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Committee of Public Accounts

London Underground Public Private Partnerships

Seventeenth Report of Session 2004–05

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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The following was also a member of the Committee during the period of this inquiry.

Ms Ruth Kelly MP (*Labour, Bolton West*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

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

Committee staff

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

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Contents

Report *Page*

	Summary	**3**
	Conclusions and recommendations	**5**
1	**Rationale for the Public Private Partnerships**	**7**
2	**Contract price**	**11**
	Risks	11
	Costs	12
3	**Other costs**	**14**
	London Underground costs	14
	Bidders' costs	15
4	**Contract management**	**17**
	Formal minutes	**18**
	Witnesses	**19**
	List of written evidence	**19**
	List of Reports from the Committee of Public Accounts Session 2004–05	**20**

Summary

By the end of March 2003 the Department for Transport (the Department) had concluded three 30 year Public Private Partnerships (PPPs) for the maintenance and renewal of London Underground trains, stations, track and signalling. This followed a five year procurement process costing some £455 million. The PPPs provide for spending of an estimated £15.7 billion over 30 years at present values, of which £9.7 billion is in the first 7½ years. Two of the three PPPs are with the Metronet consortium. The third is with the Tube Lines consortium.

The PPPs split the Underground business in a new, complex way. London Underground retains responsibility for operations and safety while three private sector infrastructure companies (Infracos) maintain and renew the infrastructure over 30 years. London Underground pays the Infracos largely on the basis of their delivery of specified outputs, such as asset availability, rather than on the cost of the work. There is a built-in periodic review mechanism, untried in any other PPP arrangement, which enables the parties to respecify requirements within the PPP scope and reprice the deals at least every 7½ years.

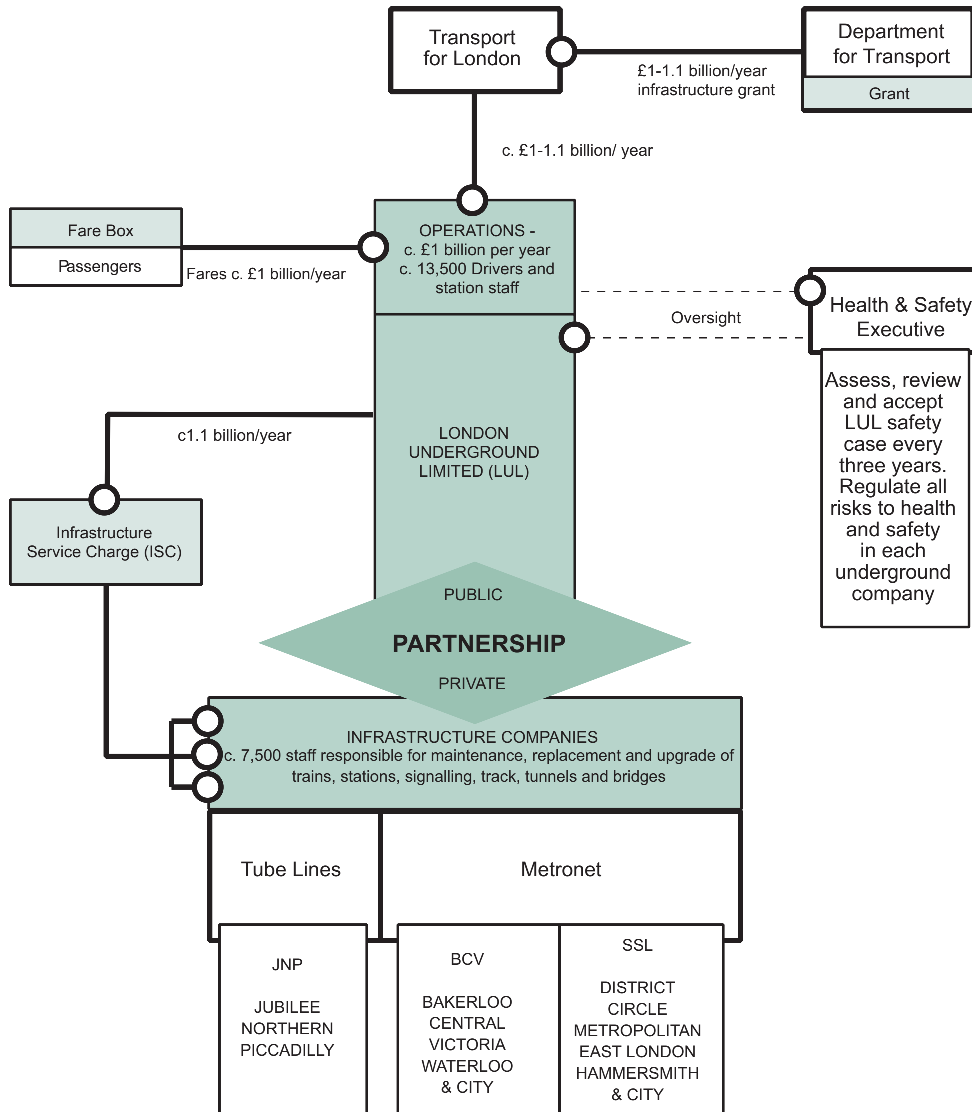
In July 2003, ownership of London Underground was transferred from central government to Transport for London (TfL), which reports to the Mayor of London. As provider of grant of some £1 billion a year the Department nevertheless retains an interest in the effectiveness of the PPP. **Figure 1** shows the responsibilities of the key parties to the PPPs, and the funding flows between them.

The Government saw the PPP as the best way of ensuring stability of funding for the maintenance and renewal of the Tube, continued public sector management of operations, and the benefits of private sector management of a major infrastructure program. Achieving these goals through three output based PPP contracts resulted in a complex structure with multiple management interfaces. An alternative option, of public sector management of maintenance and renewal financed by bonds raised by TfL, was ruled out on policy grounds. This would have allowed a simpler structure.

To deal with concerns of potential lenders, particularly the continued disagreement between TfL and the Government about the PPPs, the Government agreed that lenders of £3.8 billion (the "senior debt") would receive 95% of their investment back in the event of termination of the PPP. Despite this protection, the senior debt will cost approximately £450 million more than repaying government loans for the same amount. This extra cost reflects the judgement of the financiers that the borrowing structure carried higher risks than government debt, leading to higher interest charges.

Shareholders put in some £725 million and, if the Infracos meet their performance targets, stand to earn 18 to 20% returns, a premium of about 15% above the risk free rate of return of 4.5% at the time the deals closed. The cost overruns that the Infracos have to bear are limited provided they act economically and efficiently (a concept as yet untested). In the case of Metronet the limit in each 7½ year period is £50 million. Tube Lines has to bear a £200 million limit in the first period and £50 million thereafter. These limits exclude the risk of cost overruns in repairing certain assets of unknown condition, such as tunnel walls.

Figure 1: Responsibilities and funding flows under the PPPs



Source: C&AG's Report, London Underground PPP: Were they good deals? (Figure 1) (HC 645, Session 2003–04)

The early refinancing of debt by Tube Lines, completed in May 2004, provided it with a further return. The public sector stands to receive £59 million (70%) of the gain over time. Tube Lines has obtained an extra £25 million over and above the returns it makes for maintaining, renewing and upgrading the infrastructure.

On the basis of two Reports by the Comptroller and Auditor General[1] the Committee took evidence from the Department and London Underground on 24 June 2004. We examined the rationale for the PPPs; the contract price and other costs; and the contract management arrangements.

1 C&AG's Reports, *London Underground: are the Public Private Partnerships likely to work successfully?* (HC 644, Session 2003–04), and *London Underground PPP: were they good deals?* (HC 645, Session 2003–04)

Conclusions and recommendations

1. **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.

2. **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.

3. **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.

4. **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.

5. **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.

1 Rationale for the Public Private Partnerships

1. The Government decided that a PPP was likely to be the best way of ensuring stability of funding for the maintenance and renewal of the Tube, continued public sector management of operations, and the benefits of private sector management of a major infrastructure program. The Government considered four business structures:

- a public sector unified business;
- a private sector unified business;
- separate private sector businesses split vertically by group of lines; and
- horizontally split businesses (with operations and infrastructure maintenance, renewal and upgrading carried out by separate businesses).

It selected the latter option, with three private sector Infracos and one public sector operator. Its chosen course of action was influenced by delays and cost overruns on the Jubilee Line Extension Project and London Underground's failure to deliver, in full, target improvements in journey times when upgrading the Central Line in the 1990s. The outcome of the PPP compared to the objectives is set out in **Figure 2**.[2]

2. A key element of the initial work to assess the value for money of the PPP was a Public Sector Comparator (PSC) exercise. The PSC was defined as the assessed cost of acquiring the same service through conventional funding, in which the public sector retains significant management responsibility and exposure to risk. In this case, the PSC was London Underground's estimate of the cost to the public sector of independently procuring the maintenance, renewal, and upgrade of Tube trains, station, track and signalling as specified in the PPP contracts. The PSC included adjustments to reflect the failure of the public sector to deliver all project goals and historic overruns on projects such as the Central Line upgrade.

3. The PSC is only one part of a value for money assessment as a focus on costs alone is likely to miss out important non-cost issues relevant to the decision, such as whether the public sector could deliver the desired outcome, to time and cost, and whether an effective output specification or performance regime could be developed. The accuracy of PSCs is also subject to considerable uncertainty. As we noted in our report on the Redevelopment of the Ministry of Defence's Main Building, the outcome of this form of long term financial comparison is very sensitive to the costing of risk.[3]

2 C&AG's Report (HC 645), Executive Summary, para 5 and paras 1.2, 1.5–1.6, 1.19

3 Qq 150–158, 186; C&AG's Report (HC 645), paras 2.39–2.41; C&AG's Report, *The financial analysis for the London Underground Public Private Partnerships* (HC 54, Session 2000–01); 4th Report from the Committee of Public Accounts, *Private Finance Initiative: redevelopment of MOD Main Building* (HC 298, Session 2002–03)

Figure 2: Outcomes against key objectives for the PPP

Objective	Aim at start of procurement (1997/1998)	Position at deal close (2002–03)
Key objective: Value for money[4]		
A. Stable funding	Desire to bring an end to past unpredictable financing on an annual basis	Achieved for the first 7½ years
B. Little or no grant	Reduction over time in the amount of government subsidy	Grant of around £1 billion per year to pay the PPP Infrastructure Service Charge
C. Better value than a publicly run investment programme	Cheaper than the Public Sector Comparator price	Impossible to determine, due to periodic price review – see para 7
Key objective: Private sector investment and expertise[5]		
D. Risk transfer to the private sector investors	Risk of cost and time overruns, and underperformance should be largely transferred to the private sector	Significant caps, caveats and exclusions on risk transfer to the private sector – see para 9
E. Private sector expertise	Private sector companies would bring in project management expertise, and innovation	Some expertise and the prospect of innovation brought in[6]
F. Price competition within the PPP	A separate Infraco for all three line packages	Bidding competition rules resulted in two Infraco owners[7]
Key objective: Safeguarding the public interest		
G. A unified structure for passenger safety, ticketing and marketing	Passenger safety, marketing and ticketing would remain in one organisation	Passenger safety, marketing and ticketing responsibilities remain with London Underground which has also to manage retained risks that arise from separate PFI deals for improved ticketing, power and communications[8]

Source: National Audit Office, based on the references

4 Qq 30–35; C&AG's Report (HC 645), Executive Summary, paras 4, 4.3, Figure 2 and Appendix 3 (Figure 3.1)

5 Q 106; C&AG's Report (HC 645), paras 1.2, 4.1

6 C&AG's Report (HC 644), para B2.5 and case example 5

7 C&AG's Report (HC 645), paras 2.19 –2.21

8 C&AG's Report (HC 644), para C2.1

4. The Government rejected a proposal by TfL to finance the work though public sector bonds, taking the view that private sector management of the infrastructure was more likely to be effective than public sector contract management, and that the extra cost of private sector finance would be outweighed by the benefits, including better risk control. A bond option would have saved some £90 million a year because of lower borrowing costs and savings on remunerating equity shareholders, but would have left more risk with the public sector. [9]

5. The Government was, therefore, unwilling to make a special exception to the existing rules which prohibited a local authority body such as TfL from raising debt in the capital markets. Under the Prudential Borrowing regime, introduced from April 2004, TfL is now able to use bonds for an investment of £2.9 billion into its capital programme over the next five years.[10]

6. Tube Lines and Metronet were chosen as preferred bidders in May 2001, although financial close was only achieved in December 2002 for Tubelines and March 2003 for Metronet. The bidders were therefore in a position of some negotiating strength for over a year and a half. The Department had no formal back up plan if the PPP deals were not completed but would simply have simply turned the running of the Tube over to TfL.[11]

9 Qq 91, 119, 124, 145, 149; Ev 33–35

10 Q 124; 2004 Spending Review announced 12 July 2004

11 Qq 88–89, 169

2 Contract price

7. The Department estimates the net present value of spending under the PPPs over 30 years to be £15.7 billion. The ultimate price of the deals is unknowable, since the contracts are re-priced every 7½ years. The reward premiums available to the private sector shareholders and funders reflect those of a high risk project rather than the limited risk to which they are exposed in these deals.[12]

Risks

8. Railtrack's entry into administration in October 2001 and ongoing disagreements between TfL and the Government about the PPPs illustrated the risks of costing asset maintenance and renewal when the condition is not well known, and highlighted the potential risks for lenders. The Government agreed to increase, from 90% to 95%, the amount lenders of £3.8 billion of senior debt would recover in the event of termination, leaving the lenders at risk for only £190 million. This increase was considered necessary to obtain the total amount of finance required from the bank and bond markets for all three deals. The original 90% was agreed because, unlike most PFI deals, in this case the senior lenders could not protect their investment by re-letting the contract to an alternative service provider.[13]

9. There are caps, caveats and exclusions to project risks borne by the Infracos. The risk of cost overruns in repairing assets of unknown condition, such as tunnel walls, is excluded because knowledge of their residual life and associated costs is incomplete. In the case of assets whose condition has been fully identified against specific engineering standards, the cost overruns that the Infracos have to bear are capped, so long as the Infracos can demonstrate that they are acting economically and efficiently. In the case of Metronet the limit in each 7½ year period is £50 million. Tube Lines carries £200 million in the first period and £50 million thereafter. There is no definition of economic and efficient behaviour in the contracts; an independent arbiter can make a ruling if asked. Exclusions to the risks borne by the Infracos include passenger demand, lower income with fewer users and capacity constraints in the face of increased use. These are borne by London Underground. **Figure 3** summarises the financing for the deal and the limitations on the risks that each is bearing.[14]

12 Qq 5, 14–16, 25–27, 123, 182–183

13 Qq 13–15, 45–47, 90–92, 121–122, 183–184; C&AG's Report (HC 645), para 2.36

14 Qq 6–11, 75–76, 86–87; C&AG's Report (HC 645), paras 2.15, 4.12; C&AG's Report (HC 644), Section C1, paras 12–13, Appendix 2

Figure 3: Senior debt and shareholder financing, and risk limitations

Source of finance	Shareholder funds (£m)		Senior debt (£m)	
	Tube Lines	Metronet (two Infracos)	Tube Lines	Metronet (two Infracos)
Planned	270	350	1,530	2,290
Standby	45	60	273	360
TOTAL	**315**	**410**	**1,803**	**2,650**
Risk limitations	If acting economically and efficiently		190 maximum (at least 95% of senior debt is repayable by public bodies in the event of termination)	
	Repair costs for assets of unknown condition, e.g. certain tunnel walls			
	200 (50 after first period) on other cost overruns	100 on other cost overruns (50 each Infraco)		

Source: C&AG's Report (HC 645) Figure 11, condensed, and paras 2.36, 4.12

Costs

10. Despite the Government's commitment to repay 95% of the debt in the event of termination and limited project risks, the debt was given a BBB grade rating by the rating agencies. Perceived risks leading to this low rating included potential disagreements about the appropriate level of funding between central and local government, and uncertainty around what might happen at the end of each 7½ year periodic review. Under a BBB rating, the lenders are charging about £450 million more in interest on the amount borrowed than they would charge on some £3.8 billion of direct Government loans with AAA rating.[15]

11. On the basis of the Infracos meeting their performance targets, London Underground will be likely to pay nominal post tax equity returns to investors of 18 to 20%, a premium of about 15% above the risk free rate of return of 4.5% at deal close. These returns are some 50% more than most deals with an established PFI structure. Investors may receive lower returns if the Infracos use all their standby funding or fail to achieve upgrades through inefficient and uneconomic behaviour.[16]

12. The Tube Lines deal was refinanced very early in the life of the PPP, in May 2004. The refinancing was in contemplation when the contracts were finalised, suggesting that a better deal for the public sector might have been possible. Refinancing reduces borrowing costs and the gains are shared between the public and private partners. Tube Lines has refinanced £1.8 billion of debt. TfL receives £50.4 million of the benefit initially, which represents a 60% share of the total £84 million gain. Its share rises over time to £58.8 million (70% of the total). This percentage is higher than that suggested in Treasury

15 Qq 58–60, 184

16 Qq 13–14, 182–184; C&AG's Report (HC 645), para 2.32

guidance on the sharing of refinancing gains, which calls for a 50-50 split. The public sector share is paid over to TfL, is not subtracted from the grant provided to it by the Department, and may be used in any part of London's transport network.

13. There is some scope for Metronet also to carry out a refinancing to achieve lower interest payments on its debt, which is held mostly in bonds. The amount of any such refinancing benefit will only be determinable at the time of refinancing and would be dependent on factors such as the underlying interest rates, the financing structure available at that time and the level of pre-payment penalties to its existing bondholders.[17]

17 Qq 136, 174–181, 185–186; C&AG's Report (HC 645), para 2.38; Treasury guidance on refinancing is available at: http://www.hm-treasury.gov.uk/media//FB2F8/PPP_Refinancing_Guidance_Note.pdf

3 Other costs

14. Transaction costs for the deal were £455 million, or 2.8% of the net present value of the deal. London Underground's own costs were £180 million. It also reimbursed bid costs of £275 million. The Department said that it had learned a lesson about controlling bid costs.[18]

London Underground costs

15. London Underground's own PPP costs amounted to £180 million. These costs included external advice on legal, commercial advice and internal costs such as those of the corporate reorganisation that preceded the PPPs (see **Figure 4**). Contract negotiations took longer than anticipated, which increased the costs for all parties. Without the PPP, the Department said that London Underground would have had to negotiate separately a potentially very large number of other contracts, each with its own transaction costs.[19]

Figure 4: London Underground's costs

	£ million
1. Advisers to London Underground	
Freshfields (legal)	29.2
PriceWaterhouseCoopers (commercial)	21.4
Arthur Anderson (re-organising operations)	13.8
PA Consulting (re-organising engineering activities and dynamic simulation model)	12.5
Ove Arup (engineering)	6.0
Other firms (project management, audit, insurance, property, pension and miscellaneous technical advice)	26.5
	109.4
2. London Underground internal costs	
	61.0
Effect of discounting	**10.0**
TOTAL	**180.4**

Source: London Underground

18 Qq 75, 131, 160, 162

19 Qq 12, 80–81, 84; Ev 35–39

Bidders' costs

16. Winning bidders expect to recover bid costs in their originally bid contract prices. In this case the costs became a specific item that, after the extended negotiating period, increased the Infrastructure Service Charge that London Underground pays the Infracos. Total bidder costs, including those for unsuccessful bidders, amounted to some £275 million (**Figure 5**).[20]

Figure 5: Bidders' costs

	Unsuccessful bidders (£m)	Tube Lines (£m)	Metronet (£m)
Lawyers for bidders	–	13.6	14.0
Advisers	–	13.1	16.4
Lawyers for banks and funding bodies	–	7.8	6.2
Banks technical advisor, modelling, etc	–	4.4	2.5
Other 3rd party advisers' costs to end 2002 – tax, audit, VAT	–	4.2	3.4
Balance of 3rd party costs forecast for remaining period to close	–	5.4	3.0
Bid team resources	–	16.6	14.3
Transition team resources	–	21.5	2.4
Project office expenses	–	1.4	3.2
Unsuccessful SSL bid	–	7.0	–
Success fees	–	39.0	50.6
Unsuccessful bidders	25.0	–	–
TOTAL (£m)	**25.0**	**134**	**116**

Source: London Underground and Department for Transport

17. The bidders' costs included success fees to compensate them for the use of staff and other resources which might otherwise have been used profitably elsewhere. Tube Lines received £39 million of success fees and Metronet £51 million. In total, success fees amount to over 30% of overall bid costs. The Department said it had learned a lesson and that it ought to have established from the outset what was a legitimate bid cost in relation to this element. Faced with a similar situation again it thought there was a strong argument to disallow success fees from bid cost reimbursement.[21]

18. Excluding success fees, Tube Lines was reimbursed £95 million of bid costs and Metronet was reimbursed £65 million of bid costs. Tube Lines concluded one deal, while

20 Qq 131–134, 166–167; Ev 35–39

21 Q 131

Metronet concluded two. Allowing for £7 million reimbursement for a bid that Tube Lines did not win, the immediate cost for one Tube Lines contract was £88 million. This was £23 million higher than the amount that Metronet was reimbursed for two contracts. The Department gave the following reasons for the differences:

- Earlier deal closure (December 2003 for Tube Lines, compared to April 2004 for Metronet). As the Tube Lines contract was negotiated, developed and completed earlier, the company incurred greater costs than Metronet in being the first to agree contract principles. The Tube Lines contract work was incorporated into the two remaining contracts, thus reducing transaction costs on the Metronet bids where agreed terms could be incorporated from the Tube Lines deal.

