Channel Tunnel Rail Link (High Speed 1)

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Although many of the UK's infrastructure projects are driven by political as much as business and economic motivations, few deals can carry such a powerful whiff of the political zeitgeist as the privatisation of the Channel Tunnel Rail Link did in 2010. Conceived by the then Labour government in the midst of an economic downturn, and part of a list of divestments dubbed a 'fire sale' in some quarters, the sale of High Speed 1 carried responsibility for helping to pay off a budget deficit of over £180 billion. Could the government's expectations have been any higher?

In the event, however, ministers need not have worried. The structure of the asset and its unique status as a high speed rail (HSR) line meant that bidders flocked to buy the asset, with banks close behind. As one insider on the deal comments: "It sort of became the trophy deal of the end of the year because of its size and credit quality. If you speak to anyone in the City, they'd say, 'that's the deal that we want to be part of."

Background and Procurement

At the time of writing in March 2011, with High Speed 2 still in its consultation phase, High Speed 1 remains the only purpose-built high-speed rail line in the UK. The line stretches 109km (67 miles) from the Channel coast to London's St Pancras rail station. It was built in two sections between 1998 – four years after the opening of the Channel Tunnel to Eurostar services – and 2007, at a cost of £5.8 billion. The opening of the line meant that, for the first time, Eurostar trains could travel at up to 186mph (300km/h) on entering the British side of the tunnel, instead of slowing down to 100mph.

In October 2009, then Prime Minister Gordon Brown announced the government's intention to sell HS1 alongside the Dartford crossing and a number of smaller state-owned assets. But by the time the sale was formally launched in June 2010, a new coalition government had inherited the plans.

At the time, the sale was expected to bring in around £1.5 billion. The sum was tiny compared to the UK government's deficit, never mind the national debt, but both governments felt a political need to divest assets to pay off at least a fraction of the deficit. Citigroup advised the Department for Transport, while UBS was financial adviser to London and Continental Railways, the state-owned company that owned the line.

Even before the sale was announced, Citigroup and UBS sought out soft staple financing from banks. By July, a staple of £1.5 billion from such banks as Barclays, BNP Paribas and UBS, was in place. The staple was rated at A- and BBB+.

As the scale of bidder interest became clear, UBS on the advisory side counselled bidders not to make banks exclusive to them to allow the maximum number of bids with financial commitment to be submitted.

Big banks responded enthusiastically, with some operating three or four support trees to support multiple bids. Without them, bidders would have struggled to find available capital in a project finance market still recovering from the financial crisis. As it was however, some consortia – including the eventual winner – were able to submit fully funded bids. In August 2010 the following firms sent in preliminary bids:

- Borealis (the infra investment arm of Ontario Municipal Employees Retirement System) and Ontario Teachers' Pension Plan
- Cheung Kong Infrastructure (CKI) and Barclays Capital
- Groupe Eurotunnel, Goldman Sachs Infrastructure Partners, M&G's Infracapital, Universities Superannuation Scheme (USS) and CDC Infrastructure (Caisse de Dépôts et Consignations)
- Morgan Stanley Infrastructure, 3i Infrastructure and Abu Dhabi Investment Authority (ADIA) - Macquarie acting as financial adviser

At least one other consortium also expressed interest in the project but did not bid. By September, a final bid deadline of 29 October had been set.

Then – amid speculation that the bid deadline was slipping – a fifth bidder was revealed in the shape of Allianz and Bank of America Merril Lynch, and the Cheung Kong-Barcap team declined to submit a final bid. On 29 October the guillotine came down, and with untypical alacrity the Department for Transport announced the preferred bidder one week later.

The winner was the Borealis-Ontario Teachers consortium, who had offered the government £2.1 billion to operate HS1 over a 30-year concession – far exceeding expectations for the sale price. The sale came as a surprise to many industry watchers after Borealis had failed to buy Gatwick Airport from BAA the year before.

