



British Waterways Strategic Options Review

1st May 2007

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1. Preliminary

This document invites proposals to provide consultancy and advisory services in connection with a review by BW of the options for a strategic change to its corporate form or ownership (or both) that would facilitate the better delivery of its core objectives.

All recipients of this invitation shall keep it, the information contained within it and any other information about or concerning BW obtained in connection with it, confidential at all times (save to the extent such information is not already in the public domain otherwise that by default of the recipient, its officers or employees). This requirement for confidentiality shall continue in force whether or not the services of the recipient in question are retained by BW unless released from the requirement in writing by BW either generally or by substitution of an obligation of confidentiality under an agreement for services.

2. Introduction

The British Waterways Board (BW) is a statutory public corporation whose primary purpose is to operate and manage the inland waterways and docks under its ownership or control with “due regard to efficiency, economy and safety of operation”. Its primary source of revenue is related commercial activities although it is also grant funded.

The Minister of State for the Department for the Environment, Food and Rural Affairs (DEFRA) has invited BW to consider and investigate whether BW's current institutional form and financial structure are optimal for the long-term security and success of BW's inland waterways, or whether alternative options might better achieve this.

BW is therefore now inviting suitably qualified organisations to bid for advising on this important strategic options review for BW.

3. Background

The majority of the inland waterways and docks now owned or managed by BW were first nationalised by the Transport Act 1947 under the umbrella of the (then) British Transport Commission (BTC). BW was established by the Transport Act of 1962 to be successor to the inland waterways business of the BTC. Its powers and duties are primarily defined by the 1962 Act and by the Transport Act of 1968.

BW is the largest inland navigation authority in Great Britain. It maintains some 2,200 miles (3,250 km) of canals and navigable rivers in England, Scotland and Wales. Their original infrastructure purpose of commercial freight has largely disappeared (some traffic remains, principally Yorkshire and Humberside) and the waterways are now a national environmental and heritage asset used primarily for leisure. They host 300m amenity visits a year and are the catalyst for extensive urban (and occasional rural) regeneration.,

Although the core role of BW has evolved from transport infrastructure provider to steward of a national heritage and leisure asset, it retains the legal structure and powers of a commercially driven organisation. Accordingly BW has been at the forefront of developing innovative and entrepreneurial practice within a publicly owned business. All BW's income, whether commercially earned, grant-in-aid or third party funding, is spent on the maintenance, upkeep, and repair of its waterways. Its main sources of commercial income are an actively managed waterside property portfolio, other waterway related commercial ventures and income from leisure users of the waterways.

Currently about 44% of total revenue is government grant. Waterways are a devolved matter under the Scotland Act 1998 and since 2000 BW has been a 'cross-border authority' under that Act with two sponsoring Government Departments - DEFRA, in England and Wales, and the Enterprise, Transport and Lifelong Learning Department of the Scottish Executive, in Scotland.

BW's ambition is that by 2012 it will have created an expanded, vibrant, largely self-sufficient waterway network used by twice as many people as in 2002. It will be regarded as one of the nation's most important and valued national assets. Visitors will be delighted with the quality of the experience and as a consequence many will become active participants.

Further information on British Waterways, including annual reports and British Waterways' detailed strategy, can be found on its website:

<http://www.britishwaterways.co.uk>.

Further information on Government policy for inland waterways can be found in *Waterways for Tomorrow*

<http://www.defra.gov.uk/environment/bw/tomorrow/>

Defra's framework document for British Waterways:

<http://defraweb/environment/bw/frame/index.htm>

and in Scotland, *Scotland's Canals: an asset for the future*:

<http://www.scotland.gov.uk/library5/environment/scaf-00.asp>

In 2005 government published its Policy Review of British Waterways. This review was undertaken on behalf of Defra and the Scottish Executive. It favourably reviewed BW's performance over the previous 5 years, endorsed BW's Vision for the Future, clarified BW's Public Policy Objectives and endorsed proposals for:

- Defra funding to be made via a medium term contract
- Improved and clearer governance roles between Government, the Board and the BW Executive

This document can be viewed at:

<http://defra/environment/water/iw/pdf/bwpolicyreview.pdf>

4 Factors in this review

BW believes that there are a number of key factors which need to be considered in this review, in order to properly and fully compare alternative options for its corporate structure and status. The main ones are, in BW's view, described below. However, advisors are encouraged to bring forward others that may be similarly important.

