House of Commons
Committee of Public Accounts

Channel Tunnel Rail Link

Thirty–eighth Report of Session 2005–06

Report, together with formal minutes and oral evidence

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The Committee of Public Accounts

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Diana R Johnson MP (*Labour, Hull North*)

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Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Emma Sawyer (Committee Assistant), Ronnie Jefferson (Secretary), and Luke Robinson (Media Officer).

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Summary

In 1996, the Department for Transport (the Department) awarded a contract to London & Continental Railways Limited (LCR), a private sector consortium, to build the Channel Tunnel Rail Link (the Link), a high speed railway linking St Pancras Station, London, to the Channel Tunnel, and to run the British arm of the Eurostar international train service (Eurostar UK).

Construction of the Link was to have been funded partly by government grants and by LCR borrowing money, secured on future revenue from Eurostar UK. By the end of 1997, Eurostar UK revenues were well below LCR's forecasts. Consequently, LCR abandoned its plans to borrow money and approached the Department for an increase in the government grants.

In 1998, the Department and LCR agreed to restructure the deal. Construction of the Link was split into two sections and Railtrack Group joined the project taking management control of construction and agreeing to purchase Section 1 once it was complete. Although direct government grants were not increased, the Department agreed to guarantee most of the money LCR would borrow to fund construction. The Department also agreed to lend money directly to LCR if it, as forecast, ran out of cash several years after completion of the Link (the Access Charge loan).

Even though the economic justification of the project remained marginal, the Department decided to allow LCR to go ahead with the construction of Section 2. Railtrack Group subsequently withdrew from the project following Railtrack plc's entry into administration. The deal was restructured for a second time with LCR backed by the Department, Bechtel and a group of insurers sharing construction risk for Section 2. LCR paid Bechtel and the insurers £87 million to bear £315 million of the first £600 million of any cost construction overrun.

Section 1 of the Link was completed in 2003 on schedule and within budget. Revenues from Eurostar UK have increased but remain below forecasts and it is likely that the Department will have to lend more than the currently estimated £260 million to LCR to cover future cash shortfalls. The Department and LCR expect that Section 2 will open in 2007, but that costs will exceed budget, mainly due to higher than expected construction inflation and changes to the works.

In 2001, the Committee examined and reported on the 1998 restructuring. On the basis of a further Report by the Comptroller and Auditor General, we took evidence from the Department and LCR on progress of the project, in particular: the forecasting of future Eurostar passenger numbers and revenues; the decision to go ahead with the construction of Section 2 of the Link; and the continuing exposure of the taxpayer to the risks inherent in this project.

Conclusions and recommendations

1. **In bidding for the project in 1996, LCR forecast that passenger numbers using Eurostar would reach 21.4 million in 2004 but actual passenger numbers for 2004 were only 7.3 million.** Where future income from passengers is expected to provide a major element of the revenue needed to repay the cost of constructing transport infrastructure, it is crucial that realistic forecasts are prepared from the start. Downside risks need to be given due weight, drawing on both UK and international experience, in considering future projects.

2. **The economic case for the Link remains marginal. On passenger traffic alone the Link is not justified, so regeneration benefits are required to make the project value for money.** The Department's assessment of regeneration benefits of the Link should be rigorous, and should separate out clearly those attributable to other major infrastructure projects close to the Link, including in due course the impact of the 2012 Olympics.

3. **The initial aim was to transfer a high level of commercial risk to a private sector consortium, which did not however have the financial strength or equity capital to sustain that risk if things went wrong.** As risks materialised, the Department had to provide more and more support, while trying to ensure that private sector disciplines were maintained. In considering such major projects in future, Departments need to satisfy themselves that there is reasonable consistency between the degree of risk transfer and the extent of investors' equity stake in the project.

4. **The Department thought the Cost Overrun Protection Programme, though expensive, was a way of maintaining private sector disciplines without extra direct support from the taxpayer.** After Railtrack Group withdrew from the project in 2001, the arrangements made by the Department and LCR included placing layers of cost overrun risk with commercial insurers, as well as the project managers. The value for money of such complex arrangements is difficult to judge, and there would have been less need for them if the private sector had, from the outset, the necessary financial strength to carry the risk allocated to it.

5. **There remains uncertainty over the future call on the taxpayer.** Even though the major construction risks have passed, under the terms of the restructured deal the taxpayer remains exposed to the financial consequences of Eurostar under-performing against forecast passenger volumes. The Department should actively manage the size and timing of LCR's call on the Access Charge Loan facility, so as not to weaken the incentive for LCR and Eurostar to maximise passenger revenues. Any future changes to the structure or ownership of LCR will need to protect the interests of the taxpayer.

6. **High levels of inflation on construction projects which drove up the costs of Section 2 of the Link will continue to be a problem for the South East.** There are a number of further major infrastructure projects planned, for example, the Olympics, widening of the M25, Thameslink 2000 and the Thames Gateway, creating substantial additional demand for limited resources. The Treasury and Office of Government Commerce, together with public bodies planning major projects,

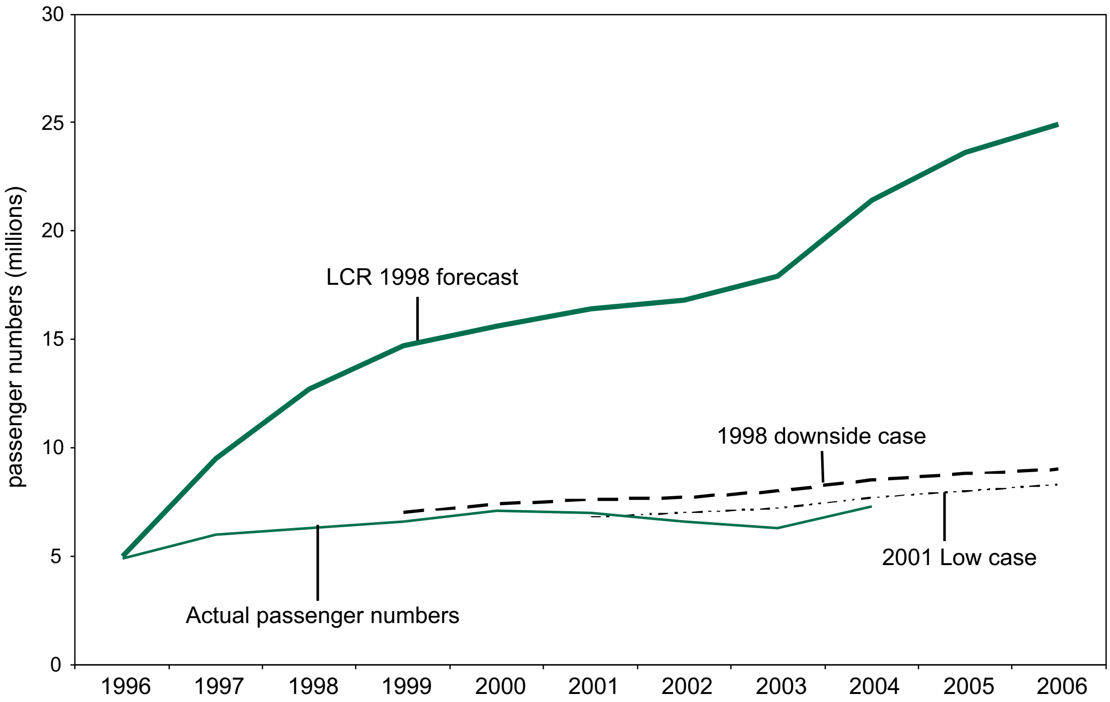
should aim to schedule the construction phases of such projects so as to manage the risks to cost, time and quality from any unplanned surge in demand.