- Metronet was a single bidder for two contracts, avoiding some inevitable duplication in costs had separate bidders been selected.

- Different pre-operational contract activities and the creation of business plans. These costs were some £21.5 million for Tube Lines, compared to £2.4 million for Metronet, reflecting the different make-up of the two consortia. Tube Lines was required to prepare supply contracts for sub-contractors before deal close and build up resources capable of letting these contracts. Metronet, with a supply chain that formed part of the consortium, was not required to undertake a similar level of preparation before deal close because contracts had already been arranged with suppliers. The Metronet supply chain will have incurred substantial costs pricing their respective obligations and in particular performing the necessary due diligence to offer fixed prices. These costs, while recoverable through the Infrastructure Service Charge, are not separately identifiable but included in the overall fixed prices offered to Metronet by suppliers.

Some of Tube Lines' costs covered design work that should already have been covered by the Infrastructure Service Charge. There is, therefore, the risk of double payment.[22]

22 Qq 169–171; C&AG's Report (HC 645), para 3.18

4 Contract management

19. The deals are now in operation, but performance outcomes can only be assessed definitively much later. It will be 2015 before most of the capability upgrades are delivered, and the Infracos are not required to get the assets to optimum state and eliminate all the maintenance backlog until the end of the third review in 2026, 22 years into the deals.[23] The evidence about how the PPP contracts are being managed to date shows that active contract management is essential to achieve these goals effectively.

Management information

20. Improved knowledge of the system's assets is needed to help the parties better manage the risk of problems arising and bring greater cost certainty. Full asset knowledge will be developed as the Infracos do remedial work on various lines. Some of the long life assets, such as tunnel walls or embankments, are very difficult to get at and all of them will need maintenance and renewal at some stage. As their actual state is unknown it is difficult to quantify the cost of that work. For example, the sub-surface lines can be walked every night for inspection and analysis, but engineers will only know if the tracks are stable and safe once the lines are taken apart. There is an urgent need for a thorough asset register to indicate which assets ought to be repaired or replaced first. London Underground is pressing the Infracos to develop full asset registers as early as possible.

21. London Underground said it needs more transparent cost information from the Infracos, for example on the cost of major capital projects. It said that initial information to date from the Infracos was inconsistent and, in some cases, inadequate compared to the greater level of detail that was available during the bidding stages of the deals. For example, London Underground does not yet know the extent to which the Infracos are using their contingency allowances. These allowances were included in the bid prices to cover potential but unspecified risks. Rather than keeping these sums separate, as they were during bid evaluation, they have been aggregated into Infraco general budgets making it difficult to track the drawdown of such risk funds. Tube Lines has expressed willingness to provide the arbiter with a breakdown of how its general budgets are spent.[24]

Managing scope changes

22. London Underground has little or no leverage to secure cost-effective changes to the scope of the contracts. The Infracos have the benefits of being the sole suppliers of infrastructure services to London Underground. They have already invested in equipment and expertise and to bring in other contractors would be very expensive. At 7½ year review, if London Underground and the three infrastructure companies cannot agree a price for the restated scope of works that London Underground wants in the following period, then the matter can be referred to the arbiter. The lenders are not obliged to provide new money for new requirements and the suppliers would have to find a new source of finance in those circumstances.[25]

23 Qq 3–4, 106; C&AG's Report (HC 644), paras A1.3, Figure 2

24 Qq 36–44, 75–76, 108–116; Ev 28–30; C&G's Report (HC 644), Executive Summary, paras 11–12, para B3.1

25 Qq 6–11, 107

Formal minutes

Wednesday 9 March 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Ian Davidson
Mr Brian Jenkins
Mr Gerry Steinberg
Jon Trickett

The Committee deliberated.

Draft Report (London Underground Public Private Partnerships), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 22 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Seventeenth Report of the Committee to the House.

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

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

[Adjourned until Monday 21 March at 4.30 pm

Witnesses

Wednesday 23 June 2004 *Page*

Mr David Rowlands CB, Department for Transport, **Mr Paul Davies,** PricewaterhouseCoopers LLP, **Mr Tim O'Toole,** and **Mr Martin Callaghan,** London Underground Limited Ev 1

List of written evidence

Transport for London Ev 20
Commissioner of Transport Ev 21
Department for Transport Ev 23
Transport for London Ev 27
National Audit Office Ev 33

List of Reports from the Committee of Public Accounts Session 2004–05

First Report	The management of sickness absence in the Prison Service	HC 146
Second Report	Tackling cancer in England: saving more lives	HC 166
Third Report	The BBC's investment in Freeview	HC 237
Fourth Report	Improving the speed and quality of asylum decisions	HC 238
Fifth Report	Excess Votes 2003–04	HC 310
Sixth Report	Excess Votes (Northern Ireland) 2003–04	HC 311
Seventh Report	Foreign and Commonwealth Office: Visa entry to the United Kingdom: the entry clearance operation	HC 312
Eighth Report	Ministry of Defence: Battlefield Helicopters	HC 386
Ninth Report	The Drug Treatment and Testing Order: early lessons	HC 403
Tenth Report	Welfare to work: tackling the barriers to the employment of older people	HC 439
Eleventh Report	Improving public transport in England through light rail	HC 440
Twelfth Report	Helping farm businesses in England	HC 441
Thirteenth Report	Ofgem: The Social Action Plan and the Energy Efficiency Commitment	HC 442
Fourteenth Report	Department for International Development: responding to HIV/AIDS	HC 443
Fifteenth Report	Managing risks to improve public services	HC 444
Sixteenth Report	Department of Health: improving emergency care in England	HC 445
Seventeenth Report	London Underground Public Private Partnerships	HC 446

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 23 June 2004

Members present:

Mr Richard Bacon

Mr David Curry
Jon Cruddas
Mr Brian Jenkins
Jim Sheridan
Jon Trickett
Mr Alan Williams

In the absence of the Chairman, Mr Alan Williams took the Chair

Sir John Bourn KCB, Comptroller and Auditor General and Ms Patricia Leahy, Director, National Audit Office, further examined.

Mr Brian Glicksman, Treasury Officer of Accounts, HM Treasury, further examined.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

London Underground:
Are the Public Private Partnerships likely to work successfully? (HC 644)

and

London Underground PPP: Were they good deals? (HC 645)

Witnesses: **Mr David Rowlands CB,** Permanent Secretary, Department for Transport, **Mr Paul Davies,** Partner and Head of the Transport Division within Corporate Finance, PricewaterhouseCoopers LLP, **Mr Tim O'Toole,** Managing Director, **Mr Martin Callaghan,** former Board member, London Underground Limited, examined.

Q1 Mr Williams: We are here today to have a hearing on the NAO Report on the London Underground Public Private Partnerships. I welcome as witnesses Mr David Rowlands, Permanent Secretary and Mr Paul Davies of PricewaterhouseCoopers. Is this your first visit?
Mr Davies: To the PAC, yes.

Q2 Mr Williams: I am sure you will enjoy it.
Mr Davies: Thank you.

Q3 Mr Williams: Also, we have Mr Tim O'Toole and Mr Martin Callaghan from London Underground. Welcome, gentlemen. May I also welcome this afternoon the Speaker and the Secretary of the Legislative Assembly of Gujarat. Welcome. May I put on record, before I start asking questions, that at one time in the past I was a sponsored member of the TSSA and it still sponsors my constituency party. I am a paid up but non participating member of that union. If I can start off with the questioning to you, Mr Rowlands. This project is starting two years later than originally planned. The maintenance backlog was meant to be 15 years and it is now 22 years. The 30 year programme looks as if it will run until 2033. The Mayor of London has promised Londoners ten years of misery; what is your estimate?
Mr Rowlands: I think you are looking at a project that needs to recover some several billion pounds, it is difficult to estimate it, of degraded assets. I think inevitably we are looking to a period, certainly through to the end of the decade, when there will be some considerable disruption in the sense of heavy station modernisation programme and probably no weekend in any of the coming years when there is not a part of the Underground closed for remedial works. It is a measure of the scale of the work that needs to be done.

Q4 Mr Williams: It has been suggested that it may be about impact 15 years before the substantial work is completed and from then on it should be less intrusive, is that familiar to your calculations?
Mr Rowlands: I think Mr O'Toole may have a better view in operational terms than I do. The position is, as I think the Committee knows and can see from the Report, the infrastructure companies are not required to get the assets to optimum state and eliminate all the backlog until the end of the third review, which is actually 22 years, although most of that will be done before then. Yes, you may well be looking, certainly through to the end of this decade and beyond, but Mr O'Toole may have a view.
Mr O'Toole: I would not quarrel with that description. The important date for me is when we finally get upgrades on the subsurface railway. It is going to be somewhere around 2015 when you would see a dramatically different railway across the piece. The upgrades for, say, the Bakerloo Line are even

later, that is 2020, but I think it puts a fairly good service forward right now. For me the change is when we finally get to the subsurface railway.

Q5 Mr Williams: I understand from the Report that the price, the scope and the funding of the project is to be reviewed every seven and a half years. That means there will be three reviews during its lifetime. Is the taxpayer being taken on a financial mystery tour? Do we have any idea how this will shape up?
Mr Rowlands: I do not think we are being taken on a financial mystery tour. We were trying to deal through the PPP contracts with the inevitable uncertainty in a huge programme of remedial work where the state of many of the assets was unknown. We could have sought, and the Report I think acknowledges it, greater price certainty and in that sense reduced the mystery tour for the taxpayer but it would inevitably have been at the expense of higher contingencies put into the bids by the private sector and the higher cost that way to the taxpayer. There is a trade-off between cost and risk, I am afraid.

Q6 Mr Williams: If after the seven and a half years there is a review and you do not agree, what happens?
Mr Rowlands: If London Underground and the three infrastructure companies at the end of the first review cannot agree a price for the restated scope of works that the Underground wants pursued then the matter goes to the arbiter for him to price on the basis of an economic and efficient Infraco supplying whatever it is that the Underground has restated as its need.

Q7 Mr Williams: Is his conclusion binding contractually?
Mr Rowlands: It is binding. The arbiter's decision, I believe, is binding.[1]

Q8 Mr Williams: Binding but not contractually?
Mr Rowlands: The contracts provide for the arbiter, in fact the arbiter is provided for in the Greater London Act 1999. Through that mechanism his conclusions are binding.

Q9 Mr Williams: I may have misunderstood the meaning. Is it not a fact that even if the arbiter makes a decision which is binding the suppliers do not have to fund extra money?
Mr Rowlands: The lenders are not obliged to provide new money for new requirements and, therefore, the suppliers would have to find a new source of finance in those circumstances.

Q10 Mr Williams: What if they say they cannot find the funds?
Mr Rowlands: Then I imagine in those circumstances the Underground with the Department would look for another route through. This is a hypothetical set of circumstances.

[1] Ev 23 – 24, 26

Q11 Mr Williams: It is not hypothetical, it is a possibility.
Mr Rowlands: You are right. It may be a market test of what in seven years' time perhaps the Underground is asking for. If a restated requirement, to take an example, produced a technologically difficult requirement, like the original Jubilee Line extension, you may find the market unwilling to price that because of the technology risk and the lenders unwilling to lend, in which circumstance you may be being told something by the market place about what at that stage might be the Underground's ambitions.

Q12 Mr Williams: Some of my colleagues may wish to follow up on that. We read the transaction costs, which include the bidding costs which you accepted and took responsibility for, came to £455 million and the private borrowing costs £450 million, that is £900 million just on the transaction cost, adding extra costs of the borrowing which I will come to in a moment, that is £900 million. Could it not have been better spent directly on the Tube?
Mr Rowlands: Yes, had it been available, but in a very real sense it would never have been available. This Report says that the transaction costs for the three PPP contracts, although expensive, were reasonable in relation to the size and complexity of the contracts. The transaction costs are in relation to £30 billion worth of business, that is the undiscounted cash cost over 30 years of these contracts. If you had not had these contracts, you would have had a whole series of other contracts, all of which have their own transaction costs because they still require lawyers and so on. I do not believe you would have escaped this set of transaction costs if you had not pursued the PPP, the costs would still have been there in a whole series of other contracts to deliver this work programme.

Q13 Mr Williams: While I do not suppose any of us were surprised to find the borrowing costs were somewhat higher than the public sector borrowing costs, we expect them to be slightly higher, we read that it is actually an 18% to 20% rate of return. To me this sounds quite huge. I cannot think of any PFI that we have had before us—and the NAO may correct me if I have got it wrong—at this level nor even near it, because I think certainly this is about a third above the normal borrowing rate. Why on earth is that?
Mr Rowlands: In terms of the rate at which the debtors were lending I think this is a reflection of the risk inherent in the project to them and at some stage as we went through this project the political risk in terms of the then TfL opposition. You have seen some of those borrowing costs come down with the Tube Lines refinancing and some of that gain shared with TfL.

Q14 Mr Williams: Mr Rowlands, you say it reflects the risk but if you look at page five, paragraph 10b, lenders are committed to advance at least £3.8 billion. They have " . . . limited downside risk (because in the event of termination they stand to get

back 95% of what they have lent) . . ." returned to them. Yet they are charging rates of interest in line with a high risk development. The risk they are exposed to is 5%, so the risk on them does not apply here.
Mr Rowlands: They are at risk for £190 million in terms of the 95%. This debt was rated as a low investment rate by the rating agencies and the borrowing costs reflect that rating, I am afraid. That is the result of what the market gives you and the justification for this level of borrowing cost is the ability to put the risk of an uncertain set of assets and a huge uncertain investment programme firmly into private sector hands and out of public sector hands.

Q15 Mr Williams: Why did you accept so low a level of risk? If the market is saying to you "Well, we are going to treat it as high risk", why not give it high risk? Why give a low risk project a high risk cost?
Mr Rowlands: I am afraid that was a consequence of the negotiations in the market at the time. They were deeply unwilling to accept anything less than originally a 90% and then 95% underpinning in the face of the political risk, as the market perceived it, from the Mayor's known opposition to PPP and tested in the marketplace that is where it came out. London Transport, in terms of evaluating the positions which were in front of them, had to model that against the public sector comparator. Even with those costs this was better value.

Q16 Mr Williams: Your Department has accepted the £455 million transaction costs, the £450 million borrowing costs, it has accepted a high risk premium for a low rate risk and then, after the competitive process is over, it accepted price rises of another £590 million. The taxpayer has been taken to the cleaners.
Mr Rowlands: The £590 million, which was the increase in the cost across the three contracts after preferred bidders were announced, is largely a reflection of additional outputs: the ten extra trains on the Victoria Line, two extra trains on Bakerloo and Northern and so on, so it was not as if the price went up and there was nothing more for the money. In input terms there was a heavy set of additional inputs going in for that £590 million.

Q17 Mr Williams: One final question before I throw it open to colleagues. Transport for London will have the major responsibility for public sector oversight yet its prime duty is inevitably to the Londoner. In that case, how can we, who represent other parts of the country, be sure the UK taxpayer's interests are going to be properly protected?
Mr Rowlands: We monitor on a regular basis, on a monthly basis, TfL's performance or, through TfL, the London Underground's performance in terms of the six performance indicators we have agreed with the Mayor. Those indicators increase over time as a consequence of this PPP improving the state of the assets. In that sense we are monitoring to see that in the overall performance of the Underground the taxpayer is getting the improved performance you would expect for this sort of money.

Q18 Mr Williams: If the prime oversight is with Transport for London and you, the Department, disagree with Transport for London, who actually wins the argument?
Mr Rowlands: Can I put it this way: what the Department cannot do is attach any conditions to the grant which it pays Transport for London for transport; it is *ultra vires* the 1999 Act. What we do have is both regular monitoring of the Underground's performance and regular discussions with TfL about its business plan. In the event that there was the sort of dissatisfaction you suggest might happen in the end that inevitably would flow through to, I guess, what the Government was prepared to set by way of the overall grant for TfL. What it would not impact on is the element of grant we pay to underpin the PPP because we have set out on a seven and a half year basis what that would be.

Q19 Mr Williams: What I am still not clear about is where there is specific disagreement. How do you see it, London Underground, do you see it differently from the Department?
Mr O'Toole: I think at the end of the day you are talking about a system that assumes the devolution of the Underground and transport generally from Central Government to the Mayor. The system, as we all know, is not complete. We still have to return to the Department for our grant, for our money. There is something of a fiction that we are completely removed from the Government because the fact of the matter is in order for us to do anything, fund any major project, we have to come back, so we feel we are connected in both directions.

Q20 Mr Williams: It may not be a matter of coming back for money, it may be the uses to which the money already has been put. Whose decision is final there?
Mr O'Toole: Ultimately that will be the Mayor's decision and the Commissioner's. Certainly the decision about how to spend the marginal pound, whether it is on buses or the Underground.

Q21 Mr Williams: I see.
Mr Rowlands: Could I just add one point to help. As I said, we cannot attach conditions to the grant which the GLA gets for TfL, it is *ultra vires* the 1999 Greater London Act, but we do discuss with TfL its business plan, we do monitor what the Underground and the buses et cetera do. If we were to discover after a year or two that the grant we had been paying was being used for some completely different purpose than set out in TfL's business plan, for example, I think we would have some serious heavyweight discussions about what the next year's grant was going to be to see if they appeared to be spending it on things they had not said they were going to spend it on.

Q22 Mr Williams: Pursuing discussions is all well and good—I apologise to my colleagues but I want to press on this—at the end of the day if London

Underground insists they want to go one route and you want to go a different route, I come back to the point, who prevails?

Mr Rowlands: To be very candid with you, I cannot give you an absolute answer to that because it is a negotiation-cum-discussion. Parliament in the 1999 Act gave London a mayor with devolved powers and responsibilities and that inevitably means it is a world where there is a degree of at least potential tension between Central Government and the Mayor.

Q23 Mr Williams: Before I move to the next questioner, does anyone else want to comment on this? To us it looks like a rather confusing and potentially conflict ridden situation. Does anyone else want to make a comment?

Mr Callaghan: If I may, I will make a comment on the specific PPP contractual position. London Underground has asked for a specific set of things under these contracts and they are going to cost a specific amount of money and that amount of money has already been provided to London Underground in the way that Mr Rowlands has described. I think in terms of what happens within the structure of the existing contract then there is not very much scope for conflict because the money is already being earmarked to do this and the management of that contract and that amount of money is in the hands of London Underground. I think the position is likely to be different on things which are outside the contract or at the review that you have mentioned already, Mr Williams, where London Underground may have ambitions to do other sorts of things, and I think that is just part of the normal discussion that takes place between any spending body and its source of funds. I think the PPP does not particularly introduce any new dynamics into that sort of relationship.