4.1 Maintaining the waterways asset

BW's primary purpose is to maintain its waterways to optimise their use and public enjoyment. Most of the network is around 200 years old so its maintenance repair and renewal is a major cost to BW. The waterways are also of significant heritage and environmental value, so repair is much more common than renewal.

In the early 1990's BW had circa £300m of outstanding repairs to our major engineering assets (bridges, aqueducts, embankments, tunnels, reservoirs, etc). After significant investment this now stands at around £100m. We estimate that in addition there is another £100m of outstanding repairs to the rest of the network.

BW has a “steady state” model to identify the cost of maintaining the network once it is in good order, or steady state. At 2006/07 prices we believe we need to spend £35m p.a. on repair of our major engineering assets and £89m p.a. on routine waterway maintenance (minor repairs, vegetation management, customer service provision), a total of £124m p.a. These costs assume the network is in good order but we know there is the backlog of circa £200m of outstanding repair needed before a steady state can be achieved.

In 2007/08 we can only afford to spend a total of around £100m on repairs, major works and routine maintenance. It is therefore reasonable to assume that the network condition is worsening year on year, but because of the huge investment in recent years that decline in condition is less dramatic than it was in the 1990's.

Users of the waterways do not currently experience this gradual decline – in fact they consider there has been an apparent improvement in condition in recent years because we have reduced the number of “bad and worst” condition assets and there has been an improvement in the general standard of waterway routine maintenance. However, the vast majority of major assets are in only “fair” condition and these are gradually deteriorating through lack of routine maintenance.

It is important to note that much has been achieved over the past few years to revitalise the canal network in Scotland with major investment in the Millennium Link including The Falkirk Wheel and the lock stabilisation programme on the Caledonian Canal, however, there is still a huge amount of potential still to be unlocked. Scotland's canals are at a different stage in their evolution to those in other parts of the UK, and this fact combined with the individuality of each canal presents a unique set of challenges and opportunities.

This review will need to consider and compare alternative structures for their ability to ensure greater certainty in the continued maintenance of BW's asset or possibly even accelerated enhancement of this infrastructure network.

4.2 Growth through an innovative commercial strategy

British Waterways is at the forefront of developing innovative and entrepreneurial practice within a publicly owned business. It is an active player in the UK's growing leisure sector and has a valuable portfolio of land and property worth over £500 million, from which it actively manages to generate significant revenue to support its other activities while stimulating major inner city and rural regeneration.

It also operates extensively with commercial partners and has a number of Public Private Partnership schemes developing its property interests. In particular it has both national and site specific property joint ventures with a number of major private sector companies including Amec Developments, Morley Fund Management, Canary Wharf, Ballymore and Miller Developments. These joint ventures involve property developments in London, Birmingham, Manchester, Leeds, Glasgow and Edinburgh. It has also created a Waterside Pub Partnership with Scottish & Newcastle that is developing and operating a network of high quality tenanted waterside pubs. Some £60 million of equity is already invested in all these joint ventures, and this is expected to increase over the next few years.

BW's commercial income and profits have been growing steadily. In 2006/07 BW had a total commercial gross income of over £100 million, with profits from these businesses at almost £70m. It is a core part of British Waterways' strategy to use innovative and entrepreneurial means to increase this commercial income over the coming years, and current business plans demonstrate strong growth. However, this growth, and BW's increased dependence on it, comes with increased risk to the ability to plan, with certainty, the programme for meeting BW's core role of maintaining its asset.

This review will need to consider and compare alternative structures that could accelerate the growth of BW's commercial activity and the return on equity invested.

4.3 The integrated business model

BW believes that the integration of its primary maintenance role (4.1) and its commercial business (4.2) is a vital and differentiating driver of its successes to date. BW believes that this integrated business model inspires management and staff, drives a more efficient business, and delivers true and profitable waterway-centric regeneration. This model is believed to be advantageous compared with a purely government agency publicly funded, public-service model, and is supported by the Government's 2005 review mentioned in section 3 above.

The strategic options review should not challenge this belief, but it may well be that there are alternative structures that better deliver this dual, integrated approach than the current arrangement.

