



## London Underground PPP: background

Standard Note: SN1307  
Last updated: 16 January 2012  
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Section: Business and Transport

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This note looks at contemporary assessments of the investment needed to upgrade the London Underground, some of the proposals consequently put forward to bring this about and the Labour Government's final decision to fund future development with a Public Private Partnership (PPP).

By the late 1990s there was general agreement that it should be a priority to secure investment in London Underground in order to improve services and bring the network up to modern standards. This could only be achieved with a stable funding regime to allow investment to be planned ahead.

While the previous Conservative Government announced its intention to privatise the Underground, the Labour Government that took office in 1997 opted instead for a PPP. In taking this decision it faced opposition from a number of quarters, including unions and safety campaigners and the first Mayor of London, Ken Livingstone. Mr Livingstone and his Transport Commissioner, Bob Kiley, took the government to court over the decision and championed an alternative method of raising money, via the issue of bonds secured against future fare revenues from London. This was rejected by the Treasury.

Mayor Livingstone was ultimately unsuccessful in his challenge and the PPP went ahead in 2003.

Plagued by problems, the PPP collapsed in 2010 when Transport for London bought out the private companies in the Tube Lines consortia; this followed the administration of Metronet in 2007. These matters are dealt with separately in HC Library note [SN1746](#), available on the [Railways Topical Page](#) of the Parliament website.

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# 1 Introduction: investment in London Underground

London Transport submitted a Memorandum of Evidence to the Transport Select Committee in 1997 in response to thirteen specific questions posed by the Committee on London Underground's finances and investment programme.<sup>1</sup>

'Backlog' was defined by LT as "the historical under investment in assets which results in service degradation or additional running cost". 'Steady state investment expenditure' was defined as the average annual investment required to fund at the end of their normal economic life the replacement of assets to current equivalent standards. A backlog is derived from an assessed shortfall of expenditure against steady state investment.

LT indicated that the size of the then investment backlog had been assessed at £1.2 billion. The most recent analysis at that time indicated that the required average steady state investment expenditure was in the region of £350 million per annum at 1997-98 prices rising to £380 million when the Jubilee Line became operational. LT stated that the reduction in LT funding under the 1996 public expenditure settlement over the three years, 1997-98 to 1999-2000 amounted to £380 million; this reduction coming in the last two years. No provision had been made for the additional Jubilee Line Extension (JLE) costs of £296 million so LT estimated that the total loss of funds for core investment would amount to around £700 million over the period to 1999-2000. The majority of this reduction would fall on the existing core network of London Underground which had led to both investment plans and financial projections being significantly revised. LT estimated that the backlog would increase by an extra £300 million by 2002-2003.

LT spoke of 'nominal self-sufficiency' which it defined as the "financial position attained when the business generates a sufficient annual Gross Operating Margin before depreciation and renewals to fund its average steady state investment". It did not include clearance of the backlog. With steady state investment of £380 million per annum after the commissioning of the JLE in 1998, LT forecast that it would achieve nominal self sufficiency by 2001-02. LT stated that grant would be needed to fund the following investment requirements:

- Recovery of remaining backlog
- Above average asset replacement due to peaks in life cycles
- Addition of new facilities within the core network
- Any further new lines and extensions following opening of the JLE

The only ways of reducing the investment backlog which emerged during the Committee Sessions were either increased Government grant or privatisation. The second Committee Session took evidence from the then Transport Minister, Mr John Bowis, on a proposal by the Conservative Government to privatise the London Underground.<sup>2</sup>

The new Transport Sub-Committee of the Environment, Transport and Regional Affairs Environment Select Committee took further evidence from London Transport on the finances of London Underground at a hearing on 29 April 1998. London Underground Limited (LUL) stated that the investment backlog remained at £1.2 billion. An improvement in performance was reported with passenger journey numbers up to 825 million in 1997-98 and an increase

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<sup>1</sup> Transport Committee, *London Transport: Minutes of Evidence* (session 1996-97), 327 i-ii, 19 February 1997

<sup>2</sup> *ibid.*

in train service volume of seven per cent. Gross margin was expected to be £260 million for 1997-98, up by £50 million from 1996-97.<sup>3</sup>

## **2 Conservative Government: LUL funding options, 1992-97**

### **2.1 Privatisation**

On 25 February 1997 the then Secretary of State for Transport, Sir George Young, announced a proposal to privatise the London Underground.<sup>4</sup> He suggested three possible models: the sale of London Underground as a single business; the sale or franchising of vertically integrated lines or groups of lines under which a single operator would be responsible for the stations, track and trains on each line or group of lines; or a structure like the national railways model, with a track authority owning the network and franchisees running trains on individual lines or groups of lines. The Conservative Manifesto for the 1997 General Election promised that proceeds from the privatisation would be recycled in order to modernise the network within five years and that the majority of the remaining surplus from privatisation would be channelled into additional support for transport investment in London and elsewhere in the country.

The then Minister, when interviewed by the Transport Select Committee, declined to put a price on the Underground although £2 billion was a figure mentioned at the time.<sup>5</sup>

The Labour Manifesto for the 1997 General Election stated that the Conservative plan for wholesale privatisation of London Underground was not the answer and proposed its own public-private partnership (PPP). The Chartered Institute of Transport (CIT) considered a simple sale of the entire tube network was unlikely for economic as well as political reasons.<sup>6</sup> The article suggested that although it might be possible for a single bidder such as Railtrack to take over the whole of the Underground, this would not necessarily provide the long-term competitive framework conducive to raising standards and containing costs for consumers. Furthermore, the tube infrastructure was so badly in need of a major overhaul that it was unlikely to be capable of being funded purely by the private sector.

### **2.2 Private Finance Initiative (PFI)**

An agreement between LUL and GEC Alstom for the supply of Northern Line trains was made after a competitive bidding process. Under the terms of the agreement Alstom would supply and maintain a fleet of 106 trains for the Northern Line. The company would finance the entire cost of the trains and their maintenance and would take a substantial share of the risks involved in the project. LUL agreed to pay Alstom between £40 and £45 million a year over twenty years. The new trains would, however, operate with old signalling, the provision of new signalling not being a sufficiently attractive project for PFI.

London Underground had three other PFI deals being developed at the time:

- Prestige, an automated ticketing system;
- Power, the operation, maintenance financing and renewal of LUL's high voltage generation and distribution assets and the provision of power supplies to the network; and

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<sup>3</sup> ETRA Committee, *London Underground* (seventh report of 1997-98), HC 715, 15 July 1998, Vol. II, p51

<sup>4</sup> [HC Deb 25 February 1997, cc149-152](#)

<sup>5</sup> "Mind the funding gap", *The Guardian*, 1 March 1997

<sup>6</sup> "Hard Labour on the London Underground" *Transport Law and Policy*, August/September 1997

- Connect, the provision of an integrated radio service across the Underground network.

These were valued at around £400 to £600 million.

London Transport in its 1996 Memorandum to the Transport Committee stated that not all investment needs lent themselves to a PFI solution, particularly crucial infrastructure work, and that it regarded PFI as a supplement to its investment funding not as a substitute. In their 1995 book, *Liberate the Tube!*, Stephen Glaister and Tony Travers distinguished between financing and funding.<sup>7</sup>

- They took **'financing'** as referring to the activity undertaken by an institution or group of institutions where they assume responsibility for lending the financial capital to purchase an asset or undertake a construction project in return for a future flow of cash payments.
- **'Funding'**, on the other hand, they described as the provision of real resources, now or in the future, which correspond to the resources devoted to the manufacture of an asset or construction of a project.

They illustrated this distinction with the example of a building society and a house purchaser. The former provides finance for the purchase of a house but the funding is the responsibility of the purchaser because he/she provides the real resources. They argued that PFI was about changing financing arrangements for the Underground but not about taking the burden of funding the system; they did not think that PFI could make a major contribution to providing new funds for the Underground.<sup>8</sup>

### 2.3 Public Interest Company

At a Chartered Institute of Transport conference, London First, an organisation of London businesses set up in 1993 mainly to lobby for transport improvements in London, revealed its suggestions for raising investment for London Underground. The London First Transport Initiative Funding Group had been working on proposals for new ways of financing transport investment in conjunction with Professor Stephen Glaister, then at the London School of Economics. In the long run they suggested setting up a London Transport Trust, a public interest company with a clearly defined legal structure, a definition of its liabilities, sanctions against directors etc. which would be able to borrow on the money markets.

An example was given of some American municipal transit authorities that issue municipal bonds: New York City Transit Authority at the time had \$27 billion of general obligation bonds on issue. Prof. Glaister considered, however, that the cash flow of London Underground at that time was not enough security on which to borrow. The solution would involve new sources of hypothecated revenue and a relaxation of treasury rules on the Public Sector Borrowing Requirement (PSBR). The new sources of revenue which were suggested were road user charges, charges on private non-residential parking, a levy on the uniform business rate and even a levy on the domestic rate.

Prof. Glaister considered that the public interest company which might own the Underground should then franchise the operation to the private sector. He concluded that any cost-cutting

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<sup>7</sup> Stephen Glaister and Tony Travers, *Liberate the Tube!: radical proposals to revitalise the London Underground*, Centre for Policy Studies, 1995

to be made on the London Underground could be released in this way and the procurement of Underground services would then be on a par with the procurement of services on buses and suburban rail services.

### **3 Labour Government: LUL funding decision, 1997-2001**

#### **3.1 Government's preferred option**

The incoming Labour Government in 1997 had committed to adhere to the previous Government's spending plans for two years; this meant that the future funding needs of the Underground had to be given special consideration. In July 1997 the Government appointed Price Waterhouse to provide financial advice on a range of possible public-private partnerships (PPPs) for the London Underground and to report by October 1997. The advisers' work was to be carried out within the framework set out in the [Labour's Manifesto for the 1997 General Election](#), which rejected the wholesale privatisation of the Underground. In a written answer in November 1997 the then Minister for Transport in London, Glenda Jackson, listed the options which were being considered by Price Waterhouse:

- Debt funding with public ownership;
- Partnership structures which could involve a trust;
- A joint venture concession or partial sale of the business, or a full concession; and
- Operational structures which could involve (a) single business (b) vertically integrated line businesses or (c) separating infrastructure from operations.<sup>9</sup>

The then Deputy Prime Minister, John Prescott, announced the Government's plans for the future of London Underground on 20 March 1998.<sup>10</sup> The proposal had three main elements: operation in the public sector, infrastructure investment in a PPP, and immediate extra investment. He explained that London Underground would remain as a unified public sector operating company that would:

- own the freehold of the system;
- be responsible for safety; and
- employ train drivers, station staff and line and network controllers.

It would let between one, two and three infrastructure contracts to the private sector to maintain and modernise the Underground's infrastructure. The infrastructure contractors would be under an obligation to eliminate the investment backlog and there would be a performance regime with incentives and stiff penalties; the aim being to return the assets to the public sector at the end of the contract in a much-improved condition. The PPP was expected to deliver £7 billion of investment over fifteen years. The target date for awarding new contracts was April 2000.

It was proposed that although most staff would remain employees of London Underground, staff who were, at that time, working on the procurement, installation and maintenance of

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<sup>8</sup> information on PFI generally can be found in HC Library Research Paper [RP 03/79](#) and HC Library note [SN6007](#)

<sup>9</sup> [HC Deb 3 November 1997, c67W](#)

<sup>10</sup> [HC Deb 20 March 1998, cc1139-1556](#)

hardware (track, signalling, escalators and rolling stock) would transfer with their work to the contractors. This would be subject to detailed negotiation but Mr Prescott said that he had written to each member of staff assuring them that their employment rights covering pay, hours and union recognition would be protected under the new structure and that they would be entitled to remain in the Underground pension scheme and to benefit from concessionary travel.<sup>11</sup>

Mr Prescott also announced that the Government would be providing an extra £365 million for the Underground over the following two years. In his 1998 Budget speech, the then Chancellor of the Exchequer, Gordon Brown, mentioned an additional £500 million for public transport over the following three years.<sup>12</sup> The Department for the Environment, Transport and the Regions (DETR) confirmed that the exact figure was £475 million, the £500 million came from rounding, and that this was to be spent over two years and not three. Of the £475 million, £375 million was to go to London Transport for investment in the core Underground network and for preparing for the PPP: £125 million of this was to be spent in the first year and £250 million in the second year.

The projects expected to be carried forward with the additional investment were:

- Additional track works on the Victoria and Northern Lines;
- Conversion of old Jubilee Line trains for use on the Piccadilly Line with ten new trains available by 2001;
- Replacement of fifteen escalators; and
- Refurbishment of thirty stations.

At the same time the future of the administration of London Underground was bound up with the Government's proposals for a Greater London Authority and in particular a London Transport Authority which would have responsibility for bus and tube services in London.<sup>13</sup>

The Government undertook a formal consultation process to establish contact with potential bidders before taking final decisions. London Transport placed a notice in the Official Journal of the European Communities (OJEC) on 15 July 1998 inviting organisations to express their interest in being involved in the consultation exercise. Over one hundred responses were received and of these twenty respondents were invited to meet LT, the Government and their advisers to discuss the proposals, on the basis of the criteria set out in the OJEC.