Jon Trickett: I am worried about my competence to deal with this this afternoon because this Report did not arrive with me until Monday. This is one of the largest Reports and one of the more serious ones we have received in front of the Committee of Public Accounts. I wonder whether there has been some prevarication somewhere which has resulted in a late publication date deliberately to engineer a situation where Members have not had time to study the Report adequately. I give notice now, Mr Williams, I would like you to consider whether you go around testing me and my colleagues at the end of the meeting to see if we want this meeting adjourned rather than terminated to give us a chance to adjourn and study the document with more care. If it is okay, I will give you notice now to consider whether you are allowed to do that or not.

Q24 Mr Williams: Sir John, we normally have a significant interval, sometimes over-long, which is not your fault, it is our timetabling then, between the time of our receiving the Report and the time of having the hearing. Now this is two volumes plus supplementary evidence that has been submitted. It is one of the most voluminous Reports I have ever seen, only the Ministry of Defence exceeds it in its word power. How is it that the two have run so closely together? Has it taken longer than originally anticipated to produce the Report?

Sir John Bourn: No, Mr Williams, I sympathise with what Mr Trickett has said. I think the reason the Committee did not get it with a longer opportunity to read it and reflect about it arises essentially because the task of the National Audit Office is to agree the facts with the accounting officer but in this case there were other people that we wished to consult: Transport for London who are very much concerned with these issues. These are not people who lie within the usual system. They were co-operative and helpful but the discussions with them took a long time, and I do not criticise them for that because it is crucial for them, but it was the desire on our part to bring into the debate Transport for London, not confine ourselves simply to the Department for Transport, that took the extra time. I say, I sympathise with what Mr Trickett has said and the Committee and if you decide you wish to have another cut at it I would understand that completely.

Mr Williams: I am sure the witnesses will welcome the opportunity.

Mr Bacon: Get them back!

Mr Williams: Mr Trickett raises a very valid point. We will look at this issue on Monday and I serve notice on everyone that a second phase of the hearing is a possibility.

Q25 Jon Trickett: I am grateful to you and if it had occurred to anybody that by getting the Report late to us somehow we would be precluded from getting a full hearing, no doubt what has been said will remove such a thought and stop the same thing happening in the future should it happen. I want to ask some preparatory questions for a later fuller hearing perhaps. I note on the second of the two Reports, which is about whether the PPP are likely to work successfully, that the NAO states—I refer to page five, paragraph five and it is the second bullet point and this is a remarkable statement by the NAO given how diplomatic they are with the use of language—"There is only limited assurance that the price is reasonable, reflecting the complexity of the PPPs and some uncertainty about the eventual price, but any price revisions have to meet tests of economy and efficiency and greater price certainty . . . ". I would like to know who inserted that particular clause? " . . . and greater price certainty would have resulted in a higher price". So in order to get a more certain price it is going to cost us more but because we did not get certainty there is limited assurance that the price is reasonable. That is a very interesting and complex sentence, the meaning I am going to ask Sir John to explain to us.

Sir John Bourn: The essential point is the one that Mr Rowlands made. Here was an attempt to put together a very complicated deal and in order to bring it to completion the Government essentially had to agree to spend a great deal of money to get it. That is why they did feel, because they spent the money, that the game was worth the candle but it

cost a lot of money to do a very complicated deal and to get all the people on board to do it. That is the essence of the matter that lies behind that.

Q26 Jon Trickett: This is the equivalent of you saying you will not sign off the set of accounts. I do not think you are able to say to this Committee, and I put it to you, you cannot say to this Committee, that the taxpayer has got value for money in this particular deal? That is what the sentence says.
Sir John Bourn: I am not saying that it has because nobody knows.

Q27 Jon Trickett: You cannot tell the Committee one way or another and, therefore, Parliament and the House of Commons whether or not this deal represents value for money. That is a fact.
Sir John Bourn: No, I cannot. I am giving the Committee the right answer. Nobody can tell that.

Q28 Jon Trickett: Mr Rowlands, do you want to add anything to that?
Mr Rowlands: Since this is a preparatory hearing, can I give you a little bit of background?

Q29 Jon Trickett: Sure, an abbreviated response if you do not mind because I have some other questions.
Mr Rowlands: Okay. The original estimate that began the PPP for the so-called maintenance backlog, one to one and a half billion pounds, had no engineering basis to it whatsoever. It was quite clear as this progressed that the backlog, as I said earlier, could be measured in many billions of pounds, such was the state of the infrastructure. This deal attempted to deal with that degree of uncertainty and that is why the NAO have said quite reasonably what they have said.

Q30 Jon Trickett: I think you signed this contract off, you are the accounting officer. Can you say that the taxpayer has got value for money from this contract?
Mr Rowlands: Yes.
Mr Williams: The NAO says there is only limited assurance the price is reasonable.

Q31 Jon Trickett: You have agreed to that. You have agreed to that sentence.
Mr Rowlands: It is not saying that the price is unreasonable. Had the price been unreasonable the Department would not have signed it off.

Q32 Mr Williams: There is only limited assurance that it is reasonable.
Mr Rowlands: Because greater price certainty, as it says here, could only have resulted in a higher price. It was a trade-off between risk and price.

Q33 Mr Williams: If you are buying a secondhand car on that basis you would be very conscious of *caveat emptor*.
Mr Rowlands: Indeed, and the problem with this secondhand car is the tunnels are 150 years old and nobody knows what state they are in.

Q34 Jon Trickett: You have agreed to this sentence.
Mr Rowlands: Yes.

Q35 Jon Trickett: You assent to this sentence?
Mr Rowlands: Yes.

Q36 Jon Trickett: Okay. I want to move on then. Paragraph 12 of the same Report talks about the seven and a half year periodic review. This is rather important, given the sentence we have just talked about, because periodic reviews tend to make sure the contracts are on track and one of the recommendations on page 11, paragraph 12 says that "LUL report that initial information to date from the Infracos is inconsistent and, in some cases, inadequate". Can I ask Sir John where the evidence is for that for the Members to consider?
Ms Leahy: You are asking for the evidence for that sentence?

Q37 Jon Trickett: Yes, where is the evidence for that sentence?
Ms Leahy: That is a statement that LUL made to us, a statement that Mr O'Toole and many of his colleagues have made. We do not have any evidence of that, we put it as that is what they have reported to us.

Q38 Jon Trickett: Is the periodic review, as I stated it, a rather important matter in making sure the contracts are on time but also economic and so on? Therefore, I would have expected further information to back that sentence up. I do not want to delay things now but I wonder whether supplementary information could be provided as to in what way you find the information from the Infracos inconsistent and in some cases inadequate and what steps you have taken to ensure that you get adequate information? Can you provide us something about that in writing, please?
Mr Rowlands: I cannot because this is an LUL statement, I am sure Mr O'Toole can.
Mr O'Toole: I would be happy to.[2]

Q39 Jon Trickett: Fine. Thank you very much. I want to go on to the highlighted block below. "If partnership is to work, LUL needs to be given accurate, consistent, and regular information . . . ". That paragraph then is supplemented by a reference to paragraph A3.4. Can someone tell me where A3.4 is, please, in the Report because there is no such paragraph? Where is that paragraph?
Mr Rowlands: It is actually in A3.2 if that is helpful.

Q40 Jon Trickett: It is not because I have not had a chance to look at it.
Mr Rowlands: I think that is where it is, page 20.
Jon Trickett: It refers to A3.4, if you go to page 21 you will find A3.3 but there is no A3.4.

[2] Ev 24, 28 – 30

Q41 Mr Williams: NAO?
Ms Leahy: Sorry, it is actually A3.2 on page 20 and there is a paragraph at the end of that page which does give some of the evidence.

Q42 Jon Trickett: I went to A3.4 and could not find it.
Ms Leahy: I am very sorry.

Q43 Jon Trickett: I did not get this until Monday. I think it does demonstrate the problems we are being faced with by being given late information.
Ms Leahy: Sorry. It is the last paragraph on page 20.

Q44 Jon Trickett: It is not A3.4, that does not exist.
Ms Leahy: I am sorry, it is page 20, A3.2.

Q45 Jon Trickett: I do not want to say it is shoddy but it is not helpful when we get Reports at the last minute and it mentions paragraphs which are not there. This is a key part of the text. I want finally, if I have time left, to go to the first Report, paragraph 2.36 on page 25. Mr Williams has already referred to this discussion. I understand you, Mr Rowlands, to say that the risk is £190 million on the private sector?
Mr Rowlands: On the debt, yes.

Q46 Jon Trickett: Yes, on the debt. Yet the public sector appears to have been penalised by £450 million because of the risk which the private sector is taking. Am I understanding that correctly?
Mr Rowlands: No, this is not the totality of the risks taken by the private sector because the equity is at risk put up by the infrastructure companies as well. There is a table elsewhere in the Report that sets out the detail of that.

Q47 Jon Trickett: This sentence which you have agreed to, which we have only had 48 hours to look at, says: "although they ultimately carry risk reduced to 5% or less . . ." and you have told us that is £190 million, ". . . lenders are charging about £450 million more than they would charge on some £3,800 million of direct Government loans . . ." I can only draw the £190 million comparison of risk to the private sector to the additional £450 million cost which you have agreed to on behalf of the taxpayers and draw the conclusion that is one of the worst deals ever in front of the Committee of Public Accounts.
Mr Rowlands: This says that if the Government had paid this money directly it would have saved £450 million over it being supplied by the private debt markets. If we had been supplying the money directly we would have been taking on, I think, the risk inherent in a set of assets whose state is unknown to everybody.
Mr Williams: You see, Mr Rowlands, of the £3,800 million £3,610 million is guaranteed by the Government.
Jon Trickett: Exactly. It is more than that. Elsewhere in the Report we find the Government has written letters of comfort to the private sector, presumably giving them some further certainty as well. This must be one of the worst deals ever put in front of the Committee of Public Accounts, quite frankly. How you can say this is demonstrably value for money I do not know frankly. Anyway, my time is more or less up.

Q48 Mr Bacon: May I say to start with that I too am glad there will be another opportunity to look at this. I do not feel I have had enough time to prepare. There has to be a reasonable gap between publication of the Report and our meeting, so I welcome that agreement from you earlier. Mr O'Toole, you work at the headquarters of London Underground at St James's Park tube station?
Mr O'Toole: Yes.

Q49 Mr Bacon: Do you take the Tube to work?
Mr O'Toole: Yes, I take the Tube everywhere I go.

Q50 Mr Bacon: You do. So you are aware that there are delays and you experience them yourself?
Mr O'Toole: Yes.

Q51 Mr Bacon: May I ask where do you commute from in the morning, which tube station?
Mr O'Toole: I commute from High Street Kensington or from Notting Hill, I live in between the two of them.

Q52 Mr Bacon: Mostly you go round on the Circle Line?
Mr O'Toole: I do. I arranged my life so I could take on the line that has caused the most on-time problems.

Q53 Mr Bacon: If you are requiring to come round from High Street Kensington, you cannot take the District Line, you have to take the Circle Line. The Circle Line only seems to run every 20 minutes or so.
Mr O'Toole: Actually it runs on eight minute headways.

Q54 Mr Bacon: What does that mean?
Mr O'Toole: It means that it is scheduled to have eight minutes between trains. The Circle Line's problem, of course, is that the Circle Line does not actually exist. It runs on the District Line and it runs on the Metropolitan Line and it is sacrificed whenever there is a problem on either of those lines. Often you feel you have a poor Circle Line service inflicted on you but it is a problem that is on one of those other lines.

Q55 Mr Bacon: It is said because the Piccadilly goes out to Heathrow a special effort is made to keep the Piccadilly running more than most other lines. Is that broadly correct?
Mr O'Toole: No, I would not say that is broadly correct.

Q56 Mr Bacon: Given you are the boss, have you not made an effort to make sure the Circle Line runs a bit better?
Mr O'Toole: Actually I have in the sense I do not believe you should sell something you cannot make. I have said to the operating department we have to

find a way to make the Circle Line run better. We have run one experiment which gave preference to the Circle Line at the corners, both when it ran into the Met and when it ran into the District Line. It may have gone unnoticed so far but in the last two periods the Circle Line has been turning in performance it has not turned in in about seven years in terms of the number of trains run in the peak periods. We are running now in the mid 90s, it typically has been in the low 80s.

Q57 Mr Bacon: Mr Rowlands, can I ask you about the extra costs of the private debt compared with public debt?
Mr Rowlands: Yes.

Q58 Mr Bacon: The Report says that the extra cost is £450 million, what is the total cost of the debt?
Mr Rowlands: The total size of the debt is £3.8 billion.

Q59 Mr Bacon: The extra cost is £450 million?
Mr Rowlands: Over triple A.

Q60 Mr Bacon: If it had been publicly funded.
Mr Rowlands: If it had been publicly funded, triple A.

Q61 Mr Bacon: Am I to understand from that the total cost of the debt would have been £3.35 billion had it not been for the fact that the private funding was used?
Mr Rowlands: I am not sure that is right.

Q62 Mr Bacon: I am subtracting £450 million from £3.8 million. Is that right?
Mr Davies: No. One is the size of the original debt, which is £3.8 billion, the extra cost of £450 million is the extra interest charge over 30 years.

Q63 Mr Bacon: Right. If you roll it all up, my question was not what is the total debt but what is the total cost of the debt? Can you give me an answer to my question?
Mr Rowlands: We will have to give you a note on that.[3]
Mr Davies: We can give you a note on that.[4]

Q64 Mr Bacon: You have come to this Committee to talk about financing of London Underground and you do not know the answer to how much is the total cost of the debt.
Mr Rowlands: No.

Q65 Mr Bacon: Do you really not have that?
Mr Rowlands: Not off the top of my head.

Q66 Mr Bacon: Why not?
Mr Rowlands: I am sorry, I did not come with the figure.

Q67 Mr Bacon: Is it not pretty obvious. It says here the extra cost of the debt, the extra cost of the private debt rather than the public debt, is £450 million.
Mr Rowlands: Yes.

Q68 Mr Bacon: To arrive at that figure you must be able to compare one figure with another and say the difference between the two is £450 million. That is what the Report says. I am asking you what are the figures, the difference between them being £450 million.
Mr Rowlands: I do not have those figures in my head.

Q69 Mr Bacon: Does the National Audit Office?
Ms Leahy: We set out the amount of total debts per Infraco and the extra costs of the debt per year and we have worked out the total discounted value of the extra interest. I do not think we added up, you know, the year by year figures.

Q70 Mr Bacon: I am hesitant about the phrase "you know" because if I knew I would not ask you the question.
Ms Leahy: I think we could give you a reasonable approximate value at the moment in the sense that the discounted value of the total deal over 30 years is £15.7 billion and a very large part of that is the debt. It would not be very dissimilar but I do not have the exact figure here. We did not look at it year by year, the extra cost per year, and as I say we did actually aggregate the extra cost over the whole 30 years. I do not think we did that for the particular debt figures.

Q71 Mr Bacon: Mr Rowlands said it is a £30 billion programme, is the other £15 billion something else? Is that equity or what?
Ms Leahy: That is the discounted value. I would expect the other figure to be an undiscounted.
Mr Rowlands: The other figure is undiscounted.
Mr Bacon: Right. I am slightly surprised to have so little accurate information on something so fundamental.

Q72 Mr Williams: As we may be returning to this subject, will you see if you can get that information to us as quickly as possible after this hearing. I think we have to ask the Department that.
Mr Rowlands: Yes.[5]

Q73 Mr Bacon: May I ask, while I am on the subject, is this debt all on the balance sheet?
Mr Rowlands: Yes.

Q74 Mr Bacon: As far as the Government is concerned?
Mr Rowlands: This transaction is on the balance sheet.

Q75 Mr Bacon: If I could ask you to turn, Mr Rowlands, in the first Report to page 31, which is figure 13. This is another figure of £450 or, in fact,

[3] Ev 24 – 25
[4] Ev 24 – 25
[5] Ev 24 – 25

£455 million which are the transaction costs. The Report says that the transaction costs were £455 million. In this Report here it summarises some of these transactions costs. Much has been made of the poor asset condition and the lack of knowledge about asset condition. You will notice Ove Arup, the engineering advisers, were paid £6 million on the assessment of the asset condition whereas at the top there Freshfields—a very blue chip law firm which I am sure we would all want to go to if we could—were paid £29 million. So the engineers who were assessing the asset conditions got £6 million and the lawyers got £29 million. Do you think that is the right way round? Do you think that is an accurate reflection of the priorities the Department should have?
Mr Rowlands: Yes, because you would not have anywhere near bottomed the state of these assets by spending two or three times as much money with Arup's.

Q76 Mr Bacon: Could you speak up.
Mr Rowlands: Sorry. You would not have bottomed the problem with the state of these assets by simply spending two or three times as much money with Arups or, indeed, any other engineering consultancy. This is about the state, for example, of Victorian tunnels which can only be discovered when you start to take the brick work off and do the remedial work and that is the risk the private sector is taking.

Q77 Mr Bacon: It was right to spend five times as much on lawyers as on engineering consultants?
Mr Rowlands: In the context of this deal, yes, because the risk that was so difficult to establish was being passed to three infrastructure companies to handle.

Q78 Mr Bacon: One of the things that worries me about this, and I share Mr Trickett's concerns, you answered Mr Trickett's question: "This is good value for money". "Do you think it is value for money?" and you said "Yes". Mr Trickett earlier had asked Sir John if it was good value for money and he said "We cannot tell". Quite how the two are in sync with one another, I do not know. It cannot both be the case that we do not know, we simply cannot say whether it is good value for money or not, and that you say it is good value for money. In addition to that, you then say that there are these huge unquantifiable risks. It reminds me of some computer contracts we have looked at where precisely because the risks are unquantifiable the Government ended up recognising, and the Treasury ended up recognising, that they are unsuitable for Public Private Partnership or PFIs. Why is that not the case with this?
Mr Rowlands: Because this is not an IT contract. It has been structured on the basis where the NAO's Report does acknowledge that basically all the project risk is with the private sector. It will not come back to us. These contracts place the risk of remediating these assets firmly in the private sector's hands. They have bid a price for it and if they have got the price wrong then they will bear the consequence in terms of their rate of return or eventually loss of their equity.

Q79 Mr Bacon: This little lot here on page 31, these fees that are referred to for various advisers and so on, adds up to £170.4 million, the transaction costs in the same Report were £455 million. What is the rest?
Mr Rowlands: The rest is composed of bidders' costs, relatively small sums for the losing bidders and, as the Report shows, from memory I think it was £134 million for Tube Lines' bid costs and £116 million, from memory, for Metronet's bid costs.

Q80 Mr Bacon: There is a reference in the Report also to the repayment. Do you not think it would be helpful—perhaps the National Audit Office could answer this—to have a chart summarising all these transaction costs in one place?
Sir John Bourn: Yes, and we will rework it and give it to you.[6]
Mr Bacon: I have run out of time, unfortunately. Thank you very much.
Mr Williams: You can have extra time if you want.

Q81 Mr Bacon: Mr Rowlands, other external advisors, it says £26.5 million. Who are these other external advisors? What did they each get?
Mr Rowlands: We would have to give you a note on how it breaks down. As the Report says, in one place earlier on it covers Hornagold & Hills who were paid from memory, I think, £6 million out of that sum for project management. It covers KPMG and, as the Report says, it covers 25 other providers. I am afraid I do not have with me how that sum of 20 odd million breaks across 27 different companies. We will have to let you have a note.[7]

Q82 Mr Bacon: I am looking at an article here from the *Mail on Sunday* from February last year in which it says that one of the consortia bidding for the taking of the London Tube is refusing to disclose how much it is paying to bankers and to legal advisers. A spokesman from Metronet confirmed the consortia would not be disclosing the full figures, and I quote: "It was very clear that we did not have to and we did not want to", he said. "Details have been passed to London Underground . . . " so to Mr O'Toole " . . . but we will not be making it public". Do you think that is an appropriate attitude with taxpayer's money?
Mr Rowlands: No.

