

TRANSPORT FOR LONDON

BOARD

SUBJECT: PPP UPDATE

DATE: 24 MARCH 2010

1 PURPOSE AND DECISION REQUIRED

1.1 The purpose of this paper is to:

- (a) provide a summary of the Arbiter's findings published on 10 March 2010 and the implications thereof;
- (b) address the impact of the Arbiter's findings on the affordability of the works to be undertaken by Tube Lines (TLL) in the second Review Period (RP2) of the PPP Contract (Contract) and describe how the Arbiter has addressed the responses made by the Mayor, Transport for London (TfL) and London Underground (LU) on this and other matters; and
- (c) describe the position on TLL related issues.

1.2 The Board is asked to note the contents of this report.

2 BACKGROUND

2.1 The Contract with TLL commenced on 1 January 2003. It is a 30 year contract with a 'Periodic Review' every 7.5 years to re-set the costs going forward. The Contract requires certain key deliverables (eg the Jubilee line upgrade (JLU)) plus a general obligation to improve asset condition and deliver a target level of asset performance. LU pays TLL an 'Infrastructure Service Charge' (ISC) each four-week period.

2.2 The Periodic Review process commenced formally in December 2008 when LU issued Restated Terms and its Affordability Constraints¹. The Restated Terms involved pragmatic scope reductions which it was anticipated would result in a decrease in cost from the current Contract terms.

2.3 The TfL Board was advised on 5 November 2008 that, at that time, it was thought that, if the Arbiter's determination of costs was in line with his Initial Ranges Guidance provided in 2008, then the Restated Terms would imply a funding shortfall, assumed to be financed by TLL as prescribed in the Contract. The Board was advised that LU would continue to take steps to mitigate that gap, but in the event that these steps were unsuccessful, there was a risk that TfL would need to revisit its Business Plan. This was prior to the impact of the economic downturn and the measures adopted in the 2009 Business Plan.

¹ Restated Terms are part of the Periodic Review process whereby LU gets an opportunity to change the PPP Contract and TLL can revise its pricing for performing the obligations, whether LU changed them or not. Affordability Constraints represent LU's best estimate at the time of the level of payment it expects to be able to afford to pay TLL.

- 2.4 Following the issue of Restated Terms, early in 2009 LU shared the build-up of its Affordability Constraints with the Arbiter and acknowledged that they would likely imply a need for further finance, based on the understanding of likely costs at that time.
- 2.5 On 30 June 2009, TLL submitted its pricing proposals to LU for RP2; TLL's price was £6.8bn, well above LU's view of base costs for RP2, which by June 2009 had materially reduced to £4.2bn² based on the Initial Ranges Guidance with adjustments for pragmatic reductions in scope, reductions in the risk profile reflected in Restated Terms, and changes in economic conditions.
- 2.6 LU engaged with TLL over the summer of 2009 and came to various agreements over Contract terms and scope which led to a marked reduction in TLL's prices to £5.8bn, but they were still considered by LU to be unacceptably high, given its own assessment. LU's view of RP2 costs reduced marginally to £4.0bn during this period (as the tightening of scope definition was offset by identified minor scope omissions); at this level of cost, no finance would be required.
- 2.7 On 23 September 2009, LU called upon the PPP Arbiter to set a fair price for the Restated Terms, as per the process defined in the Contract.
- 2.8 The Arbiter published his draft direction on base costs on 17 December 2009 together with his views on scope, performance, access and whether the Restated Terms involve a material increase in risk. He assessed RP2 costs at £4.4bn which, when converted to outturn, led to a funding gap of £463m in RP2. He also published 'Initial Thoughts' on affordability and financing. He requested representations from the parties and stakeholders by 5 February 2010.
- 2.9 The Arbiter invited LU and its stakeholders (TfL, the Mayor and DfT) to confirm whether the costs in his draft direction were affordable, or whether LU wished to de-scope to avoid having to finance this amount. If it were to be financed, the Arbiter sought representations on whether the finance would better be raised by TfL or TLL.
- 2.10 On 3 February 2010, the Board considered these questions and endorsed a response to the Arbiter rejecting the invitation to reduce scope and seeking the removal of the secondment fees payable to the shareholders. Further, the Arbiter was asked to reconsider his position on the raising of finance by TLL. LU made detailed representations that the Arbiter's costs were overstated and should be reduced to below £4bn.
- 2.11 The Arbiter has now issued a final costs direction and a draft direction on the ISC and financing issues. He invites representations on his draft direction by 9 April 2010 with a view to making final directions on ISC and financing issues by 29 April 2010.
- 2.12 The remainder of this paper describes the Arbiter's latest findings and considers the overall implications.