### **3.2 Immediate reactions to the Government's proposals**

Most Members of Parliament who responded to Mr Prescott's statement in March 1998 were positive about the proposals, though not everyone agreed. Sir Norman (now Lord) Fowler, then Shadow Opposition Spokesman for Environment, Transport and the Regions, said that the Government's proposals were "an unsatisfactory and inadequate compromise". He went on:

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<sup>11</sup> DETR, *London Underground Public-Private Partnership: Facts and Analysis*, 20 March 1998 [HC deposited paper DEP 3/6283]

<sup>12</sup> [HC Deb 17 March 1998, cc1111-1112](#)

<sup>13</sup> further information on the governance changes in London and how it affected London transport is available in HC Library Research Paper [RP 08/36](#)

The Secretary of State has accepted the principle of privatisation for infrastructure investment - in total contrast to many of Labour's statements before the general election - but he is content for operations to remain as a nationalised industry, which almost everyone now thinks is an outdated and failed model.<sup>14</sup>

The Transport Sub-Committee of the Environment, Transport and Regional Affairs Committee conducted an inquiry into the principle of the plans announced on 20 March 1998 and how they would work in practice.<sup>15</sup> London Underground, in its memorandum to the Committee, said that it fully supported the PPP because it secured consistently adequate funding to support future investment. It had expressed the view in its earlier memorandum to the Transport Committee that this was the key to the Underground's future. LUL agreed with Price Waterhouse's assessment that there would be a healthy level of investor interest, based on an analysis that they had carried out the previous summer. Mr Peter Ford, however, who had been dismissed as Chairman of London Transport the previous week, said in his evidence to the Committee that the PPP option was low down on LUL's list of preferred options. He also said that he expected the extra costs of splitting the Underground into private and public sector bits would be around £1 billion over 25 years.<sup>16</sup>

Denis Tunncliffe, then Managing Director of LUL, said in his evidence that the management would prefer to deal with one private sector owner of the Underground infrastructure. Peter Ford also said that the fewer the number of interfaces the easier the structure would be to manage. Mr Tunncliffe stated that the most likely period for track concessions would be 15 to 25 years.<sup>17</sup> Railtrack, who also gave evidence to the Committee and were expected to show an interest in taking over the Underground infrastructure, said that they would favour contracts of at least 20 years. Railtrack issued a press notice on the day of Mr Prescott's statement welcoming the proposal to use private sector funding to regenerate the Underground and stating that it felt that it would be an ideal partner to work with Government on the project.<sup>18</sup>

Jimmy Knapp, then General Secretary of the Rail Maritime and Transport (RMT) union, said in his evidence to the Committee that there were many preferable ways of funding the Underground, such as parking and congestion charges or a supplement on business rates.<sup>19</sup> On the 15 and 16 June 1998 the RMT called a 48-hour strike on the Underground to demand no compulsory redundancies when the Government's plans for the Underground were put in place, a commitment LUL were not in a position to give. It was reported that the union wanted all Underground staff to remain employed by LUL and contracted out to the private sector rather than be transferred to the new companies.<sup>20</sup>

The London Regional Passengers Committee (LRPC), now [London TravelWatch](#), the statutory representative body for Underground users, welcomed in particular the retention of London Underground as a single, integrated, public-sector operator. It also welcomed the establishment of binding long-term contracts for infrastructure repair and replacement which would put an end to the stop-go financial planning regime. The LRPC also highlighted the importance of a system of incentives and penalties to ensure the quality and quantity of improvements required. It raised the question of how the improvements would be paid for if

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<sup>14</sup> [HC Deb 20 March 1998, c1542](#)

<sup>15</sup> op cit., *London Underground*

<sup>16</sup> ibid., Vol. II, p118 and "Cost of plan for Tube sell-off comes under fire", *Financial Times*, 7 May 1998

<sup>17</sup> ibid., pp1-15

<sup>18</sup> Railtrack press notice 98057, 20 March 1998

<sup>19</sup> op cit., *London Underground*, Vol. II, pp21-25

<sup>20</sup> "Talks bid to stop 2-day strike", *London Evening Standard*, 10 June 1998

there was a shortfall in fare income once the Underground had been taken over by the GLA. The White Paper on the GLA did not offer the Authority any sources of income beyond those then available to local government generally and therefore the LRPC considered that additional revenue would have to be found, if not from fare-payers or council taxpayers then from sources such as road pricing. It also mentioned the problem of congestion, even when the investment backlog was made up, and commented that the Government's statement was silent on the question of extensions to the system.<sup>21</sup>

### 3.3 Transport Committee report and Government response, 1998

The Transport Committee published its report on London Underground on 15 July 1998; its conclusions and recommendations were:

The Underground is vital to the economic, social and environmental well-being of London and, because of the importance of the capital to the rest of the country, the deterioration of the system has national as well as local implications. It is a tribute to the management and staff that the Underground has continued operating despite the difficult conditions caused by a lack of investment. **It is crucial that a higher and consistent level of funding is found for the Underground in order to renovate the network quickly and efficiently and at minimum cost to farepayers and taxpayers. We share the Government's view that a key criterion for judging PPP options should be the extent to which they achieve a rapid reduction or removal of the investment backlog.**

The importance of the public service ethos is valued by many and the Government has acknowledged this by retaining operation of the Underground in the hands of a single, publicly owned organisation. There might, however, have been advantages to be gained from retaining the Underground as a vertically integrated railway rather than separating its operation and its infrastructure. Equally, a case could be made for the sale of London Underground so that the benefits of the discipline of commercial responsibility could be felt by passengers. The split by the Government between the public and private sectors in this partnership makes the infrastructure and line particularly susceptible to management outside its control. This might limit the number of companies or investors willing to participate in the venture.

It would appear that Treasury rules have forced the adoption of this form of Public-Private Partnership, which is rather a convoluted compromise, when other financial solutions might have been more cost-effective. We are concerned that the cost of the Government's preferred method of modernising the Underground relative to the other potential options is not known. We welcome, therefore, the Government's decision to compare bids from prospective private infrastructure providers with a public sector equivalent to ensure value for money is being provided. **The Government must demonstrate clearly that its proposals for the Partnership represent the best deal for passengers and taxpayers. The Department of the Environment, Transport and the Regions should review the costs, making its calculations transparent, of the following approaches in comparison with the option that has been selected for the PPP and publish the results:**

- funding investment through public subsidy;
- allowing the Underground to raise its own funds while remaining in the public sector;

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<sup>21</sup> op cit., *London Underground*, Vol. II, pp16-20 and pp57-59

- **privatising the Underground as a single entity or split between track and rolling stock; and**
- **alternative methods of raising finance as used in other cities to pay for investment in transport, such as the tax levied on employers in Paris, which might be suitable for use in London.**

There was a dispute between our witnesses about the degree of consultation the Government undertook on the proposals for modernising the Underground. This was reflected by inconsistencies in the evidence. The advice to the Government from London Transport, and the Price Waterhouse evaluation of financing options, were supplied to the Sub-committee. However, we received these substantial documents significantly later than we had requested so that we were unable to consider them before agreeing the report. In addition, the DETR requested us not to copy them and to treat them in strict confidence. **We recommend that the report by the Government's consultant, Price Waterhouse, which evaluated the possible financing options for modernising the Underground and the advice submitted by London Transport, should be made public. If necessary, any information that remains commercially sensitive could be deleted before publication.**

There have been reports of safety standards on the National Railways network being undermined by the use of external contractors and sub-contractors and the greater casualisation of the workforce. Safety must be paramount in all activities relating to the Underground. The public must have confidence that safety will not be compromised. **All specifications and contracts, including contracts of employment, must incorporate the need to maintain and improve safety standards.**

Various National Audit Office reports on previous privatisations have shown that the private sector requires a large premium for bearing financial risk, even though in the event of a major infrastructure failure, the responsibility for paying for the failure to be rectified could ultimately fall to the Government. **It is essential that the full extent of the financial risk that is transferred from the public to the private sector should be transparent. It should be possible to vary the contracts if there are any significant changes in circumstances.**

We are seriously concerned that in the event of a gap between the income from fares and the payments to contractor(s), the Mayor of London may be under pressure to raise fares and reduce service levels. A shortfall could arise from a failure to achieve anticipated efficiency improvements or increases in expenditure caused by project delays. Use of the Underground is also closely linked to the strength of the economy and a fall in passenger journeys during a period of recession, as happened in the early 1990s, could substantially reduce the Underground's income from fares. **The Government must set minimum passenger service levels and it must cap fare increases. Any reductions in staff should not be at the expense of lower safety standards or the quality of service offered to the passenger.**

It will be essential to provide a method for bridging any funding gap that might occur. We believe that in view of the considerable benefits conferred by the Underground on non-users as well as users, any additional costs should not be borne solely by passengers. **We believe from evidence presented to us that the GLA should have access to additional revenue for spending on public transport from new hypothecated sources of transport-related taxation within the GLA area. Again the process must be transparent and the hypothecation must be total as far as the transfer of funds is concerned. In order to clarify the position on funding, the Government should make known at an early stage its decision on whether to make its own money available in the event of a funding gap.**

**In order to keep the total amount paid to the infrastructure provider(s) to a minimum, contract(s) should be no longer than 15 years. The GLA will be assuming responsibility for the Underground once the contracts are signed and it should be able to control the Underground's long-term funding strategy at the earliest opportunity. There needs to be a clear statement as to the level of debt for which the GLA will assume responsibility.**

The specifications for contracts must be so tightly drawn as to ensure compliance with the high standards set within the contract price. A rigorous system of incentives and penalties must be instituted to ensure that contractor(s) comply with their contractual commitments and deliver improvements to the network as agreed and on schedule. **The focus, rather than the byproduct, of the performance regime for the infrastructure provider(s) should be the provision of passenger benefits.**

**The respective roles and responsibilities of all the parties involved with the Underground concerning the setting, monitoring and enforcement of performance targets for the operator and infrastructure provider(s) must be clearly defined. The Government should make clear who will take responsibility for extensions, new lines and smaller capacity enhancements.**

**In view of the overlap with the National Railways network, the Underground's relationship with the Train Operating Companies, the Strategic Rail Authority and the Office of the Rail Regulator should also be defined.**

Our experience of the privatised National Railways network does not give us confidence that "common sense will prevail" in the contractual relationship between the operator and the infrastructure provider(s). **A mechanism should be provided to enable the resolution of any disputes arising between the operating company and the infrastructure provider(s). The Rail Regulator should be given responsibility for overseeing the operation of the infrastructure contract(s) and for resolving any disputes that arise.**

We believe that greater emphasis should be placed on consumer representation in the new structure for the Underground. **As recommended in our Third Report, *The Proposed Strategic Rail Authority and Railway Regulation*, the role of the London Regional Passengers' Committee or its successor should be strengthened. It should be given additional rights and resources to make it more effective and influential.**

It is currently estimated that up to £65m may be spent on administrative preparations for the Partnership. This is money that could otherwise be invested in the modernisation of the network. This figure also compares unfavourably with the £50m being allocated for improvements to rural public transport in the first year of a three year programme. **Expenditure on consultancy fees, etc. should be limited as far as possible.**

Parts of the Underground are already at capacity at certain times of the day and passenger usage is likely to rise if the Partnership is successful in providing an attractive and more reliable system. Furthermore, we believe that the Underground will play a central role in any integrated transport strategy for London. If the Government is to meet its aspiration to encourage a shift towards less environmentally damaging forms of transport, then detailed preparations for new lines and extensions must be started sooner rather than later. **The Partnership proposals must address the provision of major capacity enhancements. In view of their potential impact on the existing network and the long time-scales involved, there must be a programme for new lines and extensions, and central government must start**

**planning now for new projects to be taken forward within the new framework. The Government should confirm whether smaller schemes, such as the proposed extensions of the East London line and the Croyley link, will be included in the infrastructure contract(s).**<sup>22</sup>

The Government's response to the report was published on 29 October 1998.<sup>23</sup> The Government said that it intended to demonstrate that any bids received represented best value for money by developing a Public Sector Comparator, which would be prepared assuming that the same outputs that were being sought from the private sector were to be achieved using conventional funding. On the question of safety standards the Government responded that subject to the advice of the Health and Safety Commission, it envisaged that the London Underground operating company would continue to submit a statutory Safety Case to the Health and Safety Executive. The Government envisaged that there would be a requirement for the contractor(s) to submit to the London Underground operating company their own non-statutory safety case. The Government would consider the Committee's suggestion that safety should be made contractually explicit at every level.

The Government stated that it had no intention of placing restrictions on changes in fares. For the following two years fares would remain the responsibility of London Underground and once the GLA was established Underground fares would remain the responsibility of the Mayor and the Mayor would be accountable to Londoners. The Government agreed that the GLA should have access to a hypothecated source of transport-related taxation and that once the powers were available for local authorities to introduce road user charging and a levy on parking places the Mayor could choose whether or not to use them.

On the question of relations between the different parties involved the Government made two points in its response. London Underground at that time had relationships with Train Operating Companies (TOCs) and Railtrack, where either TOCs operated over infrastructure owned by London Underground or Underground services ran on track owned by Railtrack. These relationships would need to be translated into any new structure. The relationships between the PPP parties and the then proposed Strategic Rail Authority (SRA) and Rail Regulator would also need to be defined. At the time, the Government was of the view that the Rail Regulator should be given responsibility for overseeing the operation of the infrastructure contract(s) and for resolving any disputes that arose. The Government was apparently considering whether to include the smaller enhancements to the network such as the extension of the East London Line in the PPP contracts, but major extensions would be the responsibility of the GLA.

### **3.4 London governance changes**

The PPP was taken forward as part of wider reform of the governance of London. Following the 'yes' vote in the referendum on 7 May 1998 to elect a mayor and assembly for London, a Bill was presented to Parliament and the *Greater London Authority Act 1999* received Royal Assent on 11 November 1999.<sup>24</sup> The 1999 Act provided for the Greater London Authority (GLA), the elected Mayor of London and the London Assembly. Part IV of the Act concerns transport and road traffic in and around Greater London. The Mayor has a duty to produce an integrated transport strategy for London and can fund new services, make investments and introduce new ticket systems. [Transport for London \(TfL\)](#) is his executive arm and directly

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<sup>22</sup> *ibid.*, Vol. I, paras 72-87 [emphasis in original]

<sup>23</sup> *The Government's Response to the Report on London Underground of the Environment, Transport and Regional Affairs Committee*, Cm 4093, 29 October 1998

<sup>24</sup> for more information on the Bill see: HC Library Research Paper [RP 98/116](#)

accountable to him. It implements the Mayor's transport strategy and oversees transport services on a day-to-day basis.

The former Labour Member of Parliament Ken Livingstone, running as an independent, was elected as the first Mayor of London on 4 May 2000 and TfL was officially established on 3 July 2000. Under the 1999 Act, TfL is directed by a Board of Members appointed by the Mayor, who chairs it. On 9 October 2000 TfL announced the appointment of Bob Kiley, the former Chief Executive and Chairman of New York's Metropolitan Transport Authority, as the first Commissioner of Transport for London.<sup>25</sup> The 1999 Act provided for the winding-up of the London Regional Transport Board and the transfer of its property, rights and liabilities to TfL. The Act also provided for the repeal of the *London Regional Transport Act 1984*. The Bill as first published contained a clause allowing the Secretary of State to make regulations in connection with PPP agreements. This clause and associated schedule were replaced by amendments at Committee stage. The primary legislation for the PPP is now contained in Part IV, Chapter VII of the 1999 Act, sections 210-239 and Schedules 14 and 15.