1 Forecasting of passenger traffic

1. The original deal envisaged that LCR would draw on revenue from Eurostar to service the private debt raised and to provide a return for its shareholders. LCR's business plan therefore depended on whether revenue from passengers using the Eurostar service would meet or exceed forecasts made by the company. If passenger revenues fell below expectations, the Department might have to lend more money to LCR to keep it afloat.[1]

2. Estimates of passenger numbers have been progressively reduced. In bidding for the deal in 1996, LCR forecast that passenger numbers would reach 21.4 million by 2004 but actual numbers reached only 7. 3 million **(Figure 1)**. In 2004, passenger numbers and revenues were revised downwards and the central case numbers are now below the 1998 and 2001 low case forecasts. The Department does not, however, expect the impact on the cost/benefit analysis to be as negative as it might have been because the effect of lower patronage has been offset by a reduction in LCR's cost of capital and a reduction in market interest rates.[2]

Figure 1: Estimates of passenger numbers have been progressively reduced



Source: C&AG's Reports (HC 302 of Session 2000–01, Figure 6 and HC 77 of Session 2005–06, Figure 8)

3. Over optimistic forecasts of Eurostar's passenger numbers and revenues were produced when the project was first planned by British Rail and SNCF. Inaccurate forecasts were also produced ahead of the restructuring of the project in 1998 and, in 2001 and 2004, by the Department's advisers, Booz Allen Hamilton Ltd. The Department is nevertheless

1 22nd Report from the Committee of Public Accounts, *The Channel Tunnel Rail Link* (HC 630, Session 2001–02) para 2

2 C&AG's Report, para 15

employing Booz Allen Hamilton Ltd again to forecast passenger traffic. The Department was unable to say whether a competition had been held to see if anyone else could have made more realistic forecasts. Nevertheless, the Department said it was satisfied that Booz Allen Hamilton Ltd had done the best professional job it could do at particular points in time.[3]

4. The Department is currently preparing a new forecast of when LCR may need to draw on the access loan charge arrangements, as it is likely that Eurostar revenues will be revised downwards. Although past forecasts have accurately reflected the increase in revenues following the opening of Section 1 of the Link, what were not taken into account were potential downside risks such as the events of September 2001 and the outbreak of foot and mouth in 2002. The Department and LCR consider that passenger numbers have not yet recovered from those events. The London bombings of 2005 added to this list of one off shocks to passenger trends.[4]

5. A further reason for the lower than expected passenger revenues is the success of the low-cost airlines in competing with Eurostar on price, and their much larger range of destinations. These events illustrate the difficulty of accurately forecasting revenues on novel major projects. The Link is moreover the only high speed railway in the country and the first new railway line for a hundred years, so there is no recent national experience with which to compare it.[5]

6. The Department told us that it has now learned from all this experience, and that the next time it considered undertaking a major transport project, it would factor more severe downside assumptions into its business case analysis.[6]

3 Qq 88–90, 92

4 Qq 2, 4, 52–53

5 Qq 47–49

6 Q 49

2 Justification for Section 2 of the Link

7. When the project was restructured in 1998, the Department experienced difficulties in quantifying the regeneration benefits. When the project was restructured again in 2001, in advance of construction works for Section 2, the Department concluded that the then expected international transport benefits alone would exceed costs by a factor of about 1.4:1. Under Booz Allen Hamilton Ltd's low case assessment, however, the benefit cost ratio fell to 0.5:1, **(Figure 2)**. The Department believed that once the benefits of domestic services were included the benefits would exceed the costs. If passenger forecasts were revised downwards again, regeneration benefits would necessarily have to be higher to justify public support for the Link.[7]

Figure 2: Cost-Benefit analysis for Section 2 of the Link

	Mid-case passenger forecast (£ million)	Low-case passenger forecast (£ million)
International transport benefits (increased capacity and journey time saving)	1,527	842
Costs	1,101	1,851
Benefit: Cost ratio (excluding regeneration and domestic transport benefits)	1.39:1	0.45:1

Source: C&AG's Report

8. The justification for public funding of the Link is dependent on wider and unquantifiable benefits, such as regeneration and national prestige. The Department expects regeneration benefits to arise in the Thames Gateway and the areas surrounding the three international stations at St Pancras, Stratford and Ebbsfleet. At these sites, the Department expects the project to create about 100,000 jobs, and some 18,000 homes and a substantial number of retail developments to be built. The Department is not only assessing transport costs and benefits, but now requires all projects to undertake an economic impact report looking at the regeneration consequences for major transport infrastructure projects.[8]

9. The achievement of regeneration benefits at the planned level will be the key indicator of the success of the project. The Department intends to re-visit the costs and benefits of the Link to establish the outturn position and the lessons to be learnt for the handling of other projects. The Department will face a challenge in separating out the genuine regeneration benefits of the Link from those attributable to other major projects such as the Olympics, particularly at Stratford. The work will be easier in the case of the Kings Cross railway lands, which have stood semi-derelict for a long time, and Ebbsfleet because of the considerable improvements in transport links with central London. The Department considers that its new methodology for measuring regeneration benefits, which it will use

7 Qq 10, 16

8 C&AG's Report, para 4.8; Q 10

once the Link is in use from 2007, will be able to distinguish the benefits generated by the Link from other developments close by.[9]

9 C&AG's Report, para 16, Qq 21–22,68–69, 83

3 Potential exposure of the taxpayer

10. Our 2001 Report on the Link concluded that the level of equity capital was insufficient to reflect the high level of commercial risk in this project, which depended on inherently uncertain forecasts of passenger numbers. If a project involves a high degree of commercial risk, then it needs to be financed with a commensurately high level of risk capital relative to bank debt. LCR only had a total of £60 million in equity and was not, therefore, sufficiently capitalised to bear the risk of a £5.8 billion project.[10]

11. The Department considered that direct public financing for the project would weaken the incentives for the private sector to manage construction to time and budget and to maximise the revenue yield from the Eurostar business. Accordingly, as part of the 1998 restructuring of the deal, Railtrack Group contracted to purchase Section 1 after its completion for a price based on the actual cost of construction, and secured an option to purchase Section 2. Following Railtrack plc's entry into railway administration and Railtrack Group's subsequent withdrawal from the project, the Department looked at whether it should itself take all the risk on cost overrun. Although such an option was the least costly over a range of possible outcomes, the Department concluded that it was not a sensible alternative, as the Department could not manage construction risks. The last time the Department had borne construction risk, on the Jubilee Line extension, the project was completed 21 months late and £1.4 billion over budget. The Department therefore sought to layer the risks so that the project managers would be responsible for a significant amount of the initial overrun.[11]

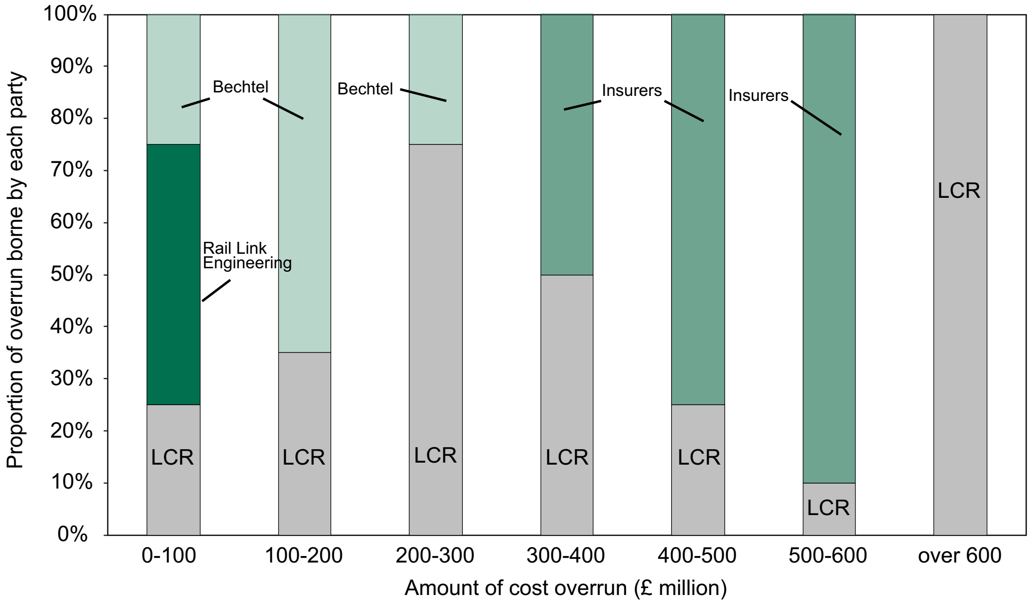
12. The Department, LCR and Bechtel negotiated the Cost Overrun Protection Programme (COPP), which the Department thought at the time was expensive. Bechtel, a key project manager on the Link and a shareholder in LCR, received £60 million for arranging the proposal. It involved carrying a £100 million share of the first £300 million of potential cost overruns, in excess of a target construction cost for Section 2, providing the overruns were not the consequence of inflation greater than a contractually determined and defined cap of 3% per annum. A group of insurers received a £27 million premium for bearing £215 million of potential cost overruns in the range £300 million to £600 million. Overruns arising from inflation greater than 3% a year were to fall on LCR and ultimately on the Department. LCR was to bear the full cost of any overruns above £600 million **(Figure 3)**.[12]