² All RP2 costs are expressed in February 2008 prices.

3 SUMMARY OF THE ARBITER'S FINAL COSTS DIRECTION AND GUIDANCE

3.1 The key points are:

Costs

- (a) The Arbiter's RP2 costs have changed from £4.394bn to £4.459bn, an increase of £65m. A cost summary is attached as Appendix 1 showing the changes between the draft and final Costs Direction. All costs in paragraph 3 are expressed in February 2008 prices.

Impact of LU Behaviour

- (b) The Arbiter confirms his position that he is not persuaded he should make a specific allowance in Notional Infracosts, in either RP1 or RP2, to reflect the behaviour of LU as client under the Contract. Rather the Arbiter considers that these are matters which are properly the subject of claims. He refers to the outcome of the £327m claim from TLL with respect to the Jubilee and Northern Line Upgrades (JNUP), which was dismissed in its entirety and says that the adjudicator's opinion supports a view that it is TLL's approach that has increased costs rather than LU's behaviour.

Timing/Costs of Upgrades

- (c) The costs awarded for the Upgrades have increased by £75m from £535m to £610m (against TLL's submission of £1.138bn and LU's of £476m). The Arbiter maintains his position that the Northern Line and Piccadilly Line Upgrades (NLU and PLU) can be delivered by the Contract dates meaning that all of JLU falls in RP1. As regards NLU and PLU, the increase is due to changes in the benchmarking analysis he has used and a reassessment of how much work on NLU would fall in to RP2 (now increased to over 50%).

Secondment Agreements

- (d) The Arbiter has not materially changed his position in relation to payments under the Secondment Agreements from TLL to the shareholders Ferrovial and Bechtel for RP2 (albeit it continues to be based on his own assessment of costs rather than TLL's). He dismisses the arguments made by the Mayor and TfL about the relationship between payments to shareholders and the affordability gap. He accepts LU's arguments relating to failure of TLL to deliver the JLU (which enables him to revisit the payments under the Secondment Agreements), but then decides that it is appropriate to assume a Notional Infracost could have in place secondment agreements of this nature.

Closures

- (e) The Arbiter accepts that the allowances for closures in RP2 set by LU in Restated Terms are sufficient. It should be noted this is Guidance only – TLL has referred this matter to dispute resolution as envisaged under the Contract and a decision of an adjudicator is expected on 13 April.

Differential Inflation

- (f) The Arbiter has increased his allowance for differential inflation costs from £172m to £196m. However, he has reduced his allowance for differential inflation risk (£138m reduced from £160m). The overall position is therefore largely unchanged.

Material Change in Risk

- (g) The Arbiter maintains his position that there is no material change in risk arising from the contractual provisions in Restated Terms. However, he has now raised the suggestion that there could be a material change in risk arising from the ISC payment profile (see paragraph 4).

Reopeners

- (h) The Arbiter's costs direction is final, save in three respects where it may be reopened without time limit (save where time limits are created by the Contract provisions for the Latest Financing Date, which could only be extended to 30 June 2011). First, he has invited LU and its stakeholders to consider whether they wish to change the Contract and his cost directions can be reopened to incorporate the effects of any such changes. Secondly, his direction assumes that TfL provides the finance for the Piccadilly Line rolling stock under leasing arrangements, but these arrangements have not yet been finalised, so his direction may need to be revised if TfL does not approve them. Thirdly, the dispute in relation to closures may result in further changes to Restated Terms.

4 SUMMARY OF THE ARBITER'S DRAFT ISC AND FINANCING DIRECTION

4.1 The key points are:

Effects of LU's Affordability Constraints

- (a) The Board was provided with a full description on 3 February of how the Contract was intended to operate in circumstances where there was a funding gap between the total costs and the amount that LU could afford to pay in ISC as notified to TLL and the Arbiter in its Affordability Constraints and ISC profile³ issued with Restated Terms in December 2008.
- (b) According to the Contract, TLL is required to attempt to raise finance to meet the funding gap if costs exceed LU's Affordability Constraints. If TLL fails to raise the necessary finance, LU is given a series of options ("LUL Options"), including paying more or reducing scope so as to reduce cost. LU can decide not to exercise any of the options, in which case the Contract will end through a process called 'Special Mandatory Sale' under which an LU nominee would acquire TLL through an asset transfer. As with Metronet, this would require TLL's existing debt to be repaid (unless it was possible to agree direct arrangements with the lenders). The shareholders would receive nothing, unless the Arbiter found that LU had made changes to Restated Terms making finance harder to raise than anticipated, or it was established that a Notional Infraco was incapable of raising finance.