Q83 Mr Bacon: You do not think it is appropriate?
Mr Rowlands: No, and I think the position will change statutorily from January of next year with the Freedom of Information Act coming into effect.

Q84 Mr Bacon: I am aware we got to this £455 million but still I would hope perhaps at some time we will get, before this inquiry is over, a much

[6] Ev 25, 35
[7] Ev 25, 35

more thorough breakdown of what went where—£170 million of it is only some way down the line—and also some sub breakdown of how Freshfields managed to run up costs of £29 million, how the accountants managed to run up costs of £21 million, how Arthur Anderson—spelt with an "o" instead of an "e" I see—ran up a cost of £13 million and how PA ran up costs of £12 million. It would be interesting to see a breakdown of each of these.
Mr Rowlands: We will supply, if the NAO are happy, in conjunction with the NAO, so they are content with the figures, as detailed a breakdown as we are able to give you.[8]

Q85 Mr Bacon: If it is possible to have that before the next hearing that will be most helpful.
Mr Rowlands: We will do that.

Q86 Jon Cruddas: Can I start from a slightly different tack, Mr O'Toole. Many of the improvements including line upgrades, which the Chairman touched on, to increase the capacity of the network are not intended to be delivered until after the seven and a half year contract but, according to the Mayor's own spatial economic development plan, London is growing quite extraordinarily over the next ten to 15 years, possibly up to 800,000 new people living in the city, possibly 5–600,000 extra jobs. Are you concerned about the lack of constraint in capacity versus the huge growth in prospective usership?
Mr O'Toole: I am concerned about it. I think it points up why it is so critical that financial commitment has to be followed through into that second period. Some of the time we have to wait but we have to be sure that it is not delayed and you know these public spend projects -worldwide I am speaking—do not have a great record in terms of being turned in on time and on budget. It is absolutely critical that we have the information, that we are able to chart this and drive it so that it comes in on time. I would say further, however, and I do not mean to cause an unnecessary digression but this is why we have to have CrossRail.

Q87 Jon Cruddas: Sure. There are other issues in terms of total infrastructure. Do you model prospective usage of the Tube versus the capacity of the network, notwithstanding the CrossRail issue, over the next seven and a half years?
Mr O'Toole: We do model it. We are seeing the ridership on the Tube at the moment fairly flat but as there is further development to the east there are going to be more and more demands placed on especially those arteries going out to the east which is why it is so critical, for example, that the Jubilee Line upgrade comes in on time because our capacity will go up between 40% and 50% when that new signal system is put in place.

Q88 Jon Cruddas: Mr Rowlands, it says in paragraph 2.10 of Report one that by October 1999 bidder interest in the PPP was fading. What was your Department's contingency plan if the PPP had not been agreed?
Mr Rowlands: The Department's position—as set out in the Committee stage I think when the Greater London Act was going through—was that the Underground would be transferred to TfL once the PPP had been completed. Formally I think it is fair to say that there was no plan B if PPP had never been completed, although if you want me to speculate—

Q89 Jon Cruddas: You had contingency plans?
Mr Rowlands: —plan B, if PPP could not have been completed, would have been to pass the Underground to TfL, to the Mayor. I think that was effectively plan B.

Q90 Jon Cruddas: Your earlier argument was that the political dynamics which shadowed a lot of this created a lot of risk and upset some of the discussions and made them more protracted in terms of deliberations?
Mr Rowlands: Certainly it was the case that in carrying the PPP through it was probably worth, as the Report acknowledges, bearing in mind that it was subject to two judicial reviews mounted by the Mayor.

Q91 Jon Cruddas: You would not accept the charge, which is a charge that is quite commonly put, that the refusal to consider alternative direct Government borrowing not only resulted in a waste of public funds but prevailed in powerful and unnecessary bargaining with leverage to the private sector risk benefit?
Mr Rowlands: No, as a matter of policy the Government decided that it wished the underground to be refurbished by means of the Public Private Partnership. It was prepared as a matter of policy to accept the inherently higher financing costs in the public sector.

Q92 Jon Cruddas: Because of the political imperatives, if you like, and the debates that occurred at that time you do not see that tilted the negotiating framework in favour of the prospective bidders?
Mr Rowlands: No. I think it made it more difficult for London Transport and London Underground to negotiate with the prospective bidders because there was a degree of political uncertainty. Certainly it reflected itself in a more prolonged process than anybody would have wished and arguably it impacted on some of the cost of it.

Q93 Jon Cruddas: Mr O'Toole, if I can come back to you, have you seen, I assume you have, the note from Bob Kiley which was sent to this Committee?
Mr O'Toole: On the first Report?

[8] Ev 25, 35

Q94 Jon Cruddas: Yes.
Mr O'Toole: I have seen it but the first Report is not anything that, I have to tell you, I can comment very usefully on since I came to this story after this battle was fought. I have focused pretty much on the matters that are contained in the second Report.

Q95 Jon Cruddas: I think you have probably just anticipated the question I am going to ask. I will still try anyway. It says in point two that: "The Underground understood that it faced a Hobson's choice: the PPP according to the terms demanded by the private sector or no new investment programme. Had a bond option been taken seriously, the final terms of the PPP would likely have been far more favourable to the public sector—as the bond option would have provided another 'and quite viable' form of competition to the private sector." Given your earlier comments, do you feel you cannot comment on that?
Mr O'Toole: I do not think I can comment usefully on that, no.

Q96 Jon Cruddas: Mr Kiley has commented quite effectively in terms of his views.
Mr O'Toole: Yes.

Q97 Mr Williams: Before we leave that—if you are leaving that—in paragraph 2.27 it says: "In modelling this risk there was, over the bidding period, a noticeable convergence between the public sector comparator (although this was kept confidential) and the bids". Why was it kept confidential?
Mr Rowlands: Paragraph 2.27 in the Report?

Q98 Mr Williams: Yes, 2.27.
Mr Rowlands: I have not seen Mr Kiley's letter.

Q99 Mr Williams: This is in the report which you signed up to. Paragraph 2.27 of the first Report on page 22.
Mr Rowlands: As a matter of, I suppose, in the end negotiating strategy, and perhaps policy, we did not make public what the public sector comparator was saying nor did we make available in any guise whatsoever any notion of what we might be prepared to pay because otherwise you were setting a target for the bidders to bid against.

Q100 Mr Williams: If they were converging, what was the problem?
Mr Rowlands: There was not a problem. They were converging because as people, I think, worked their way through the reality of what they were bidding against, there was a tendency for the bidders and for the PSC to begin to move into similar territory. Mr Callaghan may be able to help rather more than me on this, I do not know.[9]
Mr Callaghan: I will help if I can. As Mr Rowlands has said, and clearly there has been debate about this, one of the key issues in any transaction—this one because of its scale more than most—is whether or not this was the right thing to do given the alternatives that might have existed. The alternative we tested it against was a purely publicly funded alternative and a bond fund alternative. The analysis that we did suggested that this was better than either. You have to have a benchmark against which to test the prices which come back from the market. That benchmark at the time that we did this—and the guidance has moved on a bit—was the figure given by the financial calculation in the public sector comparator. If you know that is the thing that you are trying to get below and you make it public, all you do is invite the private sector to bid just to beat the target and you end up destroying the value because it is actually the existence of that hurdle which keeps the competition.

Q101 Mr Williams: Did the convergence of a public sector comparator make the bond issue more or less viable?
Mr Callaghan: The two things are not directly connected. What happens in the convergence is that the bidders' estimate of what it was going to cost to do the work and our estimate of what it was going to cost to do the work converged because as we were talking to the bidders about what they had found from going out and about on the railway and looking at the state of the assets and as the contractual terms changed in negotiation, in order to have a like-for-like comparison you have to take the new information you have got and recalculate your comparator to compare it against this.
Jon Trickett: The people preparing the public sector comparator accepted and took on board risks identified by the private sector bid, so rather than the private sector being aware of what the PSC wants, the PSC itself was moving and the convergence was because the people preparing the public sector comparator were aware of risks being identified by the private sector. Is that not the true problem, the public sector comparator got higher and higher so it was comparable with the private sector? That is how it seems to me.

Q102 Mr Williams: Which way was it? Was the convergence from the public comparator upwards or downwards? Who can answer?
Mr Davies: I can answer. The public sector comparator increased over time but it was a wholly separate exercise and was not by the same people looking at the bid evaluation.

Q103 Mr Williams: If it increased over time and was converging, therefore, it must have been below the bidding, the private market price, must it not?
Mr Davies: The convergence means it was increasing at a lower rate than the original bids because the bidders were getting better information on the assets. The process that was happening was we were getting more asset data and, therefore, both sides were getting more accurate pictures of what the true cost would be.

[9] Ev 25

Q104 Mr Williams: It is most unusual for us to come across a case where the public sector comparators have been admitted to be lower than the private sector figures.
Mr Davies: It was not lower than.

Q105 Mr Williams: Why did you say it was converging when it was increasing?
Mr Davies: Converging means both were increasing but one at a slightly higher rate. They are getting closer but it was never lower than.

The Committee suspended from 4.30 pm to 5.20 pm for divisions in the House

Mr Williams: My apologies to everyone for the long delay. We will carry on straight away. Jon Cruddas?

Q106 Jon Cruddas: I have just one final question, and that is to Mr O'Toole. You have managed to swerve around commenting on Mr Kiley's letter but can I ask you to comment on your own one to the secretary? Generally, just because this is a preliminary hearing, do you want to make some comments about, firstly, the NAO Report and, secondly, your experience of the PPP over the last year because you have made some quite trenchant criticisms of it in the last letter?
Mr O'Toole: When I came here I wanted to make very plain to the parties that my interest was in service performance, in doing what I had to do to make this work. I did not want to reduce this to a battle of lawyers, I wanted to see if I could work within this system, and we continue to do that. It has been made plain to me, from working on it day to day, this is an extremely convoluted, complex, big structure in which to work. I would say the Infracos themselves have had to come to grips with the fact that it is very difficult to drive action within this structure and that we are struggling to make sure that we are able to produce the change that you are all looking for and we are paying for on the schedule that is expected here. As we pointed out, we certainly have not had the turnaround in performance in the first year of this deal that was originally projected. We point out, also, that in all fairness you usually see this when you have a transfer of structure of this kind but this year, certainly, and next will be the proving ground because, as you pointed out, we do not get the bright shiny new kit for many years so we better improve maintenance in the near term or London is going to have a very, very long wait for a turnaround.

Q107 Jon Cruddas: Okay, but you said, also, that there is difficulty in obtaining information from the Infracos, there is not yet evidence of strong planning capability within the Infracos. You said there is little evidence of the promised innovations of new plant and equipment for the infusion of external engineering expertise. You said the power to require work to be undertaken pending resolution of dispute is not available generally to London Underground Limited. Finally, you said LUL has little or no leverage to secure changes which are required to deliver the Mayor's transport strategy and to improve customer services.
Mr O'Toole: I have said all that.
Jon Cruddas: Okay. Thank you.

Q108 Mr Curry: Chairman, having read the Audit Office Report I was inclined to wait for the video but I am trying to find my way through the prose which seem to me to have been subject to vast amounts of arbitrage from all sorts of different people. I can see from the Comptroller and Auditor General there is an imperceptible nod coming from him. Being a journalist this did strike me as having been written by a committee, very strongly, which is somewhat very hesitant of the prose, if I may describe it in those terms. It meant, also, of course, we had the time delays which have made it difficult to absorb all this. Mr Rowlands, you said something which gave me quite a turn. I came to work in London in 1970 and I have been using the Tube every since. You said "Tunnels are 150 years old and nobody knows what state they are in". Here am I travelling on the Tube on a daily basis and I rather assume that I am travelling on a safe system. If somebody had said "We do not know what state the tunnels are in, and we do not know what state the bridges are in, and we do not know what state the embankment is in"—how come we will not know for seven and a half years—I think I would have got on my bike. That is what I do now, thanks to the Congestion Charge, I have never used my car so much as now I live within the Congestion Zone. Does it not appear rather curious that millions of people use the Tube and they must make the assumption that the people running it know what they are running?
Mr Rowlands: I think this is Mr O'Toole's patch not mine. I suspect they make the assumption they are travelling on a safe system. To the extent that the state of some assets is unknown that does not mean that the system is unsafe. That is the Underground's responsibility as the safety case holder and the railway inspectorate's responsibility to police it. Where there is a problem with asset states you can, I believe, take remedial measures like putting on temporary speed restrictions, for example. It keeps the service safe even though the asset may not be in anything like an ideal condition.

Q109 Mr Curry: Should there not be a notice as you go down the escalator which is not working in any case so you have plenty of time to read it, and the notice says "Notice to passengers. We do not know what state the Tube is in but we believe it to be safe"? Would that not be fair, a notice to passengers?
Mr Rowlands: No, I think it would be unfair on London Underground who run a safe system in the face of—to repeat myself, I am afraid—assets, some of whose condition is unknown and some of whose condition is known to be less than satisfactory.

Q110 Mr Curry: It is the condition of assets being unknown. Page 17 of the first Report says: "London Underground knew that despite investigations by its own advisers, Ove Arup, and investigative work by

bidders, the condition of less accessible fixed assets (tunnels, some embankments, bridges *et cetera*) would not be known before award of the contracts, and in some cases not before the end of the first seven and a half year period". Pretty frightening, is it not?
Mr Rowlands: No, I do not think it is frightening, I think it is a consequence of the nature of the Underground system. Some of the long life assets are very difficult to get at, like tunnel walls or embankments and other structures. They are in need of remedial maintenance and renewal. Because their actual state is unknown it is very difficult to quantify the cost of that work. That is the problem and the risk, if you like, that underlies the PPP.

Q111 Mr Curry: My essential point is to say as a traveller and a consumer of London Underground services the fact you do not know the state of the tunnels through which the trains are running does make me feel a bit twitchy. I wonder if you feel slightly twitchy? If you had British Airways saying "We think the wings are all right, but we cannot be absolutely certain about it" would you feel a bit nervous?
Mr Rowlands: I travel on the Underground, I travel on the big railway and I am not twitchy. Mr O'Toole manages this Underground, I do not suppose in that sense he is twitchy either.

Q112 Mr Curry: Mr O'Toole, when you ran Consolidated Rail Corporation, did you know the state of the bridges over which your rail track ran?
Mr O'Toole: Yes, I did.

Q113 Mr Curry: In fact you would regard that as a normal circumstance?
Mr O'Toole: Yes, I would.

Q114 Mr Curry: Would you regard it as a normal circumstance for London Underground not to know the condition of bridges?
Mr O'Toole: I think London Underground does know the condition of its bridges. I do think it is very important that we distinguish the points here. London Underground knows quite a lot about its assets. It knows that it is safe. We do not operate assets on a guess, on a hope. We are quite clear on the safety regime we follow and why it is responsible for us to continue to provide service. What is not known here, what should be known as quickly as possible and what I would have liked to have seen done at the very beginning, is a thorough asset register that tells you the complications you are going to run in to over time as you try to rebuild these assets. I will give you two examples to illustrate this point. Once you take apart the sub surface lines, which you can walk every night, you can run inspections through it, taking analysis of it, you can know the tracks are stable and safe, but once you take it apart you are then going to learn the nature of the lateral support on those Victorian walls. It is at that point unpleasant surprises can show themselves. Similarly when you go to rebuild a station, when you tear open the walls you learn some things that are in those walls which when the deal was put together people did not know. I think that is the knowledge gap and that is why at London Underground we have been going to the Infracos and unfortunately have not had heard good noises to say: "The first thing that has to be done . . . " and you will note the thing that was not done by Railtrack was: " . . . you have to have an asset register put together". It is only then you can make an informed decision about what you really ought to be fixing first.

Q115 Mr Curry: You want the *Doomsday Book of London Underground*?
Mr O'Toole: That is precisely what we want.

Q116 Mr Curry: Could I refer to your own letter. These bullet points, you say "The NAO Report places great reliance on partnership issues in the section on success factors but there are other relevant success factors that might have been addressed, including . . . " and then you have got these six or seven bullet points. Had they been included,on which side of the balance sheet would they have gone? Would they have been included on the things that were being addressed or would they have been included on the things which ought to have been addressed but have not been addressed? I rather read it as on the negative side of the balance sheet.
Mr O'Toole: Certainly if you look at the NAO's Report or if you look at the Report I put out it equivocated on the conclusion and said the jury is out. My point is the parties to this deal need to be focused --- We are not in this for a relationship, we are in this to accomplish certain things and they ought to be told "This is how we will be judged" not on whether we get along. Although getting along may be good in its own right, it is not the goal.

Q117 Mr Curry: When you first arrived, and I know you will not comment on things put together before arrived, and you had a look at this wonderful landscape which you have been presented with, in polite language what was your first expression?
Mr O'Toole: That this would be an enormous challenge and I was not sure that people understood what they were going to have to live through in order for us to transform it.

Q118 Mr Curry: In any private moment did you say "If this had been the States it would have happened like this"? How would it have happened?
Mr O'Toole: Certainly Bob Kiley has had plenty of experience in handling these kinds of transformations with direct bond finances.

Q119 Mr Curry: Page 26 of this Report, just coming to that, and I guess this is for Mr Davies. It may be that my financial knowledge has slipped a bit since I worked on the *FT* but on paragraph 2.42 "Ernst & Young advised the Secretary of State that any potential saving from granting a public sector London Underground access to the bond markets, based on Transport for London's credit rating, would be an arbitrage saving . . . ." and therefore it

did not count. Could you not have done with all the subsidy you needed? This reads to me as if you said "We are going to make sure this playing field is skewed in favour of what the Government wants to do". Here we are £825 million, which is a bob or two when you really think about it, the savings, you were not going to have them because somehow this altered the equation you were determined to present, is that not what it means?

Mr Davies: No, I do not think it means that. What this refers to, the arbitrage saving, was that one of the apparent savings, if you like bond finance is the public sector methodology for evaluating value for money, uses a discount rate different from the price of debt. The result is that it makes it more attractive than they are saying is really the case. What they are saying under here is you should be looking also at the underlying cost of the deal, i.e. not the cost of the transaction but what is happening to the cost of the assets. What is driving value for money is whether or not you believe the private sector PPP option will deliver the upgrades and the service at a lower cost not like this technical discount rate that you see in the valuation.

Q120 Mr Curry: To what extent were you influenced, also, by the need not to carry this on the public sector borrowing requirement?

Mr Davies: It is on, it is on the balance sheet, so it was not a driver in the slightest, it was only about value for money not getting off balance sheet which is often a criticism people throw at these types of transactions.

Q121 Mr Curry: Right. There is a reference to the beloved Mayor on page 29. Of course he has now been reunited with his happy party, and I do not wish to comment upon that. It says "In particular, the Mayor's opposition proved to be more deep-seated than the Department anticipated and had a more serious impact on completing the deals". Is that impact one which is quantifiable in financial terms? It is not major politics to say that the Mayor favoured one financial mechanism and the Chancellor of the Exchequer was damn well determined to get another. Between these two how much did it cost us to sort this out?

Mr Davies: I cannot give you a definitive figure, I can give you some indications.

Q122 Mr Curry: Give me some indications.

Mr Davies: Obviously there was the whole issue of whether or not this delayed the transaction which in my view it certainly did; not only the judicial reviews but we did have a period where we were negotiating changes that were asked and requested by TfL. That took time, and some of the transaction cost which have been discussed earlier today were directly as a result of that. The second thing, which may not be financial costs but had elements within the transaction, was we were negotiating on certain terms which were as a result of the opposition of the Mayor to the deal. There was a period of negotiation on those additional terms which were as a result of concerns by lenders in particular to the political environment.

Mr Curry: I have been given a red light, I will come back, if I may.

Q123 Mr Jenkins: I would like to reinforce or reiterate the comments made by several Members about the lateness of the Report. As a Member of Parliament of course we were sitting here on Monday afternoon, reading a Report on Monday, I had other things to do yesterday so it was difficult to get into this rather complicated matter. Take it as a given that Members realise we have to have some time to read these Reports or we have to have an adjournment and call you back. Mr Rowlands, when you read this Report and signed it off were you pleased by the Report or saddened by the Report or just took it as a given?