10 22nd Report from the Committee of Public Accounts, *The Channel Tunnel Rail Link* (HC 630, Session 2001–02); Q 104

11 22nd Report from the Committee of Public Accounts, *The Channel Tunnel Rail Link* (HC 630, Session 2001–02) para 5 (xii); Qq 12, 15, 104

12 C&AG's Report, para 3.19; Q 12

Figure 3: The sharing of cost overruns between the parties



Source: C&AG's Report

13. The expected cost of Section 2 of the Link has increased. Bechtel will be called upon to cover only a very small part of this increase in costs because the bulk of the increase is due to railway inflation of over 6%, double that of the contractually determined cap of 3%. Railway inflation has been higher than expected because of a greater demand for limited labour and materials after the Hatfield disaster and for the West Coast main line renewal. These events resulted in higher wages and higher materials costs.[13]

14. The Department was confident that there would be no further sizeable increases in the construction costs of Section 2, as work had reached a point where it was over 80% complete. Remaining costs amount to between £100 million to £200 million, against total expenditure of £3 billion.[14]

15. In 1998 the Department granted LCR an access charge loan facility, capped at £360 million at 1997 prices in present value terms, for it to draw down funds to meet Eurostar UK's obligations to pay track access charges. As a result of construction cost increases, LCR is likely to draw on the access charge loan facility earlier than originally expected. The Department and LCR believe, however, that over the remaining 80 years of the franchise, sufficient revenues will be generated to enable LCR to repay the loan.[15]

16. For the future, the Department considers that there will be substantial inflationary pressures on projects in London and the South East, such as the Olympics, widening of the M25, Thameslink 2000 and Thames Gateway. The Department acknowledged the need to phase major infrastructure projects to reduce supply side pressures.[16]

13 Qq 31–33, 36, 109

14 Qq 36, 39, 72, 109

15 C&AG's Report, para 3.28; Qq 8, 58, 60

16 Q 109

Formal minutes

Monday 27 March 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Greg Clark
Mr Ian Davidson
Helen Goodman
Mr Sadiq Khan
Mr Austin Mitchell
Mr Alan Williams

A draft Report (Channel Tunnel Rail Link), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 16 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

Resolved, That the Report be the Thirty-eighth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 29 March at 3.30 pm.

Witnesses

List of Reports from the Committee of Public Accounts Session 2005–06

Thirtieth Report	Excess Votes (Northern Ireland) 2004–05	HC 917 *(N/A)*
Thirty-first Report	Northern Ireland's Waste Management Strategy	HC 741
Thirty-second Report	Working with the voluntary sector	HC 717
Thirty-third Report	The Royal Parks and the Diana, Princess of Wales Memorial Fountain	HC 644
Thirty-fourth Report	Returning failed asylum applicants	HC 620
Thirty-fifth Report	The refinancing of the Norfolk and Norwich PFI Hospital	HC 694
Thirty-sixth Report	Tackling the complexity of the benefits system	HC 765
Thirty-seventh Report	Inland Revenue Standard Report: New Tax Credits	HC 782
Thirty-eighth Report	Channel Tunnel Rail Link	HC 727

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Monday 28 November 2005

Asterisks in the oral evidence denote that part or all of a document has not been reported, at the request of the Department for Transport and with the agreement of the Committee.

Members present:

Mr Edward Leigh, in the Chair

Greg Clark	Kitty Ussher
Mr Ian Davidson	Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, National Audit Office, was further examined and gave oral evidence.

Ms Paula Diggle, Second Treasury Officer of Accounts, HM Treasury, was further examined.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

PROGRESS ON THE CHANNEL TUNNEL RAIL LINK (HC77)

Memorandum submitted by Department for Transport

Witnesses: **Mr David Rowlands CB,** Permanent Secretary, **Mr Mike Fuhr,** Director of Major Projects, Department for Transport, and **Mr Rob Holden,** Chief Executive, London and Continental Railways, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts, where today we are looking at the Comptroller and Auditor General's Report on Progress on the Channel Tunnel, which examines progress made in the Channel Tunnel Rail Link since the last PAC Report on this in March 2002. We welcome back to David Rowlands, the Department's Permanent Secretary, Mr Michael Fuhr, who is the Director of Major Projects, and Rob Holden who is the Executive Chairman of London and Continental Railways. You are all very welcome. Can I start by asking you, Mr Rowlands, to look at figure 11 on page 27. You will see there that the latest Eurostar revenue forecasts are even below the low case ones for 2001. Is that right?
Mr Rowlands: Yes.

Q2 Chairman: What is the likelihood then, Mr Rowlands, that they will be revised down again?
Mr Rowlands: We are looking at the moment at the revenue forecasts to re-forecast when LCR may need to access the access loan charge arrangements. I think it is too soon to say that they will be revised down again. We will have a clearer view at the end of the year.

Q3 Chairman: You do not know. Mr Holden, can you add anything to that?
Mr Holden: The revenue forecasts are continually being revised. I think you need to look at this project though, in terms of more than the revenue forecasts; it is a combination of issues. Together with other things that have happened since these forecasts were last produced—and the Committee reviewed the situation in 2001—a number of things have happened which have—

Q4 Chairman: You are not answering the question. What is the likelihood of these forecasts being revised down again?
Mr Holden: I think the likelihood is that they would be revised downwards and then reviewed again.

Q5 Chairman: The likelihood is that they will be revised downwards. Thank you, that is fine. Mr Rowlands, can you now please look at page 15 paragraphs 2.5 and 2.7 and please explain to the Committee why the Government, or rather the taxpayer, has underwritten every single pound of debt in this project?
Mr Rowlands: Because financially it was the most efficient way to structure a project that was in the private sector. What we ensured was that we did not underwrite all of the risk associated with the project; much of that remains with both insurers and with Bechtel, as you have seen from the NAO's Report.

Q6 Chairman The taxpayers are over a barrel over this, are we not?
Mr Rowlands: No, we are not over a barrel.

Q7 Chairman: Can you explain why not then?
Mr Rowlands: In the event that this project significantly overruns in terms of cost, for example a 20% cost overrun, the insurance market is out to

the tune of £215 million, and Bechtel is out to the tune of £100 million, as is well set out in the Report.

Q8 Chairman: Let us pursue these factors further. Can we look at the access loan charge, which is dealt with on page 34, paragraph 3.29. Can you explain to the Committee, Mr Rowlands, how much of the access charge loan will be repaid; or is it going to be just another subsidy from the taxpayer?
Mr Rowlands: As the Report says, the LCR expectation is that they will repay all the amounts they draw down under the access charge loan arrangements.

Q9 Chairman: Can you now please look at figure 20 on page 38? This is an important matter; it is the value for money assessment of the case for going ahead with section 2. Obviously, the economics of the project depend heavily on assumptions about regeneration benefits—do you accept that?
Mr Rowlands: Yes.

Q10 Chairman: So can we be confident about the numbers in this figure?
Mr Rowlands: If you look at the extreme right-hand side down the bottom, 0.7, that is the calculated benefit cost ratio for the low case, that is the case which includes a £300 million overrun on the original target construction costs. It is 0.7, but that does not include any benefits from domestic services. We believe that once those are included that that will take it above one. We will be looking again at this once the project is complete, but bear in mind that at Stratford, Ebbsfleet, King's Cross and indeed at Eastern Quarry, you have about 100,000 jobs tied to the arrival of this project. From memory, there are 18,000 homes and a lot of retail developments. It is fair to say that though this project depends in part upon its regeneration benefits, not just its transport benefits, those benefits are materialising, as the report sets out.