³ Affordability Constraints were expressed in outturn and the ISC profile represented the RP2 Affordability Constraints deflated to February 2008 prices using assumptions considered appropriate at the time.

- (c) However, in his draft direction, the Arbiter has maintained his interpretation of the Contract that he is not necessarily bound by LU's stated Affordability Constraints, but can require it pay an ISC above this level. He also states that he considers TLL should be funded by ISC in RP2.
- (d) The Arbiter has failed to explain his reasoning in full for his view on Contract interpretation (despite LU explicitly requesting him to do so in its Representations), thus denying LU a proper opportunity to make informed representations on the point.
- (e) The Arbiter also considers that LU's interpretation is inconsistent with his statutory duties to allow LU a chance to descope for affordability, to promote economy and efficiency and to allow Infraco to plan its activities with reasonable certainty. He cites three factors:
- TLL's financing would count against TfL's borrowing limits, as was recently confirmed to him by DfT;
 - The independent financial adviser appointed jointly by the parties (Royal Bank of Canada) agrees with TLL's argument that the extra cost of private finance is not outweighed by the benefits of external scrutiny of new private finance; and
 - Private finance would significantly increase RP3 and RP4 costs (by £125m per year in RP3).
- (f) Finally, the Arbiter states that LU's interpretation might lead to circumstances where a Notional Infraco would be incapable of financing performance of Restated Terms on any basis, such that LU would have to submit revised Restated Terms. Further, he states that it would not remove the problems of affordability, because:
- TfL would need a higher borrowing limit which DfT would probably not allow;
 - There could be a material change in risk; and
 - There could be a financing impossibility.

Credible Plan

- (g) Representations made by the Mayor, TfL and LU in February 2010 all emphasised the need for TLL to raise finance in order to achieve an independent source of scrutiny and assurance as to its plans for delivering its obligations. The Arbiter has not accepted this, but states that this issue will be addressed following completion of Periodic Review. The Contract contains a requirement for TLL to produce a draft asset management plan by 28 October 2010. The effect of this is that the public sector is being required to finance the Contract when no one apart from TLL (and possibly its existing lenders) has any visibility of whether TLL has a credible plan to deliver its RP2 obligations when its last cost submission was £1.4bn above the sum awarded by the Arbiter.

- (h) This position seems very much at odds with the conclusions reached by the House of Commons Committee of Public Accounts in its report entitled “Department for Transport: The Failure of Metronet”, published on 2 March 2010. This report was highly critical of the arrangements in place for oversight and monitoring of Metronet. It is also at odds with the approach the Arbiter adopted in relation to the Metronet Extraordinary Review in 2007 where he made his award of interim ISC conditional on Metronet being able to fund any gap between the ISC and its cash requirements to deliver its obligations.
- (i) On 10 March 2010, TfL wrote to the Security Trustee appointed with respect to TLL’s existing debt, reminding TLL’s lenders of their powers of scrutiny over TLL’s plans and encouraging them to use those powers to ensure that TLL presented a credible plan for RP2. The letter also sought lenders’ views on the desirability of TLL being required to raise further finance. Both TLL and the Arbiter have taken issue with the letter but TfL has re-asserted its right to raise these questions.

Material Increase in Risk

- (j) The Arbiter has raised a wholly new point, which is that requiring TLL to raise finance might result in a material increase in risk, because of the increase in ISC in RP3 which would result, as the new finance starts to be repaid. The Arbiter says that an increase in ISC from RP2 onwards is inconsistent with what the parties expected at transfer, and that this might amount to a change to the ‘essence of the deal’ they agreed. He also suggests that lenders might be worried about the risk of a payment default by LU.
- (k) LU believes that the Arbiter’s position is incorrect for two reasons. First, LU does not consider that the Arbiter has the power to make a direction that there is a material increase in risk on this basis. Second, the proposition that the parties thought the ISC would reduce from RP2 is inconsistent with the facts and with the inclusion of the Periodic Review financing provisions in the Contract which, if used, would inevitably increase the ISC. Whether the deal is the ‘same in essence’ as that at transfer has no contractual relevance. The idea that LU, as a public body backed by TfL and operating under a Government comfort letter, would default on its payment obligations, lacks credibility.

Financing Impossibility

- (l) If LU’s Contract interpretation were correct, the Arbiter states he would need to consider whether a Notional Infraco could raise the necessary finance, given the level of LU’s Affordability Constraints and that such a finding would require LU to modify the Restated Terms to remove the cause of a financing impossibility. However, the Arbiter accepts that LU asked him to adjust the Affordability Constraints in RP3 and RP4 to the extent he considered necessary, and he has done so in giving his ISC directions. He could therefore only direct a financing impossibility by treating the Affordability Constraints as binding for this purpose, but non-binding for the purposes of his other directions.

