens and South Lancashire which places a question over the financial implications and viability of introducing the recommended discounts on tolls for local and regular users. The Government would be well advised to probe HBC deeply on this issue, and particularly on whether the Council is prepared to forego discounts for local users in order to ensure that finance can be raised on satisfactory terms.

A major issue for both sides is how HBC, Government and the concessionaire will behave and be impacted if traffic falls consistently below forecast. For example, HBC or Government could guarantee a minimum level of income regardless of traffic levels or offer commitments about tolls on alternative routes, but this will come at a price. HBC and Government will have to decide if they are so keen on getting this project built that they are prepared to guarantee minimum project revenues however accurate
the traffic forecasts. This is an important area of risk and one which HBC and Government should aim to transfer to the private sector.

**Financing the Bridge – the key issues**

Financing for a PFI is always uncertain until financial closure. There were considerable difficulties in concluding several PFI projects during the financial crisis which precipitated the collapse of Lehman Brothers in 2008. Special measures were put in place to support projects through public funding and the terms on which PFI deals are concluded are now less favourable than they were in 2007. The consequential increase in the costs of private finance raise questions over the viability and value for money of this approach. It is against this background that we have carried out our review of the financing issues surrounding the MGB project. We have reached four key conclusions:-

(a) The disclosure of commercial information about the project during the planning enquiry was inadequate and more information could have been put in the public domain without endangering commercial confidentiality.

(b) The interest margins which financiers now demand on PFI projects are higher than they were in the past and likely to stay at elevated levels. Against this background the case for using PFI as a project finance mechanism is weakened and an independent review of the value for money case for using PFI finance for the project should be carried out.

(c) The viability of the project with tolls set at a similar level to those on the Mersey Tunnels is questionable without the benefit of enhanced PFI credits.

(d) Halton Borough Council, as the project promoter, and Government as a major source of funding face difficult decisions in negotiations with potential concessionaires and financiers and still have the option to withdraw from the project if they cannot achieve an adequate level of risk transfer to the private sector to justify what are likely to be high interest margins.

**Disclosure of Commercial Information**

A Public Inquiry serves both formal and informal objectives. At the formal level it is the procedure through which the project promoter makes the case for the project and objectors make the case against it. It leads to a report by the independent Inspector with recommendations and eventually decisions by ministers. But a Public Inquiry also serves the purpose of promoting a wider public debate, through the press, councils, community groups and other interested parties to satisfy the public that the proposal is justified and that all necessary measures are taken in its proper implementation. These groups may not choose to formally participate in the Public Inquiry but their opinions are informed and developed by the Inquiry process. Bearing in mind that the local authority is the project promoter, we would expect them to wish to put as much information as possible into the public domain so as to encourage this debate to demonstrate that it has performed its duties effectively.

In the case of the MGB, Halton Borough Council decided to keep private the advice it was receiving from KPMG, the firm of accountants which it has appointed as its financial adviser. The Inspector was satisfied with this decision and we can also understand the desirability of keeping the Council’s negotiating position and market expectations confidential in the run up to an invitation to tender for potential concessionaires and financiers.

However, under current circumstances, where the conditions for PFI funding have changed materially in the last two years, and hence the benefits of a PFI scheme for the MGB are uncertain, there is a strong public interest in exposing some of the key issues to public scrutiny and debate. In particular, the public and the Government need to be assured that the relevant risks will be wholly transferred to the private sector in order to justify the higher costs of financing the project under PFI arrangements. For instance, the public should be made aware of the impact on the level of tolls of the increased costs of financing the scheme under PFI, particularly the increased cost of debt finance in recent years. It would, for instance, have been possible to include in the traffic report prepared by Mott MacDonald an analysis of the sensitivity of the level of traffic and revenue to different levels of tolls and the impact on toll revenue of different traffic growth scenarios.
There was some discussion of the impact of high and low tolls at the Public Inquiry but the level of tolls were not specified and the discussion focussed on the impact on traffic flows rather than revenues. The discussion could and should have been better informed by the information published in the Mott MacDonald report. However what was indicated from the evidence presented by Mr Pauling on behalf of HBC was that the benefits from the scheme are very sensitive to the level of the tolls. At ‘high’ toll levels (undefined) the net benefits turn strongly negative. This indicates that there is little scope for raising tolls higher than has been assumed in the analysis and therefore little headroom for risk that traffic levels may not develop as forecast.