Mr Rowlands: I do not think I was either pleased or saddened by it. I think it underlined quite rightly the complexity and it is a very complex set of contracts to deal with a difficult problem. I think it flagged up—this may be an own goal on my part—one or two lessons that the Department can learn and perhaps other Government Departments can learn from this. In one sense, and it is part of the difficulty I have with the Committee, it is spot on in the way it said it was difficult to have other than limited assurance about value for money because of the nature of the contract because you only know the prices for the first seven and a half years.

Q124 Mr Jenkins: This shortened structure at the end was no-one's first choice so why do you think we should believe this is the best option?

Mr Rowlands: Because other first choices, and the Mayor and Mr Kiley, for example, would have had a municipal bond issue to pay for remediating the London Underground, that was a policy choice that was not open to Transport for London. No local authority in this country issues its own municipal bonds, it was not available as an option even though it was the Mayor and Mr Kiley's choice, for example.

Q125 Mr Jenkins: If I look at page three, figure one—simple question because most of the difficult ones have been asked already so I will ask the simple questions—am I right in looking at this and thinking that the Department of Transport is putting something like £1.1 billion a year into the system and fare payers are paying about a billion pound a year?

Mr Rowlands: Yes.

Q126 Mr Jenkins: When I buy my £2 ticket on the Underground for Zone 1, effectively it is costing me £4 because I am putting £2 in as a taxpayer, am I not, is that right?

Mr Rowlands: Yes, in the sense that the fare box covers about half the annual cost of running the London Underground.

Q127 Mr Jenkins: So it has a 100% subsidy?
Mr Rowlands: It is 50% subsidy.

Q128 Mr Jenkins: 50% and matching it. So to be self-financing, you have to double the fares?
Mr Rowlands: That is assuming you do not drive the passengers off.

Q129 Mr Jenkins: They have got nowhere else to go very often in London.
Mr Rowlands: Yes.

Q130 Mr Jenkins: What did London Underground do to maintain their own assets? Did they draw that from revenue or were they subsidised through the amount they could spend on maintenance?
Mr Rowlands: It is slightly complicated. Prior to the PPP effectively London Underground received capital grant from the Government in respect of the big enhancement projects so the Jubilee Line extension was paid for by grant from the Department, there was no borrowing by anybody other than the Government through gilts in the first place. It sought to cover its operating costs and at one stage the way it was accounted for, they were making a surplus on operating accounts, although that surplus has now disappeared I think.[10]

Q131 Mr Jenkins: In the last few minutes I looked through and on page five, paragraph 11 there is "The costs of the PPP". One of the things that Members have mentioned is the total of £275 million of bidders' costs which are reimbursed. I looked down what the bidders' costs amounted to, how they are made up. I thought this should be simple enough. I can understand what we have got here is, for instance, the costs included success payment payable to the sponsors—which is quite nice—the costs for lost opportunity of utilising this capital to make other business investment returns, which I can live with, I think, just about and then any risk of non recovery of costs during the three year bid process. Can you explain that to me please?
Mr Rowlands: This was, as I understand it, Tube Lines putting an element into their bid costs as in effect a reward for the risk that they might actually not be able to recover any costs at the end of the bid process. I think I said there were certainly some lessons in this Report for the Department and perhaps for other Government Departments and I think there is a lesson in relation to bid costs in this case. Certainly in a project of this magnitude with these sums of money I think, looking backwards, the Department and London Transport ought to have established from the outset what was going to be a legitimate element in a bid cost and in relation to this particular element, although it was allowed as part of the bid costs, because it all surfaced at a relatively late stage I think there is possibly quite a strong argument that faced with such a proposition again you might want to disallow it. I think that is a lesson for us.

Q132 Mr Jenkins: It is a lesson we have learnt that when the private companies out there get their hands in the public pocket they think it is Christmas. I could have told you that before this process started.
Mr Rowlands: What happens normally is you do not know what a winning bidders bid costs are because they simply recover them through whatever their winning bid is. In this particular project they were driven out publicly.

Q133 Mr Jenkins: Would you say that the compilation of their costs was transparent and easily accountable to you?
Mr Rowlands: It was audited by London Transport and should have been transparent to them.

Q134 Mr Jenkins: Who paid it?
Mr Rowlands: It is ultimately recovered through the monthly infrastructure charge over 15 years and therefore is paid out of the grant that is paid by the Department to TfL.

Q135 Mr Jenkins: We pay it, the taxpayer pays it, do we not? If you look at page five—I am on refinancing—paragraph ten, section c, it relates to the fact that we will get some money back, as I read it—
Mr Rowlands: Yes.

Q136 Mr Jenkins: --- on the refinancing of the debt. Is this across all parts of this package? Do we get money back if any part of the package is refinanced?
Mr Rowlands: That is ultimately now a matter for TfL and the Infracos. My understanding is, I think I am right, that in the event of refinancing on the other Infracos, TfL will also share in refinancing.

Q137 Mr Jenkins: Asset maintenance, we have drawn a lot, and I was as much surprised as Mr Bacon we had only spent £6 million establishing the state of assets with engineering. You refer to the fact that we could not undertake certain works because they were hidden, et cetera, I understand that. If I look on page 19 at figure nine, there is this big uncertainty of the asset base which caused us so much concern in the packaging and the financing of this deal. Am I reading this right because on figure nine does it not say there that rolling stock and signalling capital expenditure is reasonably high, averaging just over 20%; asset maintenance cost is probably less than 20% of the total financing package? Am I right there?
Mr Rowlands: Yes.

Q138 Mr Jenkins: Down the bottom it says track capital expenditure. I am not sure what track capital expenditure is if it is not asset maintenance but I presume it is for replacing the track?
Mr Rowlands: Yes.

Q139 Mr Jenkins: This 20% is approximately, roughly, what £200 million a year on the actual maintenance of the asset, refurbishment of the asset, yes?
Mr Rowlands: Yes.

[10] Ev 27, 32

Q140 Mr Jenkins: It is 20% of the total package and yet a lot of play has been made of the fact that we had to increase the cost, the final figure put in, because we were uncertain of the state of the asset.
Mr Rowlands: Yes.

Q141 Mr Jenkins: Do you think that was overplayed?
Mr Rowlands: No, I do not think it was overplayed. The costs that have gone in and as bid in these contracts are a reflection of the risk inherent in remediating the assets, the risk inherent in introducing line upgrades. This Report itself acknowledges that the Central Line upgrade that was undertaken by the old Underground was six years late and 31% over budget. Over time what has been driven out is the cost of remediating the assets and the cost of the risk involved in undertaking these works and integrating the track, trains and signalling system.
Mr Jenkins: It is just that I thought well since the administration is nearly as much as the asset maintenance cost maybe they should have given extra money for the uncertainness of the administration costs; I am not sure we do that. My time is up.
Jim Sheridan: I do not have any questions to ask for two reasons. Mainly I agree with my colleagues that I think it is important we have some quality time to look in detail at this Report and, secondly, what initial findings I have found in this Report have already been covered by my colleagues. Perhaps we should have another look at this Report another time and, given what I have read, maybe we should get the Fraud Squad to look at it as well. I am reminded of the Secretary of State for Transport's comment yesterday when he said that he comes to work under a black cloud and that black cloud is called "Looking for money for public transport". All I would say is perhaps if he stops this gravy train we will maybe get some money for public transport. Other than that I would just welcome the opportunity to have a detailed look at this Report.
Mr Williams: I do not think any of you need feel obligated to respond to what Mr Sheridan has indicated. Extra time, so you know, we give each other a set time and then we can ask supplementary questions. Mr Bacon?

Q142 Mr Bacon: First of all, Mr O'Toole, can I just check, from what you were saying in answer to an earlier question it sounds like you think bond financing would probably have been better, is that right?
Mr O'Toole: Given my background, I would like to be able to control the whole enterprise if I could. I come from operating a railway where I had an engineering department, a maintenance department and an operating department and certainly it clarified the lines of authority in a way that this structure does not provide.

Q143 Mr Bacon: It is true by the time you came on board in July 2003 this had pretty much been decided?
Mr O'Toole: Right.

Q144 Mr Bacon: Nonetheless, London Underground and Mr Kiley had been giving advice and its views to the Department of Transport prior to your arrival?
Mr O'Toole: That is my understanding.

Q145 Mr Bacon: There must be documents in London Underground, prior to your arrival, containing advice that you had given to the Department of Transport on your preferences for bond financing?
Mr O'Toole: Not that I had given but that TfL had given.

Q146 Mr Bacon: I am sorry, the TfL had given.
Mr O'Toole: Right, not in London Underground.

Q147 Mr Bacon: Is it possible that any of these could be forwarded to the Committee?
Mr O'Toole: I am confident that TfL would welcome the opportunity to forward those documents.[11]

Q148 Mr Bacon: I would like to see what advice was given to the Department of Transport about the likelihood of value for money being produced by the option which was eventually arrived at.
Mr O'Toole: I will pass the request on.
Mr Callaghan: If I might say, Mr Bacon, I might save you some effort. London Underground published two reports called the *Final Assessment Report* and the *Update to the Final Assessment Report* which summarised everything Mr Kiley had to say at some length. Rather than forcing you to go back to the original document you might find everything you need there.
Mr Bacon: Thank you very much.

Q149 Mr Williams: Can I ask NAO, before we leave that, if you send it to NAO at the same time I wonder if the NAO could do a brief critique of it for the Committee in case we have a further hearing.[12]
Sir John Bourn: I would be glad to do that.
Mr Callaghan: These are in fact public documents and they are still on the Tube's website.

Q150 Mr Bacon: Mr Rowlands, do you agree with the National Audit Office that the public sector comparator is pseudo scientific mumbo jumbo which confers a spurious precision, which replaces thinking with modelling and is often not information but just noise?
Mr Rowlands: I do not remember the exact quote in the Report.

Q151 Mr Bacon: It is not in the Report but it is the opinion of the National Audit Office.
Mr Rowlands: No, I recollect that in 2000 the National Audit Office looked at LUL's public sector comparator and the methodology and said it was satisfied with it. What it warned at the time was that London Underground should not rely exclusively on

[11] Documents provided, not printed.
[12] Ev 26, 30 – 31, 33 – 35

the public sector comparator, that any evaluation was much more subtle than that and other factors needed to be taken into account. London Underground indeed did heed that advice. In reaching its evaluation it looked at quite a number of factors and it did not rely solely or exclusively on the public sector comparator.

Q152 Mr Bacon: Can you now answer my question?
Mr Rowlands: I thought I had answered your question.

Q153 Mr Bacon: No. My question was do you agree with the NAO that the public sector comparator is pseudo scientific mumbo jumbo?
Mr Rowlands: No, I do not agree with them, and they did not say that.
Mr Bacon: They have said that but we will pass on.
Mr Williams: Not this particular one, just in general.

Q154 Mr Bacon: In general, the National Audit Office has said that.
Mr Rowlands: Sorry, I misunderstood.

Q155 Mr Bacon: The uncertainty surrounding this project is, as you have acknowledged, so tremendous that what I do not understand is how you could work out a public sector comparator with any chance of it being meaningful?
Mr Rowlands: It was worked out by London Underground with its own management through a whole series of workshops, basically asking a very simple question: "If we were doing this for ourselves how would we go about it? What do we think it would cost? What are the risks inherent in it?" In very simple terms that is how they approached it.

Q156 Mr Bacon: You are the accounting officer responsible for how public money is spent in your area in your Department. When you took a look at all this, given the uncertainties and the lack of ability to say whether this represented value for money, which we have heard Sir John attest to, did you decide you needed to seek direction from ministers to authorise spending of this money?
Mr Rowlands: I was not the accounting officer at the time but the then accounting officer did not decide to seek a direction because on the basis of the evaluation undertaken by London Underground, which is freely available to the Department, by comparison with the public sector comparator, including a bond financed public sector comparator, this was value for money.

Q157 Mr Bacon: This was considered value for money?
Mr Rowlands: Yes.

Q158 Mr Bacon: Even though Sir John now says in this Report that it is not possible to say whether the whole thing represents value for money or not?
Mr Rowlands: (a) the accounting officer at the time did not have this Report in front of her when such decisions were reached because (b) it was on the basis of the evaluation that London Underground had carried out against the public sector comparator. These three contracts stood up in value for money terms.

Q159 Mr Bacon: We may pursue this discussion at a later date.
Mr Rowlands: I suspect we will.

Q160 Mr Curry: Patience Wheatcroft, who writes on financial matters for *The Times* – and not as far as I know a rabidly left wing journalist—when she read the Audit Office Report she wrote the following: "To paraphrase the carefully crafted prose of Sir John Bourn this looks like a potentially very expensive scheme that may not deliver very much in the way of benefits to travellers but is certainly a bonanza for the private sector. For everyone from consultants and lawyers to engineers and construction companies, the Tube has turned into a gravy train. Gordon Brown is the driver. The Chancellor has determined that Ken Livingstone would not have his way and finance the much needed revamp of the Underground through a bond issue. As far as the Chancellor was concerned it was PPP or nothing and eventually he fought London's Mayor throughout the courts to get his way. Mr Brown's devotion to the PPP was not wasted on those who might put it into practice. They saw a desperate customer coming and as the NAO relates pitched their charges accordingly." If one picked a scale of zero meaning she is absolutely all over the place and ten just about spot on, where would you put that comment?
Mr Rowlands: One.

Q161 Mr Curry: Which bit has she got right?
Mr Rowlands: She has captured the notion of the complexity of the PPP but for the rest she is a journalist, it is good copy but I do not agree with it.

Q162 Mr Curry: I am a journalist as well. The suggestion that the thing can be defined as being wrong because it is written by a journalist, which seems to be the implication you are making, does seem to me to be one I would be slightly cautious about in general. Has she misinterpreted the National Audit Office Report or is that a criticism you would make of that Report?
Mr Rowlands: I do not know what her interpretation is apart from the words on the page in *The Times* with which basically I do not agree. I do not believe this was a gravy train for consultants or advisers and the NAO's own Report says the costs were reasonable in relation to the scale and complexity of the deal. These are £30 billion worth of contracts. The costs though in absolute terms largely represent about 1½% of the total cost of the contract. That is not outrageous or unusual in relation to a contract.

Q163 Mr Curry: It is true that on this occasion on this deal, which you say is enormous, very long in its timescale and extremely complex one did have two principal political personalities engaged who had opposite views of the way to go forward and neither of whom were inclined to give way, and in the end it had to be fought out on a legal basis. All might be

changed now though, we will not comment on that, but would it have been easier, do you think, had there been a greater harmony between those personalities?

Mr Rowlands: I suspect the answer is yes but that is about as far as I can go really.

Mr Williams: It is a question of how far the witnesses can go in this direction.

Mr Curry: No, no, I do not intend to take him any further at all. The Audit Office Report itself made reference to that, which was why I asked the question.

Mr Williams: It puts him in an embarrassing position as a civil servant.

Mr Curry: We ought to have the Chancellor here.

Q164 Jon Cruddas: Just one question that has not been covered in all this. The Committee of Public Accounts in other analysis of PPPs looked at the way the terms and conditions of employment had taken the strain at times. As far as I picked out, when I read these Reports, there are two references to the employment conditions of those workers transferred over which I think amount to some 7,500. It hints that certain understandings were made about the protection of those workers. Could you give some details about that?

Mr Rowlands: Yes. This is from memory. It was made explicitly clear by the Government at the time the PPP was initially conceived that the terms and conditions of any members of staff transferring into an Infraco would not suffer detriment and that in particular the Infraco's membership would remain in the existing pension scheme and not be placed in another one.

Q165 Jon Cruddas: Does that include new recruits as well because there has been quite a significant amount of recruitment as well?

Mr Rowlands: I need to come back on that, if I may, but my recollection is it did not and could not cover new recruits because you could not define the position 25 years out for a new recruit into one of the Infracos.[13]

Q166 Jon Trickett: Something which has not been addressed and it is very hard to understand from this Report, is this issue of the compensation we pay to bidders. Companies or consortia which were bidding for the contracts were reimbursed the cost of their bid. I think we see reference to it on paragraph 3.16 on page 32. It seems that one company bid for two contracts and was reimbursed £116 million, which was Metronet, and another company called Tube Lines which bid for only one line was reimbursed £134 million, more than the consortium's bid for two lines. When I went to paragraph 3.16 and table 14 on that page there, there is an analysis of the expenditure by Tube Lines on the bid and it appears that most of the expenditure which that company had took place after the contracts had been awarded. First of all, how can you reconcile the fact you paid more to a company which was only bidding for one contract than you paid to a company which was bidding for two contracts? Secondly, can somebody explain this table to me in a way which makes sense? If I have understood it correctly how on earth have we given them the money for bid costs after they have won the bid?

Mr Rowlands: Can I start with your second question, if I may?

Q167 Jon Trickett: Sure.

Mr Rowlands: Can I begin by, I am afraid, repeating myself. All winning bidders recover their bid costs in their contract prices. If winning bidders do not recover their bid costs they go out of business in the end. What this process did was make visible, if you like, what the bid costs were in relation to these particular contracts. To take your second question first, most of the work that both bidders did happened in the latter stages of the process because this was when Metronet were putting into place the contracts that it was supplying its outputs through and Tube Lines was beginning to do due diligence in relation to the contracts it was going to let. This is a heavyweight expenditure on financial and legal advisers in relation to closing out the contracts. So, for example, on the financial side, the Tube Lines' bid costs include tens of millions for the financing fees for debt that was put in place and tens of millions for the insurance with which they wrapped some of the debt to get a better interest rate on it and insure some of it in the market.

Q168 Jon Trickett: Can we have an analysis of the differences between the two amounts of money?

Mr Rowlands: Indeed. I have already promised we would send these details.[14]

Q169 Jon Trickett: It has been a long hearing for you and no doubt for others as well. Secondly, given the fact that competitive tension had gone out of the bidding process once a preferred bidder had been determined, how can we be certain that the bidders who had then been excluded would have spent less money on the post tender bidding process, as you seem to have described it? It seems to me hundreds of millions of pounds here, probably £200 million between the two contractors, after they had been given the tender but still allegedly part of the bidding process. Where was the competitive tension to make sure they got a decent price for those amounts of money?

Mr Rowlands: I am afraid that once this competition moved to preferred bidder, although there were reserve bidders they were not undertaking this activity, they were not closing out on the deals so they were not spending this kind of money.

Q170 Jon Trickett: The taxpayer reimbursed that amount of money, although it was part of the bidding process, the bidding had finished, had it not?

[13] Ev 26

[14] Ev 25, 35 – 39

Mr Rowlands: But they had to move from preferred bidder through to financial close and that meant putting in place very large debt facilities and financing costs.

Q171 Jon Trickett: Why did the bidding process not ask them to put a price in for the post tender so-called bidding, which is not really bidding at all, is it, but the post tender preparatory work?
Mr Rowlands: They did.

Q172 Jon Trickett: Can we have a note on it?
Mr Rowlands: Yes.[15]

Q173 Jon Trickett: There are tens, possibly hundreds of millions of pounds here.
Mr Rowlands: We will do that.

Q174 Mr Jenkins: I want to get something clear in my mind, I want to revisit the financing deals. I am not sure I have got this perfectly clear. The example we have got here on page five is one of Tube Lines. They refinanced and they disclosed a gain of £84 million and so 60% was the share to the public sector which will rise to 70%. Now that 70%, where does it come from?
Mr Rowlands: This refinancing happened after the transfer to TfL was negotiated by TfL with, in this case, Tube Lines. If I can help you. What was generated was cash, up front, of which TfL, through their 60% share, got 60% of £84 million, about £42 million from memory. That is cash that has gone to TfL.

Q175 Mr Jenkins: Since the taxpayer is funding this package they must have been in on the contract, the arrangement would be to pay TfL rather than pay it back to the Treasury, yes?
Mr Rowlands: The arrangement in the contract provided for TfL and the Infracos to share any refinancing gains, though this particular split was negotiated by TfL after transfer, 60:40 split.