A pleased Transport Secretary Philip Hammond said, "This is great news for taxpayers and rail passengers alike. It is a big vote of confidence in UK plc and a big vote of market confidence in the future of high speed rail… The £2.1bn receipt exceeds the highest expectations for the sale and will make a welcome contribution to reducing the deficit."

The clock now started on the financing of the deal, with the authority seeking financial close just 14 days after announcing the preferred bidder.
The pressure was on the nine-strong lending group, the sponsors and their financial advisers JPMorgan, Lexicon Partners and RBC Capital Markets – also an MLA – to deliver.

Project Description

As a brownfield project, one of the attractions that HS1 carried for lenders was the absence of construction risk [Transactions Database]. Revenue from the 30-year concession comes from train operator access charges based on the number of timetabled trains using the line. About two thirds of this currently comes from London and South Eastern Railway, operators of the Southeastern franchise.

The remainder comes from Eurostar, itself owned by London and Continental Railways, French train operator SNCF and Belgian counterpart SNCB. All three are state-owned, minimising the revenue risk.

The semi-regulated nature of the asset, via UK rail and franchising regulations, places HS1 in an interesting asset class. Even HS1's subterranean next-door neighbour, the Eurotunnel, isn't quite the same, as it carries more traffic risk.

This hybrid nature required detailed examination by the financial advisers before they could quantify the risk. "You had to work out where it fitted with all these benchmarks," says Hugo Parker, Director of transport and logistics at RBC Capital Markets.

The financial model for HS1 includes assumptions about growing future rail traffic. And as anticipated, several train operators are planning or showing interest in adding their services to the line. Deutsche Bahn is currently awaiting approval for a planned London-Frankfurt and London-Amsterdam service, while Spanish state operator Renfe and private French firm Veolia are also interested.

The main O&M costs come from track maintenance, which is largely contracted out to Network Rail, a company partly funded and backed by the UK government which owns and maintains most of the country's other rail infrastructure.

Financing

The consortium, their financial advisers and the lending group had just two weeks to close the deal after Borealis was picked. Financial close was reached on time in December 2010, meaning that the entire process – from the Government's announcement to close – had lasted a mere six months.

Eight commercial MLAs and one export credit agency, Export Development Canada, provided £1.31 billion of acquisition debt, while the sponsors raised about £705 million of equity. The banks were:

- BNP Paribas
- Grupo Santander
- JPMorgan
- Lloyds TSB
- National Australia Bank
- RBS
- RBC Capital Markets

- Scotia Capital

The biggest tickets of £155.6 million each were taken by RBS, Lloyds, BNP and RBC.

The debt was structured as an £819 million 5-year senior term loan, £428.7 million 7-year senior term loan and £61.9 million in a working capital tranche.

Initially banks floated the idea of a long-term debt package, but the lack of certainty that so much debt would be available in such short order meant that the debt eventually raised was intended as a bridge to an eventual bond issue. An innovation of this deal was the unusually long term of the debt for a bridge.

Everyone seems to agree that HS1 will be refinanced in the near future through a bond issue. “Its natural long term home is in the bond market,” Hugo Parker of RBC affirms. Syndication on the debt is underway at the time of writing in March 2011.

Herbert Smith was legal adviser to LCR, CMS was legal adviser to the Department for Transport, Linklaters were legal advisers to the sponsors and Allen & Overy advised the lenders.

Conclusion

For all the in-built security and prestige of High Speed 1, the bidders still faced challenges in valuing the asset and sealing the deal on a very tight timeframe. Despite the haste, however, the Government exceeded its own wildest expectations for the sale price. The transaction proceeded smoothly and to schedule despite the appearance of a last-minute bidder and the late holding of banks’ credit conferences. In short, it couldn’t have given a better reassurance to ministers and the public as to the promise of the Government’s privatisation programme.

At the same time, the sale raises a new benchmark for brownfield transport projects and has encouraged market appetite for successive divestments. The keen pricing of debt on the more recent Gatwick Airport refi – featuring a £600 million bond issue - is arguably one example of this.