The Government also introduced amendments to allow a slimmed down London Transport (LT) to be kept in existence as long as necessary to see through the PPP process. For a transitional period, TfL and LT would exist in parallel: LT would remain in existence under Ministerial sponsorship until the PPP contracts were let. During this period LT would retain responsibility for operating the Underground. Once the PPP contracts were let, management of the PPP and LT's Underground functions would pass to the Mayor and TfL. Once this transfer was completed the PPP Infracos (infrastructure companies) would work under contract to London Underground, which would in turn be directly accountable to the Mayor. The Mayor would be responsible for all aspects of the day-to-day operation of LUL, its trains and stations. He would also have powers to review all aspects of the contracts at periodic intervals, to deliver changing performance requirements.<sup>26</sup>

### **3.5 PPP progress report, 1999**

On 15 March 1999 LUL, in consultation with the Government, published a progress report on the PPP.<sup>27</sup> The paper followed a market sounding process announced by the Government in its original announcement of the PPP. An invitation was placed in the Official Journal of the European Communities (OJEC) inviting participation. One hundred and fourteen companies expressed an interest in being consultees on proposals for the PPP and were invited to respond to 40 questions in writing. The progress report confirmed the basic structure of the PPP: the infrastructure would be leased to the private sector (Infracos) under 25 to 30 year concessions but operations would remain with a publicly-owned body (Opsco), formed by the restructuring of London Underground.

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<sup>25</sup> succeeded by [Peter Hendy](#), February 2006

<sup>26</sup> sections 297-303 of the 1999 Act

The line groups offered to the private sector were as follows:

Sub Surface Lines (SSL)	Infraco BCV	Infraco JNP
Circle	Bakerloo	Jubilee
District	Central	Northern
East London	Victoria	Piccadilly
Hammersmith and City	Waterloo and City	
Metropolitan		

The BCV and JNP infracos were for 'deep tube' lines, so-called because the tunnels on these lines are smaller, running through tunnels bored deeper under the centre of London. The sub-surface lines are only just below ground level, having been built in 'cut and cover' tunnels.

Mr Prescott announced on 15 June 1999 that LUL was inviting companies to pre-qualify as bidders for the Infracos.<sup>28</sup> He said that he had decided to allow London Transport to explore with Railtrack a way of linking the national rail network to the sub-surface lines in a PPP under which Railtrack would undertake and finance the maintenance and upgrading of the sub-surface lines for London Underground, under contract to LU and Railtrack would build links between the underground and national rail lines. He said that Railtrack would announce that it would not seek to pre-qualify for the two deep tube PPP competitions. It had been reported that some potential bidders for the underground infrastructure concessions would withdraw if they had to compete with Railtrack.<sup>29</sup>

On 7 October 1999 London Underground published the shortlist of bidders for the two deep tube PPP contracts. LINC, Metronet, TubeRail and NewMetro would be invited to tender for Infraco BCV. LINC, Metronet, TubeRail and TubeLines Group would be invited to tender for Infraco JNP.<sup>30</sup> At the time of their bids, the consortia were composed of the following companies:

- **LINC:** Bombardier, Prorail, John Mowlem, Fluor Daniel, Alcatel Telecom, Anglian Water
- **NewMetro:** Siemens, Taylor Woodrow Construction, Innisfree, Gibb, Mott Macdonald
- **Metronet:** Adtranz, WS Atkins, Balfour Beatty, Seeboard, Thames Water
- **TubeLines Group:** Bechtel/Halcrow, Amey, Hyder Investments, Jarvis
- **TubeRail:** Brown & Root, Alstom Transportation, Projects, Almex, Carillion

<sup>27</sup> London Transport, *PPP for London Underground: progress report*, 15 March 1999 [HC deposited paper DEP 99/579]

<sup>28</sup> [HC Deb 15 June 1999, cc155-167](#)

<sup>29</sup> "Potential Tube bidders wary of doing battle with Railtrack", *The Times*, 31 May 1999

<sup>30</sup> London Underground press notice, 7 October 1999

On 30 November 1999 the DETR announced that the Government, Railtrack and London Transport had agreed not to proceed with discussions about the possibility of Railtrack taking on the responsibility for upgrading and maintaining the sub-surface lines and linking them into the railway network.<sup>31</sup> There would be a further competition for the sub-surface PPP. On 28 March 2000 the Government announced that three bidders had been shortlisted for a maintenance contract on the sub-surface lines.<sup>32</sup> The three were LINC, Metronet, and Surface Lines Group (comprising Amey, Bechtel/Halcrow and Jarvis). Two bidders were shortlisted by LT in July 2000 for each of the two deep-tube lines: Metronet and LINC were asked to take their bids to 'best and final offer' for the BCV contract with TubeRail and TubeLines Group competing for the JNP contract.

London Underground was working during the bidding period to prepare for the changes the PPP would require. In September 1999 LUL created three infrastructure divisions and reorganised the operations side of the management, to replicate the organisational structure that would apply under the PPP. The arrangements were tested and modified during this 'shadow running' period until transfer to the private sector. The re-organisation met the stringent requirement of [Her Majesty's Inspectorate of Railways \(HMRI\)](#) and further work was carried out to ensure that the maximum safety benefits would be gained from the PPP.

### **3.6 Transport Committee report and Government response, 2000**

The Transport Sub-committee of the Environment, Transport and Regional Affairs Select Committee published a further report into the PPP on 12 July 2000. The Committee concluded that the longer the Government delayed in implementing a solution the larger the backlog was becoming. It was particularly concerned that safety standards and lines of responsibility should not be blurred by the PPP. The Committee thought that the National Audit Office (NAO) was the right organisation to evaluate the Public Sector Comparator (PSC) but was concerned about the possible timing of the appraisal and recommended that it happen at the earliest possible stage in order to complete and report on its review before the PPP contracts were signed. The Committee also stated, however, that the Mayor "should honour his commitment to the Committee to take an objective view of the comparator and abide by its findings".

On the PPP/bond question the Committee stated that it had received widely differing estimates of the cost of the PPP compared with bond financing and the size of the probable gap between the costs of the PPP and the Underground's revenue. It therefore found it difficult to reach firm conclusions about the respective merits of the options until the PPP bids had been analysed and the findings made public. The Committee was of the view that, irrespective of whether the PPP or a revenue bond scheme was chosen, it was unlikely that the Underground's revenue stream would be sufficient to pay the full costs of financing the investment. It recommended that the Government make "an unequivocal commitment to bridging the 'affordability gap' should it prove necessary. Failure to do so would undermine the Government's objective of providing the Underground with the high and stable funding with which to plan its investment programme". The Committee thought that:

...the Government should provide firm evidence to support its claims about the efficiency savings that can be expected under the PPP. The Government should also demonstrate clearly why the benefits of the PPP could not be secured by London Underground within the public sector, in conjunction with a bond financing scheme.

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<sup>31</sup> DETR press notice, "London Underground announces PPP bidders", 30 November 1999

<sup>32</sup> DETR press notice, "[Keith Hill welcomes tube PPP progress](#)", 28 March 2000

The public sector comparator should be objectively carried out and the final decision on proceeding with the PPP or an alternative funding option should be based on this comparison and not pre-judged.<sup>33</sup>

The Committee highlighted the following issues for the Government to address should it decide to proceed with the PPP:

The Government must frame the PPP contracts in such a way as to ensure that all parties are held firmly to their obligations. In particular, the infrastructure companies should not be allowed to renegotiate the deals simply because they are unable to honour their original commitments.

With parts of the Underground already at capacity at peak times, doubt has been cast on its ability to accommodate the extra passengers that will be needed to generate the additional revenue that will be required by the PPP. The Government should re-examine the projections of future passenger use of the Underground on which the PPP is based, to ensure that the projections are realistic and would not involve passengers being subjected to intolerable overcrowding and delays.

We are concerned that the incumbent infrastructure companies will be in a strong negotiating position to press for more favourable terms when performance requirements are reviewed at 7½ year intervals. The operating company and the arbiter must be given sufficient powers to prevent the infrastructure companies from exploiting their positions and to ensure that their charges are fair and reasonable.

The Mayor's ability to prepare a comprehensive integrated transport strategy for the capital will be constrained by not transferring responsibility for the Underground to him until the PPP contracts are signed. It is essential that the Government keep to its commitment to work closely with the Mayor during the transitional period as accountability for London's transport will ultimately lie with him. It is also essential that the Mayor take a pragmatic rather than an ideological approach to working with Government.

Expenditure on consultancy fees, at more than £60 million, has already been substantial. We recommend that the Government set firm limits on the amounts to be spent on consultants. It should publish regular updates in future on the total amounts spent on consultancy fees.

We are disappointed that little progress has been made with plans for expanding the network since our last report. We recommend that the Government ensure that comparatively minor schemes, such as the East London line extensions and the Croyley Link project, are implemented rapidly under the PPP.<sup>34</sup>

The Government's response to the report was published on 1 November 2000. On the question of the benefits of the PPP versus any other funding scheme, the Government said:

Only the final bids themselves will provide conclusive evidence that the PPP will deliver efficiency gains. That is why we have always said the ultimate value for money test of the PPP is that of the bids against the public sector comparator. There is no question of prejudicing this outcome.

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<sup>33</sup> Transport Committee, *Funding of London Underground* (fourteenth report of session 1999-2000), HC 411, 19 July 2000, para 44

<sup>34</sup> *ibid.*, para 46

We should reiterate that the efficiency savings of the order of 15 to 20% estimated for the PPP are modest compared to those which have already been achieved in other sectors.

It is our belief that the introduction of strong project management skills, providing innovative solutions and backed by a strong PPP contract, which offers the right incentives and distribution of risk, will provide the optimum efficiency savings we seek.

As the Committee has pointed out, there is no evidence that a bond finance scheme would be any better than the PPP. We believe that the PPP will offer better value because it links financing with risk transfer in the design and delivery of the investment. The public sector comparator will also evaluate bids against the bond alternative.<sup>35</sup>

### **3.7 Mayor Livingstone's legal challenge to the PPP**

Mayor Livingstone opposed the PPP plan for London Underground on the grounds that it would fragment the unified management and operational structure of the Underground. He campaigned for the infrastructure modernisation to be funded by the issue of bonds. In a press notice issued after the [Hatfield rail accident](#) he supported a motion by the London Labour Party calling on the Government to abandon its plans for the PPP on safety grounds:

Following the Hatfield tragedy, the Greater London Labour Party has made its views quite clear. Like most Londoners they say that the government plan to break up the system will make the Tube less safe and less efficient. This approach has already produced tragedy and chaos on the national rail network. It will be even more dangerous on the Tube where the margin for error is far narrower. The government should now review the Public Private Partnership (PPP) and accept London's view that the Tube must remain an integrated system under a world class unified management, led by Bob Kiley, which brings in the very best private sector expertise without jeopardising the system's integrity.<sup>36</sup>

It was also reported that the Mayor was planning to challenge Ministers in the High Court if they refused to show Bob Kiley the detailed bids for the PPP contracts.<sup>37</sup> On 13 December 2000 Mr Kiley outlined his plan for modernising the Underground. His plan centred on raising approximately £3.8 billion by the securitisation of a portion of ticket revenue (borrowing money on the basis of future income). He called the PPP scheme 'fatally flawed'. Mr Kiley said:

My plan calls for £10 billion in investment over 15 years. That consists of roughly £6 billion in surplus operating revenues and government grant, £2 billion in partnerships with the private sector and £2 billion in revenue securitisation obligations, which serve the same function as bonds. This plan can be accomplished without exposing the public to fare increases and without any form of financial guarantees from the government. Transport for London fully expects that at least 90 per cent of the investment programme will be carried out by the private sector under this plan ... the

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<sup>35</sup> [The Government's Response to the Report on Funding of London Underground](#), Cm 4877, 1 November 2000, paras 13-16

<sup>36</sup> Mayor of London press notice, "[Mayor welcomes London Labour call for Government to drop plans to partially privatise the Tube](#)", 11 November 2000

<sup>37</sup> "Mayor poised to take legal action over Tube", *Financial Times*, 13 November 2000

basic structure of London Underground's PPP as presently conceived is fatally flawed and will not promote an improvement in the service offered to Londoners.<sup>38</sup>

A December 2000 article in the *Financial Times* suggested that Mr Prescott was prepared to overhaul the PPP scheme to accommodate Mr Kiley's plans.<sup>39</sup> In February 2001 the Minister stated in the House of Lords that the Government was in discussions with Mr Kiley and would try to accommodate his plans "where they do not threaten our core intention of providing best value".<sup>40</sup> After weeks of negotiation a Memorandum of Understanding was agreed between Mr Prescott and Mr Kiley under which Mr Kiley would assume responsibility for developing modifications to the PPP tender and when the modifications were agreed, Mr Kiley would assume the Chairmanship of London Transport. On 27 March 2001 Mr Prescott published a letter he had written to Mr Kiley in response to his letter of 24 March in which Mr Kiley had made clear that the Government's proposals did not meet his requirements for unified management control. Mr Prescott said that he could not modify the PPP any further and he understood that Mr Kiley was seeking recourse to litigation.<sup>41</sup> On 10 April 2001 Mr Kiley was given leave in the High Court to seek a judicial review of the planned PPP.<sup>42</sup>

On 2 May 2001 Tube Lines was announced as the preferred bidder for Infraco JNP (the Jubilee, Northern and Piccadilly Lines) and Metronet the preferred bidder for Infraco BCV (the Bakerloo, Circle and District Lines).<sup>43</sup> After the selection of the preferred bidders the then Minister for Transport in London, announced in the House of Commons that Mr Prescott had reached agreement on a way forward for the PPP and that Mr Kiley would be appointed LT Chairman and would lead negotiations with the bidders.<sup>44</sup> On 3 July Mr Kiley reported to the Secretary of State that he had been unable to reach agreement with the bidders; that notwithstanding, the Secretary of State announced that he intended to proceed with the plans for the PPP subject to the approval by the HSE of London Underground's safety plans.<sup>45</sup> On 17 July 2001 the Secretary of State announced that Mr Kiley's appointment as Chairman of and a member of the Board of London Transport was been terminated.<sup>46</sup>

On July 30 2001 Mr Justice Sullivan dismissed the application by TfL for judicial review of the decision by London Underground (LUL) and London Regional Transport (LRT) to enter into a PPP for renewal of the Underground. TfL had submitted that the PPP contracts, under which it would be bound for 30 years, would make it impossible to implement the transport strategy formulated by the Mayor under the *Greater London Authority Act 1999*. The Judge found

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<sup>38</sup> Mayor of London press notice, "[Commissioner tables alternative to 'fatally flawed' PPP](#)", 13 December 2000; also in December 2000 the press reported that the Government had rejected all four bids to run two of the three infracos as too costly and had told the consortia to prepare fresh bids by 5 January 2001 (see: "Underground auction derailed", *The Sunday Telegraph*, 24 December 2000); further reports indicated that safety inspectors had demanded improvements to LUL's new PPP safety regime (see: "Tube sale plan may be delayed by safety fears", *Financial Times*, 17 January 2001)