Q176 Mr Jenkins: Since we are well aware—and this Committee has highlighted the refinancing arrangements in this area—and since we have spent so much time and very, very heavy costs on lawyers knitting these views together, why was it left to somebody else after we handed it over? Surely we should have handed over a complete package which included any refinancing gains coming back to the Treasury?
Mr Rowlands: I cannot speak for TfL but they might have been reluctant to accept such a package. What it means, certainly, is that if TfL do not get any share of the gain you have removed one part of the contract's interest in what is going on. I am not clear, you will be at the mercy of the Infraco to conclude whatever arrangements it wanted if you were not careful on refinancing. This was policed by TfL.

Q177 Mr Jenkins: The private sector, when they are going to refinance a deal, refinance the deal because they make quite a heavy profit, a windfall gain. They are not loath to passing some back if we negotiate in the contract they must pass back 50/60/70%.
Mr Rowlands: Yes.

Q178 Mr Jenkins: I understood this deal was all sewn up, all knitted together before it was handed over?
Mr Rowlands: The refinancing was done after the event and it was not worked up before transfer.
Mr Jenkins: That is appalling.

Q179 Mr Williams: Hold on. To the Treasury: you gave us an indication that some guidelines had been agreed some months ago on the minimum share that should come to the public sector in the case of refinancing. Would that have been relevant at the time of this?
Mr Glicksman: Yes. The guidance was 50:50. TfL negotiated a better deal than that, they negotiated 60:40, 60% to the public sector, so they did better than the Treasury guidance.
Mr Rowlands: They negotiated—I may have this wrong—in effect 70% over time because some gains come later. If all the gains from a refinancing were to go to the Treasury, why would the infrastructure company bother to refinance because it gets no benefit from it, it simply goes to the Treasury?
Mr Callaghan: If I may help, Mr Jenkins, I think you asked two questions. One was were there refinancing provisions in the contract? The answer to that is yes. In general the Treasury follow the Treasury guidance and in relation to this specific refinancing, which was in contemplation when the contracts were finalised, it was 60:40. In the negotiations that happened subsequent to the contract, TfL and LUL did a better deal than that. The answer to your second question, which is why is it TfL and not the Treasury, is that the contract is between London Underground and the private sector so the money went to London Underground and ultimately to whoever owned London Underground at the time it was done, which is why it was TfL.

Q180 Mr Jenkins: I understand that, but what I am concerned about is the fact that this cost a lot of money to knit together, when we handed it over the arrangements were in place and although I expect that they will gain some money, I also expect the return to come back to the taxpayer. What you are telling me now is not only will they get one billion pounds, they will also get the windfall gains of refinancing deals by the public private sector, is that right?
Mr Callaghan: They being TfL. London Underground get it, London Underground's owners get it and, therefore, TfL get it.

Q181 Mr Jenkins: On top of the £1.1 billion we are putting in and then they subtract it from that £1.1 billion?
Mr Rowlands: It is not subtracted from the £1.1 billion.[16]

[15] Ev 26

[16] Ev 26, 28 – 30, 31

Q182 Mr Williams: Following on what Mr Jenkins said, since the deal was entered into and established clearly with the concept of it being a high risk project, and I think we have established it is a much lower risk project, does that not suggest there is now still a substantial scope for a refinancing of the scheme? Who is it best to put that to? Mr O'Toole, are you the best person to answer that?
Mr O'Toole: No.
Mr Davies: I will be best. Can I break that down into parts firstly. Firstly, talking about whether or not we have established it is a high or low risk project, can I differentiate between the equity investment made by shareholders and the bank debt. Can we first focus on the equity because I think there was some confusion earlier in the discussion. The equity rate of return is higher, as the NAO point out, than the standard PFIs but this is a totally different kettle of fish than a standard PFI. If you contrast a standard PFI between—depending on the scale—a 10 and 15% rate of return, say building a road where you would have a piece of open ground, no previous asset condition and building a road which is relatively low tech, or building a new hospital on a greenfield site, which is classic PFI territory, you compare that risk to the risk of putting together working multiple assets, line upgrades implemented on an existing working line, what is called system integration risk which is bringing new signals, new trains and putting them all together, it is a different proposition. I think to compare them in rates of return to standard PFI would be wrong. Earlier on people were asking what other deals could you do as an example. Probably the best example I can think of is an earlier one which was at the time described as PFI, which is the Channel Tunnel Rail Link. There the equity investors were looking for over a 20% rate of return and that is not atypical of project finance deals. For the equity component, for the shareholders here, there are big risks and there are big downsides if they get it wrong. If they perform, for instance, like the Central Line, the Central Line upgrade on the London Underground grid, they would lose almost all of their equity, if not be completely extinguished and be terminated by London Underground. On the equity side, personally I would say it is very wrong to say there is no risk here.

Q183 Mr Williams: That is only 15% of the deal, 85% is debt?
Mr Davies: Yes, 85% is debt.

Q184 Mr Williams: That is covered by the 5% rule?
Mr Davies: And that has the 95% underpinning it, that is correct, yes.

Q185 Mr Williams: Coming back to that, I think with the 5% one would still presume there must be considerable scope for refinancing?
Mr Davies: Yes, which is exactly what Tube Lines has done on that basis because it has said given that underpinning we can refinance.
Mr Rowlands: Just to pick that up, the point about over time TfL will get 70% rather than the 60% share upfront is that there is scope some years on for a further refinancing, certainly of part of the debt, from which under the agreement they can expect to get 100% of the benefits. It is uncertain how much that is worth because it will depend on interest rates in a few years' time but, yes, the scope for refinancing has not disappeared.

Q186 Mr Williams: Thank you. It has been a fascinating hearing but there are follow-ups we will want because we may be calling you back. Can I ask you to provide the following information, please. First, following on from what we have just said, could you let us have a note on the scope for further refinancing?[17] Secondly, Mr Rowlands, you drew the distinction when I asked about the arbiter, his decision being contractually binding, you said binding but not contractually binding. Can you give us a note on the distinction, as you see it, between those two comments, yours and mine, and are there any penalties for non-compliance with the arbiters and, if so, what, with the arbiter's decision?[18] Can you also let us have a note on the convergence of the comparator and the market figures, please, because it will be interesting to see—can we have figures—the trend, not just a diagram but matching figures.[19]Finally, following on Mr Jenkins' point about the ratio between subsidy and share, would it be possible for London Underground, because they must have this information available—Mr Jenkins pointed out it is a one to one ratio at the moment—could you give us the moving ratio year by year for the last 25 years because that may help to explain various matters relating to the knowledge and condition of the infrastructure, is that possible?
Mr Rowlands: I will provide whatever information is available.[20]
Mr Williams: Thank you very much. We have given you a somewhat rough time and we have got a lot to read, as you gather, but there is a lot of preparation for you to master the two documents. We have to take that into account. We do reserve the right, which we will consider briefly after this meeting, whether we do want to recall you and we will let you know our decision on that. Thank you very much for your patience during the long break in between. Thank you, gentlemen.

[17] Ev 26
[18] Ev 26
[19] Ev 27, 28 – 30, 31
[20] Ev 27, 28 – 30

Letter to the Committee from Transport for London

I have been invited to give evidence on 23 June before the Committee of Public Accounts and I should be obliged if you would circulate this memorandum to Members of the Committee prior to the meeting.

I am enclosing a copy of London Underground's report on the first year of the PPP that gives my perspective on performance.[1] It gives a more detailed view than that contained in the NAO Report and accordingly gives what I believe to be a more balanced view of performance over the full year. Additionally, there are some structural problems affecting the chances of success of the PPP which are not fully addressed in the NAO Report but which are described below.

As is mentioned in both reports, London Underground has been experiencing difficulty in obtaining information from the Infracos. This is now having an impact on our ability to plan our own resources and discharge our own obligations under the PPP. We have spent over a year agreeing the principles of what is to be provided by the Infracos about their capital and maintenance programmes, but until the information starts flowing comprehensively, conclusions about the progress being achieved by the Infracos is largely anecdotal as illustrated by both reports. In order to demonstrate success, the Infracos need to develop their information systems as a matter of urgency.

Infraco progress in developing required asset management plans has been slow and there is not yet evidence of a strong planning capability within the Infracos. There is also limited demonstration of a whole-life asset management approach, and this has led to LUL rejecting or giving qualified approval to asset management regimes and plans.

The asset performance information referred to in section 5 of LUL's report was provided to the NAO and I believe that it provides some useful insights on the underlying performance of the assets. As yet, it is difficult to observe the type of improving trends that might be expected over the next few years.

The NAO Report assessed the question of whether the Infracos are applying private sector innovations to project management and asset design to ensure early identification of problems. It concluded that, as might be expected at this stage, there are no significant examples although the report described a change in working arrangements implemented by Tube Lines. So far, there has been limited evidence of the promised innovations of new plant and equipment and the infusion of external engineering expertise.

As we all know, the fundamental question about the PPP is whether it will deliver a better Tube and the promised improvements. Partnership, although important, cannot of itself deliver success. The NAO Report places great reliance on partnership issues in the section on success factors but there are other relevant success factors that might have been addressed, including:

- a contractual framework and structure that is sufficiently clear with adequate incentives and contractual remedies;
- robust contract management by LUL to ensure that the public gets the full benefits of what we (and the Government) are paying for;
- effective, state-of-the-art project management by Infracos (and indeed by LUL) to ensure early identification of problems, on-time and on-cost delivery and clear visibility of progress along the way;
- flexible and proactive approach to problem resolution, rapid escalation/resolution of disputes on both sides;
- clear prioritisation and management focus on the most critical projects;
- bringing in expertise from the private sector to fill gaps in knowledge, including in making the Underground's assets operate as efficient as possible; and
- balancing a need for processes against excessive bureaucracy, and learning from early experience to ensure that process does not replace decision-making and effective, rapid action.

I am also of the view that the lack of clarity around PPP/PFI interfaces and LUL's limited change rights and remedies were deserving of more weight in the NAO Report given that these issues have a very strong bearing on whether the PPP is likely to work successfully.

It should be noted that LUL is committed to procure works from its PFI contractors in circumstances where it does not necessarily have the rights to procure them through its PFI contracts. As the PFI contracts were signed at different times, and prior to PPP, they are not always "back to back" and this creates opportunities for exploitation by both PPP and PFI contractors.

The NAO Report recommends that there should be clarity of interfaces with other contracts and where this does not occur, remedial action should be taken. Our power to take remedial action is curtailed by the scope of the change rights available. Also, more debate should have been afforded to the issue as to whether LUL had been left with the tools necessary to meet the management challenges ahead. For example, the power to require works to be undertaken pending resolution of a dispute is generally not available to LUL.

[1] Not printed.

LUL has little or no leverage to secure changes that are required to deliver the Mayor's Transport Strategy and to improve customer service.

The Report does not fully discuss the most important success factor of all: adequate and guaranteed funding for the life of the PPP.

Tim O'Toole
Managing Director

18 June 2004

Note to the Committee from the Commissioner of Transport

The National Audit Office has submitted to Parliament an official Report as to whether the London Underground PPPs were good deals. Transport for London was supplied with several early drafts of the Report and we provided our views to NAO on a number of matters addressed in the drafts. Our most recent correspondence with NAO, which is available to the Committee on request, goes into some detail as to our remaining concerns. By this written evidence we hope to bring to the Committee's attention our key concerns.[2] We note that while there are numerous points in the Report with which we agree, there are other points that are quite troubling and appear to be based on conclusory assertions by the Department that are not supported by evidence.

Our specific key concerns are as follows:

The Report makes clear that there is no assurance that the price of the PPPs is reasonable; instead there is ample reason to conclude that the price is unreasonable.

NAO concludes that "There is only limited assurance that the price that would be paid to the private sector is reasonable." This is disturbing to TfL as the agency responsible for paying the PPP bills, and especially so since Parliament was specifically led to believe that the Government would not allow LUL to proceed with the PPPs unless they provided value for money (Secretary of State 7 February 2002). In fact, NAO's Report does not identify any basis for assurance that the price is reasonable, and indeed it identifies a number of reasons for alarm that the price to be paid by LUL to the private sector is in excess of a market price:

- The rate of return greatly exceeds the rate on recent PFI deals. The 18-20 stated range (which applies to Metronet should they deliver to bid) is described as being about a third higher than on recent PFI deals. The Tube Lines rate of return (26%) identified in the Report is far higher still.
- These stated rates of return do not even take into account the potential upside to the private sector should they not fully use the £1 billion in contingency that is included in their pricing for the first 7.5 years. Did the market really require that all savings on investment in the Underground should go to enhance already over-market rates of return?
- These rates of return also do not include the unusual success fees paid to the private sector when the transactions were closed.
- The price increased dramatically after selection of preferred bidders, when work was rebid and contract terms were revised in a non-competitive environment.
- Lenders have "limited downside risks. . . but are charging rates of interest in line with an independent credit rating of the companies as 'low investment grade'." Although Lenders have only about £250 million at risk (5% of £3800 million), they are charging about £450 million more than they would charge for loans with the highest credit rating.

The Department is reported to explain a number of these seeming overpayments, as well as the erosion of contractual terms, as compensation to the private sector for political risk and controversy. Political risk is a straw man, a deflector of attention. In fact, the increases in price and the last minute dilution of key risk allocation provisions reflect inexcusable failures in the public sector's negotiating strategy. The PPP procurement process was conducted in a manner that violates fundamental tenets of effective negotiation tactics. Most importantly, competition was eliminated from this procurement far too early in the process—competition from other bidders, and as noted in the next section, competition from a willingness to consider viable alternatives to the PPP.

The refusal to consider the alternative of direct government borrowing not only resulted in a waste of public funds, but provided powerful and unnecessary bargaining leverage to the private sector.

The significance of the savings that NAO notes would have been generated by direct government borrowing is diminished in the Report by noting that such borrowing was against Government policy. To us, this begs the very question at hand. We understand that it is not NAO's role to evaluate Government policy. However, we also believe the decision-making about PPP was skewed precisely because of this policy and this must be faced should lessons truly be learned from this procurement. The Underground understood

[2] This written evidence is based on the final draft report provided to us by NAO on 27 May 2004 and a further e-mail dated 9 June 2004 attaching correspondence from Patricia Leahy to Jay Walder describing additional changes to the Report.

that it faced a Hobson's choice: the PPP according to the terms demanded by the private sector or no new investment program. Had a bond option been taken seriously, the final terms of the PPP would likely have been far more favourable to the public sector—as the bond option would have provided another (and quite viable) form of competition to the private sector. Eliminating alternatives made the PPP the only game in town, leading to a very weak—and expensive—PPP.

Important lessons can and should be drawn from the chronology of this procurement, especially as to the implications of selecting preferred bidders whilst major issues remain unresolved and the scope of work remains unsettled.

The Report notes the long and costly delays in closing the transactions. There were numerous factors, many of which are noted and quantified in the Report, which delayed LUL and which should be considered by the Committee as it evaluates how such delays might be minimised in the future. The prime causes of delay included unreasonable demands by the prematurely selected preferred bidders for significant changes in the transaction and repeated rescoping of the work (primarily for affordability reasons and incorrect assumptions about power availability).

The chronology of events should be closely reviewed when considering how this procurement might have been better managed and certainly before the two judicial reviews and the state aid contest are flagged as any significant cause of delay. Commercial close—the initialing of contract terms subject to a long list of still open items for each of the PPPs—did not occur until 8 May 2002, a year after preferred bidders were selected for the two deep tube Infracos (and almost 10 months after the first judicial review was concluded in July 2001). Most commercial concessions occurred in this lengthy run-up to commercial close (and most specifically, in the period from September 2001 through February 2002, when the committed finance offers were approved by LUL). The second judicial review followed commercial close and was complete within two months—a two month period that formed but a small part of another long period during which LUL was receiving and reviewing draft finance documents (initially with terms to which LUL took significant objection) and the bidders were revising and finalising their financial models and the parties were endeavouring to resolve the very long list of items left open at commercial close (including the very complex restructuring of the Northern Line Train Services Contracts.) These LUL activities continued well after TfL and the Mayor withdrew their request for a second judicial review.

As for state aid proceedings, it should be remembered that the Government-initiated state aid proceedings were required not only as a matter of prudence but also as a matter of contractual obligation under the Share Purchase Agreements between LUL and the private sector. The Commission's state aid decision was not rendered until early October 2002. The Commission's ability to give state aid clearance was greatly compromised and complicated by a very material fact about the transaction that is prominently noted by the NAO in its Summary: "The terms of the deals changed markedly during prolonged negotiations with the eventual winning bidders." The Government's own submission to the Commission indicated that the price of the contracts had increased by £590 million in the non-competitive period of the procurement—a complex fact that the Commission had to address in making its decision. It was not the fact of the contest that caused the delay—it was the problematic procurement.

Measured against the original objectives for the PPPs—including comprehensive risk transfer and value for money—the PPPs do not constitute a good deal for the public sector.

Most fundamentally the question of whether the PPPs represent good deals for the public depends on the measuring stick. To what are the PPPs to be compared? To what the market might have offered if the transactions were negotiated effectively—ie, if the bidders thought that there was a viable alternative to their proposals? It is clear from the NAO Report that much was left on the table. By way of example, the Report identifies that the refinancing gains enjoyed by the Tube Lines sponsors could have been 100% available to the public sector; also the rates of return exceed market rates even before any portion of contingency is made available to enhance those rates; and the success fees are significantly out of line with market.

Or are the PPPs to be considered in light of whether they will achieve the Government's objectives? In that case, one must identify those objectives. The Report at one point defines those objectives as a transfer of comprehensive risk and responsibility to the private sector. Yet the Report does not explicitly consider whether this was achieved—except to note (in what we consider to be a significant understatement) that the negotiations "led to London Underground accepting more risk sharing than it had originally hoped to negotiate."

Instead the NAO reframes the objectives as limited to "bringing in the private sector expertise to manage the upgrade projects and to maintain the infrastructure on a whole life basis supported by stable funding." This is a low bar to success, and could have been achieved in quite a number of ways, each of which would have been compatible with use of the much cheaper bond alternative for stable finance. In our view, whether the PPPs were a good deal should be considered in light of the reasonableness of the price—was there value for money—and their effectiveness at transferring real risk and responsibility. As noted above, the Report

confirms that there is no comfort to be had that the price is reasonable (and indeed there is reason to be concerned that the opposite is in fact true.) As for comprehensive risk transfer, that key objective and rationale for giving up unified public sector control of the Underground fell entirely by the wayside. There is not a single example of significant risk transfer offered by the Report—unless one considers the private sector's responsibility for its own persistent uneconomic and inefficient behaviour to constitute acceptable and comprehensive risk transfer. It is our view that the private sector would have borne that risk even in a traditional contract structure.

Robert R. Kiley
Commissioner of Transport for London

21 June 2004

Letter and supplementary memorandum submitted by the Department for Transport

At the Committee of Public Accounts hearing on Wednesday 23rd June, the Committee requested a number of notes which I am pleased to enclose.[3]

I thought it might also be helpful to the Committee if I set out why I consider the PPP contracts do represent good value for money. As the National Audit Office (NAO) Report notes,[4] the Department's objectives for the Public Private Partnership were to obtain private sector investment and expertise to modernise the Tube, while guaranteeing value for money for passengers and taxpayers and safeguarding the public interest, in particular safety.

London Underground's (LU) infrastructure is widely acknowledged to be a large and complex asset base that has suffered from many years of under investment and is in need of modernisation and additional capacity. This is highly challenging in engineering terms as it requires existing services to just under one billion passengers a year to be maintained, while carrying out improved day to day maintenance and the capacity enhancements and upgrades needed, all within very limited engineering hours.

The PPP bidders had to deliver better value for money against the public sector alternatives, as measured by the public sector comparator. These were tested against a bond option, even though it was not available to LU, as well as more conventional funding. The public sector comparator provided a range of prices over the 30 year contract period. LU's conclusions depend on the Infracos delivering the expected level of performance with sufficient economy and efficiency to offset the higher private sector borrowing costs. As the NAO Report explains[5] "The costs [of higher borrowing] will be covered if the PPP delivers about one third of the performance benefits considered in bid evaluation.". It should also be noted that the premiums charged by lenders are in line with the rating agencies' independent assessment of correct market rates. Consequently, the lenders' premiums reflect the real levels of risk faced on the non-guaranteed portion of the finance provided.