Q11 Chairman: So if we look at the early part of this Report at paragraph 6, which you will find on page 1, the NAO states there that the economic case for the link remains marginal. Do you agree with that?
Mr Rowlands: I agree in the sense that, as we speak, the regeneration benefits are beginning to go in place. They will start to build out Stratford city in 2006 and King's Cross in 2007. I do not think any of us, with hand on heart, can say that that is exactly the regeneration benefits, but they are there. They are still marginal but I think they will be less marginal as time passes.

Q12 Chairman: In relation to the cost overrun protection programme you can find on page 32, paragraph 3.21, the Report states that both the Department and the Treasury felt the Department was in a weak position when negotiating the Cost Overrun Protection Programme and that it was expensive. The obvious question is: why did you go ahead with it?
Mr Rowlands: We looked at the alternatives. There was a Railtrack alternative, which the Report well sets out, that was even more expensive. You see that in table 17 on page 31. We looked at whether the Department in effect should take all the risk on cost overrun. As the Report sets out, at the mid-case forecast that would have been, in NPV terms, perhaps £40 million cheaper, so essentially we had to look and say: "To save £40 million in net present value we take all of the construction risk: is this a sensible thing to do when we cannot manage those risks?" The conclusion we came to was that it was better to go with what we genuinely did think was an expensive proposition, but it was the best proposition we had in front of us.

Q13 Chairman: Do you want to comment on that, Mr Holden?
Mr Holden: I have nothing to add to what Mr Rowlands says. We believe we put to the Department a proposal which met their objectives.

Q14 Chairman: The product is going to cost us £5 billion. Is that broadly right?
Mr Rowlands: In finite term prices I should think more like about £5.8 billion.

Q15 Chairman: Would it have been cheaper just to have done it as a government project?
Mr Rowlands: It depends whether you believe the Government would have been able to control the costs, the timetable and the scope. The last thing we did, if I am allowed to say so, was the Jubilee Line extension, which came out 21 months late and £1.4 billion over budget. At least against that yardstick, this project is performing a great deal better.
Chairman: We have the Auditor General of Bulgaria, Professor Valeriy Dimitrov, with us. Welcome.

Q16 Kitty Ussher: I wanted to probe the wider potential benefits of this scheme. Can you look at the second phase. Why was it decided that that should go ahead, in terms of policy-makers in your Department?
Mr Rowlands: Remember that this project, when it was restructured in 1998, was broken into two parts, section 1 and section 2. At that stage, albeit that it was difficult to properly capture the employment and regeneration benefits, it was decided to go ahead with the project. When it was reconstructed in 2001, and particularly going ahead with section 2, when that was reappraised the case was still there in cost-benefit terms.

Q17 Kitty Ussher: Can you explain that a bit more? The case was still there in cost-benefit terms. Do you mean in terms of recouping your investment purely on passenger numbers, or on wider considerations?

Mr Rowlands: At the time, as I recollect, even the international transport benefits were sufficient to justify the case on the basis of the mid-range forecast. It did not stand up at the lower end. Remember, this project was originally conceived not simply for its transport benefits but for its regeneration benefits as well. Although it was difficult at that stage properly to quantify it, I think in my earlier answer I set out some of the consequences that are beginning to flow and will flow. When we looked at it back in 2001, it was a combination both of a transport benefit but also of the then more clearly emerging regeneration benefits.

Q18 Kitty Ussher: So that we can be completely clear, the mid-range forecast showed that it was probably a good idea to go ahead purely on the passenger benefits and the transport benefits although there were clearly some risks at the lower end.
Mr Rowlands: That is right, yes.

Q19 Kitty Ussher: But you presumed that there would also be wider positive benefits from economic generation of jobs, but those were not quantified and no analysis was done. Is that correct?
Mr Rowlands: Yes, I think that is right, and I think the Report says that this route began life back in 1991 when the then government rejected BR's so-called southerly approach because it did nothing for the regeneration of east London; and that is why this route was chosen. That is why you see, for example, the station at Stratford, to drive redevelopment there.[1]

Q20 Kitty Ussher: Once the link is complete it will be easier to travel, for example, from my constituency in Burnley, in the north-west all the way through to the Continent. Was there any assessment of wider economic benefits to the UK as a whole?
Mr Rowlands: Not to the wider economic benefits. That is what we will need to look at when we go back on this project when it is complete and finally assess what the out-turn costs were and what the benefits are.

Q21 Kitty Ussher: Obviously I support any kind of decision that is good for jobs, but do you agree with me that it is unusual for major government projects to look at the wider jobs impact, and that there are other areas of government procurement in defence and the NHS where that is not normally looked at?
Mr Rowlands: If you had asked me that question in 2001 I would have probably said "yes" but it is not the case in 2005. My Department particularly is moving to assess transport projects on a wider basis than the traditional, may I say, rather narrow transport cost-benefit approach. We now require all projects for example to undertake an economic impact report—and again the NAO Report touches on that. We are doing one, for example for Crossrail which looks at unemployment and employment consequences for major transport infrastructure. We are broadening the basis on which we look at projects now.

Q22 Kitty Ussher: Does that mean you are developing a new methodology to be able to quantify economic benefits of large projects like this?
Mr Rowlands: The guidance on economic impact I think we posted on our website and it runs to about 24 pages, so, yes, there is an emerging methodology for this.
Kitty Ussher: Chairman, I look forward therefore to improved train links to my own constituency as a result of this assessment.

Q23 Greg Clark: Sir John, in cash terms the total support for the rail link comes to about £5 billion. Do you believe that that represents value for money, Sir John?
Sir John Bourn: My view essentially is that the Government launched on this project on the basis the private sector could do it. That was the original conception of what "value for money" meant. Since then of course it has become clear that it cannot be done on that basis, and the taxpayer has been called upon to stand behind the project to an increasing degree, in circumstances, as we know, with everything Mr Rowlands has said, where there is still a degree of uncertainty; and there is also uncertainty about the economic regeneration benefits which underscored the original cost-benefit analysis. So in terms of what the original conception of what value for money was, this project does not meet that. That is not to say of course that in their desire to keep, if I put it this way, the show on the road, it has not been addressed with a lot of care and thought, in the way that the report brings out. However, in terms of what was originally intended, the value for money has not been achieved.

Q24 Greg Clark: Mr Rowlands, in answer to a question from the Chairman you pointed out that the expected benefit-cost ratio is 0.7 excluding regeneration. Do I take it that this will go down if, as indicated by Mr Holden, the passenger forecasts for Eurostar go down?
Mr Rowlands: If nothing else were to be included, you are right that that number would go down; but, as you say, 0.7 does not include the regeneration benefits and it does not include the benefits of domestic[2]—

[1] Note by witness: To amplify the answer I gave in response to question 19, an attempt was made in 2001 to quantify the benefits from regeneration area jobs and this is the source of the £475/£450 million figures given in table 20 of the NAO's Report. The NAO favour excluding this estimate from the BCR as Departmental guidance at the time recommended not monetising these benefits. The Department now requires Economic Impact Report (EIR) guidance to be followed. It is not clear what level of benefit would be identified by following the EIR approach.

[2] Note by witness: In my reply I inadvertently agreed to a statement from Greg Clark that is not consistent with table 20 in the NAO Report. The 0.7 BCR in table 20 does include an early assessment of regeneration and since then the guidance has changed.

Q25 Greg Clark: Sure, but the standard practice, I understand, from the Treasury, is that one should not include these benefits, which are difficult to quantify, so from a position of only 0.7—
Mr Rowlands: I am sorry, Mr Clark, my Department's position now is that we do intend to capture these benefits.

Q26 Greg Clark: I am sorry, I missed that, but the financial benefits go down from 0.72. Where would you estimate it might be headed to—0.5?
Mr Rowlands: I think you are tempting me into an answer I should not give you. We may have a clearer idea when we get to the end of the year and we have done some re- forecasting.

Q27 Greg Clark: Perhaps you can write to the Committee and give us the percentage.
Mr Rowlands: I am very happy to do that.[3]

Q28 Greg Clark: Mr Holden, LCR attributes, on page 34, paragraph 3.27 of the report, the increase in cost to the effect of railway-related inflation being greater than assumed in 2001. Is that correct?
Mr Holden: Yes.