<sup>39</sup> "Prescott may think again on tube funding", *Financial Times*, 21 December 2000; a report by the NAO in December 2000 found that the case for the PPP had not been proven (NAO, [The financial analysis for the London Underground Public Private Partnerships](#) (session 2000-01), HC 54, 15 December 2000)

<sup>40</sup> [HL Deb 1 February 2001, cc794-797](#)

<sup>41</sup> DETR, Letter from John Prescott to Bob Kiley, 27 March 2001, including Memorandum of Understanding [available on request from the House of Commons]

<sup>42</sup> "Court clash over Tube after poll", *Financial Times*, 11 April 2001

<sup>43</sup> London Underground press notice, "Key milestone in Tube fit for the future: Preferred bidders named in Public Private Partnership" 2 May 2001

<sup>44</sup> [HC Deb 10 May 2001, c255W](#)

<sup>45</sup> DTLR press notice, "[A 21<sup>st</sup> century tube £13bn modernisation plan for a publicly run, privately built Tube gets go ahead](#)", 5 July 2001

<sup>46</sup> DTLR press notice, "[Kiley removed as Chairman of London Transport](#)", 17 July 2001

that the Government, through LUL and LRT, was entitled to enter into 30-year PPP agreements even if this conflicted with the Mayor's transport strategy.<sup>47</sup>

LUL and LRT had banned the Mayor and Mr Kiley from publishing a report by Deloitte and Touche which was critical of the PPP. They applied to the High Court for the ban to be lifted and on 31 July 2001 Mr Justice Sullivan said he would allow an edited version of the report to be published. He refused to give London Underground leave to appeal but he delayed lifting the injunction for 21 days to allow it to apply directly to the Court of Appeal. The Court of Appeal judges were in agreement with the High Court judge and the Deloitte and Touche Report was published on 24 August 2001.<sup>48</sup> The Court of Appeal also agreed that an unedited version of the report could be sent to the National Audit Office for consideration. The edited version of the report is available on the archived London Mayor website.<sup>49</sup> It looked at the value for money aspects of the PPP and bid evaluation. It found that London Underground had added £2.5 billion to the Public Sector Comparator, despite LUL's original figures having been approved by outside consultants and the NAO. The report said that the adjustments were "judgmental, volatile or statistically simplistic" and could have included double counting. On the bids it found that preferred bidders had been chosen too early and could now push up prices over outstanding issues.

Mr Kiley had also requested consultants to perform a due diligence of the LUL Engineering and Safety Standards Regime and to give a view as to whether the safety regime was adequate to control the standards of workmanship and safety related activities of the infracos under the anticipated PPP contracts. The consultants, Parsons Brinckerhoff Ltd (PB), found that the standards while the regime was comprehensive and prescriptive, there were gaps and that, overall, they were in need of a comprehensive update:

LUL have been running the Shadow PPP since September 1999. Upon award of the PPP contracts to the private sector the working relationships between LUL and the Infracos will inevitably become more contractual. The current standards are neither adequate nor appropriate to be used as a management control tool to protect LUL's long-term interests in exercising control over Infraco workmanship and safety under the PPP.<sup>50</sup>

The Secretary of State met the two preferred bidders for the PPP on 31 July 2001 and the consortia gave more details of the first three years of the contract.<sup>51</sup> On 4 September the Secretary of State announced that the negotiations with the bidders would continue on the basis of a revised draft contract published by LUL.<sup>52</sup> This contract included a number of changes to strengthen the safety role of LUL; it would:

- appoint a Partnership Director to the board of each infrastructure company;
- have approval rights over the companies' work plans;
- have step in rights to ensure all work complies with health and safety requirements;

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<sup>47</sup> "Government Underground power precedes Mayor's", *Times Law Report*, 2 August 2001

<sup>48</sup> TfL press notice, "Suppressed PPP report released", 24 August 2001

<sup>49</sup> Deloitte & Touche, [London Underground Public-Private Partnership: emerging findings](#), 17 July 2001

<sup>50</sup> *LUL standards overview by Parsons Brinckerhoff*, July 2001, para 1.4; summary available in [Parsons' evidence to the Transport Select Committee](#), 17 October 2001

<sup>51</sup> DTLR press notice, "Bidders reveal improvements to the tube", 31 July 2001

<sup>52</sup> DTLR press notice, "[Byers – proposed tube contract changes will strengthen public sector role and put safety first](#)", 4 September 2001

- have open book access; and
- have the power to impose new standards.

Finally, on 19 September Metronet was announced as the preferred bidder for the Underground sub-surface lines.<sup>53</sup>

## 4 PPP contract approval, 2001-02

### 4.1 Overview

The Government estimated that, under the PPP, Metronet and Tube Lines would realise over £16 billion of investment in the Underground over the following 15 years and the PPP would save an estimated £4 billion over the same period.<sup>54</sup>

The final bids were submitted to LUL on 4 January 2002; the procedure for agreeing them was as follows:

- LUL and its advisors, PricewaterhouseCoopers (PwC), made recommendations to the Board of London Transport once a final analysis of the value for money of the bids had been completed;
- the Board of London Transport then took a decision on each of the three contracts at a Board meeting on 7 February 2002;
- this was followed by a three-week consultation period with the Mayor and Transport for London (TfL) during which time the Government took independent advice on the value for money of the bids from its advisor, Ernst and Young;
- following the consultation the Board of London Transport made a final decision on the contracts, which was then sent to the Secretary of State for approval; and
- the Health and Safety Executive concluded that the PPP was safe (the safety test) and the Secretary of State made his final decision based on the submission of London Transport and the advice of Ernst and Young (the value for money test).

On 8 May 2002 the then Secretary of State for Transport, Stephen Byers, announced that the Board of London Transport had agreed to the signing of the PPP contracts, following consultation between the then Mayor of London, Ken Livingstone, and the London Transport Commissioner, Bob Kiley.<sup>55</sup> The agreements would come into effect when the remaining contractual 'conditions precedent' were satisfied – including those relating to competition clearances under European law and acceptance by the HSE of London Underground's revised railways safety case. Mr Kiley issued a press notice on the same day contesting that his concerns about the PPP contracts had been ignored and that he would be consulting lawyers on the final contracts.<sup>56</sup> The HSE announced on 10 July that it had formerly accepted LUL's revised safety case so the PPP could proceed.<sup>57</sup>

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<sup>53</sup> London Transport press notice, "Preferred bidder for Underground Sub-Surface Lines contract named today", 19 September 2001

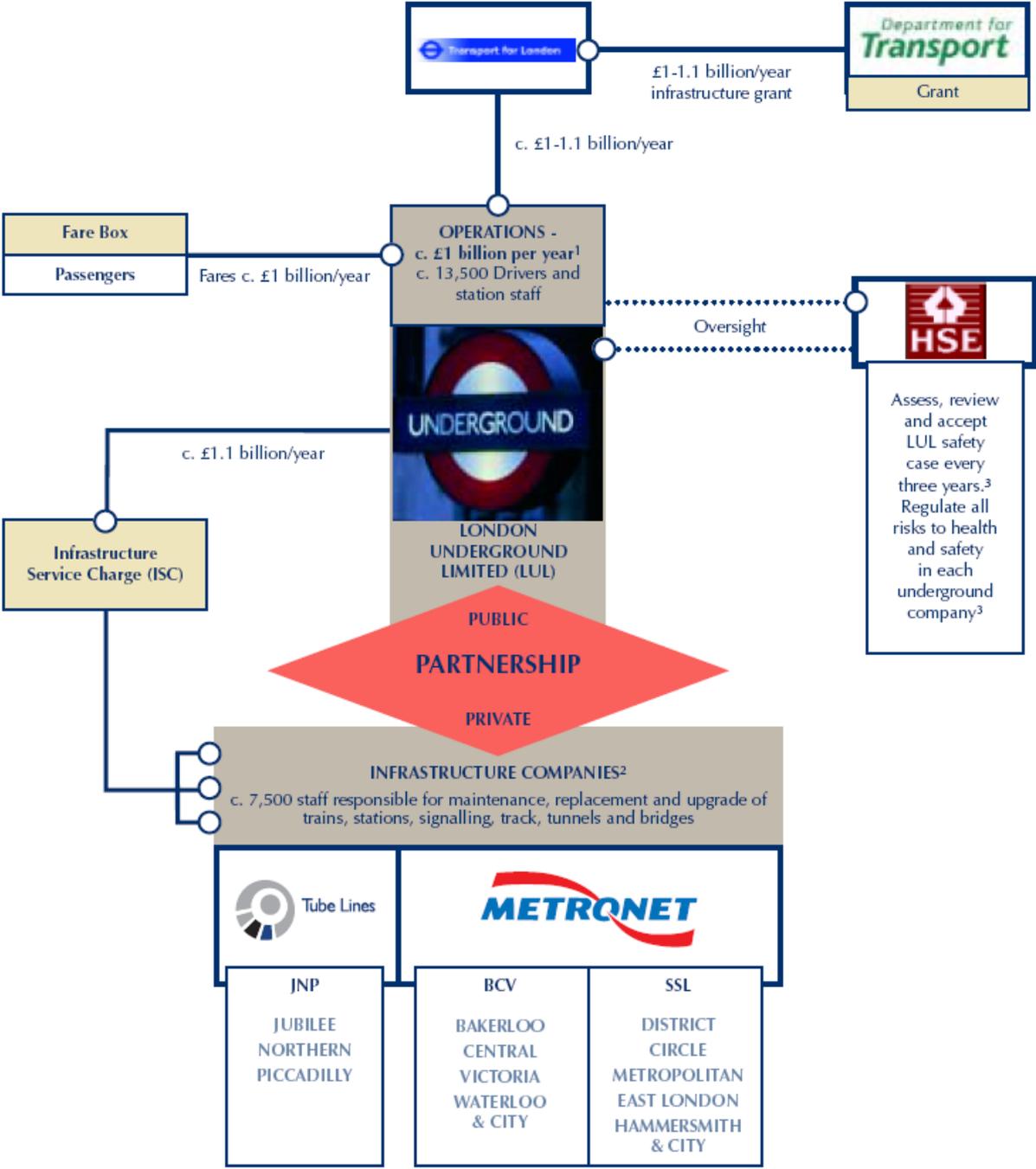
<sup>54</sup> [HC Deb 7 February 2002, cc1128-1130](#)

<sup>55</sup> DTLR press notice, "[The Tube is on track thanks to £ billions in modernisation](#)", 8 May 2002

<sup>56</sup> TfL press notice, "[Kiley: PPP is not a done deal](#)", 8 May 2002

<sup>57</sup> HSE press notice, "[HSE accepts London Underground's 'PPP' safety case](#)", 10 July 2002

The way the whole framework would operate was set out in a graphic by the NAO, reproduced below:<sup>58</sup>



**NOTES**

- 1 All monetary amounts are the most recent annual figures.
- 2 A Partnership Director, nominated by LUL, sits on all three Infraco boards.
- 3 Each Infraco is also required, under the PPP agreement, to satisfy safety requirements.

<sup>58</sup> NAO, *London Underground PPP: Were they good deals?* (session 2003-04), HC 645, 17 June 2004, p3

## 4.2 The role of the Treasury

The Transport Committee's February 2002 report touched on the role of the Treasury in making the important funding decisions that led up to the adoption of a PPP for the London Underground. The Committee concluded that: "It is inconceivable that the Treasury did not take a meaningful and material role in such a significant financing commitment that will have ramifications for public finances over a 30-year period". The Committee was displeased that no Treasury Minister or official made themselves available to appear before the Committee in the course of that inquiry.<sup>59</sup> Consequently, the Committee issued a special report in April 2002 which repeated the allegations made against the Treasury: that it was responsible for the principal decision to fund the improvements to the Underground with a PPP; and that it made key decisions about the scope and nature of the deal; that it was responsible for the timing and level of funding and for "delaying vital improvements to the network":

### **The decision to opt for a Public Private Partnership**

One of the bidders for the PPP contract, Michael Cassidy, chairman of LINC told the Sub-Committee that:

"This was a scheme that was..., conceived, designed and manufactured by the Treasury".

The Treasury has provided insufficient and uncertain funding to the Underground over a number of decades. A source of secure investment is vital for the efficient running of London Underground. Whilst the Secretary of State for Transport, Local Government and the Regions, Rt Hon Stephen Byers MP, claimed that money would be made available for whatever scheme was found to offer the best value for money, London Underground made it clear that one of the major benefits of the PPP was that it was the only way to provide a guaranteed stream of Government funding. London Underground's Final Assessment Report is predicated on the Treasury's rationale for PPPs despite its own initial assessment which identified continued public sector ownership or full privatisation as the preferred options. It is clear that the Treasury's refusal to provide adequate funds for a public sector solution has been of the utmost importance.

### **The amount and timing of the funding**

Throughout the process of preparing the PPP scheme, the Treasury continued to be involved in the details of the scheme. Mr Cassidy informed us that "it was apparent, at various stages of the bid process, that it was necessary for the Treasury to exercise their role of influence on the bidding process." The Treasury decided what improvements would be purchased. Major changes were made at Christmas 2000, when the combined total of the three contracts became clear. At this point all of the bidders were told by the Treasury "that the totality of this project was now too expensive for the nation to afford, so please go away and readjust your bids by taking out sectors of the work or delaying expensive parts of the work to later years." London Underground Limited admitted that, but for this decision, it would have been possible to deliver some of the key benefits earlier.

The result of these changes was that the capacity enhancements of 15 per cent offered by the PPP were delayed from year 20 to year 30 of the contracts, which falls behind expected passenger growth. Thus, vital improvements to the Underground, which are necessary for the economy of London and the UK, have been unnecessarily delayed. Moreover, delaying more expensive work to periods where the prices are not

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<sup>59</sup> op cit., *London Underground*, HC 387, para 64

fixed will add further to the risk that the final cost of the PPP will be higher than forecast.

The Sub-Committee invited a Treasury Minister to give oral evidence to it on 9 November 2001, but this request was declined.

### **Conclusions and recommendations**

In its report on the Treasury in the last Parliament, the Treasury Committee concluded

"We are concerned that the Treasury as an institution has recently begun to exert too much influence over policy areas which are properly the business of other Departments, and that this is not necessarily in the best interests of the Treasury or the Government as a whole."