To provide assurance that the PSC developed by London Transport was fair; the Department commissioned Ernst & Young to review the overall robustness of the value for money assessment. This included reviewing the methodology, the assessment of risk retained by LU in the PPP contracts and that transferred to the private sector, consideration of financial and non-financial factors in the overall value for money assessment, and the overall robustness of the conclusions reached. Ernst and Young concluded that the methodology adopted for assessing value for money "had been robust and appropriate". KPMG, LU's own auditors, also undertook a methodology review of the PSC and confirmed that HM Treasury's guidance had been adhered to, as well as auditing the financial model and related sensitivities.

The bids for the PPP contracts offered higher performance than LU in some areas, as well as additional enhancements. In order to deliver the returns quoted for the shareholders the Infracos will need to have much stronger control over costs and full project planning than LU had previously managed to ensure work is completed to time and budget. The Central Line upgrade of the 1990s was six years late, failed to meet capability targets and was 31% over budget. If just one of these failings were repeated by an Infraco under the PPP contracts for an upgrade, then its rate of return could easily be halved for the full 30 years of the PPP contract. If all three aspects were to be repeated on a line upgrade, then the Infraco would make very low levels of profits for the life of the contract, and these would only be available if the Infraco delivered all its other upgrades successfully. Project and integration risk has genuinely been transferred to the private sector with the Infracos heavily incentivised to manage it well.

Across the 30-year contract, there are periodic reviews and the independent PPP Arbiter provides assurance on value for money by determining at the outset of each review period the economic and efficient price for delivering the services required by London Underground. Only if the Infracos achieve these levels of service and deliver them within the price set by the Arbiter will they achieve their target levels of return on equity.

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[3] Ev 24 – 27

[4] Paragraph 1.1 of NAO Report "*London Underground PPP: Were they good deals?*"

[5] Paragraph 2.44 of NAO Report "*London Underground PPP: Were they good deals?*"

NAO comment that there is only limited assurance that the price is reasonable, largely because there is uncertainty about what that final price will be. However, detailed analysis showed the PPP to be cheaper than the alternatives in delivering like-for-like outputs, while the Arbiter ensures prices remain reasonable in the long term. Consequently, while there is uncertainty about the long-term price, I am confident that it will offer better value for money than the alternatives. Greater price certainty would have increased the cost because bidders, faced with a fixed and inflexible contract, would have based their cost estimates on a worst case scenario to ensure a return. This would have reduced value for money, as acknowledged by the NAO.[6]

Finally, although large, the costs of the transactions are not excessive given that they were for 30-year contracts to maintain and upgrade large and complex infrastructure. The negotiations took longer than anticipated as the NAO Report acknowledges and this increased the costs for all parties. Without the PPP, LU would have had to negotiate separately a potentially very large number of other contracts to provide the maintenance, modernisation and capacity enhancements that the PPP will deliver. These would all have had their own transaction costs and it would have left the risk of integrating and co-ordinating all the workstreams entirely with LU.

David Rowlands
Permanent Secretary

9 July 2004

Questions 36-38 (Jon Trickett): Supplementary evidence on inadequate and inconsistent information from the Infracos.

I understand that Transport for London (TfL) will be providing further information on this issue.[7]

Questions 57-71 (Mr Bacon) and Question 72 (Mr Williams): Extra costs of private sector borrowing: Breakdown of total debt costs—private and estimated public costs and basis for £450 million difference.

The private sector's cost of borrowing on senior loans is made up from the addition of the underlying interest rate and the margin charged by its financiers to reflect their perception of the credit risk of the borrower. The blended margin (including fees) of the three Infracos, averaged across their 11 separate finance facilities, is 1.35% a year and the underlying blended interest rate is 5% a year, giving a total cost of finance of 6.35% a year.

The total amount of the three Infracos' debt service (interest, fees and principal repayment) over the 30 years is £4.3 billion (using Government's 3.5% real discount rate[8]) or £9.7 billion, expressed in nominal or money of the day terms.

If the PPP had been funded using public sector finance, raised by way of bonds, then providers of finance will price their bonds not on the risks inherent in the company, but the risk of default by the bond guarantor. In the example given in the National Audit Office (NAO) Report "*Were they good deals?*" (paragraph 2.36) the NAO considers the reduced cost if the bonds were issued directly by central Government, who attract the highest credit rating; AAA. The underlying interest rate on these bonds is the gilt rate on which no additional margin is paid. So the cost of finance would be cheaper by a combination of the avoided margin and lower interest cost; around 1.6% a year cheaper overall, giving a total cost of finance of 4.75% a year.

Funding London Underground's (LU) investment programme in this way (using the Infracos debt profile) would lead to the cost of funds being lower by around £445 million over the life of the PPP (at 3.5% real discount rate) (using the NAO's calculation methodology) ie a total debt service cost of £3.855 billion or an average of £14.8 million per year lower than the cost of debt raised by the private sector. The high level analysis by the NAO estimated a similar discounted sum of £450 million over the 30 years ie a total debt service cost of £3.85 billion at an average of £15 million per year lower.

If the PPP investment programme had been financed using bonds guaranteed by TfL, then the cost of finance would have reflected their lower credit rating, ie AA, which trades at a cost approximately 0.6% a year higher than Government gilts. Therefore, TfL's total cost of finance would be lower than the Infracos by about 1.0% per year and total cost of finance would equal 5.35% per year. Cost of funds would be lower than that achieved by the private sector by a total of £210 million over the 30 years at an average of £7 million per year (at 3.5% real discount rate) ie a total debt service cost of £4.09 billion.

The Department's main objectives for carrying out the PPP were to bring in and incentivise private sector expertise, achieve clear risk transfer, maintain the infrastructure on a whole life basis and all with the support of stable funding. Requiring the private sector to raise its own finance and to have facilities in place to allow it to invest and absorb risk is a fundamental part of meeting those objectives.

[6] Paragraph 4b of the Executive Summary, NAO Report "London Underground PPP: Were they good deals?".
[7] Ev 28 – 30
[8] 3.5% is the current discount rate that changed from 6% in April 2003.

Therefore, the Department considers that the key question is whether the higher cost of private sector debt—of which LU were fully aware at the time of the PPP process—is outweighed through the competition, introduction of private sector management skills and incentives to deliver performance that the PPP is designed to achieve. Under the PPP the higher cost of finance will be outweighed if the Infracos deliver the service requirements and cost controls anticipated under the contracts.

It should be noted that any private sector lender that has not been guaranteed by Government will impose a number of disciplines on its borrower, including requiring repeated technical due diligence, sensitivity analysis, reporting requirements, monitoring and control clauses, and regular reviews of performance. These disciplines are an important factor in ensuring that borrowers meet their expected performance levels and deliver the anticipated efficiencies.

Analysis showed that the benefits of the PPP option over a public sector bond option exceeded the £445 million savings available under gilts. However, any bond finance option would have entailed issuance by TfL. Consequently, there is an even stronger case for the PPP compared to TfL issued bonds which would have been £235 million more expensive than gilts, yet without introducing any new incentives or disciplines to improve performance.

To put this key question in context, the NAO calculates in paragraph 2.44 of the "Were they good deals?" Report that the incremental costs of finance would be mitigated if the PPP delivers about one third of the performance benefits anticipated. As another example, the additional cost of finance of the Infracos of £7.0—£14.8 million per year above the Government or TfL alternatives represents around 0.7—1.48% of the year one Infrastructure Service Charge. If those sorts of levels of efficiencies are delivered by the private sector, then the incremental cost of debt will have been outweighed.

Questions 79-85 (Mr Bacon) and Questions 166-168 (Jon Trickett): Transaction costs—Detailed breakdown of transaction costs, including all consultants paid by London Underground, difference in legal and engineering consultancy costs, differences on amounts paid to successful bidders.

We are currently assisting the NAO who are compiling the additional information requested.[9]

Questions 97-105 (Mr Williams) and Question 168 (Jon Trickett): Convergence of consortia and London Underground's cost estimates in the public sector comparator.

As a matter of policy, public sector comparators, which are the public sector's estimate of delivering the same level of service as the PPP/PFI scheme under consideration, are not made public during the competition.

This is because the public sector is looking to obtain best value through competition. There is a justifiable concern that disclosure of the public sector comparator would lead to bids only marginally below that value, so that competition would have been dampened.

The PPP public sector comparator is now fully disclosed in LU's Final Assessment Report. This report, which is being provided to the Committee by TfL, analysed the full background to the transaction, the alternatives available to LU for bringing investment to the Tube, and TfL's alternative proposals. In reviewing whether the PPP was value for money, LU considered in depth both the quantitative analysis, comparing the bids to the relevant PSC, as well as the qualitative arguments, why the PPP offered better value over public sector alternatives.

During the PPP procurement, the public sector comparator was regularly updated to reflect improving asset and performance data, a better analysis of underlying risks, and LU's changing performance requirements. Similarly the private sector bids were being updated on the basis of the same updated data and its own due diligence.

The chart included by the NAO in Appendix 3, figure 3.2, which compares movements in the 30 year public sector comparator with movements in the bidders' Infrastructure Service Charge in the first seven and a half years, shows that over time the relative rate of growth of those figures converged, ie that by the end of the bidding period they had grown by about the same amount since March 2000. This reflects the fact that they were responding to the same changes in underlying data and performance requirements.

While over time the respective costs grew at the same rate, the private sector bids were growing from a lower level. Throughout the procurement process, the total bid costs were at the bottom of, or below, the range of the public sector comparator. The extensive quantitative analysis conducted by LU therefore suggested throughout that the deals represented value for money. This, combined with the qualitative analysis documented in the Final Assessment Report, led LU to consider that the PPP represented the best overall value for money from a range of possible alternatives.

[9] Ev 35

Questions 142-149 (Mr Bacon and Mr Williams): Transport for London preference for Bond Financing—Advice/views provided by TfL to Department for Transport. Summary of this based on London Underground's Final Assessment Report and Update.

I understand that TfL will be providing to the Committee and the NAO copies of LU's Final Assessment Report and the Update to the Final Assessment Report.[10] The NAO will separately be providing a summary of the issues raised by TfL on bond finance.[11]

Questions 164-165 (Jon Cruddas): Staff transfer, new recruits to Infracos & pensions position.

The Committee asked whether new staff of the Infracos were able to join the LRT Pension Scheme. There is nothing in the trust deed and rules that prevents new recruits joining. But it is for the relevant employers to decide whether membership should be offered as part of their recruitment packages. Only ex LRT employees have a statutory entitlement to continued membership of the LRT Scheme.

We understand that Tube Lines has not offered membership of the Scheme to new recruits since January 2003, but instead they are entitled to join the Tube Lines Pensions Scheme. Metronet is also understood to be considering alternative arrangements.

Questions 169-173 (Jon Trickett): Selection of preferred bidder, premature end of bidding process and increase in costs—did bidders estimate their costs after selection and what were they.

As the NAO Report "Were they good deals" points out in paragraph 2.19, the policy of maintaining reserve bidders had drawbacks, but no realistic alternatives were available. The option of pursuing a full reserve bid would have only doubled the bid costs with little value for money and would not have been attractive to those reserve consortia selected. As Figure 14 in the Report illustrates, the cost increases for Tube Lines are significant after the selection of preferred bidders in May 2001.

The appointment of preferred bidders was necessary to ensure that the selected consortium and their backers retained confidence in the bidding process. The consortium were reluctant to commit to detailed negotiations and preparation unless selected as a preferred bidder.

On the issue of recovering costs, successful bidders in any tendering process have to recoup their costs through the prices they charge for their services. In the PPP these are not an upfront cost to the public sector. Instead they are recovered through a component of the monthly Infrastructure Service Charge. While the bidders did not provide an exact estimate of their costs after selection, the scale of these costs was known since they largely relate to items such as legal and financial transaction costs which any preferred bidder would have had to incur prior to concluding the contract. As such, they were part of the cost that was evaluated as being better value for money than a public sector alternative. So the £114 million and £134 million paid to Metronet and Tube Lines respectively were included within the PPP process and pricing before the contracts were closed.

Questions 174-181 (Mr Jenkins) and Questions 182-186 (Mr Williams): Tube Lines Refinancing—Scope for further refinancing and possible gains.

I understand that TfL will be providing further information on this issue.[12]

Questions 6-11 and Question 186 (Mr Williams): Arbiter—decisions (binding & contractual position), penalty for non-compliance.

How are the Arbiter's decisions binding ie through the contracts or through another mechanism?

Section 229 of the Greater London Authority Act 1999 gives the parties to a PPP contract the ability to refer matters specified in the PPP agreement to the Arbiter for a direction. Where a matter is referred to the Arbiter he is required to make a determination which shall be final and binding. While there is no appeal from the Arbiter's decision, his decision would be susceptible to judicial review.

What is the penalty for non-compliance with a decision of the Arbiter?

The Arbiter has no sanction to impose any penalty on the parties to the PPP Agreement for non-compliance with his decision under the Greater London Authority Act 1999.

However, where the Arbiter's determination takes effect as a term of the PPP Agreement (see above) it is enforced in the same manner as any other provision of the agreement. The matter must initially be dealt with under the Dispute Resolution procedures contained in the PPP agreements which can result in the dispute being referred to Adjudicator and ultimately the Courts.

[10] Neither report printed.
[11] Ev 33 – 39
[12] Ev 28 – 30

Questions 125-130 (Mr Jenkins) and Question 186 (Mr Williams): Note on fares over 25 years and balance of subsidy & London Underground income.

I understand that TfL will be providing further information on this issue.[13]

Supplementary memorandum submitted by Transport for London

Questions 144-147 (Mr Bacon): Whether Transport for London had provided advice to the Department of Transport concerning TfL's recommendations for a public bond financing to support required capital investment in the Tube?

In fact, beginning in late 2000 TfL had provided its views and detailed recommendations to LUL and DETR/DfT concerning what TfL believed to be a cost effective alternative to the PPP financing scheme. Although some material was formally submitted only to LUL, at all relevant times LUL was acting under the direction of DETR/DfT through London Transport. This record is summarized below, and includes the following attachments:[14]

— Outline of a Programme for the Rehabilitation and Management of the London Underground; 13 December 2000. Transport for London, available via the Web at http://www.tfl.gov.uk/tfl/pdfdocs/report02.pdf.

  This piece outlines the use of securitisation, a form of public borrowing, to provide the bulk of the financing to support an alternative approach to the refurbishment of the London Underground. The paper also addresses the in-depth involvement with the private sector, the management of risk between public and private sectors, the need for a full assessment of asset conditions, and the likely levels of Government support required for such a programme.

  While the report was not addressed to DETR, it was provided to DETR and made broadly available to the public. As the next document attests, it was considered in detail by DETR.

— *Response to Questions Raised by DETR Concerning TfL's Outline of a Programme for the Rehabilitation and Management of the London Underground*; 29 December 2000. Confidential correspondence from Robert R. Kiley to Mike Fuhr, Director, London Underground Task Group.

  Regarding TfL's plan of 13 December, DETR tabled various questions on strategic and technical points raised by the paper. The note therefore was direct correspondence from TfL to DETR.

  This paper re-emphasised the role the private sector would play in a TfL plan, the controls that the public sector would require, and the specifics of the proposed financing plan and risk allocation by TfL.

— London Underground Public Private Partnership, Emerging Findings; 17 July 2001. Deloitte & Touche Corporation. Executive summary available via the Web at http://www.tfl.gov.uk/tfl/pdfdocs/report02.pdf.

  This report examines a TfL bond plan for works within the Public Sector Comparator with regard to the value for money analysis of the BCV and JNP Infracos. The report notes that the value of public sector bond financing has been largely dismissed by LUL's application of a concept termed "reputational externality". Also, net financing costs for the public alternative were inflated by an inefficient treasury management plan, which raised and held for five years large cash balances from bonds, despite substantially lower investment rates than borrowing costs. Deloittes notes that these costs could be significantly reduced by standard treasury management techniques. In LUL's analysis of VfM, supporting its decision to proceed with preferred bidders, its presentation of these two factors disadvantaged a viable public bond case by £900 million. See paragraphs 3.7.2 and 3.7.3.

  The Deloitte report also notes that selection of preferred bidders too early in the process could lead to a materially adverse impact on VfM. Independent of the benefit of public financing and highly material adjustments to the PSC, the 7.5year bid for the JNP line did not show value for money and the BCV bids show that there was a scenario where the PSC offers better VfM than the preferred bid.

  This report was shared by TfL with LUL's management.

— *Interim Consultation Response to London Transport on PPP documents provided between 11 February 2002 and 15 March 2002; Chapter VI Value for Money*; Transport for London. Available via the Web at http://www.tfl.gov.uk/tfl/report/pdf—05.pdf.

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[13] Ev 31
[14] Not printed.

The chapter describes various criticisms of the value for money analysis, and describes that a TfL bond-funded alternative would project present value cash savings of £1.7 billion against mid-point estimates related to works undertaken in the first contractual period, or £1.2 billion against the highest estimates of the PSC (see page 44). Even when conceding for discussion LUL's questionable estimates of social costs that against the PSC, the savings of the PSC over the bids range from £1.1 billion (against its central estimates of public costs) to £500 million (against the 95% high end of estimated public costs). This chapter notes that TfL's bond plan has never been accurately represented during any stage in the evaluation of the PPP, despite the presentation variously to DfT and LUL of the above materials.

Also in the chapter are criticisms of the adjustments to the construction of the PSC, in that:

- Its wide risk ranges were never adjusted to reflect the increasingly narrow risks that ended up being built into the PPP contracts;
- the VfM ignored contract management costs of the PPP;
- the 30-year analyses have no substantive value;
- that the 7.5-year analyses, even when putting aside the debate regarding public sector financing costs, do not show value for money (this has now seemingly been echoed by NAO);
- the "wider factors" did not include either a full listing of downside risks, or some attempt to give them financial weight or, failing a full analysis, some discussion of commercial significance; and
- that there was an overall breakdown in the chain of verification of the VfM process.

This report, as a consultation response, was of course shared with LUL management.

TfL staff are available to discuss the above reports and correspondence at the Committee's convenience. We believe now, as we believed then, that the public bond alternative would have provided a more prudent and cost-effective approach to financing the modernisation of the Tube.

Robert R Kiley
Commissioner of Transport

7 July 2004

Questions 36-38 (Jon Trickett), Questions 174-182 (Mr Jenkins) and Questions 182-186 (Mr Williams): Summary of position on information provision.

INTRODUCTION

Paragraph A3.2 of the NAO Report "London Underground: *Are the Public Partnerships likely to work successfully?*" set forth the position on the exchange of information between LUL and the Infracos as at the end of the fiscal year, March 2004. This note summarises the position as at 13 July but the position is evolving and subject to change.

INFORMATION TO BE PROVIDED BY INFRACOS TO LUL

The PPP contracts span a wide range of complex activities that are undertaken by Infraco and LUL on the Underground network. The contract sets down the information to be provided to LUL that LUL requires to fulfil its functions, for example to assure itself of the safety of the railway. In some areas, the contractual information sharing provisions are expressed in general terms and do not specify the form and content of submittals. It should be noted that the PPP contracts specifically refer to the Infracos undertaking their obligations on an open book basis. Some of these information requirements are set out below:

Capital Projects

LUL has the responsibility to co-ordinate the execution of capital works across the Underground network by several different PPP and PFI contractors. This is to ensure both that proposed works do not over-lap in space and time (with consequent risk of interference) and that impacts on the operation of the railway can be managed. To do this, LUL has developed a Master Projects Database (MPD) into which the Infracos—as well as LUL itself and its PFI contractors—are required to feed accurate project plans showing when and where work will be undertaken. MPD is critical to the management of the unprecedented work programme being undertaken on the network.

LUL has been planning for many months upon the basis that MPD would be capable of being used as a management tool by September 2004. LUL itself is on target to meet this deadline although its PFI contractors have trailed behind the Infracos, given that PFI contractors involve some entities related to Infraco shareholders and discussions did not commence with them until after the Infracos agreed the principles of what they would provide in early 2004.