Q29 Greg Clark: What is railway-related inflation at the moment?
Mr Holden: It is very difficult to get a precise measure on it, but there are two factors we have taken into consideration. One is the fact that indices as measured by the ONS in the construction industry are running at about twice the level we previously assumed, but specifically railway inflation, following the events of Hatfield and the Railtrack administration—costs increased enormously.

Q30 Greg Clark: I am asking how much. What is it currently running at?
Mr Holden: In terms of impact on the project we believe it is in excess of £300 million.

Q31 Greg Clark: No, but as a rate of inflation your forecast was based, by implication, on a certain rate of inflation, and it has been greater than that.
Mr Holden: It has doubled from 3% to over 6%.

Q32 Greg Clark: So the rate of inflation is 6% rather than 3%.
Mr Holden: It is in excess of 6%.

Q33 Greg Clark: Why was that not anticipated when the original assessment was made?
Mr Holden: It is very difficult to anticipate inflation a great many years into the future. On section 1 of the Channel Tunnel Rail Link, we actually over-estimated the effects of inflation, and unfortunately in section 2 we have under-estimated the rate of inflation. To forecast specific events, as was the case which happened with Hatfield and the Railtrack administration, is, I guess, impossible.

Q34 Greg Clark: What are you assuming for the next five years the rate of railway inflation will be?
Mr Holden: We are assuming basically a continuing level like we have seen in the last three or five years of between 5% or 6%.

Q35 Greg Clark: Why should that continue when Hatfield is receding into distant memory?
Mr Holden: I think we are being very prudent at this point in time so that we do not have a recurrence of the problem we are now talking about.

Q36 Greg Clark: Is that the reason for inflation being higher? Can you explain why Hatfield has put inflation up; rather than requiring more things to be done? Why should the cost of doing those things be higher?
Mr Holden: There was a greater demand for a limited amount of resource, and suppliers in the industry took great advantage of that inequality of supply and demand, as you would expect and ordinarily see in many aspects of business.

Q37 Greg Clark: So there are more public funds chasing a limited number of people who can carry it out?
Mr Holden: This was both private and public funds at the same time. We were, by the schedule of CTRL, required to do certain works at a certain time, and therefore we were of course at a very great disadvantage.

Q38 Greg Clark: Were the contractors making more in profit? Presumably people were paying the same rates of pay to the engineers and the people working on this; or were they just taking more profit?
Mr Holden: I think the rate of profit is the same generally, because profit is generally calculated on what we call a de-escalated basis, ie, without the impact of inflation.

Q39 Greg Clark: So where is all this extra money going? In whose pockets is it ending up?
Mr Holden: In terms of additional costs and in terms of additional wages for people and in terms of additional cost of materials.

Q40 Greg Clark: Going forward, do you expect to see that, presumably as capacity comes on-stream, some of these cost pressures to reduce—yet you are assuming a continued higher rate of inflation?
Mr Holden: As I say, we are being very prudent now in terms of our costs for completion of the project. Many aspects of the project are now complete, so we are talking in a much more limited range of costs which we need to estimate.

Q41 Greg Clark: You are currently re-forecasting the passenger forecasts, as I understand it. Who is carrying out that forecast?

[3] Note by witness: We will be able to provide the updated passenger demand forecast and the updated ACL figures, as shown in answer to question 79. We will not be in a position to provide a formal update of the BCR at this stage, as the project will not be re-evaluated until after Section 2 opens, as described in answer to question 83. But we will attempt to provide a broad indication of the likely movement in the BCR.

Mr Holden: This is the commercial team within the Eurostar business.

Q42 Greg Clark: Have they contracted any consultants to help with that?
Mr Holden: They do contract consultants and they do undertake various market research analyses.

Q43 Greg Clark: Do you know which firm is doing the forecast?
Mr Holden: I do not know which firm at this particular point is doing the work. I know that in the past LEK have undertaken the work, and Booz Allen have undertaken the work for the Department for Transport.

Q44 Greg Clark: According to the Report, Booz Allen conducted the work in both 2001 and in 2004, in terms of the projections. Was it sensible to employ the same firm to project into the future since they got it so disastrously wrong in 2001?
Mr Holden: There is a balance to be taken between bringing in new people who have very limited knowledge of the business, and people who do. That judgment has to be made every time a decision is made.

Q45 Greg Clark: The consequences of the over-estimation in 2001 were pretty catastrophic. It was not the consultants' fault, then, that they made that mistake?
Mr Holden: I do not believe it has been catastrophic because there have been a number of other things that have happened since those estimates were made, which have kept the economics of the project very much the same today as they were in 2001, at the time of the first NAO Report.

Q46 Greg Clark: Just in terms of the forecast revenues, if it was not the fault of the consultants, was it the fault of the Department? Who misperceived the—
Mr Rowlands: I think Booz Allen were forecasting for the Department not for LCR.

Q47 Greg Clark: I am sorry, the question should be put to you, Mr Rowlands.
Mr Rowlands: It is certainly the case that the forecasts substantially over-estimated the position today. I think it is the case that even when Booz Allen did the 2001 forecast, which they actually did in 2000, they, and frankly nobody else, really quite figured out the stunning success of the low-cost airlines. The low-cost airlines did not exist when this project was put together.

Q48 Greg Clark: They did not exist in 2000?
Mr Rowlands: Not with the sort of success that you have seen in 2005 with an ever-growing range of low-cost destinations; nor could they foresee 9/11 and the impact that that would have.

Q49 Greg Clark: This is a firm of strategy consultants who have a feel for the developing trends in the sector, and you are saying that five years ago they had no inkling that low-cost air travel was likely to increase.
Mr Rowlands: No, I did not say that. I think I said that they, and nobody else, quite estimated the stunning success of the low-cost airlines. What it does tell you, and a warning for the future—and again the NAO has drawn it out—is the difficulty of accurately forecasting revenues and ridership on very novel major projects. This after all was the only high-speed railway in the country, and the first new railway line for a hundred years. Looking back, a lesson that we will want to draw out is that the next time we look at anything like this we will want to look a great deal more severely at the downside.

Q50 Greg Clark: Presumably you are doing that now. Is Booz Allen conducting the current review?
Mr Rowlands: I believe they are.

Q51 Greg Clark: They are, for the third time.
Mr Fuhr: They will be conducting the review in due course.

Q52 Greg Clark: So they have got it wrong twice before. Why are you confident that they are not going to get it wrong for the third time?
Mr Holden: I am sorry, I think we need to correct an impression there. The increase in revenues relative to the introduction of CTRL on section one of the Booz Allen forecast was very much on line. What they, and everybody else, failed to take into account were the macro events which have occurred since 2000. As Mr Rowlands has said, there was 9/11; and there was also a huge impact in this country through the effects of foot and mouth. They have taken a long time to recover from. If you put those macro things to one side, which I do not believe anybody is capable of getting right, the underlying remaining issues—they have been very close to the mark.
Greg Clark: My time is up but I think chart 9 speaks for itself in terms of their forecasting being inaccurate.

Q53 Mr Davidson: Can I return to this question of the estimates, and looking at the first set of estimates on page 24, chart 8. So far we have had an explanation that it was low-cost airlines which apparently could not have been foreseen; 9/11; and, the one that takes the biscuit, foot and mouth. Basically, the difficulties therefore of this have been caused partly by foot and mouth. Can you clarify for me whether or not there are any other factors that you think made these figures over-optimistic?
Mr Holden: In terms of the current year, 2005, yes, the events of 7 July in this country. Until that point we were experiencing a 15% growth in revenues; since that point in time we have had no growth in revenues over the previous year. These are very significant effects which take an awful long time to recover from.

Q54 Mr Davidson: Of course they are; that is absolutely correct; but a reputable firm like this do not factor in the impact of any possible cataclysmic event, do they not? They work on the basis that everything will be hunky-dory and that nothing wrong will ever happen.
Mr Holden: Cataclysmic effects, as you quite rightly point out, are not factored in on an annual basis; they are factored in throughout—

Q55 Mr Davidson: They are not factored in!
Mr Holden:—what is an 86-year project.