If the claims made to the Transport Sub-Committee are right, there could be no better example of the excessive influence of the Treasury than the decision to plump for a PPP scheme for London Underground to the exclusion of other options, and then to interfere with the bidding process. It is argued that one man has been principally responsible for this choice, the Chancellor of the Exchequer. The Secretary of State for Transport, Local Government and the Regions has been little more than a messenger. The Chancellor has imposed the PPP scheme despite the opposition from a wide range of experts. It is a scheme which will not provide the capacity enhancements which Londoners and the national economy require. It has not been proved to offer better value for money than other options, which could be rapidly developed. It fails to adequately transfer risk and it is needlessly complex.<sup>60</sup>

The Committee then asked the House to make an order that a Treasury Minister attend the Committee to give evidence on the PPP.<sup>61</sup> The Chairman of the Committee, the late Gwyneth Dunwoody MP, returned to the question during an Estimates Day debate on the Committee's report in June 2002. She said:

Under normal circumstances ... one would have expected a major scheme of funding for the London Underground to be not only carried forward, but controlled at every point by the Department that was directly responsible—the Department of Transport, Local Government and the Regions. Of course, the Treasury must have an important guiding role in deciding public expenditure. Nobody disputes that.

However, the normal procedures that all Governments follow have always meant that the Department with the controlling interest went to the Treasury, discussed the figures at various points in the spending review, asked for the amounts of money that it needed, and negotiated on the basis of information about the sum that the scheme demanded. When the Department received a reply, it undertook the negotiations with the people concerned. That is the traditional way of proceeding, and I have not heard it argued that it did not work.

What concerned the Select Committee was that the more evidence we took, the more it became clear that the Treasury had somehow reversed its role, and was negotiating directly on a transport scheme that would determine the future of transport in our capital city and had been going on for over four years. Successive Governments have not found the money to keep such schemes going and to improve them, but we are discussing a scheme that is so complicated, and which creates and even replicates so

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<sup>60</sup> TLR Committee, *The attendance of a Minister from HM Treasury before the Transport, Local Government and Regions Committee* (first special report of session 2001-02), HC 771, 18 April 2002, paras 2-7

<sup>61</sup> *ibid.*, para 8

many of the difficulties that we saw in Railtrack, that we felt that we were almost in danger of doing the same thing again.<sup>62</sup>

The Conservative MP Chris Grayling, who was on the Committee at the time of the report and was later Opposition Spokesman for Transport, returned to the theme:

One of the most disturbing things about the evidence taken by the Select Committee was the regular indication that the Treasury had intervened in the project to ensure that its phasing meant that the expensive projects took place in the later years while the cheaper projects took place in the early years. We heard evidence from a number of people that the Treasury had intervened during the process to ensure that not too much money was pushed upfront in the project. That is reflected in the fact that the focus in the early years is on smarter stations rather than on new trains or radical changes to the infrastructure. As a consequence, passengers will again have to wait for the improvements that they want.

It is scandalous, though not untypical, that no Treasury Minister was willing to appear to discuss the project. I give credit to the Transport Ministers for their assiduous attendance at the Committee and their willingness to talk to it on request. We can have no complaints about their behaviour in that respect. In stark contrast, their counterparts at the Treasury refused and continue to refuse to participate in debates on areas such as these, even when it is palpably clear that they are pulling many of the strings from behind the scenes.<sup>63</sup>

The Government responded to the Committee in July 2002 stating that it believed that it was inappropriate for a Treasury Minister to give evidence to the Committee; the Committee published the response in October:

The Government has considered very carefully the points raised by the Committee's report but continues to believe that it would be inappropriate for a Treasury minister to give evidence to the Transport Committee on the London Underground PPP.

In keeping with the long established doctrine of collective responsibility, the Secretary of State for Transport is answerable to Parliament for transport policy, on behalf of the Government as a whole.

Naturally, the Treasury has been involved in the Government's decision to make an unprecedented commitment to long-term, stable funding for London Underground, but as we made clear to the Committee in May 2002, "the Secretary of State for Transport, Local Government and the Regions speaks for the Government on transport matters, including these modernisation plans. It is he who will take decisions on these matters, and it is therefore appropriate that he should give evidence to the Committee on behalf of the Government."

Treasury ministers are, of course, always ready and willing to give evidence to select committees of both Houses of Parliament on subjects for which they, on behalf of the Government, have responsibility, and they have done so before various committees in recent years. Indeed, the then Financial Secretary to the Treasury (Paul Boateng) appeared before the Transport Sub-Committee's inquiry into the 10 Year Plan for Transport, to discuss aspects of taxation policy, as recently as March 2002.

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<sup>62</sup> [HC Deb 27 June 2002, cc991-992](#)

<sup>63</sup> *ibid.*, c1018

The Government therefore believes it would be inappropriate for the House of Commons to make an Order in the terms recommended by the Committee.<sup>64</sup>

### 4.3 Contingent liabilities and Government subsidy

On 25 February 2002 the Government announced that the then Secretary of State, Stephen Byers, was considering issuing a 'comfort letter' in relation to the tube modernisation contracts.<sup>65</sup> This would ensure that TfL, which is funded by Government grant, would have the resources to cover any additional debt incurred under the PPP contracts. On 21 March the Secretary of State published draft comfort letters which he then sent to the infracos upon the signing of the PPP contracts.

When a Government Department proposes to undertake a contingent liability in excess of £100,000 for which there is no specific statutory authority, the Department concerned presents a Minute to Parliament giving particulars of the potential liability created and explaining the circumstances. The Government must refrain from incurring the liability until fourteen days (exclusive of Saturdays and Sundays) after the issue of the Minute, except in cases of special urgency. The Minute on the PPP states that:

In the event that London Underground was unable to meet its financial obligations under any of the Public Private Partnership contracts I (the Secretary of State) regard it as untenable that:

- I would not consider whether it was appropriate to adjust transport grant for the GLA under section 101 of the GLA Act or to make payment of a special grant under section 88B of the Local Government Finance Act 1988;
- I would not take London Underground's financial obligations in respect of sums owed by Infraco to the Providers of Finance into account;
- I would stand by and do nothing in those circumstances.<sup>66</sup>

The Minute states that it is not possible to quantify precisely the size of the potential liability represented by the comfort letters and that they do not create binding obligations. The Treasury describes 'letters of comfort' as follows:

Letters of comfort, however vague, give rise to moral and sometimes legal obligations. They should therefore be treated in the same way as any other proposal for a liability. Great care should be taken with proposals to offer general statements of awareness of a third party's position, or oral statements with equivalent effect. Creditors could easily take these to mean more than intended and threats of legal action could result. Treasury approval is normally essential.<sup>67</sup>

At the time it was expected that the contractual payments to the infracos would be in excess of £1 billion a year. Annex B to the comfort letters gives a statement of how the Government intended at the time to fund the London Underground in the long term.<sup>68</sup>

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<sup>64</sup> [Government Response to the First Special Report of the Transport, Local Government and the Regions Committee](#), HC 1241, 28 October 2002, paras 1-5

<sup>65</sup> [HC Deb 25 February 2002, c787W](#)

<sup>66</sup> DTLR, *London Underground Public Private Partnerships: Contingent Liabilities*, 20 March 2002 [HC deposited paper DEP 2002/101]

<sup>67</sup> HM Treasury, *Managing public money*, October 2007, para A5.5.18; a contemporary description, which differs slightly in wording, was given in: HM Treasury, *Government Accounting 2000*, para 26.3.1

<sup>68</sup> *op cit.*, *London Underground Public private Partnerships: Contingent Liabilities*, Annex B

When the PPP was initially proposed, one of the Government's objectives was to "avoid paying further grants if possible",<sup>69</sup> although that was never a pre-requisite to the PPP proceeding.<sup>70</sup> At the time of the Transport Committee's 2000 inquiry into the PPP, the then Chief Executive of London Underground, Dennis Tunnicliffe, estimated that the requirement for continued Government subsidy would be "modest".<sup>71</sup> In its response to the report of that inquiry the Government stated that it had "never ruled out the possibility of continuing subsidy to London Underground".<sup>72</sup> In September 2001, the Government estimated that for the first seven and a half years of the PPP 45 per cent of its costs would be paid for with Government subsidy; 30 per cent from income from fares; and 25 per cent from private finance.<sup>73</sup>

#### 4.4 Bid costs and Government indemnity

On 28 August, 2002 London Regional Transport entered into an agreement with Tube Lines, the consortium bidding to take over the JNP Infraco. This agreement confirmed that Tube Lines were guaranteed to receive 90 per cent of their bid costs even if their bid was unsuccessful. Amey plc, a member of Tube Lines, then used this agreement to secure a loan of £11.4m from the Bank of Scotland. TfL argued that this 'bail out' amounted to public sector support being given to a private sector company. TfL also saw this as a likely case of state aid and asked LRT to explain if they had received the necessary clearance from the European Commission for the agreement.

On 2 October 2002 it was announced that the European Commission had decided that the compensation to be paid to the infracos did not constitute state aid:

It is the hope of the Commission that the restructuring of the London Underground will put investment in the network back on track to meet the growing demands placed on it as a result of the vibrancy of London and its economy.

For these purposes, each Infraco will be granted a lease of the property for which it has responsibility. The public sector will retain the freehold of the real property elements of the network. As compensation for their obligations under the PPP, Infracos will receive from London Underground Limited regular, four-weekly payments which will be made available by the public sector operating company over the life of the Service contracts. These payments are fixed according to a fee structure during the first 7½ years. These fixed basic payments will be subject to adjustment by defined bonuses and abatements relating to performance. The performance factors taken into account will be capability -the maximum capacity of the system-; availability -the day-to-day ability of LUL to make use of this capacity-; and ambience -the quality and comfort of the system as experienced by passengers.

The Commission is of the opinion that these arrangements, notably the compensation to be paid to the infrastructure companies, do not constitute state aid. They are indeed the result of competitive procurement processes eliminating any possible advantage. Any shift in the value of the contracts for the infrastructure companies in the negotiations that took place after the selection of preferred bidders would be within the

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<sup>69</sup> [SC Deb \(A\) 23 February 1999, c755](#)

<sup>70</sup> *op cit.*, [Funding of London Underground](#), HC 411, Q411

<sup>71</sup> *ibid.*, para 37

<sup>72</sup> [The Government's Response to the Report on Funding the London Underground](#), Cm 4877, 1 November 2000, para 7

<sup>73</sup> DTLR, [Your tube: Publicly Run, Privately Built: Investing for Improvement](#), September 2001, p10

margin of change that can necessarily be expected in the negotiation of such complex and innovative contracts.<sup>74</sup>

TfL was given three months in which to appeal against the decision. In the meantime LRT announced its intention to grant an indemnity, in respect of each of the three contracts, assuring the PPP bidders and their lenders that it would receive protection in the event of any successful legal challenge in relation to the state aid decision having a material adverse effect on an infraco. The Government laid a Minute of the contingent liability that LRT was intending to enter into in respect of the PPP before Parliament on 4 December 2002.<sup>75</sup> The then Secretary of State explained his decision in the House:

I am not prepared to see this crucial investment delayed while the Mayor of London engages in further legal challenges. I have therefore agreed that London Regional Transport should offer the preferred bidders and their financial backers an indemnity against the material adverse consequences of any legal challenge in relation to the Commission's state aid Decision. I propose in turn to guarantee London Regional Transport's indemnities in accordance with my powers under the London Regional Transport Act 1984.

I have also agreed against this background that, while the full debt required to fund the bidders obligations will be committed at financial close, London Underground will not require it to be drawn down in the early months of the contract. This will mean bringing forward direct payments by London Underground in the early months of the next financial year. It will not increase the sum of those payments next year, or in any subsequent year.

The PPP contracts also envisage a statutory Arbiter whose key role is to decide the fair price for work to be undertaken in future years. I can announce today the appointment of Chris Bolt, formerly a Director of Transco plc and of Lattice Group, and a former Rail Regulator, as the PPP Arbiter. He will take up post upon financial close of the JNP contract.

In the light of recent statements by the Mayor of London which indicate that he may be seeking to challenge the decision of the European Commission that the PPP arrangements do not constitute state aid, it is appropriate for me to set out my intentions regarding the transfer of London Underground to Transport for London under the provisions of the Greater London Authority Act 1999.

I do not consider that the transfer of London Underground Limited to Transport for London could take place against the background of threats of further legal challenge by the Mayor of London and/or Transport for London or while such proceedings were in progress.

When the Mayor withdrew his legal challenge to the PPP arrangements in July this year it was my intention that the transfer of London Underground to Transport for London should take place following the completion of the PPP Agreements. However, I do not think that it would be appropriate for the transfer to take place while the threat of a further legal challenge by the Mayor exists. As a result I do not propose to make any transfer under section 409 of the Greater London Authority Act 1999 of London Underground Limited to Transport for London, nor will I direct London Regional Transport to make any such transfer scheme until after the period for lodging any

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<sup>74</sup> European Commission press notice, "[Commission clears the Public-Private Partnership for the renovation and enhancement of the London Underground](#)", 2 October 2002

<sup>75</sup> Secretary of State for Transport, *London Underground Public Private Partnerships Contingent Liabilities*, 4 December 2002 [HL HINF 2002/2562]

appeal against the Decision of the European Commission has expired without any such appeal being lodged; and if an appeal is lodged, the appeal having been finally determined.

The same position applies in relation to any legal challenge in the English Courts.

The Mayor of London's actions leave me no alternative but to take this course of action. The Tube needs investment—and the PPP means that £6 million a day, £16 billion over 15 years, will go into much needed improvements to the benefit of London.

In accordance with the guidance set out in Government Accounting, I am today notifying Parliament of the contingent liability arising from my decision to guarantee London Regional Transport's indemnity.<sup>76</sup>

#### **4.5 Public Sector Comparator**

A value for money (vfm) test was devised to examine whether the infraco bidders would offer better value for money than an alternative, publicly funded infrastructure option. To assess value for money, a Public Sector Comparator (PSC) was created. A Public Sector Comparator is an estimate of the likely public cost of funding the infrastructure improvement proposed by the bidders under alternative financing scenarios. The PPP bids were compared against a traditional funding model of a combination of public subsidy and fares revenue and a second option of public subsidy and bond financing with the bonds raised against future fares revenue. Each of the three infraco contracts was assessed independently of the others for value for money.

In its July 2000 report the Transport Committee expressed concerns about how the PSC had been created. The Committee recommended that the National Audit Office (NAO) examine the financial analysis of the PPP at an early stage to ensure that the process was well-guided and transparent.<sup>77</sup> In September 2000 the Industrial Society<sup>78</sup> published its independent review of the PPP and also questioned the assumptions on which the PSC was based:

The logic and imperative underpinning the dynamics of the PPP (the need to secure private sector expertise as a result of perceived weaknesses in LUL's competencies) have not been followed through the construction of the PSC.