4.4 Grant Funding and aspiration for financial self-sufficiency

BW currently receives an annual grant from Government. This grant is in decline in England and Wales, and therefore in total also, despite growth in recent years in Scotland:

Year	England/Wales	Scotland	Total grant
2004/5	59.09	12.60	71.69
2005/6	62.59	11.94	74.53
2006/7	55.50	14.85	70.34
2007/8 agreed	55.34	11.40	66.74
2008/9 CSR probable	54.06	11.40	65.46
2009/10 CSR probable	52.82	11.40	64.22
2010/11 CSR probable	51.61	11.40	63.01

Clearly, Government in England and Wales would like to see BW continuing to further reduce its need for taxpayer's support. This would only be possible if commercial income grows at a higher rate than the expected increase in operating costs. This is not the case in Scotland. The Scottish Executive is keen to invest in Scotland's canals as the asset responds to wider agendas in Scotland in leisure and tourism; health and community; regeneration and economic development; environment and sustainability.

In parallel with this, the 2005 policy review of BW, on behalf of Government, concluded that there would be substantial benefits in putting in place a longer-term (seven years) contract-like arrangement: to provide greater definition of what Government is purchasing for its grant support and to facilitate cultural change within BW.

The strategic options review will need to consider the extent to which these issues can be better achieved under alternative structures.

4.5 BW funding structure and capital raising

BW is ineligible from raising new sources of equity to fund these growing commercial businesses, and largely ineligible also from raising debt in its own right other than through non-consolidated joint ventures over which it has no overall control. Equity funding for BW's commercial activities is generated largely through the disposal by BW of property assets, but it is anticipated that over the next few years, the incremental returns from this "asset for equity" swap rate will become more marginal. BW believes that an ability to raise commercial debt could be a substantial factor in facilitating greater commercial growth and return on equity invested.

It is also possible that BW could sell property assets to invest in accelerated track maintenance, but the commercial case for this “one-off” opportunity has thus far not been examined.

The strategic options review will need to consider how alternative structures might address this issue and the benefit from an ability to raise debt.

4.6 Custodianship, restoration and other sources of public funds

British Waterways has a key role to play as guardian of an important national asset. Much of the canal network is over 200 years old and is an important part of our industrial heritage. Its waterways embrace 65 Sites of Special Scientific Interest and 800 designated conservation sites. It is also Britain’s third largest estate of listed buildings and structures with over 3,000 individually listed structures and 130 scheduled ancient monuments. British Waterways actively maintains these waterways and has extended the usable network in recent years through a programme of restoration of former canal lengths. With safety and customer service as top priorities, British Waterways runs a continuous programme of maintenance and improvement of the waterways network, creating a safe and attractive environment for its many customers.

BW works on a wide variety of projects of this nature in partnership with local authorities, voluntary and charitable organisations, to achieve common goals, from promoting access to its network for disadvantaged people, to education initiatives for children such as *WOW – Wild Over Waterways*. British Waterways’ also make a valuable contribution to the urban and rural environment, and its waterways perform important land drainage and water resource functions.

Over the last few years, BW has been successful in attracting substantial funding from sources such as the EU, central and local government initiatives and the Lottery, in order to carry out additional improvements to the waterway network for the public benefit. These range from a number of major multi-million pound restoration projects to create new, or re-create former canals, to smaller, local enhancement schemes. In 2005/6, this amounted to £14.5 million

Continued eligibility for such funding would clearly allow BW to enhance further the public benefits of the Waterway network. The review will need to consider how alternative structures might address this issue.

There is a very strong culture and tradition of community ‘ownership’ of the waterways generated and maintained by a well established network of national and local stakeholder groups and organisations. The restoration or renewal of a number of BW waterways was inspired and driven by these bodies of passionate enthusiasts which reinforces that culture of ‘ownership’. They can be a powerful lobby and they jealously protect the heritage they have played a key part in saving.

Certain local authorities that have a history of financial support of their local waterways also adhere to a culture of community ‘interest’ in their local waterways. The review will have to take into account these strong traditions.

4.7 BW’s Balance sheet and the waterway network

BW’s balance sheet is strong, largely underpinned by ungeared property assets. However, BW’s statutory duty for the maintenance and upkeep of the waterway network places a considerable liability on the organisation, which is not reflected in the balance sheet.