A proper analysis would provide useful insights into potential demand side risks for the project financing. It would enable the potential impact on the level of tolls to be paid by users, or on the level of public sector financial support that may be needed, if traffic fails to develop as forecast or on changes in the cost of financing the project through PFI or other means. Whether or not this information is made public, both HBC and the Government should ensure that they fully consider these issues in deciding whether to proceed with the scheme.

**Future Use of PFI Financing for Road Schemes**

Two recent reports from the National Audit Office have looked at the use of PFI to finance road schemes. The first on “Financing PFI projects in the credit crisis and the Treasury’s response” was published in July 2010 and included a number of examples of PFI projects from different sectors as examples. The most relevant in the present context is the contract for the widening and maintenance of the M25 which was signed with a consortium led by Balfour Beatty and Skanska in July 2009. The second report on “Procurement of the M25 private finance contract” was published in November 2010 and examined this contract in more detail and in particular looked at procurement arrangements by the Highways Agency. The challenges faced by PFI projects from spring 2008 onwards, and in particular following the collapse of Lehman Brothers, fell into two categories. The first is the availability of credit and the second is the cost, ie the interest rate. The Department for Transport put in place special measures to ensure that the M25 contract could be financed, but in the event these measures were not needed and finance was obtained through markets. However, the interest rate paid was substantially higher than in previous deals. Up to the spring of 2007, the interest margin (ie the margin that borrowers have to pay over the rate of interest on long term gilt edged securities) for large high to medium risk PFI deals was 1% – 1.15%. In the case of the M25 deal, which the NAO assessed as medium risk, the expectation at the preferred bidder stage of the process was that the interest margin would be 0.75% - 0.85%. In the event the interest margin was 2.5% – 3.5% at contract letting.

The Highways Agency went ahead with the deal despite the much higher costs of finance. There were detailed contract negotiations and one of the measures put in place was an agreement that the interest rate would be reduced if the cost of borrowing could be renegotiated to a lower rate of interest in the future. This refinancing is common practice in PFI deals since risks are often reduced substantially once the construction phase is complete when borrowings can be refinanced on better terms. There are arrangements to share the benefit of refinancing debt between the PFI contractor and the project promoter. In the case of the M25 deal, the terms were set to give the Highways Agency the majority of the benefit of any renegotiation. However, the NAO expresses pessimism about the likelihood of significant cost reductions through this route, stating that “There is no certainty that refinancing will take
place, but if it does, we estimate it may allow the Agency to recover potentially around £100 million through its refinancing gain share. This is lower than the Agency’s estimate of £200 million."

The NAO report does not speculate directly on the likely future level of interest margins. But the pessimism about costs being reduced significantly by this route is suggestive that they believe interest margins will remain high in the future. We share their pessimism. Interest margins are highly unlikely to return to their pre-crisis levels in the foreseeable future.

The Bank of England has provided some £185 billion in emergency loans to UK banks and building societies through its Special Liquidity Scheme which are due for repayment by January 2012. The Bank has already said the loans will not be rolled over or replaced. In addition the Bank of England has provided £200 billion of funds to credit markets through quantitative easing, achieved largely through purchases of gilt edged securities. Depending on the course of inflation and money supply, the Bank may in due course wish to withdraw this credit as the economy recovers and monetary policy is put on a more normal footing. The new Basle agreements are also forcing banks to hold more equity and tier one capital relative to their loan books. The UK’s Banking Commission may well go further in its recommendations for restructuring the banking sector and may press for banks to raise capital over and above that required to meet the Basle rules. The Swiss authorities are already following a similar course of action. This reflects the particular risks faced in economies such as Switzerland and the UK which have large banking sectors relative to the size of their economy.