The PPP is being tested against a model capturing the best that LUL could achieve utilising its existing resources, reflecting its historic record. This is despite the fact that it is inconceivable that a bond financed Underground in public ownership would not make full use of the skills and expertise of the private sector, both in a supplier and project management sense. Indeed, the £65 million that has already been expended in consultancy fees to take forward the PPP will already have enhanced LUL's ability to manage such private sector collaborations.

The PSC does not therefore offer a sufficient realistic or robust test of the PPP, against the more robustly constructed, and most practically likely real world alternative is the PPP was to fall.<sup>79</sup>

The NAO published its report in December 2000.<sup>80</sup> In its February 2002 report the Transport Committee summarised the NAO's findings on the PSC as follows:

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<sup>76</sup> [HC Deb 4 December 2002, cc81-82WS](#)

<sup>77</sup> *op cit.*, *Funding of London Underground*, HC 411, para 43

<sup>78</sup> now [The Work Foundation](#), part of Lancaster University

<sup>79</sup> Industrial Society, *The London Underground Public Private Partnership: An Independent Review*, September 2000, pp76-77

The National Audit Office found that the Public Sector Comparator had been developed using a clearly documented methodology to estimate the costs of conducting the work in the public sector. It also concluded that the evaluation of the bids submitted by the private sector was thorough and comprehensive. London Underground Limited's auditors, KPMG, found that the methodology for the comparators complied with the relevant Treasury guidance.

Although concluding that the methodology used in the development of the Public Sector Comparator was sound, the National Audit Office identified several concerns about the financial analysis:

- There is considerable uncertainty in modelling the costs of conducting such a major programme of work over a 30 year period.
- The financial models alone would provide only limited guidance as to the most likely cost of a public infrastructure operation.
- There is uncertainty over the most appropriate financing approach for the cost of public infrastructure operation.<sup>81</sup>

Subsequent to the NAO report, TfL commissioned work from Deloitte & Touche Corporate Finance which found that adjustments made to the PSC were “judgmental, volatile or statistically simplistic”.<sup>82</sup> In October 2001 the Government appointed Ernst & Young to carry out an independent review of the value for money assessment being undertaken by London Underground. The report examined the adjustments to the PSC base costs and the underlying Infrastructure Service Charge (ISC)<sup>83</sup> for the Underground carried out by LUL.<sup>84</sup> Ernst & Young concluded that, overall, the methodology adopted for assessing the value for money by London Underground was robust and appropriate; and that London Underground’s recommendation that the PPP proposals would deliver value for money was a subjective one supported by its analysis.<sup>85</sup>

#### 4.6 PPP consortia

In late 2002 it was reported that Metronet, the preferred bidder for the SSL and BCV infracos, was unable to raise sufficient financing until January 2003 and that the PPP would therefore take place in two stages. It was also reported that Tube Lines had been requesting a staggered closure of the PPP deal.<sup>86</sup> A new proposed timetable was outlined by the then Secretary of State, Alistair Darling, in December 2002:

With the relevant conditions now satisfied, the two bidding consortia have begun to put in place the necessary finance to enable the contracts to become effective. I expect the Infraco JNP contract (covering the Jubilee, Northern and Piccadilly lines) to come into force at the beginning of next year, and those for Infraco BCV and Infraco SSL

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<sup>80</sup> op cit., *The financial analysis for the London Underground Public Private Partnerships*, HC 54

<sup>81</sup> op cit., *London Underground*, HC 387, paras 27-28

<sup>82</sup> Deloitte & Touche Corporate Finance, *Transport for London: London Underground Public Private Partnership: Emerging Findings*, 17 July 2001, p2

<sup>83</sup> the ISC is the amount of annual service charge that will be paid to the private sector infracos under the PPP, assuming that the contracted levels of service are achieved

<sup>84</sup> more details on the PSC for the Underground can be found in HC Library Research Paper [RP 02/13](#)

<sup>85</sup> Ernst & Young, *London Underground PPPs: value for money review*, 5 February 2002, para 1.5

<sup>86</sup> “Tube set to be finalised in two stages”, *The Times*, 12 November 2002

(covering the Bakerloo, Central and Victoria lines and the Sub-Surface Lines, respectively) in the Spring.<sup>87</sup>

There were also reports of financial problems at Amey, part of the Tube Lines consortium.<sup>88</sup> After the Transport Secretary's statement (above) it was revealed that Amey's partners in the Tube Lines consortium<sup>89</sup> would each fund half of Amey's equity commitment to the London Underground.<sup>90</sup> This would allow closure of the PPP agreement while Amey continued to negotiate with its lenders. On 31 December 2002 Tube Lines announced that it had reached final close on the contract to upgrade the Jubilee, Northern and Piccadilly lines and responsibility for the JNP infraco was transferred.<sup>91</sup>

The final stage of the PPP was completed on 4 April 2003 when Metronet signed the 30-year contract with LUL for the upgrade of the Bakerloo, Central, Victoria and Waterloo & City lines (BCV) and the Sub Surface Lines (SSL).<sup>92</sup>

#### **4.7 Transfer of London Underground**

The *Greater London Authority Act 1999* provided the legislative basis for the PPP contracts and provided for LT to remain in existence under Ministerial sponsorship until the PPP contracts were let. It was intended that once the PPP contracts were let, management of the PPP and LT's Underground functions would pass to the Mayor and Transport for London (TfL). The private consortia, however, found a loophole in the GLA Act. As the Act did not contemplate the possibility of a significant delay between completion of a PPP agreement and transfer of the London Underground to TfL, there was no provision for ensuring the return of the assets of LUL to the public sector in the event of a PPP company defaulting on a contract before LUL was transferred to TfL. Nor was there provision for the insolvency provisions to come into effect if a PPP company became insolvent before the transfer of LUL to TfL. The private consortia insisted that the Act be amended before London Underground transferred to TfL.

The necessary amendments were made in section 114 of the *Railway and Transport Safety Act 2003* and on 15 July 2003 London Underground and all the remaining assets and liabilities of London Regional Transport transferred to TfL.<sup>93</sup> Since the transfer the PPP infraco(s) have been working under contract to London Underground, which is directly accountable to the Mayor. The Mayor is responsible for all aspects of the day-to-day operation of the Tube, its trains and stations. He also has powers to review all aspects of the contracts at periodic intervals and to deliver changing performance requirements.

#### **4.8 Consultation with and legal challenge from TfL**

The Secretary of State said that the LRT would consult the Mayor of London and TfL under the terms of the *Greater London Authority Act 1999*, and the final decision on whether to proceed with the PPP would be taken in the light of that consultation.<sup>94</sup>

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<sup>87</sup> [HC Deb 4 December 2002, c80WS](#)

<sup>88</sup> "Vultures starting to circle ailing Amey", *London Evening Standard*, 12 November 2002

<sup>89</sup> then Bechtel and Jarvis

<sup>90</sup> "Amey bailed out by Tube deal partners", *Financial Times*, 5 December 2002

<sup>91</sup> Tube Lines press notice, "New future for tube starts here: Tube Lines reach financial close on PPP contract", 31 December 2002

<sup>92</sup> London Underground press notice, "Tube PPP investment plans finalised", 4 April 2003

<sup>93</sup> [HC Deb 14 July 2003, c1WS](#)

<sup>94</sup> "Transport secretary ignored Tube sale warning", *Financial Times*, 7 March 2002

In a speech to the Institution of Civil Engineers on 5 March 2002 the London Transport Commissioner, Mr Kiley, stated that since the selection of the final bidders in the summer of 2001 the PPP contracts had undergone massive changes. He claimed that the value for money exercise made in February had been based on incorrect information. Further, the documents being used at that time had resulted in a massive programme of 'de-scoping' as a result of an LUL 'affordability exercise', or as Mr Kiley interpreted it, the Treasury had asked for the costs to be reduced. He also stated that the revised contracts demonstrated that the PPP was becoming a set of 'cost plus' contracts.<sup>95</sup>

On 21 March TfL issued its interim consultation response to LUL in which Mr Kiley claimed that the documentation had been incomplete and the co-operation from LUL and its advisers sparse. The response also labelled the contracts "by far the most complex contractual arrangements ever attempted to be applied to an urban mass transport system" and that they were "difficult to decipher even for experienced transport lawyers and financial experts". TfL concluded that "the final PPP is nothing less than a scandal".<sup>96</sup> On 23 July 2002 Mayor Livingstone and TfL applied for a Judicial Review on the Government's proposed PPP on the following grounds:

- that the procurement was unlawful because it breached public procurement rules;
- because the contracts had not been properly procured the best deal had not been obtained from the private sector and the contracts therefore could not satisfy the Government's own value for money test; and
- based on the then current funding promises from Government, London simply could not afford PPP.

In a statement to the court on 26 July, however, Lord Lester stated that the Mayor and TfL had been advised that they had no standing to complain to the High Court and were withdrawing their application for judicial review.<sup>97</sup>

## 5 Were the PPPs good deals?

On 17 June 2004 the National Audit Office (NAO) published two reports on the PPP deals for the Underground. The reports considered whether the PPPs represented good deals and whether they were likely to work successfully. The NAO found that there was limited assurance that the price of the PPPs was reasonable and expressed uncertainty about the eventual price, warning that any price revisions would have to meet tests of economy and efficiency. The PPPs were complex and offered the "prospect, but not the certainty" that improvements would be delivered.<sup>98</sup> The report concluded that:

The complexity of the deals resulted from the scale of the work required to modernise the Tube, the decision to have innovative output-based contracts and limited knowledge of the condition of the less accessible infrastructure.

There is only limited assurance that the price that would be paid to the private sector is reasonable. The terms of the deals changed markedly during prolonged negotiations

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<sup>95</sup> *Speech by Bob Kiley: Restructuring the capital's transport system*, 5 March 2002

<sup>96</sup> TfL, *Interim Consultation Response to London Transport*, 21 March 2002, p2 and p112

<sup>97</sup> see, for example, "Livingstone's £4m Tube humiliation", *The Scotsman*, 27 July 2002 and "Taxpayers face £4m bill as Tube case is dropped", *The Times*, 27 June 2002; the decision to take the matter to review was criticised by opposition politicians and also by the QC for Tube Lines

<sup>98</sup> NAO press notice, "[London Underground PPPs: were they good deals?](#)" 17 June 2004

with the eventual winning bidders. Periodic review at the 7½ year breakpoints leaves some uncertainty about what the price eventually will be - but given the uncertain condition of some assets, greater price certainty would have resulted in bigger contingency provisions and a higher price. Revisions to the price have to meet tests of economy and efficiency for the rate of return to be unchanged.

The process of negotiating the deals, and obtaining consents (including state aid clearance), was costly for all the parties involved. Extra time and costs were incurred as a result of partially rebidding contracts on two occasions before the selection of preferred bidders, and - the Department for Transport believes - as a result of the legal challenges from Transport for London although Transport for London disagree. The public sector (comprising the Department for Transport, London Regional Transport and London Underground Limited) spent some £180 million and the winners of the three bids a further £275 million. This £455 million equates to about 1½ per cent of the undiscounted 30 year deal value (2.8 per cent of the discounted deal value).

Compared to London Underground's pre-1997 investment regime, the resulting deals offer an improved prospect, but not the certainty, that the infrastructure upgrade will be delivered. The work will start 2 years later than originally planned. Recovering the maintenance backlog will take 22 years rather than the 15 years originally intended, following the Department for Transport's decision to spread the scale of remedial work required, which proved greater than anticipated, over a longer period.<sup>99</sup>

The NAO's second report assessed whether the PPPs were likely to work successfully. It concluded that the potential existed to deliver improvements for passengers and that many success factors were already in place; however, important tests remained ahead and there were limits to what the deals could achieve:

The Infracos have contracted to improve the Tube through better day-to-day performance, meeting asset condition benchmarks, asset replacement and renewal. To date, performance against benchmarks is mixed, while it will take time and good information to determine whether performance will improve to meet the full range of customer-facing contractual benchmarks. There are financial bonuses and abatements as incentives for the Infracos to deliver better performance and enable them to make significant returns on their investments, but with possible limitations on their impact.

In general, the deal is clearly specified and understood, and the parties are building a good partnership – which the Government expects to be the most effective way to improve the Tube and, therefore, service to passengers. The management of ageing assets poses serious challenges for the Infracos and it is unclear yet whether the oversight mechanisms provided for in the contracts enable LUL to deliver the outcomes to the public that are promised in the contracts. Effective contract management by all parties is essential for the full partnership benefits to be achieved.

The 30-year contracts are reviewed by the parties, with the assistance of an independent Arbiter (if called upon), every 7½ years but possible before then. Therefore it is intended that the price and scope of the deals could change. Amongst other considerations, a repricing is subject to the Department agreeing to adjust the annual grant it pays to TfL for the running of the Tube. Additionally, some Tube services are provided outside the PPPs through separate PFI contracts which bring delivery and financial risks to the PPP itself. Finally, the Mayor's transport strategy for

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<sup>99</sup> NAO, *London Underground PPP: Were they good deals?* (session 2003-04), HC 645, 17 June 2004, para 4

London, and the Department for Transport's actions on rail and roads in the south east will also indirectly impact upon Tube operations.<sup>100</sup>

The Public Accounts Committee consequently took evidence from the Department for Transport, PwC and LUL in June 2004 and published a report on the PPP in March 2005 that was broadly critical of how the PPP had been put together. The report said:

**An alternative solution might have been to restrict the PPP approach solely to major upgrade work.** A major part of the justification for the PPPs was London Underground's inability to carry out major upgrades effectively. Yet much of the infrastructure work covered by the PPP is just ongoing maintenance and renewal work.

**Departments should not use the Public Sector Comparator (PSC) as conclusive evidence of the value for money of the PPPs.** Recent Treasury guidance, following representations from this Committee and the National Audit Office, downplays the role of the PSC in favour of a broader more meaningful analysis. The Department and London Transport did consider wider, non-quantitative factors alongside the PSC in this case and assessed value for money based on a broader, more judgemental basis.

**Issuance of a public sector bond should be considered for financing future infrastructure projects in which significant risk transfer to the private sector may not be achievable.** Bond financing would have been cheaper than the PPP financing costs though the risk of non-performance would then have fallen directly on the public sector. TfL is now planning to use bonds for investment under new rules introduced in April 2004.

**Disagreement between the main parties responsible for procuring and managing a PPP ideally should be resolved beforehand and certainly before the terms of a PPP are agreed.** The perception by financiers of political risk (such as the amount of central government support to local government), rather than project risk, appears to account for much of the £450 million extra cost of private finance.