The waterway network requires considerable annual costs to maintain it in an acceptable state, irrespective of an existing backlog of major maintenance arrears and BW’s desire to continually enhance the quality of the network

The review will need to consider how alternative structures will best be able to secure the long term upkeep of the waterways and the impacts on BW's balance sheet.

4.8 Devolution

As a single entity cross border authority BW is subject to the policy direction of two governments with the following consequences:

- Separate funding regimes
- Separate objectives of the different governments
- Increased pressure on BW for transparent separation of its finances between Scotland and England & Wales
- Increased clarity about cross-border flows

BW has hitherto funded its business as a single organisation within this framework and believes that this has resulted in a more effective business. However, this review will need to ensure it addresses the needs and aspirations of both Governments and it is possible that recommendations may be different for the two parts of BW's business.

4.9 Clarity of relationship with Government

An outcome of the last quinquennial Policy Review of BW (March 2005) was a recommendation that Defra funding of BW be changed from annual deficit grants to a performance monitored contract of 5-7 years duration. Such move (endorsed by BW) was intended to improve the efficacy and certainty of Defra funding, as well as clarifying and defining the outputs from BW in return for the proposed contracted grant.

Before any contract could be agreed, Defra budget difficulties caused in-year cuts to BW grant and accelerated reductions of grant funding for future years, confirming the unreliability/volatility of this revenue source.

It is arguable that any contractual arrangement with government that provides relative security of funding over a period of years will only be credible if BW is further distanced from government by being taken out of direct state ownership. Political acceptability of this will depend on the nature of the alternative and may vary north and south of the border.

4.10 Governance structures

BW is governed by a wholly non-executive Board consisting of a chairman, vice-chairman and (currently) seven members. Appointments are made by the Secretary of State for Environment, Food and Rural Affairs, apart from two board members who are appointed by Scottish Ministers. Reporting to the Board is an executive team of directors, headed by a chief executive, who is appointed by the Board and has responsibility for management of the organisation.

The Board operates within the framework of a specific existing statutory regime that is outside the Companies Act but in certain respects emulates it. Ministerial reserve powers are regulated by a Financial Memorandum with each of DEFRA and the Scottish executive which governs the reporting mechanism and authority levels.

A key (and challenging) part of the Review will be the consideration of alternative governance structures in the event that an ownership arrangement other than direct state ownership is recommended. This review will need to examine how any proposed governance structures will provide assurance of standards of stewardship acceptable to a broad community of stakeholders as well as effective and efficient management of a relatively complex business by persons with the necessary skills and capabilities.

4.11 Taxation and Accounting

The review will need to consider the comparative taxation impact of alternative structures in the light of the following:

- Normal corporate tax status applies
- But expenditure on the waterways is fully expensed in the year and is not capitalised
- Hence target of break-even revenue result and little corporation tax
- Though capital gains tax on property transactions
- Realised property disposal gains are taken to capital reserve and do not form part of the revenue result
- Joint venture dividends are treated as revenue income and taken account of in the break even revenue result

4.12 Statutory and regulatory framework

In addition to its key constitutional statutes (Transport Acts 1962 and 1968) the waterway estate is held under powers contained in and regulated by some 350 other local Acts, the majority being late 18th or early 19th century. There are also some 25 or so post war private Acts relating to the waterways.

A key modern impact is the recent significant growth in environmental regulation much of it being of EU origin (e.g. Habitats Directive & Water Framework Directive). The impact of this regulation is growing a cost of compliance.

There is no dedicated economic or conduct of business regulator of BW though there is a dedicated Waterways Ombudsman that determines complaints of consumers and small businesses that are not resolved under BW's internal complaints procedure.

This review will need to identify the changes that will be necessary both through primary legislation and other, in order to implement any recommendation, as well as identifying those elements which need to be protected

5. Scope of this review

BW seeks to examine whether alternative structural options, to the current Public corporation status can be both acceptable to stakeholders and better deliver the issues described above in section 4, and if so, whether the improvement is sufficiently transformational to progress a change.