Invitation to Change Scope

- (m) The Arbiter invites LU to state whether it wishes to change its requirements.

Funding Gap

- (n) According to the Arbiter, his cost directions give rise to a funding gap of £330m. This understates the true position. When LU issued Restated Terms in December 2008, it issued its Affordability Constraints in outturn prices and the ISC profile in 2008 prices. The Arbiter has taken LU's ISC profile and inflated these using his own inflation assumptions which are higher than LU's projections in December 2008⁴. However, LU's actual affordability limit is the Affordability Constraints which are in line with TfL's Business Plan. The Arbiter has also disregarded various other pressures on LU's Affordability Constraints as notified to him in LU's February representations. The estimated shortfall against the part of TfL's Business Plan relating to TLL is therefore not £330m, but £618m.

Profile

- (o) As the Arbiter appears to assume that the ISC profile is a "shape" rather than a constraint on his ability to set an ISC above LU's Affordability Constraints, he has set an ISC that front-loads the ISC, so that TLL will have a cash surplus of circa £190m in the period to 30 September 2013. This places additional pressure on TfL's Business Plan in the early years. It also demonstrates that the contractual interpretation being adopted by the Arbiter is capable of damaging consequences when carried to its logical conclusion.

Cost of Finance

- (p) The Arbiter estimates that if TfL were to fund the gap (as he calculates it), it would need to raise £449m of debt⁵ at a funding cost of £785m over the remaining periods of the Contract. If TLL were to raise the finance, it would need to raise £802m (85% debt: 15% equity) at a funding cost of £1.85bn. TfL is reviewing these projected funding costs.

Representations and Next Steps

- (q) The Arbiter has listed six issues on which he seeks specific representations from the parties and their stakeholders. These are:
- any changes to the Affordability Constraints and ISC profile LU wishes to make;
 - whether LU wishes to change its requirements (i.e. reduce scope);
 - the value for money of different approaches to closing the funding gap, having regard to the views of the independent financial adviser jointly appointed by the parties;
 - whether the change in future payment profiles to fund TLL finance would result in a material increase in risk;

⁴ The Arbiter has used the following RP1X assumptions: 2011/12 – 1.86%, 2012/13 – 2.40%, 2013/14 – 2.51%, 2014/15 – 2.60% and thereafter 2.69%.

⁵ The difference between this figure and £330m is the additional amount needed to pay interest on the new finance in RP2.

- whether the ISC profile and Affordability Constraints create a financing impossibility; and
 - whether, given his statutory objectives, the Arbiter should require TLL to be fully funded by ISC.
- (r) The final date for such representations is 9 April. Final directions on the remaining issues (which are level and profile of the ISC, financing requirement, financing impossibility, material change in risk and fixed amounts) are due on 29 April. LU is seeking clarity from the Arbiter as to how the reopener referred to in paragraph 3(h), which provides LU with an opportunity to change the Contract following his costs direction, will interact with his final directions on ISC and financing.

5 RELATED ISSUES

Line Upgrades

- 5.1 TLL has advised in its recovery plan that the JLU will be complete by October 2010 and a programme of weekend closures up to October 2010 has been agreed, in line with LU's Contract obligation. Progress has been made at the eastern end of the line, but the key risk now is the final section of the line at the north end, which encompasses mixed mode running with the Metropolitan line and with Neasden depot. TLL is working on an alternative proposal to commission the line that would see a series of weekends with a split service from May; using the new signalling east of Waterloo and conventional signalling north of Green Park, with no service at Westminster station only. The proposal avoids a big bang approach to commissioning and may reduce the full weekend closures required.
- 5.2 LU served a Corrective Action Notice (CAN) on TLL in January 2010 requiring completion of the JLU by October 2010. This is a contractual remedy which could ultimately lead to a mandatory sale if TLL fails to remedy the breach. TLL has not challenged the validity of the CAN.
- 5.3 The impact of the delay on the JLU on the completion date for the Northern Line Upgrade (NLU) is as yet unknown but it is likely to be significant. TLL is currently set upon starting an intensive weekend closures programme from the end of March 2010, with circa 65 weekends requested, plus early closing of the whole line north of Stockwell every Sunday-Thursday for 16 months from July 2010 (that would mean last trains leaving central London before 22.30 hrs). LU has urged TLL to re-visit its plans to develop a much less disruptive approach and they are now working on a series of smaller, albeit earlier (from 22:00 hrs) weekday shutdowns on discrete branches of the line, which will be less disruptive to customers overall. LU has urged TLL to present its plans as soon as possible given the urgency of the imminent closure programme. The major shift in approach that LU hoped to see – with a move to an “overlay” signalling design that would dramatically reduce disruption, and/or a greater investment in off-site testing – has not been adopted by TLL.
- 5.4 In 2009, TLL submitted a claim for £327m for delay and disruption arising from LU's conduct with respect to JNUP – this claim was rejected “in its entirety” by an independent adjudicator on 22 January 2010, with TLL found to bear full responsibility for the costs and delay. TLL has now referred this matter to court.