**Public sector bodies should ensure that the contractor discloses the existence of any success fees in bid competitions and that there is satisfactory justification for such fees.** It is common for the public sector to reimburse bid costs to winning bidders through the PPP service charge. Success fees of some £90 million, approximately 30% of total bidders' costs of £275 million, were paid to the winning bidders in this case.<sup>101</sup>

## 6 Appendix - PPP vs bonds: the funding debate

The Labour Government's original aim was to have the PPP in place by April 2000, consequently there had been no provision for Treasury funding for the Underground after 1999-2000. The Transport Minister said during the Second Reading debate on the *Greater London Authority Bill 1998-99* that the position on Treasury funding for London Underground would be reviewed if the PPP was not in place by April 2000.<sup>102</sup> During Committee stage of the Bill the Minister raised the possibility of Government funding for the Underground even with the PPP in place.<sup>103</sup> On 15 July 1999 Mr Prescott announced an allocation of £517

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<sup>100</sup> NAO, *London Underground: Are the Public Private Partnerships likely to work successfully?* (session 2003-04), HC 644, 17 June 2004, paras 7-9

<sup>101</sup> PAC, *London Underground Public Private Partnerships* (seventeenth report of session 2004-05), HC 446, 31 March 2005, paras 1-5 [emphasis in original]

<sup>102</sup> [HC Deb 14 December 1998, cc725-735](#)

<sup>103</sup> SC Deb (A) 23 February 1999, c755

million of additional resources for investment in London Transport over two years.<sup>104</sup> The £517 million was to include all LT programmes including the existing underground network (the 'core' network), the Jubilee Line Extension and LT buses.<sup>105</sup> The July 2000 Comprehensive Spending Review allocated a grant of £104 million to London Underground for the financial year 2001-02 with the possibility of further grant.<sup>106</sup>

There was a great deal of debate on the relative merits of the PPP and the issue of bonds to fund improvements to the Underground. A summary of the arguments put both for and against both options is given below.

## 6.1 PPP option

The main argument made in favour of the PPP was the efficiency gain from the introduction of the private sector investment and expertise into the Underground. In evidence to the Transport Committee in April 2000 Professor David Currie from the London Business School argued that the PPP could produce cost savings of around 20 per cent over and above the savings that could be achieved in the public sector.<sup>107</sup> This was because "the introduction of private capital into the management of previously publicly owned organisations brings considerable benefits as the lines of management, the risks and incentives are much more prominent". Some witnesses argued that such efficiency gains would be possible with better management under a bond-financed regime.<sup>108</sup> Declan Gaffney and Dr Jean Shaoul argued that privatisation had not led to improved investment in the case of Railtrack or the water industry. Below is reproduced the section of the Committee's 2000 Report on the case for and against the PPP:

### The relative cost of capital

16. The ability of the public sector to borrow money more cheaply than the private sector is a key assumption underlying the debate about whether the PPP or bond financing is the best option for funding the Underground. This is reflected in the analysis carried out for the Government which acknowledges that the cost of private sector finance is higher, but that it will be more than outweighed by efficiency gains. According to Professor Currie, however, focussing the debate on this issue is "seriously misguided". He argues that the cost of borrowing for the private and public sectors are the same for a given project. By contrast with their counterparts in the private sector, risks are passed to taxpayers without any compensation. A risk premium should, therefore, be put into the cost of capital for the public sector. This is why the test discount rate used by the Treasury is higher than the bond rate.

### Efficiency savings

17. The Deputy Prime Minister told us that while the PPP is more complex than the traditional arrangements for funding the Underground, the structure would allow LT to concentrate on providing services, while benefiting from the efficiencies of private sector involvement in the system's infrastructure. The Government believes that PPP deals generally lead to cost savings of between 15 and 20 per cent. This view is shared by Professor Currie. Drawing on experiences of the contracting out of activities and of the Private Finance Initiative (PFI), he thinks that the PPP could produce cost savings of around 20 per cent over and above the savings that would be achieved in

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<sup>104</sup> [HC Deb 15 July 1999, cc299W](#)

<sup>105</sup> DETR press notice, "Extra £500 million will boost the Tube", 15 July 1999

<sup>106</sup> [HL Deb 28 February 2001, c139WA](#)

<sup>107</sup> op cit., *Funding of London Underground*, pp28-32

<sup>108</sup> e.g., Prof. Glaister, Mr Travers and Susan Kramer MP

the public sector, because the introduction of private capital into the management of previously publicly owned organisations brings considerable benefits as the lines of management, the risks and the incentives are much more prominent. Moreover, incentives to improve efficiency would be blurred in an arrangement where the capital is provided by one source and the management by another as would be the case with bond financing: incentives are much clearer when the management team is answerable to shareholders.

18. Professor Glaister argued that savings under the PFI had been achieved through repeated competitive tendering and greater freedom in labour markets and not, as in the case of the London Underground PPP, "a one-off thing with protection for the transferring employees, which is a different game". This argument is countered by Professor Currie, who said that the privatised utilities had not needed repeated competitive tendering to produce cost savings and that labour market constraints would ease over time. The Government did not in any case claim that cost savings would be found mainly through reductions in labour costs: in its view most savings would result from better project management. That view, too, was challenged by witnesses such as Gaffney, Shaoul and Pollock, who argued that privatisation had not led to improved investment: they argued that, for example, Railtrack's infrastructure investment has not risen in line with need, expectation or commitments, and efficiency savings following the privatisation of the water industry came from lower than anticipated levels of capital investment rather than reductions in operating costs. The railway trades unions pointed out that the Underground's own experience of the PFI had resulted in new rolling stock for the Northern line delivered four years behind schedule. The unions claimed instead that efficiencies would result from an attempt to lower labour costs through "a serious assault" on the jobs and conditions of their members, a fear shared by other witnesses.

19. While Glaister, Scanlon and Travers have little doubt that there are significant cost savings to be made in the delivery of London Underground's services, they find it "difficult to accept" that efficiency gains could not be obtained with better management under a bond-financed regime. It would be "perfectly possible" for money raised by London Underground bond issues to be invested in projects where there is private sector contract management and private sector procurement practices for all new investments. Mrs Susan Kramer also told us that the cheaper financing of revenue bonds could be combined with measures to achieve greater management efficiencies. Similarly, the railway trades unions do not see why the reward and penalty arrangements planned under the PPP have to be linked to the overall funding and financing policy for the network rather than being implemented on a contract-by-contract basis.

20. There is also the prospect of the PPP imposing as yet unquantified, but possibly substantial, additional costs in terms of monitoring. Negotiation and contract administration could become "a significant item" in the case of the PPP because of its complexity and the difficulty in allocating risk between the different parties. LT said that it did not have a definitive figure for the cost of on-going administration, but it believes that it would be "a small number of millions". It should also be noted that the money spent, so far, on consultancy fees in preparation for the PPP is considerable and stood at £60.3 million at 31 March 2000. The Department of the Environment, Transport and the Regions told us that "it has never been the practice to answer questions about future costs of advisers while a project is still under way", but the Government is committed to giving periodic updates on expenditure incurred. Regrettably, it appears likely that LT's earlier hope that the cost of preparing for the PPP would be less than the working estimate it then had of £65 million will prove to have been overly optimistic.

### **The division of risk between the public and private sectors**

21. The extent to which risk is successfully transferred from the public to the private sector will be another important indication of the PPP's success. The Deputy Prime Minister assured us that there will be penalties and incentives in the PPP contracts so that risk will clearly be placed upon the private sector infrastructure companies. There will be "a very few limited risks", however, which will remain in the public sector. Although the exact division of risk had yet to be agreed, the Department of the Environment, Transport and the Regions was confident that private sector bidders for contracts under the PPP knew what would be expected of them in this respect.

22. Gaffney, Shaoul and Pollock argued that the introduction of private finance makes the efficient transfer of risk more difficult in practice because the public sector cannot ignore debt incurred by the infrastructure contractors in the event of any cost overruns. Moreover, as the private sector would not be assuming all risks, there would be many reasons why the public sector might be left paying for cost overruns. They also noted that while it is possible to specify the risks to be transferred, it is a very different matter to transfer them in a legally enforceable contract. This point was echoed by Professor Glaister and his colleagues, who stressed that the allocation of risk must be clearly identified and specified in the contracts. This would be very difficult in view of the complexity of the Underground PPP. He warned that "unless substantial penalty clauses are included in the contract and they are enforceable in practice, all risks fall to the public sector, not the private sector".

### **The use of long-term contracts**

23. Long-term, probably 30-year, contracts for the infrastructure companies would be necessary, according to Professor Currie, to realise the full benefits of the PPP. Efficiencies would be gained from having the same party managing assets over their full life-cycle and thus ensuring that there is an incentive at the design stage to take into account subsequent building and maintenance considerations. Longer-term contracts would also give the private sector certainty in planning for investment, reduce the cost of capital and provide incentive to innovate. Greater stability would also be brought into the financing of the Underground, something which has been lacking for some time.

24. It would, however, be unrealistic to fix the level and pattern of Underground services over the next 30 years at the time when the PPP contracts are signed. Formal reviews would take place, therefore, every 7½ years, when London Underground could change "almost any aspect of its requirements" and the infrastructure companies would be "obliged to deliver those new requirements at a fair price". The contract would provide guidance on what is fair and in the event of a dispute, the matter would be determined by an arbiter. LT expected that as well as redefining its requirements from the infrastructure companies, it would negotiate a new service charge, which should be lower, reflecting increasing efficiency over the first period of the contract, while maintaining the rate of return the companies anticipated in their bid for the contracts.

25. Even with provision for periodic reviews, Professor Glaister argued that there was a "fundamental difficulty" with the inflexibility of the PPP's 30-year contracts. He believed that it would be "very difficult to enforce these contracts rigorously were the contractor to fail to deliver". There would be a risk that a very long-term contract structure will create "a one-sided bet" for the private sector, since although it might become necessary to renegotiate the contract to avoid the company failing in the event of an economic downturn, there would be no renegotiation if profits prove better than expected. The Deputy Prime Minister told us that he was satisfied that there will be sufficient penalties and incentives to ensure that the infrastructure companies perform to the standards that are expected of them, and that poor performance would attract escalating penalties, including the possibility of losing the contract. In the highly

unlikely event of an infrastructure company withdrawing from a contract, the Government would, in conjunction with the Mayor, look at the next best value for money option that could be devised. Lord Macdonald, the Minister for Transport, however, pointed to the strength of the consortia bidding for the contracts and the access that this would give to international expertise and project management skills and the consequent innovation this could be expected to bring.

### **Increasing the number of passenger journeys**

26. Over the next 20 years, LT expects that use of the Underground will grow by one per cent per annum at peak periods and by "quite significantly" more than that at off-peak times. The PPP will expand the peak capacity of the existing system by about 15 per cent over twenty years, so the provision of extra capacity will be exceeded slightly by growth. Mr Tunnicliffe warned that although the additional passenger carrying capacity provided by the PPP should prove sufficient until the beginning of the next decade, there were limits to how many passengers the existing system could accommodate.

27. According to Gaffney, Shaoul and Pollock, the financial viability of the PPP hinges on London Underground's estimates of increasing revenue. Its projections assume that fares will increase in line with after 2001-02, but a 40 per cent increase in fare revenue generated by more passenger journeys is anticipated: thus unless extra demand is confined to off-peak times, the revenue projections will depend on increases in network capacity. This view was confirmed by the London Regional Passengers' Committee (LRPC) which commented that with critical parts of the system operating at or close to capacity at peak times, "there is little short-term scope for attracting additional usage except at the cost of worsening travel conditions".

28. Although increasing the capacity of the existing Underground network could be achieved by improving its performance, it is generally accepted that capacity constraints must be addressed through the construction of additional lines and extensions to existing lines. However, the Government has said that it would not be appropriate to include major lines or extensions in the PPP, although relatively small-scale, but nonetheless valuable extensions, such as the those of the East London line and the Croyley link on the Metropolitan line could be taken forward under the PPP. For example, the Government may decide that bidders for the sub-surface lines PPP contract should be asked to provide a separate price for linking the East London line to the national rail network. If the Mayor decides to build the Croyley link, provisions would be included in the PPP contracts to increase capacity at stations and to provide for line extensions. Decisions about major projects, such as CrossRail and the Chelsea-Hackney line, are, the Deputy Prime Minister told us, the responsibility of the Mayor. He commented that there would be difficulties in raising the large sums of money that will be required for these schemes and he thought that some contribution from central government would be necessary.

29. Concerns have been raised about the complexity of the legal arrangements if contracts for new lines or major developments of the current network are not awarded to the existing infrastructure companies. Conversely, if the incumbent companies are given preferred bidder status, they may have London Underground "over a barrel" because of their very strong negotiating position. While the Government told us that it expects that the infrastructure company responsible for a particular station or line would be in the best position to offer good value for a major enhancement project, an alternative contractor could be selected if its price proved uncompetitive. The incumbent company would, however, have to be paid for providing any work which could not be undertaken by a third party.

## **The restructuring of London Underground**

30. The reorganisation of London Underground through the separation of operations and infrastructure and the creation of the three infrastructure companies has implications for, amongst other matters, safety. The Government told us that the safety regime has been designed to avoid fragmentation and to retain responsibility for the statutory Railway Safety Case for the whole network in the hands of public sector London Underground. LT believes that safety will be enhanced by the implementation of the PPP.

31. Dr Jean Shaoul told us, however, that she was extremely concerned about the division of the Underground into four units would make planning, coordination and, above all, ensuring safety "extremely difficult". Other witnesses drew parallels with the fragmentation of responsibility for safety following the privatisation of the national rail network. The Transport and General Workers' Union, for example, argued that "a similarly fragmented structure runs the risk of reducing safety standards below their present levels". Moreover, it said that experience and expertise in safety matters might be lost as a consequence of the organisational restructuring introduced by the PPP. In addition, there might be problems with coordinating the approaches of the different organisations towards safety matters, the use of sub-contractors by the infrastructure companies may increase the complexity of 'the chain of command', and financial considerations may place pressure on the infrastructure companies to look for savings which could affect safety adversely. The Mayor of London, Mr Livingstone, said that "inevitably there is the risk to safety if [the] PPP proceeds". Despite these comments, we received no convincing evidence that safety on London Underground would in reality be compromised by its restructuring. It could, indeed, be argued that safety would be enhanced, by the extra capital investment which we all hope will result from it.