The implications of these measures for banks are clear. Banks will wish to reduce the size of their balance sheets and will seek higher margins on loans in order to maintain the profitability of their businesses. While there are other potential sources of funds for PFI projects, such as the sale of bonds to pension funds and insurance companies, the scale of the banking sector’s involvement is huge and is bound to have a large impact on the availability of funds in future. The margin on PFI loans is therefore likely to remain at elevated levels compared to past experience.

The implications of this for value for money from PFI projects are clear. The conclusion is spelt out in detail in the NAO report: “Departments initially seek assurance on the value for money of PFI procurement by comparing alternative ways of providing the same results. Although we have often expressed concern about these calculations, the typical estimate of the PFI cost advantage lay in the range of 5 to 10 per cent (and some cases we have audited showed smaller savings). We estimate that financing rate changes increased the annual contract charge by around 6 to 7 per cent. This finding suggests an increased risk to value for money resulting from the credit crisis.”

Our expectation would be that the Highways Agency and other PFI project promoters will re-evaluate their commitment to PFI in the light of these developments and the NAO report. PFI evaluations have always depended on weighing a risk of higher costs through traditional public sector procurement against the certainty of higher interest rates through PFI deals. If PFI rates will be higher in the future then the potential benefits will have to be scrutinised more closely. HBC and the Government should therefore carry out an independent evaluation of this scheme under the Value for Money criteria set out for PFI projects before proceeding and the report (or at least a redacted version of it) should be placed in the public domain. This work should be carried out independently from HBC’s financial advisers.
**Project Viability**

We cannot be certain what the costs of financing the Mersey Gateway will be but it seems inevitable that HBC will be faced with interest rates considerably higher than when the proposal to fund the scheme through PFI was conceived. If rates are at the same sort of level as those experienced by the M25 scheme then the level of toll income from the project will not cover the interest costs of loans at the levels of tolls assumed by HBC so far.

The level of projected toll income is included in the Mott MacDonald report and the figures are set out below:-

<table>
<thead>
<tr>
<th>Bridge</th>
<th>Year</th>
<th>Car</th>
<th>LGV</th>
<th>OGV</th>
<th>Bus</th>
<th>Total</th>
<th>Revised Total</th>
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<td>3286</td>
<td>7119</td>
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<td>31479</td>
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<td>4642</td>
<td>9855</td>
<td>0</td>
<td>38128</td>
<td>40797</td>
</tr>
<tr>
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<td>1231</td>
<td>3225</td>
<td>0</td>
<td>7380</td>
<td>7897</td>
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<tr>
<td></td>
<td>2020</td>
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<td>1386</td>
<td>3449</td>
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<tr>
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<td></td>
<td>2030</td>
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<td>1694</td>
<td>3897</td>
<td>0</td>
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<td>9980</td>
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<tr>
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<td>21939</td>
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<td>10344</td>
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<td>36800</td>
<td>39376</td>
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<td></td>
<td>2020</td>
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All the figures apart from the final column are taken direct from the Mott MacDonald report. The final column showing revised toll income estimates have been calculated by us to uprate the toll income in the light of the change in the base tariff on the Mersey Tunnel from £1.30 to £1.40. The toll income is calculated without allowing for the impact of any concessionary scheme for local and regular users.

The results of the traffic forecasts which form the basis for the estimate of toll income appear reasonable to us. They indicate an initial fall in traffic of 21% in the combined traffic on the MGB and SJB crossings due to the introduction of tolls in 2015 when the MGB is opened. The forecasts indicate some diversion of traffic to other crossings with traffic increases of about 2-3% over alternative crossings in 2015. Overall, traffic on all crossings over the River Mersey in the region initially falls by 2.6% in 2015 when the MGB is opened. The forecast rate of growth in combined traffic on the MGB and SJB over the following 15 years to 2030 averages is 1.6% per annum. This compares with a forecast growth rate of 0.6% per annum for total regional traffic across the Mersey. The revenue forecasts are subject to considerably greater uncertainty than the traffic forecasts because of the potentially significant impact of discounts for local and regular users. We have shown that a large proportion of the traffic is local and such traffic is more likely to be regular than long distance trips. A generous discount scheme could therefore reduce revenue significantly.