At this stage BW has no pre-conceived preferences for the optimum structure but believes that the alternative options to consider should include both traditional structures of private ownership (e.g. listed plc) and also community ownership (e.g. trust or trust like entities such as Community Interest Companies). Furthermore a layered structure may be appropriate for governance reasons (e.g. umbrella trust or CIC with different structure below it). The possible range of structures includes:

1. Status Quo
2. A plc, quoted on the London Stock Exchange
3. As for (ii) with majority control by Government
4. As for (ii) with a Government "Golden Share"
5. Non-listed company, limited by shares or by guarantee
6. Community Interest Company (limited by shares or by guarantee)
7. Non charitable Trust
8. A Charitable Trust
9. Charitable Incorporated Organisation

Within these options, there is also the potential to consider any need or preference to adjust BW's current integrated business model (above).

There is also a need to consider the potential for separate solutions in England/Wales and Scotland

BW seeks to understand from this review:

1. What the realistic alternative options are compared with the status quo;
2. Their comparative abilities to address the issues in Section 4;
3. The comparative implications for BW as an organisation and its people, the Government and the nation at large;
4. Their comparative acceptability to BW's stakeholders, including relevant departments of Governments in both England/Wales and Scotland
5. The major issues to be addressed in any programme to change, and the relative complexity of these
6. An outline implementation plan, timetable and indicative cost for such a change

BW's appointed advisor will be expected to liaise with relevant stakeholders, particularly Government, to facilitate agreement to its recommendations.

6. Appointment of advisors

Eight firms have been invited to consider this brief. They are:

1. JPMorgan Cazenove
2. KPMG
3. L.E.K Consulting
4. Merrill Lynch International
5. The Monitor Company
6. Morgan Stanley UK Limited
7. Navigant Consulting
8. N.M. Rothschild & Sons

BW reserves the right to add other organisations to this initial list; and also the right not to appoint any of these organisations.

These organisations are invited initially to confirm their interest in this opportunity, and then to submit initial outline proposals to BW as to:

1. The nature, scope and process for undertaking the review;
2. Initial thoughts on the issues that will emerge and how they might be addressed;
3. Their credentials;
4. The team members their expertise and role in the project,
5. In particular, the expertise and role of the lead partner/director
6. Indicative approach, programme and duration for the review; and
7. An indicative pricing proposal.

BW anticipates that the optimum approach to this review will involve discreet phases, allowing the Executive, Board and (if appropriate) Government(s) to agree each phase and help shape subsequent phases. It is expected that the review will involve some detailed financial modelling as part of the comparison of the various options and their ability to address the points in Section 4 above.

It is anticipated that BW's selection of advisor will be strongly influenced by the experience of the advisor and in particular the lead partner/director in similar engagements, the level of involvement of the lead partner/director and his/her credibility within the relevant Government Departments.

In particular, because of the devolved nature of BW's governance, the selected advisor will specifically need to demonstrate, through their own offices or sub-contracting, if appropriate, an ability and a process for separately progressing solutions in England/Wales and Scotland. BW has not pre-selected any specific sub-contractors in Scotland, but is aware of organisations who may be appropriate for this role, should advisors wish to progress this option.

BW is also concerned to ensure their appointed advisor can clearly demonstrate their independence, in providing best advice to BW, irrespective of any potential subsequent transaction and, while taking into account the objectives of existing stakeholders, best reflect the optimum solution for British Waterways.

It is anticipated that prior to submitting their initial proposals, advisors will have considered the background material listed in Section 3 and any further requested material which BW will make equally available to all potential advisors.

BW executives will be available for discussions in order to help advisors shape their initial proposals. These initial proposals should be submitted within two calendar months of the date of this letter.

Proposals will be considered by a steering group of BW executive directors: Robin Evans, Chief Executive; James Froomberg, Commercial Director; Philip Ridal, Finance Director, Nigel Johnson, Legal Director and Steve Dunlop, Director, Scotland.

It is anticipated that the steering group will then invite some or all bidders to attend a discussion and interview session, which the BW Chairman, Tony Hales, and the Chairman of the BW Scotland Group, Campbell Christie, will join.

The steering group may then seek further refinement of (some of) these proposals, in discussion with interested parties and it is anticipated that the selection of the appointed advisor, together with agreeing the full scope and contract for their appointment, will take a further 2 calendar months from receipt of initial proposals.

Proposals and enquiries should be addressed, in the first instance to:

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Hard copy or electronic submissions are equally welcome.