## **The Public Sector Comparator**

32. The Government stressed that its preference for the PPP is based "not on dogmatic adherence to any particular structure, but on a determination to deliver best value for the Tube, its passengers and the taxpayer". A public sector comparator will be used to test for best value and will act as the 'yardstick' against which private sector bids will be judged. Contracts will be awarded only if the bidders can demonstrate that they can provide better value than the public sector. As we have said, the design, construction and use of the comparator will be open to examination by the NAO. The Government has stated, however, that the timing of the NAO's scrutiny and the publication of its opinion is a matter for the Office itself. The NAO has in turn made clear that it cannot involve itself in the decision-making process, although it has already provided the Department of the Environment, Transport and the Regions with guidance on the preparation of the comparator.

33. A number of our witnesses stressed the importance of having the comparator checked independently by a body like the NAO. Mr Livingstone said that he would be prepared to support the PPP if it is found to be the best option and if the comparator evaluation is "fairly done". There was also much support for ensuring that the NAO's evaluation is completed before the PPP contracts are signed, rather than following the Office's usual practice of examining matters retrospectively. Glaister, Scanlon and Travers in any case believe that the test using the comparator should be carried out in the public domain so that the process is open to scrutiny. The Government, however, intends to publish the full results of the comparator only once the contracts have been awarded. In its opinion, to do so earlier would "give away our negotiating position and prevent us from achieving best value for money".

34. Other concerns were also raised about the comparator. The most significant related to the level of interest rate that will be assumed for the public sector bond as this will have a significant impact on the value for money judgement. Dr Shaoul and Mr Gaffney told us that they were alarmed at the prospect of the standard discount rate being used as, based on London Underground's figures, it could be 2.5 per cent higher than the bond interest rate. They said that any appraisal which did not use a bond interest rate would "deservedly be taken as evading the central issue". In addition, the case for using the standard discount rate to reflect the full financing costs of a public sector bond is "quite irrelevant" in these circumstances. They argued that the cost of project risks would already be taken into account by raising the comparator's values to reflect the risks that are being retained.

### **Accountability**

35. Responsibility for the Underground will not be transferred to the Mayor and Transport for London until the PPP contracts have been signed, which could be many months after he has taken office. The Government has, however, rejected transferring control before the negotiations have been completed because it would "create uncertainty for the bidders" and could interrupt the completion of the agreements. The Deputy Prime Minister said that it would be better and quicker to continue with the PPP, providing that it is shown to offer best value, rather than waiting another three or four years for the matter to be renegotiated. The Government has made clear that it wants to work closely with the Mayor in the interim in a way consistent with the rapid implementation of the PPP. After all, the Mayor is already responsible for setting fares on all former LT services and will be able to review the PPP contracts periodically once they are in place.

36. The Underground will play a key role in any transport strategy for London. Consequently there is view that Greater London Authority should be directly involved in decisions that are made about the PPP. Instead the PPP's long-term contracts are felt to give the Authority little say in the overall funding and strategic decisions for the network. Indeed, the Mayor's control of all the Underground's assets have been described as being "fettered for up to 30 years" by the PPP. There is also unease about the lack of transparency surrounding the PPP arrangements due to the desire to maintain commercial confidentiality. Mr Livingstone described it as being "outrageous" that the PPP deal should be "done over the heads of the Mayor and Assembly", when they will be responsible for paying any loans that the infrastructure companies may have taken, in the event of those companies defaulting. Following his election as Mayor, Mr Livingstone announced the establishment of an independent panel of experts "to scrutinise the various options for financing the modernisation of the London Underground".

### **The requirement for external funding**

37. Although it was originally hoped that the PPP would remove the need for continuing Government subsidy, it has become increasing apparent that this is unlikely to be the case. As we have said, there is likely to be a gap between the Underground's revenue and the financing charges regardless of whether the PPP or the revenue bonds option is chosen. Mr Tunnicliffe told us that under the PPP there was likely to be "a modest" requirement for continuing subsidy, although LT believes that the PPP will be the option that requires the lowest public subsidy.

38. Whatever option for funding London Underground is adopted, it seems clear that there will be an on-going need for external funding, most likely in the form of direct grant from central Government. Indeed, Mr Livingstone argued that it would be unacceptable for the Treasury to withdraw public subsidy, and was particularly

concerned at the prospect of congestion charging having to be introduced in London, not to create a new source of funds for transport expenditure, but to bridge the gap between the Underground's revenue and the PPP's infrastructure charges. There was also concern that the provision of grants should be guaranteed for every year of the PPP, rather than being the subject of annual negotiations, to ensure that the Underground benefits from stable and long-term funding. The Minister for Transport said that the Government has "never ruled out subsidy, but we believe it is pointless to speculate about the level...until the bids have been scrutinised".<sup>109</sup>

## 6.2 Bond financing

There was much discussion both in the media and amongst transport economists about the use of bonds to provide finance for the Underground rather than the PPP.<sup>110</sup> A bond is a form of loan similar to a bank loan. It is basically a document that says a company or Government will pay the holder an interest rate of 'X per cent' a year for an agreed number of years and at the end of this term the company or Government will repay the money. The bond is used to raise finance on the stock market and credit rates are set on the basis of several factors, including ability to pay and the security of the company or Government.

Shortly after the publication of the March 1999 PPP progress report, a report prepared by the London School of Economics (LSE) said the Government's plan for the PPP was "flawed in principle and impracticable".<sup>111</sup> The Report found that the PPP threatened to impose burdensome long term pressures on LUL operating revenues, including the prospect of continually rising fares, in order to pay back up-front investment by private contractors. The authors suggested that two Government actions since the announcement of the PPP had shown a better way to secure long-term financing for the Underground. These were the move to eliminate the requirement that capital investment meet the "PSBR test", and the solution reached on the revised financing structure for the [Channel Tunnel Rail Link \(CTRL\)](#) through the issuance of guaranteed bonds.<sup>112</sup>

The authors considered that lessons could be learned from the way the New York Metropolitan Transportation Authority (MTA) had been restructured. They suggested that London Transport and later TfL could be granted the authority to establish a capital budget that would be separate from the operating budget, and to issue bonds that would be secured by pledged revenues. The financial framework agreed for MTA allowed the MTA authority to issue its own bonds directly to the capital markets.<sup>113</sup> The New York system was described as follows:

The financial restructuring of the New York Metropolitan Transportation Authority (the MTA) in 1981 also offers a prototype for London, both in the example of establishing an agreed capital needs statement and a capital budget that could be approached in five-year intervals; and in structuring a financial framework which would give the MTA authority to issue its own bonds directly to the capital markets.

This financial framework has enabled the MTA to fund over \$23 billion in capital spending for the city's transit authority, and over \$5.7 billion for the commuter rail and

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<sup>109</sup> op cit., *Funding of London Underground*, paras 16-38

<sup>110</sup> e.g., "Finding finance that is just the ticket", *Financial Times*, 27 November 1999; and "They succeeded in New York", *The Guardian*, 24 November 1999

<sup>111</sup> Glaister, Scanlon and Travers, *The Way Out: an alternative approach to the future of the Underground*, (LSE), March 1999, p1

<sup>112</sup> *ibid.*, pp2-3

<sup>113</sup> *ibid.*, p23

bus network, since 1982. Bonds outstanding have covered over \$14 billion of these investments, with direct government subsidy or pay-as-you go funding the balance.

The bonds issued are backed by a layer of revenues that are guaranteed for each five-year plan. These revenues include: subsidies from the federal, state and local governments; farebox revenues; surplus toll receipts of the Triborough Bridge and Tunnel Authority (TBTA), and dedicated taxes. The tax sources have varied somewhat over the two decades, but generally include one quarter of one percent of the city and suburban sales tax; certain petroleum-based taxes; a portion of a 'long-lines' tax on telecommunications and transport companies, and a temporary surcharge on certain businesses in the MTA District (...)

The assurance of these revenue sources and the rating of the bonds by the rating agencies (at, or above investment grade) allow the bonds to be issued without direct call on the resources of the state or city governments. Also, the MTA, as a public benefit corporation, remains fully in the public sector, with the Chairman and five board members of the Authority appointed by the state governor, and with four other appointments to the board made by the Mayor of New York City.

In summary, the New York approach has several features which could be of value to London: the clearly defined investment horizon to provide the necessary scope for planning and procurement; the issuance of dedicated bonds which have been clearly separated from other public sector needs; the public-private commitment to use a combination of public funds and dedicated taxes to support the bonds; and the public benefit organisation structure, which has retained public control of the transport system as a public trust, with full accountability to the travelling public, the business community, and elected officials.<sup>114</sup>

One of the co-authors, Rosemary Scanlon, a former New York State Deputy Comptroller, explained in an article in *The Guardian* that the "revenue bond" was a well-accepted financial mechanism in the United States and a powerful tool used for raising capital by many US states, local governments and special purpose agencies.<sup>115</sup>

The LSE publication also discusses the revised method of financing chosen for the CTRL. When London and Continental Railways (LCR) revealed in spring 1998 that they were unable to meet their commitment to finance and build the CTRL, the Government decided to provide financial support. Construction of the first phase would be financed by commercial debt and bonds, backed by direct Government guarantees of £3.75 billion to reduce the cost of financing. One of the arguments against Government-backed bond issues had been that they would count towards the Public Sector Borrowing Requirement (PSBR). However, the Government's guarantee of the CTRL scheme was deemed not to count towards the PSBR because the chance of a call being made on the guarantee was less than 20 per cent.<sup>116</sup>

Experts at the time appeared to disagree on the merits of financing infrastructure investment using bonds. An article in *The Independent* reported the findings of a study by the National Institute for Economic and Social Research. The Institute's conclusions were based on a two-year study of public transport in New York and Paris and found that the experience of New York City, which funded one-third of all public transport investment through bonds, provided a good model.<sup>117</sup> On the other hand, *The Times* reported that PricewaterhouseCoopers (PwC), the Government's financial advisers on public-private

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<sup>114</sup> *ibid.*, pp23-25

<sup>115</sup> "Bonds of trust", *The Guardian*, 24 November 1999

<sup>116</sup> *op cit.*, *The Way Out: an alternative approach to the future of the Underground*, pp21-22

partnerships, had found that issuing bonds to fund the renovation of the Underground would cost £3 billion more than the Government's proposals indicated.<sup>118</sup> The Government believed that Government-backed bonds would not realise the benefits of transferring risk to the private sector as effectively as the PPP. Consequently, they would not represent best value and would also count against public expenditure.<sup>119</sup>

Professor Currie argued to the Transport Committee that incentives to improve efficiency would be blurred in an arrangement where the capital is provided by one source and the management by another as would be the case with bond financing.<sup>120</sup> The Committee considered the bond financing alternative in its 2000 report as follows:

The Deputy Prime Minister told us that the real issue is not how the money needed for investment in the Underground is raised, but how wisely it is spent. However, as he conceded, much of the argument about funding London Underground has centred on whether money should be borrowed through a PPP, through an alternative structure which allows the Underground to remain wholly within the public sector or through other means following full privatisation. The use of bonds has attracted most attention: indeed, the Government expects the infrastructure companies to issue their own bonds to raise finance for investment. There are a number of ways in which bonds might be used. One option would be to issue Government-guaranteed bonds, as was done successfully in the case of the Channel Tunnel Rail Link. Another would be to issue 'revenue bonds', secured, as their name implies, against future revenue streams from the Underground.

The Government believes that Government-backed bonds would not be appropriate for London Underground, because they would not realise the benefits of transferring risk to the private sector as effectively as the PPP. Consequently, they would not represent best value and would also count against public spending. Revenue bonds would be issued at rates slightly higher than those for public interest debt, but since they would be supported by dedicated revenues they would be excluded from the Governments's borrowing requirement. Such bonds have been used to finance major infrastructure projects in the United States. New York's Metropolitan Transportation Authority, for instance, has issued more than \$14 billion in revenue bonds over the last twenty years which are backed by tolls, fares or dedicated taxes. The use of revenue bonds by a public sector London Underground was supported during the Mayoral campaign by two of the principal candidates, Mr Ken Livingstone MP and Mrs Susan Kramer, who subsequently became Mayor of London and a board member of Transport for London respectively.

Our witnesses reflected the debate that there has been between the supporters of the PPP proposals, those who favour the issue of a revenue bond by London Underground within altering significantly its management structure, and those who argue for little or no change. The Government, citing illustrative figures from PricewaterhouseCoopers, argued that in total, the PPP would save £4.5 billion over 15 years compared to a bond. Similarly Professor Lord Currie estimated that the PPP would save £3.3 billion compared to investment being undertaken by London Underground under existing financial arrangements, and £2.3 billion compared to bond financing. By contrast, Glaister, Scanlon and Travers, who favour the use of a bond, told us that over the thirty-year life of the PPP, the Underground would require an annual grant of between £95 and £262 million, depending on the level of the efficiencies achieved, to break

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<sup>117</sup> "Labour's plans to finance Tube are dismissed by think-tank", *The Independent*, 2 December 1999

<sup>118</sup> "Plan to overhaul Tube hits obstacle", *The Times*, 26 November 1999

<sup>119</sup> *ibid.*

<sup>120</sup> *op cit.*, [Funding of London Underground](#), pp28-32

even, whereas funding via a bond would require a top-up of between £16 and £182 million per annum.

That view was shared by Gaffney, Shaoul and Pollock. They have said that within two years of the establishment of a PPP "an affordability gap" will develop of almost £175 million between available revenues and the level of the payment that will have to be set to the infrastructure companies to enable them to service their debt and pay a return to shareholders. They see no reason for that gap to diminish. They, however, argue that the bond option, like the PPP, would also be "simply unaffordable". They believe that retaining London Underground's integrated structure and providing the necessary funds is the most economically and socially efficient way of operating the Underground. In their opinion, neither the PPP nor bonds will be able to achieve this. Instead, it will be necessary to pay the full cost of the Underground's infrastructure through local or national taxation, or a combination of both.<sup>121</sup>

The Mayor and TfL commissioned the Industrial Society, headed by the journalist Will Hutton, to undertake an independent review of the proposed funding models for the Underground.<sup>122</sup> The review took evidence from more than 30 witnesses and was able to look at unpublished documents by PwC, LUL and the then DETR. The review recommended that bonds should be used to finance individual schemes for the Underground irrespective of which framework was chosen to finance and fund the investment backlog. The review considered that before issuing bonds the capital markets would want a guarantee that TfL could marshal resources over and above fare revenue to service debts. This implied that London would need some revenue raising powers before the markets would be prepared to buy bonds at an acceptable rate of interest. Congestion charging would raise such revenue but not before 2002 at the earliest. The New York MTA was able to raise money from tolls and local taxes.<sup>123</sup>

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<sup>121</sup> *ibid.*, paras 11-14

<sup>122</sup> *op cit.*, *The London Underground Public Private Partnership: An Independent Review*

<sup>123</sup> *ibid.*, p10