Q56 Mr Davidson: So these sorts of things are factored in. Are there any other cataclysmic events that you think that they did factor in?
Mr Holden: I do not think anybody can specifically specify what they are. One generalises about the impact of—

Q57 Mr Davidson: Right. One generalises about cataclysmic events and one therefore anticipates that something might happen, but why are these estimates all erring on the one side to make the project more viable rather than being more mainstream? It seems to me that the estimates that you are working on are consistently over-optimistic.
Mr Holden: Not for 2004 and 2004. As I said, the uplift from the introduction of CTRL section 1 was exactly as forecast.

Q58 Mr Davidson: So you are quite happy that the 2004 forecasts will be completely in line over a long period and that they will not turn out to be over-optimistic?
Mr Holden: I am confident that over the 80 odd years remaining on this franchise, sufficient revenues will be generated to enable LCR to fulfil its obligations.

Q59 Mr Davidson: The difficulty about working over an 80-year time span is that I am not sure the Committee will be able to call you back at some point! If these estimates turn out to be over-optimistic, what would the effect on LCR financing and the potential recourse to the taxpayer through the access charge loan be?
Mr Holden: We will be drawing down on the access charge loan arrangement, but under the forecast that we have we also envisage being able to repay any drawings from—

Q60 Mr Davidson: I understand you envisage—that is right—but if it does not turn out as planned, what will the consequences be?
Mr Holden: It clearly depends on how bad the situation is. It would have to deteriorate quite considerably before we were in a position where we could not repay any drawings.
Mr Rowlands: The work we are doing at the moment will re-forecast, as best it can on a forecast basis, when we expect London and Continental Railways first to have to draw down under the access charge loan arrangement. Under the development agreement, I believe, from memory, that in net present value terms the total drawing that they can take under that loan agreement is £360 million. If they go beyond £360 million, they will be in breach of their development agreement.

Q61 Mr Davidson: Then what happens?
Mr Rowlands: Then the Government has a right, if it so wishes, I believe, to terminate that agreement.

Q62 Mr Davidson: Then what happens?
Mr Rowlands: It would all revert to the Government.

Q63 Mr Davidson: It all reverts to the Government in a situation where it is basically bankrupt! So we have the consolation that if it all goes wrong and the money cannot be repaid, we get it.
Mr Rowlands: Yes.

Q64 Mr Davidson: What exactly is the advantage to us of having this asset that is making such an enormous loss that it cannot repay the money that we have lent it, coming to us?
Mr Rowlands: We would still get infrastructure costs of some £5 billion. The British share of the Eurostar train sets that run the joint service with SNCF and SNCB—it may come back on the basis that it is not a profit-making enterprise at that point. If it came back in those circumstances I guess that would be true, although I have to say that much the same can be said of the existing national railway system.

Q65 Mr Davidson: Is there a limit to the amount that the Department for Transport are prepared to lend to LCR?
Mr Rowlands: That is why we have set a cap on the maximum drawings under the access charge loan agreement.

Q66 Mr Davidson: There is a limit and that is it!
Mr Rowlands: As I say, they would be in breach of their development agreement at that point. The Government would then have to decide what to do.

Q67 Mr Davidson: Can we turn to the question of regeneration benefits. Our previous recommendations indicated that there should be a "robust appraisal" of the regeneration benefits. Has that been done yet?
Mr Rowlands: We cannot do a robust appraisal perhaps in the sense that you mean until this project is built out and section 2 is running. We have seen the consequences in terms of the finalised proposals for King's Cross, Stratford, Ebbsfleet; and because it is, although not part of LCR's plans, also Eastern Quarry in Kent, which ties into Ebbsfleet.

Q68 Mr Davidson: Is much work on the methodology of that being done at the moment, or are you waiting until everything is finished before you start that?
Mr Rowlands: No. As I said to Ms Ussher, we have put out guidance on how to put together an economic impact report, when looking at the employment consequences of large and indeed small transport infrastructure projects. It is a non-trivial exercise. I believe the report being done for Crossrail

is not yet finalised, and it has taken 12 months already and is expensive to produce. We will in effect do this for this project once it is built out and running.

Q69 Mr Davidson: How will you be able to separate the boost to areas like east London from this project, as distinct from the Olympics, or from anything else that is happening?
Mr Rowlands: I should not trespass into whether or not the Olympics came here because of this project, although it certainly helped at the margin. It will be a challenge to disentangle some of the Olympic effects, but that is less so in the case of the King's Cross railway lands, which have stood there semi-derelict for heaven knows how long, and only this project has kicked it into life. Ebbsfleet would not exist without this project, and the Stratford railway lands similarly have stood desolate for decades. I think there is a real task to separate it out. There are lessons to be learnt, and it is a real task to separate out the genuine regeneration consequence from the background noise, and I cannot give you a defined answer today. That is one of the challenges for us when this project completes.

Q70 Mr Williams: Mr Rowlands, in reply to the Chairman you said that the Government underwriting all debt was the most efficient way of funding risk in the private sector. Is that right?
Mr Rowlands: I think the Chairman had asked what was the benefit for the Government seemingly underwriting every last penny of this project. I think I said in reply that it helped to maintain this project in the private sector, and therefore the carrying of a substantial degree of risk of cost overrun and proper management therefore in the private sector.

Q71 Mr Williams: We have ended up with a situation where inflation estimates have been grossly under-estimated and inflation being much higher, and with the revenue being over-estimated; the Government is piggy in the middle and the taxpayer is going to pick up most of the bill.
Mr Rowlands: I do not believe that, I could be wrong, that this project will substantially overspend, but if it does do so then the Government is not piggy in the middle. As I said earlier, for a £600 million cost overrun the insurance market will pick up £215 million and Bechtel will pick up £100 million, so we have laid off significant risk on to the private sector.

Q72 Mr Williams: What is the maximum the taxpayer could be at risk for?
Mr Rowlands: Above £600 million, the taxpayers are in for every last penny because this is a layered arrangement and the bill was up to £600 million; after that the insurers would have fallen away, but there is no evidence that this project is going to overrun to the extent of 30% or 40%. We have reached a point where it is well over 80% complete. The spend to go is only measured now in hundreds of millions against a total spend of £3 billion or so. I do not think we face that risk. The challenge is to keep a grip on it at this stage to get it finally delivered at the best cost we can.

Q73 Mr Williams: How can you say there is no way? After all, the reason that the inflation figures were altered was because they had been over-estimated previously, and that was a relatively short time ago. We are talking about revenues up to 2050. How can you say there is no way it will exceed that ceiling?
Mr Rowlands: Forgive me, I was talking about the cost of building this project. This project will complete with Eurostar inter-service into St Pancras in 2007, so there is not much more to be spent in terms of simply building the project. The risk beyond that—you are quite right—relates to performance of Eurostar itself. That is to do with its passengers and its ridership.

Q74 Mr Williams: Mr Holden, you made the point about 7 July. You had had 15% growth prior to that but now there is no growth. Can we look back to 9/11? What was the pattern then, and how did it change? Did we then suffer a significant change in revenue as a result of that, and has it recovered; and, if so, to what extent has it recovered? In other words, what I am trying to get at is how temporary or permanent you calculate the impact of 7 July to be.
Mr Holden: The year 2000 was a record year for Eurostar revenues. The first eight months of 2001 were showing a reasonable increase over 2000. In real terms we are not yet back at those levels, so the recovery period is very long indeed. Mr Rowlands referred previously to the low-cost airlines. We find that when people move away, they have now a greater number of alternatives, so the task of recovery has been difficult for 2001 and will continue to be so.

Q75 Mr Williams: In terms of your latest projections, what adjustment have you had to make to them? Could you quantify the adjustment you have had to make in forward projections as a result of 7 July?
Mr Holden: The increase that we expect from section 2 will be about the same as was previously envisaged, but we are working from a lower base, which I would say was probably between 15% and 20% lower than we would have expected without some of these major extraneous events.

Q76 Mr Williams: Is that short term or long term?
Mr Holden: It takes a long time to recover from that.

Q77 Mr Williams: So 20% is what, in financial terms, in revenue?
Mr Holden: It is £40 million a year.