The forecast toll income can be compared with the likely level of interest payable on PFI loans to support the project. In order to estimate the interest costs it is necessary to make some assumptions about capital structure. We have assumed that the capital cost of £600 million is financed with £90 million of equity and £510 million of loans at an interest rate of 7.9%. The structure and the rate of interest are the same as those applied for the M25 project. The actual rate will depend on market conditions at the time the loan is made. It may be higher or lower than 7.9%. Rates of interest on 30 year term gilts have fallen from 4.64% in May 2009 to 4.28% today. This suggests rates may be somewhat lower now than in 2009. However, there may be additional risks transferred to the private sector, for example on the traffic forecasts and the allocation of revenues from the Silver Jubilee Bridge and this could push up rates. With borrowing of £510 million, the
annual interest bill will be just over £40 million. This is slightly more than the forecast total revenue from tolls in 2015, although this rises over time and would cover the interest costs on the debt after a few years.

However, the costs of the project will be considerably more than the cost of debt and will also include:

(a) The annual cost of maintaining the two bridges and running the tolling scheme.
(b) The repayment of borrowings.
(c) A return on equity for the investors in the scheme. The allowable return on equity for the M25 scheme was 15% per annum. This would imply an expected return of £13.5 million per year on the assumed equity contribution of £90 million for the MGB.

Furthermore, the revenue from tolls available for the concessionnaire may be lower than the total forecast toll income because:

(a) Halton Borough Council may wish to have access to some of the proceeds from tolls on the Silver Jubilee Bridge to cover its own costs.
(b) Reductions in toll revenue due to any concession schemes on toll rates for regular and local users.

For these reasons the revenue from tolls alone will be insufficient to cover the costs of the PFI scheme. This is recognised in the information that has been given to the public which envisages that Government financial support will be available for the scheme in the form of a grant, originally estimated at £86 million, plus PFI credits. It is envisaged that income from tolls will cover over 70% of the costs of the scheme. We estimate that the combined costs of debt and equity financing will be approximately £55 million per annum, and the average toll revenue over the first 15 years is forecast to be £43 million. This would imply that, providing costs of operating and maintaining the scheme were no more than about £6.5 million per year (i.e. just over 1% of capital costs), the total toll revenue on both the MGB and SJB would cover 70% of the total costs of the scheme. However, this does not allow for any discounting tolls for local residents, or any share of the SJB revenue for HCB and leaves little room for potential shortfalls in traffic levels.

These figures are only broad estimates of the financial implications of the PFI scheme. KPMG, as the financial advisers to the project, will have a detailed financial model of the project costs and potential revenues. The Inspector at the Public Inquiry accepted their assurances that the scheme was financeable. We think this conclusion is probably correct although it would require far more analysis to feel absolutely confident and it does not answer the value for money question. However, the analysis shows that interest payments will require a significant part of the toll revenues and the availability of sufficient Government financial support will be critical to a successful conclusion of the negotiations with financiers.

These negotiations are likely to be complex. There are certain key areas of risk which potential concessionaires and financiers are likely to try to push back onto Halton Borough Council. In particular:-

(a) They may seek a structuring of the PFI credits which ensures that the funds are received early in the scheme life so as to limit the level of borrowing. The Department for Transport showed it was open to negotiation in the case of the M25 scheme to ensure that the project was financed successfully and it will probably be equally keen to ensure success for the Mersey Gateway scheme.
(b) They may aim to set tolls at a higher level than the Mersey Tunnel and to have the freedom to adjust tolls to deal with any financial shortfalls that may arise.
(c) They may try to obtain minimum income guarantees from the Council and Government so as to give an effective guarantee on the traffic forecasts.
(d) They will want to limit the scope of any concessionary scheme for the level of tolls.
(e) They will seek a first charge on revenues from the Silver Jubilee Bridge which will prevent HBC applying the proceeds to other uses.
The Decision for Halton Borough Council and the Government