Northern Line Claim

- 5.5 On 15 March 2010, another independent adjudicator dismissed, in its entirety, a claim for £34m which related to changes LU made to the Northern Line timetable which improved reliability of the line, but which TLL asserted had a negative impact on their business. This claim was particularly frustrating for LU since TLL submitted – and won – a number of partnership awards with LU and the fleet maintenance company, Alstom, for improvements to reliability of the Northern Line, which included the timetable changes introduced by LU.

Other Disputes

- 5.6 There are various other disputes in active stages including in relation to closure allowances for RP2 and the RP1 stations programme (in respect of which 3 “sample” stations are currently being pursued by TLL with a claimed value of £17.9m). Adjudicators’ decisions are due in respect of these two disputes on 13 April 2010.

Proposed Chief Executive of TLL

- 5.7 On 15 March 2010, TLL reported that it was in contractual negotiations with Tim O’Toole (the former Managing Director of LU) to recruit him as TLL’s new Chief Executive.

Audit of Secondment Agreements

- 5.8 LU commenced a forensic audit of payments made in RP1 under TLL’s Secondment Agreements on 10 March. TLL reported payments of £438m in its statutory accounts for the past six years, but LU does not understand the basis on which these payments have been made and does not have full copies of the secondment agreements under which they were paid.
- 5.9 Initially the audit was to be undertaken with the support of external auditors, KPMG. However, KPMG declined to take the assignment forward following objections from the Arbiter who engages KPMG and another firm as his reporters in relation to the Contracts. LU is now supported by Ernst & Young. Since 10 March, there have been a series of letters between TLL and LU with TLL questioning the ambit and purpose of the audit, although LU has broad contractual audit rights.

6 RECOMMENDATION

- 6.1 The Board is asked to NOTE the contents of this report.

7 CONTACT

- 7.1 Contact: Richard Parry, Interim Managing Director, London Underground
Number: 020 7027 8499
Email: Richard.Parry@tube.tfl.gov.uk

COST SUMMARY⁶

FINAL DETERMINATION 01/03/10: FINANCIAL SUMMARY AND COMPARATIVES					
<i>£m (2008)</i> "(")=reduction	TLL	LUL	OPPPA		
	Revised as at 01/02/10	Revised as at 17/11/09	As at 17/12/09	Revised as at 17/03/10	Change
JNUP	418.1	121.7	142.8	196.7	54.0
PLU	719.5	354.4	392.2	413.7	21.5
Rolling Stock & Depots	644.2	481.5	546.9	548.3	1.5
Rolling Stock - PL Lease	162.3	135.6	162.3	133.1	(29.2)
Rolling Stock - NL Lease	284.5	266.7	284.5	241.1	(43.4)
Signals (non-upgrade)	195.8	149.2	183.3	154.1	(29.3)
Stations	704.2	491.3	542.2	527.1	(15.1)
Lifts	111.5	77.4	36.9	78.6	41.7
Escalators	252.4	154.0	189.0	209.2	20.2
Civils	193.8	188.6	185.9	153.9	(32.0)
Track	640.4	509.9	460.5	476.6	16.1
Power	41.4	26.3	35.0	35.0	0.0
Central Costs	652.5	465.9	587.1	603.2	16.1
Secondment Fees	229.6	195.5	195.0	197.3	2.4
Total Base Costs	5,250.1	3,617.8	3,943.6	3,967.9	24.3
Risk (excluding DI risk)	188.7	168.5	263.0	304.0	41.0
Differential Inflation Risk	148.7	55.7	160.0	138.0	(22.0)
Differential Inflation	374.6	199.0	171.5	196.1	24.5
Efficiencies	(131.7)	(37.8)	(143.3)	(158.8)	(15.5)
Treasury costs and arrangement fees	11.5	11.5	0.0	11.5	11.5
Total Costs	5,841.8	4,014.6	4,394.8	4,458.7	63.8

⁶ There are small rounding differences between the Arbiter's published findings and his detailed calculation.