Q78 Mr Williams: As you say, that could be for a very long period ahead. If it were for 10 years, it would be £400 million.
Mr Holden: You would get recovery over that period.

Q79 Mr Williams: Yes, but recovery is never to the original path, is it? This is what I am getting at. It is unfair because none of us knows what is going to happen in the future, but the £40 million has now put you on a new growth path and you have now different lines of anticipated revenues, which are going for a long period to be £40 million a year or thereabouts out of what you have estimated. So the £400 million over 10 years, just on the revenue side, makes your £600 million not look as improbable as you were trying to make it sound, Mr Rowlands.

Mr Holden: One also has to look at the associated costs with that; so the net impact is considerably lower than what you would imply from that analysis. Also, as I said to one of the earlier questions, we cannot look at the revenue forecasts in isolation from other events. In particular, the cost of financing this project through the changes that took place in 2001 and 2002 have had a substantial beneficial impact, as the National Audit Office brings out. Those things combined bring you to the conclusion, which the NAO did, that the expected burden on the taxpayer is little different than it was in its previous report four years ago.

Mr Rowlands: I think we are talking about slightly different hundreds of millions of pounds. I was talking about a potential cost overrun and trying to lay the risk off on the construction costs of the second section of the high-speed railway link. That will be done and dusted by the time we are into 2007. Whatever that cost is eats into the cash that London and Continental Railways have. Your £400 million, if that is what it is, because the revenue line has been depressed, is a problem going forward, and at that point may impact on the point at which LCR have to access the access charge loan agreement, and that is the work we have been forecasting at the moment and what I promised Mr Clark the details of once we have them.

Q80 Mr Williams: The third imponderable in the calculations, as has been referred to previously, is the regeneration benefits; but, as Mr Davidson said, by the time the development work related to preparation for the Olympics is taken into account we are never really going to be able to arrive at any meaningful figure, are we?

Mr Rowlands: The biggest impact in terms of jobs is at Ebbsfleet. I do not think the arrival of the Olympics has any material impact in terms of what happens at Ebbsfleet and I think it is an irrelevance. It may be difficult to disentangle Stratford, but I am sure we can. I do not think it will have any impact in terms of Eastern Quarry in Kent, and I think the impact on King's Cross is probably limited as well, so I think it is do-able.

Q81 Kitty Ussher: When you answered my questions previously you said that you now had a developed economic methodology for assessing the benefits of transport infrastructure. To clarify, is it that guidance that you have used in 2001 of the chart on page 20?

Mr Rowlands: No.

Q82 Kitty Ussher: So since then?

Mr Rowlands: If I had answered your question in 2001 I would have answered it differently.

Q83 Kitty Ussher: Is it therefore possible to revisit the cost-benefit analysis done in 2001 using this new tool that you now have and perhaps coming up with an updated Departmental assessment of the value for money?

Mr Rowlands: That is what we propose to do. What we propose to do once this second section is open and you can see what the actual increase in ridership is and you have a clearer view of what is happening at Stratford, King's Cross and so on, is do a complete write-up of the project, so we re-visit the costs and the benefits, and we can finally establish as best you can the out-turn position. We want to re-visit it in terms of lessons to be learnt for the handling of other projects, some of which the NAO itself has drawn out in the report. We would probably want to re-visit quietly and hide in a drawer in case of FOI some of the internal Departmental handling of all of this as well because there are lessons to be learnt.

Q84 Kitty Ussher: That is interesting. When do you propose to do that?

Mr Rowlands: I do not think we can realistically do it—I think we can start the work—I am speculating now—at the end of 2006 into 2007, but I think it is not until then that you can realistically expect to produce a rounded analysis of what we finally got.

Q85 Kitty Ussher: For the record now, you are saying that if you had had the tools available in 2001 that you have now, your decision on value for money and cost-benefit analysis may have been slightly different particularly in terms of the regeneration aspects.

Mr Rowlands: I think the analysis would have been better developed. I am not saying the decision would have been different. I think the better-developed analysis would have supported well the decision that was taken in 2001.

Q86 Kitty Ussher: You have mentioned that you might want to re-visit your Department's handling of the whole issue. Do you think your Department has handled it well?

Mr Rowlands: If I am allowed to say so, this is a huge project and immensely complicated. There was a sad history of major infrastructure projects in this country going completely belly-up. This has had its problems, but I think it has been, in the round, well handled, including if I may say so by people in my own Department in terms of particularly the various crises that have riven it, from London and Continental coming in in 1997 asking for another billion pounds from the Government through to—we rather foolishly thought we had put Railtrack's balance sheet behind the project at one stage and that disappeared—

Q87 Chairman: You are getting softer and softer. Can you try and raise the volume?
Mr Rowlands: In the round it was well handled, but there are lessons to be learnt.

Q88 Mr Davidson: The estimates from Booz Allen Hamilton seem to have been quite well laid out in the beginning. Was their fee accuracy-related?
Mr Fuhr: No, there was not, and it would be quite difficult to do that because it would have to be done in retrospect; you would have to see what the out-turn was and then try to claim back if you thought it was wrong. The best way to discipline consultants who do not deliver well is not to employ them again.

Q89 Mr Davidson: That is an interesting point. Booz Allen Hamilton were wildly out in their first estimates, so you punished them by giving them another contract; and now, as I understand it, you have given them a third contract! Explain to me how the system of penalties works.
Mr Rowlands: If I may say so, the people who were originally wildly out were called British Rail and SNCF, whose original forecasts for this railway were hugely bigger than the numbers we are now looking at. It is true that Booz Allen have struggled to produce totally accurate forecasts, I think for the reasons that Mr Holden and I have tried to explain; but it does reflect the difficulty of forecasting ridership and revenues from brand-new infrastructure where you have got no analogues to look to. Again, going back to lessons learnt, next time—and I am sure there will be some kind of next time—we need to look much more substantially at the downside risks and what will drive this project under water.

Q90 Mr Davidson: The defence of Booz Allen Hamilton is, first of all, that somebody else did it worse, which does not seem to me to be entirely valid; and then they struggled to produce an accurate so-and-so—that presumably is what you are paying them for, to produce an accurate result. The idea that all this is very difficult and we should be thankful for anything we get at all does not seem to me to have the correct rigour applied to it. I do not entirely accept the point about trying to recover a fee in arrears because presumably part of the fee could be withheld if necessary in order to see how accurate they are? Quite clearly, the estimates here were quite drastically out for somebody who is selling expertise in forecasting. To get their forecasts wrong—it would not be so bad if you just picked somebody off the street and asked them to dissect a chicken and examine the innards—but these people are actually marketing themselves as being able to forecast the future accurately, and getting it wrong.
Mr Rowlands: We are satisfied that Booz Allen did the best professional job they could do at particular points in time. If we did not believe that, we would not have re-hired them.

Q91 Greg Clark: Mr Fuhr, I do not know whether you were joking in saying that the best way to discipline consultants is not to re-hire them if they get it wrong, but they got it wrong and I do not understand the basis on which they were re-hired. Did they go through a competition for the second and third times they were commissioned?
Mr Fuhr: There was originally a competition.

Q92 Greg Clark: The second and third times?
Mr Fuhr: I cannot tell you from memory whether there was a competition or whether there was a continuation of the original contract. Any consultant who is producing forecasts will produce a range, and there will be a view which you have to take within that range about where the future is likely to pan out.
Greg Clark: It was below that.
Mr Fuhr: Some of the forecasts that were produced in 1998, which were the original LCR forecasts, were very substantially higher, based on original BR and SNCF figures. The figures that were produced by Booz Allen Hamilton at the time were substantially below that, but could not take account of some of the market forces which intervened, like the low-cost airlines and some of the perturbations which we were talking about earlier.
Greg Clark: I am concerned, Chairman, in terms of the rigour of processes, when, by Mr Fuhr's own admission, a consultant gets it wrong, it should at least be looked at again; and there is no recollection at least that at the second and third times of re-hiring there was even a competition to look to see if anyone could make a better case to get it accurate.

Q93 Chairman: There are further questions we would like to ask about the effect of the taxpayer-related cost overruns, but I understand you prefer that we ask those in private.
Mr Rowlands: That would be helpful.
Chairman: Because it is commercially confidential we can agree to that. We will now move to private session and I would request all members of the press and public to leave.