Halton Borough Council now has planning permission for the MGB project. But it still has to make the final commercial decision to proceed with the project. Bearing in mind the momentum generated by the planning process and the active role taken by the Council as the project promoter, there is little doubt that the Council will be keen to reach a deal with potential concessionaires and financiers. The Department for Transport and the Government more generally will also be keen to see the scheme progress in view of the public support which they have offered. Indeed the Chancellor of the Exchequer statement in his spending review that he would “provide funding for a new suspension bridge over the Mersey at Runcorn” could be seen as prejudging the commercial case for the project under PFI.

In this environment there is a risk that both the Council and Government will simply allow advisers to drive the process, with both sides assuming that the other is making an adequate assessment of value for money. The NAO report on the M25 project states that the process was driven by advisers to the point where: “Bidders reported surprise at the advisers’ level of control.” The level of technical capability in PFIs in the Highways Agency ought to be greater than in Halton Borough Council and hence the risks of excessive adviser involvement are even greater here. In these circumstances, completion of a deal is often seen as the key mark of success without sufficient concern for the terms of the deal. These concerns are heightened in cases where the financial adviser is working for a success fee, although we have no indication of the terms on which HBC have engaged KPMG. Bidders often exploit this wish for completion by pushing for concessions in the conditions during negotiations that undermine the original justification of the use of private finance.

It is important therefore to recognise that there will be a vital role for the Department for Transport and HBC to perform in this process in order to safeguard the public interest. Advisers can identify the best terms on which the project can be financed and assess the balance between risks and interest costs. But the final decision has to be about whether the extra costs of PFI are justifiable in view of the benefits from private sector involvement. There has to be some level of interest rates at which the decision to proceed is inappropriate on commercial grounds. And both the Government and HBC must ensure that the appropriate risks lie with the private sector and are not negotiated away. If the Council or the Government has to take back project risks, for example over the use of funds from the Silver Jubilee Bridge or the traffic forecasts, then the case for PFI becomes even weaker.

The NAO has rightly drawn attention to the risks of an adviser driven process in its report on the M25 PFI and we consider that the risks of a similar adviser driven process are even greater here. The involvement of HBC and central government creates a situation in which both sides may believe the other is making the necessary value for money assessment. The number of project risks that could leak back from the private sector to the public sector is considerable. Both HBC and Government are very keen to have a deal. Costs of finance may well be higher than at the appraisal stage. We therefore recommend that an independent structure should be put in place which ensures, on behalf of both Government and HBC, that the project offers value for money on the final agreed terms.

Specifically, we propose that there should be a due diligence at the conclusion of negotiations for the project to evaluate whether the scheme should go ahead. The due diligence needs to be independent of the negotiating teams and involve both central government and HBC. There will be very little time so the arrangements have to be set up in advance so that when the deal paperwork is ready to be signed, KPMG have a data room in place and the Government and HBC have an evaluation team in place who can go into the data room, under usual commercial confidentiality rules for such exercises, and answer the question: “Does the project structure, contract terms and financing terms as negotiated meet the value for money expectations that were in place at the time of appraisal?”

The time frame for this exercise will inevitably be short so the structuring of the evaluation needs to be put in place now and KPMG need to know what is expected both in terms of paperwork and access to key personnel. The review will be led by an official with knowledge of PFI and value for money in transport projects, probably from DfT, and will be supported by such analysts as he believes he needs
to support him. His career will not depend on the project going ahead. He will be expected to give an honest conclusion. The team will have reviewed the “at appraisal” paperwork before this due diligence review commences. Once this evaluation is complete the Government and HBC can take a final decision on whether to proceed. But both sides should retain the right to walk away if the scheme does not offer value for money.

Chris Castles

David Parish

London, 9 January 2011

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