Q94 Chairman: Tell us about the effects of the contract and how much more the Department has lent LCR.
Mr Rowlands: *** In terms of what does this mean to the Department and behind us to the taxpayer, there is no immediate cost to the Department. This additional cost is met by LCR. What it will do is bring forward the date on which they are likely to have access to the access charge loan agreement that I touched on earlier when I talked about re-forecasting the current position. It is not simply about one of the Eurostar's best forecasts now for revenue and passengers, but we also need to feed in the additional cost in the project to re-calculate when LCR is likely to access the access charge level agreement.

Q95 Chairman: Mr Holden, what is your latest estimate for the cost overrun?
Mr Holden: We believe it will be in the order of £*** million.

Q96 Chairman: £*** million. The figure I was given by the NAO was £***, but let us not quibble over £*** million. You said in 2001 and earlier on there would only be a small chance of the target construction cost being exceeded, is that correct?
Mr Holden: Yes.

Q97 Chairman: What has gone wrong?
Mr Holden: As I explained earlier, over half that increase, in excess of £*** million, I think, has been explained by the inflation factor which we were not aware of in 2001. In fact in 2001, the period leading up to that—

Q98 Chairman: It still begs the question how you could have been so confident in 2001. You must have foreseen that some of these difficulties, uncertainties or inflationary pressures might have arisen?
Mr Holden: We had no reason at that time to anticipate the additional inflationary pressures we have incurred. Clearly, there have been things which we assumed and have come right, and there are other things we have not. There are things that we assumed which have not taken place and there have been cost savings. To specifically identify individual amounts is extremely difficult. That is why we have contingencies. Unfortunately, on Section 2 it has proved not to be quite sufficient, but on a project—let us remind ourselves of over £5 billion—that remains on time and within, if you exclude inflation, less than four percentage points above the original estimates 10 years ago, that is an incredible achievement for a project of this size and complexity. We should be very proud of that fact.

Q99 Chairman: ***
Mr Holden: ***

Q100 Chairman: ***
Mr Rowlands: ***

Q101 Chairman: Can you both promise us that there will be no further liabilities to the taxpayer?
Mr Holden: We cannot promise you that at all.

Q102 Chairman: Give us an indication.
Mr Holden: We are as confident as we can be at this stage that the estimates are as good as anybody can make them.
Mr Rowlands: *** We are as confident as we can be that this project is under control.
*** As I say, the forecast outturn is actually above the revised target cost, so all the incentives are there, Bechtel is at risk of having to pay out on the Cost Overrun Protection Programme and a lot of fees are also at risk.

Q103 Mr Davidson: First of all, on the point that Mr Holden made in terms of much of this having been a great success and so on and so forth, excuse us if we do not spend all our time saying how well you have done and all the rest of it; these meetings would be rather boring. All the points you are making are seen in the context of "Maybe you could have done better". I want to clarify the overall question of risk transfer because I am under the impression that, overall, a substantial amount of risk was transferred, but the Government and the taxpayer were still substantially at risk and we have ended up paying far more than might have been anticipated and paying for more than if obviously all risk had been transferred. I want you to clarify for me, if you can, this question of the balance about whether or not there are things that we ought to learn from this where, perhaps with hindsight, there were opportunities to transfer risk to the private sector that we did not take, possibly because of inexperience, and going down this road of the risk transfer in the early days we ought to be picking up for the future.
Mr Rowlands: Mr Holden had his own view, and one or two of these lessons, I think, are in Sir John's report. Since there are no journalists here, perhaps I can say looking back, trying to rest a multibillion-pound project on the shoulders of, in the jargon, a special purpose vehicle that had the grand total of £60 million worth of equity in it was probably a pretty dumb thing to do because it had no capacity to bear any kind of risk at all. Hence the difficulties in 1997 when it was realised that the original BR-SNCF forecasts were way out of line, and you might say, "Why the hell did it take until 1997?" You have to remember Eurostar did not start until 1994; there was then a fire in the Tunnel in 1996, so it was another of these cataclysmic events that nobody had forecast. It was only in 1997 it became clear that the two state-owned industries grossly over-forecast the likely ridership and at that point you could see that an entity with only £60 million worth of equity and no parent company guarantee—and none of this had been laid off back to shareholders, this was all on the shoulders of London Continental Rail—was not going to work. What we thought we were doing in the 1998 rescue was, as I said earlier, putting a real balance sheet behind it, because you have to assume and crystallise the only issues as where do you put the risk, whose balance sheet is behind it, and who can best control the risk? We did not want to put it behind the Government's balance sheet because we could not control the risk, we were not managing the project. We thought the answer was to put Railtrack's balance sheet behind it which was what happened in the 1998 restructuring process, but come 2001, Railtrack had an obligation to buy Section 1 and they were obliged to buy on the basis of the actual outturn price but could only get revenues from it on the basis of the forecast construction cost, so there was the risk shipped across to Railtrack and an option on Section 2 in the same way. Come 2001, Railtrack then got into increasing financial difficulties and what we had thought we were putting behind it was not there. We were still reluctant to put the Government's balance sheet behind it for the reasons I have explained, hence this rather complicated arrangement we have now. I think there is a genuine lesson there for projects of this enormous scale, which is I think the Government has to accept the cataclysmic risk. It is probably always going to end up with an overrun of 40 or 50% on a £3 billion project, which is a sum of

money that will bankrupt most companies. What you will try and do—it is interesting coming out of this project—is to layer the risks in a way that hugely incentivise the project management to make sure there are no substantial cost overruns, because Rail Link Engineering and Bechtel are in first for the large chunk of the first cost overruns of the 300 million. I do not know about the future, it would be worth thinking about the insurance market which is where we have put a large chunk of the next 300 million. It is pretty unique in this country, it is not so unique in the United States. Bechtel came along and said to LCR and us, "We put cost overrun into the US insurance market for the power stations that we do". So in the end, we did it. As I said earlier, it was pretty expensive, it was the only option we could look at. I think for a very big project, whether it is my Department or not, you might at least want to look at that again because I think the only way to avoid in the end catastrophic overrun, which always ends up on the Government's balance sheet, is to get people in first for very chunky sums before you get to a real catastrophe. We got people in there all the way from 0 to 20% cost, all the way from 0 to 600 million. I think the lesson here is do not be naïve, the private sector will always give you the risk back if it can manage it and do not assume that people who have not got the ability to carry risks that those risks are not capitalised for.
Chairman: That is fair enough.

Q104 Greg Clark: Just one question in terms of prospective taxpayer exposure. I understand that the LCR has appointed a consortium to handle the management of Eurostar UK, and that until the end of the contract period, it is pretty much expected that they will lose £20 million a year on this.
Mr Rowlands: In 1997 prices, yes.

Q105 Greg Clark: In 1997 prices. Is that a risk? What happens if that company defaults?
Mr Rowlands: No, the Inter-Capital and Regional Railways, the ICRR, the shareholders, National Express, SNCF, British Airways and SNCB; two state-owned railways will probably not be going out of business. We do not think National Express will be and—

Q106 Greg Clark: These are liable for—?
Mr Rowlands: They are liable for it and these sums are in the range that organisations of that standing can afford to pay. They are not going to bust the bank.

Q107 Chairman: That is it.
Mr Rowlands: Can I say one other thing?

Q108 Chairman: You can say as much as you like.
Mr Rowlands: I am not sure I should say this. Mr Holden is right; railway inflation was forecast on the basis of 3% inflation. It had been running at about 6% and it was a function of activity, amongst other things, in the marketplace; you had the West Coast Main Line being renewed, you had this project. That inflation will go away for this project because it will complete in 2007, but there is an interesting question going forward about the level of activity in London and the South-East: the Olympics, the widening of the M25, Thameslink 2000, Thames Gateway. It may be that my own Department will want to look at phasing things and have to push things to the right to just get some pressure away from the supply side.
Chairman: That is very helpful.

Q109 Kitty Ussher: Can we clarify from your point of view why this part needs to be in private because we will need to be able to revisit whether to publish the transcript later?
Mr Rowlands: ***
Chairman: Thank you, Mr Holden, Mr Rowlands and Mr Fuhr.

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