Asset Management

The Infracos have to submit an over-arching Asset Management Strategy (AMS) that sets out the management regime they intend to apply to the assets, and an Annual Asset Management Plan (AAMP) that documents the specific steps they will take under that regime for each asset class, forecasting out nine years into the future. Both of these require LUL's approval. These must demonstrate how the Infraco intends to discharge its PPP obligations including the adoption of an efficient and economic whole-life cost approach. Of necessity, this involves the Infraco providing cost information which should facilitate monitoring progress of Infracos' expenditure in relation to the baseline forecast in the PPP contracts which underpinned the level of the Infrastructure Service Charge.

Other Financial Information

The Underground's assets remain on LUL's balance sheet under the PPP contracts. To accurately account for them, the Infracos are required to provide LUL with detailed information on how their work has increased the value of the assets each period.

In addition, the Infracos are required to give LUL further information about their cash and revenues so as to allow LUL to monitor the Infracos' overall financial position: this information includes periodic management accounts. In the case of Tube Lines, LUL and Tube Lines have agreed that additional financial information will be provided—this was agreed in the context of the recent refinancing.

Sub-Contracts

The PPP contracts give LUL "step-in" rights to take over parts of an Infraco's operation in circumstances where the Infraco is in breach of contract. Under these circumstances, LUL would replace the Infraco as the counter-party to the sub-contracts put in place by the Infraco. Each Infraco therefore has to provide LUL with information about its Key Sub-Contracts, to allow LUL to check that the sub-contracts contain the rights LUL may need in the future and the appropriate terms in areas such as audit. Thereafter, LUL signs an explicit agreement (termed a "Direct Agreement") with the sub-contractor formalising the arrangement. The Direct Agreement also serves the purpose of bringing the sub-contract and the assets provided under it under the protective provisions in the Greater London Authority Act 1999 in the event of insolvency or administration of the Infracos.

The Infracos have been engaged with LUL since the contracts were signed in discussing how they might deliver their obligations in all these areas. Some information has flowed from both Tube Lines and from Metronet in each of the four areas above, but in all four areas significant difficulties have been encountered. Discussions continue with both companies as to how the provision of necessary information can be improved. In general, problems relate both to the Infracos' development of internal management information systems capable of producing required information and to the reluctance of the Infracos to provide financial information already in their possession. The position with Tube Lines is largely resolved with information flowing or dates for delivery agreed. There are substantive issues remaining with Metronet and this is disappointing, given that Metronet was helpful in resolving an impasse between LUL and Tube Lines/Metronet over the MPD.

CURRENT POSITION

Tube Lines

Capital Projects

Until Tube Lines and LUL agreed the principles about data to be submitted to the MPD in early 2004, limited capital projects information was passed to LUL. Since then, Tube Lines and LUL have been working jointly to configure the necessary automatic links between Tube Lines' internal project management systems and the MPD. The MPD is not yet a fully functional management tool because the required technical integration and data cleansing has not yet been completed. LUL expects to be provided with a full set of data by Tube Lines by September 2004.

Asset Management

Tube Lines AAMP for Financial Year 2004 included a financial review of the costs incurred in the year to date. LUL was initially unable to reconcile these costs back to Tube Lines' original bid and the data as initially provided was internally inconsistent. The problems were due, in part, to the introduction of new financial systems but a significant reason was the reallocation of cost and overheads. LUL has given Tube Lines' initial AAMP a conditional approval, limited to the 2004–05 work programme (as opposed to the nine year plan anticipated by the contract). LUL is working with Tube Lines on an improvement programme which the parties expect will lead to submission of a satisfactory 2005–06 AAMP. If Tube Lines meets the commitments made, then LUL considers progress will be in the right direction.

Other Financial Information

Tube Lines have delivered the accounting information required at a high level and have committed to work with LUL in developing more detailed information.
The management accounting information provided to date by Tube Lines has been aggregated to a high level, limiting its usefulness in understanding the evolving position. The additional information Tube Lines agreed to provide at refinancing is not due until the Autumn.

Sub-Contracts

LUL has received requests for over twenty Direct Agreements from Tube Lines and, until recently, copies of the sub-contracts were not being provided with these requests. In Spring 2004 LUL exercised audit rights to check compliance with the PPP contract requirements in this area. Tube Lines has now agreed to remedy deficiencies identified in the audit by various dates over the next few months. Since then, Tube Lines have generally submitted copies of the sub-contracts with requests for Direct Agreements but no agreement has been reached on the provision of variations.

Metronet

Capital Projects

Metronet provided only outline information to LUL about the capital works underway on its lines in 2003. In February 2004, Metronet agreed principles with LUL governing the provision of capital project cost and progress data to the MPD for delivery by late September 2004. Metronet has recently advised LUL that it only intends to deliver data on live projects in late October 2004. LUL has not yet been advised when data on the remaining 600 proposed projects will be provided.

Asset Management

Metronet agreed, in principle, to provide (in the first year AAMP only) broadly similar information to Tube Lines but this information has not yet been delivered. It is not possible to make informed judgements as to whether Metronet is demonstrating a whole-life cost approach upon the basis of the information submitted. Metronet has recently submitted further proposals which are under review by LUL.

Other Financial Information

The information being provided by Metronet on changes in asset value is insufficient to meet LUL's accounting needs. LUL's external auditors have stated that unless there is a significant improvement, LUL will not be able to support its fixed asset accounting records which would place LUL in breach of its statutory obligations under the Companies Act 1989. Metronet have subsequently agreed to provide more detailed information has to enable LUL to fulfil its statutory obligations.

Metronet's management accounts provide more detail than those provided by Tube Lines to date.

Sub-Contracts

LUL has copies of the initial Metronet sub-contracts put in place before Metronet took over responsibility for the Infracos and continues to receive Key Sub-Contracts from Metronet prior to entering into Direct Agreements. Metronet has recently agreed to copy material variations to LUL on a non-contractual basis but there is no agreement yet over what constitutes "material".

Metronet has obligations under the contract to make sure that sub-contractors undertake their obligations on an open book basis and contain certain audit rights in favour of LUL. LUL has been requiring Metronet to insert the same provisions that it required Metronet to insert in its initial sub-contracts during the bid process.

Metronet now claims that it is having difficulties securing these rights from its new sub-contractors and that it is not obliged to do so.

Metronet has regretfully referred the scope of these obligations to dispute arguing a narrow interpretation of the contractual provisions.

Questions 142–149 (Mr Bacon and Mr Williams): Potential refinancings of the PPP Debt

Why refinance? Refinancings generally occur because the borrower is able to achieve a lower rate of interest than they currently pay.

Interest payments are split into two components: the base component and the credit spread. The base component is the underlying rate of interest that is paid by high quality borrowers. In the UK for large borrowers, the base component is either Gilts—the fixed rate at which the UK Government borrows—or LIBOR (the London Inter-bank Offered Rate)—the floating rate at which banks borrow from each other. At the time of any debt issuance, Gilts will be quoted at a fixed rate of interest, whereas LIBOR will be floating rate interest for short periods (eg three or six months). Borrowers can enter into interest rate swaps in order to swap payment of LIBOR for payments of fixed rates of interest.

The credit spread is the premium that the borrower must pay for being a riskier investment than either the UK Government or banks and is quoted as basis points[15] over Gilts or LIBOR.

A borrower can achieve lower interest rates if either the base component decreases and/or the credit spread decreases.
However, if the base component is at a fixed rate of interest (either Gilts or interest rate swaps) and the borrower wishes to repay the loan in order to refinance, the borrower may be required to pay a prepayment fee to the investor.[16] Because the prepayment penalty will be essentially equivalent to any benefit that the borrower could gain from lower interest rates, the effect of fixed interest rates is that a borrower will not be able to achieve any significant benefit from reduced underlying interest rates.

With credit spreads, a borrower will be able to achieve a lower rate of interest without prepayment penalty if the borrower can reduce its credit spread. A borrower's credit spread can go down for several reasons:

(a) improved credit and therefore becoming a less risky investment,

(b) market reductions in credit spreads at that level, and

(c) structural enhancements to the debt which reduce its riskiness (although the borrower itself does not become less risky).

Questions 174–181 (Mr Jenkins) and Questions 182-186 (Mr Williams): Can Tube Lines and Metronet refinance?

In theory, both Tube Lines and Metronet could refinance their debt, as there are no limitations on their ability to refinance in the PPP Service Contract.

In practice, in the case of Tube Lines, it is unlikely that they will refinance most, if not all, of their debt. Metronet, however, has greater potential for refinancing. The potential for refinancing by both companies is described below.

Tube Lines: Tube Lines original financing was floating rate bank debt with an interest rate swap, as described above. When Tube Lines refinanced their debt in May 2004, they actually borrowed at a higher underlying interest rate than the original financing, but received payment from the interest rate swap providers for cancelling the swap, thereby achieving the net effect of borrowing at the same interest rate as the original financing.

Tube Lines achieved the refinancing benefit by being able to reduce the weighted average credit spread on the refinancing from approximately 1.60% in the original financing to 0.686% on the refinancing.

Because of the significant reduction in the credit spread achieved by Tube Lines in the refinancing, for the majority of the debt, it will be unlikely that Tube Lines will be able to achieve any material benefit—net of fees and expenses—from a further refinancing. However, the credit spread on £172 million of debt will increase significantly starting in 2010. Therefore, Tube Lines may be able to gain some benefit by refinancing this debt before the interest rate margins increase in 2010.

Metronet: There is a possibility that Metronet could achieve significant refinancing benefit if they are able to further reduce the credit spread paid on their debt. A significant portion of Metronet's current debt are in bonds. Therefore, if Metronet chooses to refinance 100% of the debt, they may need to pay substantial pre-payment penalties to the bondholders. For the floating rate bank debt, we expect that for the majority of this debt, Metronet will enter into interest rate swaps. Metronet may still need to pay a pre-payment penalty to unwind the swaps, but this payment should be less than to the bondholders.
The amount of refinancing benefit for both Metronet and Tube Lines will only be determinable at the time of refinancing as it is impossible to predict what structure would be available at that time, or the underlying interest rates or credit spread.

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[15] 1 basis point = 0.01%.

[16] The prepayment fee is paid in order to "make the investor whole" for the returns that the investor will not be earning due to the prepayment. It is calculated by comparing the interest rate on the bond or interest rate swap currently in place against the current base interest rates at the time of refinancing. If interest rates at the time of refinancing are lower than the existing bond or swap, the borrower will need to make a payment to the lender. With interest rate swaps for bank loans, if interest rates at the time of the refinancing are higher, the bank will make a payment to the borrower. With bonds, if interest rates at the time of refinancing are higher, no additional payments from either party will be made.

Annex

BREAKDOWN OF SOURCE OF LONDON UNDERGROUND TOTAL REVENUE

		1988–89	1989–90	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97	1997–98	1998–99	1999–2000	2000–01	2001–02	2002–03
LUL Revenue																
Traffic (fares)	£m	432	462	531	559	589	637	718	765	797	899	977	1,058	1,129	1,151	1,138
Other	£m	36	42	46	51	53	51	47	51	57	62	68	91	100	100	106
total	£m	468	504	577	610	642	688	765	816	854	961	1,045	1,149	1,229	1,251	1,244
Government Grant																
Core Business	£m	138	256	313	306	598	505	392	267	205	38	68	204	116	384	752
JLE & CrossRail	£m			42	68	83	125	428	535	673	506	267	498	153	99	15
Total	£m	138	256	355	374	681	630	820	802	878	544	335	702	269	483	767

Supplementary memorandum submitted by the National Audit Office

Questions 142–147 (Mr Bacon) and Question 149 (Mr Williams): Transport for London (TfL) Bond Financing Proposals

Introduction

Mr Bacon asked Mr O'Toole for documents, in London Underground, prior to his arrival, containing advice given—by TfL—to the Department on preferences for bond financing. Mr Callaghan (Q 148) referred to London Underground publishing, in 2002, two reports called the *Final Assessment Report* and the *Update to the Final Assessment Report* both of which summarised TfL's submissions at some length. Mr Williams asked the NAO to do a brief critique of London Underground's summary for the Committee.

Overview

All parties agree that the effective modernisation of London Underground requires:

- the assurance of stable funding over many years (and all recognise that such stability cannot be guaranteed with conventional public finance);
- effective risk management of the physical upgrading work (which, under all financing options would be carried out by a range of private sector contractors).

In both TfL's approach and the PPPs', stable funding is provided because the greater part of the money needed is raised at the outset. The direct costs of finance would differ: TfL's approach would be cheaper than in the PPPs.

The approaches to risk management are radically different. TfL would rely on strong public sector management of the private sector contractors. In the PPP, the private sector would have higher exposure to risk than in a conventional project but greater responsibility for managing those risks. Because private sector money would be at risk, there would be incentives for the private sector to manage the risks effectively.

If private sector risk management as in the PPPs is more likely to be effective than the public sector contract management proposed by TfL, then the extra cost of the PPP finance might be outweighed by the benefits of superior control of the risks. The Government took that view and ruled out public sector bond options accordingly. The TfL public sector bond option would also have been unique in the field of local government finance in the UK.

The bond financing proposals run up against two opposing philosophies. TfL proposed lower cost finance within a contract framework controlled by the public sector to counteract private sector self-interest. London Underground (when owned by London Regional Transport) considered that higher cost finance included transfer of sufficient risk and project control to the private sector so that their self-interest would incentivise them to deliver performance that would more than offset the extra financing costs.

TfL's bond financing proposals

In February 2002, TfL proposed raising £2 billion to £3 billion in part by bonds secured on the London Underground fare box ("Asset Backed Bonds") supplemented by bonds based on TfL's corporate good quality investment rating (which it expected to be rated as AA or high investment quality). These proposals formed part of a different public sector approach to modernising the Tube which was set out in the Mayor's Transport Strategy published in April 2001.

Several advantages were claimed for this approach to modernising the Tube which TfL claimed had been used to turn around systems in Boston, Philadelphia, New York City and Toronto:

- gives local government the financial means and full responsibility;
- provides stable funding, largely independent of annual grant negotiations (with capital funding segregated from operating budgets);
- management skills, including certain project skills, are retained in house and hold private sector contractors (handling large-scale resource intensive projects) to task; and
- lower borrowing cost than PPP, as further described below.

TfL's advisers recognised that raising the total amount would need five to seven years of Government financial backing for the bonds through grant provisions. In response to the objection that bonds would not lead to the transfer of risk to private sector shareholders, TfL argued that risk transfer could instead be achieved through rigorous contracts with the suppliers of infrastructure improvements and services, without having to pay an equity risk premium across the entire project. TfL also argued that their retained project risk under the PPP was equivalent to the project risk under their preferred structure.

On this basis TfL estimated that its proposals would lead to a saving in financing costs of £36 million to £84 million per year. About one-third of the saving would arise because of higher PPP borrowing cost (rated at a low investment quality or BBB) and the other two-thirds from saving the cost of remunerating PPP equity at around 20% per year. A further unquantified potential interest cost saving could arise if bonds were only issued in tranches of £500 million as and when funds were needed (but there would be a risk of lack of market interest or of the necessary support from central government at the time).

Transport for London estimates of financing costs:

Cost of financing (excluding fees)	*February 2002 (TfL report)*	*4 April 2003 (Metronet close)*
Estimated average cost of PPP debt and equity	6.7% to 8%	7.15% per year
Cost of AA rated corporate bond financing	5.2% to 5.5%	5.29% per year
Differential in cost of finance	1.2% to 2.8%	1.86% per year
Assumed amount of financing	£3,000 million	£5,000 million
Annual cash differential	£36 million to £84 million	£93 million

Source: Estimates based on publicly available (Bloomberg) market data. The calculation based on the market rates and the terms achieved by Metronet in April 2003 is referenced in the NAO Report "*London Underground PPP: Were they good deals*?" paragraph 2.43 (page 26).

London Underground's findings

London Underground generally did not dispute the market-based pricing that TfL put forward, but did not expect Treasury approval "recognising that this is not the way public infrastructure projects have historically been financed in the UK". As a related matter, London Underground advised their Board not to assume, under a radically changed approach, the same level of grant support as that available for a PPP that met policy objectives.

Of the contract structure, London Underground said that it would not deliver the PPP policy objectives on risk and contract responsibility, noting "Some of the contracting structures proposed by TfL, requiring equity contributions from suppliers or parent company guarantees, are not standard ways of doing business with the UK public sector, and may add to the time needed to put contracts in place." Adding to timing problems, a new procurement competition would have been required.

Publicly, the advisers to TfL and London Underground showed themselves unable to agree on a common set of assumptions for making undistorted bond financed price comparisons. Little common ground exists, and Ernst & Young,[17] as further discussed below, largely discarded London Underground's bond comparison (see NAO Report "*London Underground PPP: Were they good deals*?" para 2.42 on page 26).

London Underground's May 2002 "Update to the Final Assessment Report" gave a high level summary of TfL's objections to London Underground's findings. In addition to maintaining that the PPP was not value for money, TfL challenged the findings about the extent of delay and the availability of grant.

NAO analysis of TfL's proposals and London Underground's findings

Part 1 of the NAO Report shows that in discussion of the design of the PPP there was analysis of public operations combined with private funding (paras 1.9–1.10, 1.17). This analysis showed that such an option would only have been possible with Government backing, which the Government was not prepared to offer, in part because the Government wanted private sector direction of the expenditure in the belief that it would thereby be more effective.

Paras 2.41–2.44 discuss the possible savings from TfL's approach (updated in April 2003 to represent £5 billion of bonds at 5.29%) compared with Metronet's actual financing structure. Ernst & Young, as para 2.42 Reports, considered that any such saving should be treated with caution in project selection. In particular if the cost of capital (5.29%) is lower than the discount rate at which TfL make the comparison (8.65%), discounting the cash flows appears to reduce the public sector cost. This would imply that the more money that is borrowed by the public sector, the more value for money would improve. It is partly for this reason that Ernst & Young, correctly in London Underground's view, dismissed the relevance of bond financing comparisons, as they felt that in all circumstances an element of distortion, which they termed arbitrage, would occur.

Arguably the risks to a project under public sector management might outweigh the benefit from cheaper finance—and have certainly done so in previous projects. Instead of letting a lower public sector borrowing cost act as a form of arbitrage or subsidy to a project, Ernst & Young asked how much the public sector might save in the costs of carrying out such a project if annual grant funding were to be replaced by long

[17] The Department retained Ernst & Young to provide independent advice to the Secretary of State.

term stable funding. Ernst & Young then estimated the potential saving from such stable funding at some £825 million. On London Underground's analysis the Committed Finance Offer bids for the PPP remained value for money after reducing the estimated public sector cost by this amount of saving.

Para 2.43 identifies that the debt and equity financing structure agreed under the PPP costs £90 million more annually than the estimated cost for TfL issued bonds, two thirds of which is related to the cost of equity and is dependent on performance under the PPP. Para 2.44 estimates the annual extra cost of the private debt borrowing as £30 million. This debt cost is generally payable regardless of performance. The extra cost has to be considered against an assessment of the benefit of risk transfer and scrutiny of the project by private lenders.

Bond issues were not available to London Underground because the Government attached priority to bringing in private sector responsibility in the manner envisaged by the PPP. The scope for improved value for money compared to the option adopted would depend on public sector efficiency under the bond option compared to private sector efficiency under the PPP option.

Questions 79–85 (Mr Bacon) and Questions 166–168 (Mr Trickett): transaction costs incurred by London Underground and the PPP bidders

The additional information is provided by the National Audit Office in the form of three tables, together with notes and commentary, including the Department for Transport's commentary (where indicated).

1. The first table[18] provides, in one place as requested by Mr Bacon (Question 80), a chart of transaction costs with further breakdown on the composition of bidders' costs. The commentary following the first table describes the scope of work undertaken by the lawyers acting for London Underground and the scope of work undertaken by Price Waterhouse (subsequently PricewaterhouseCoopers) as financial advisers.

2. The second table[19] provides supplementary information on additional firms used by London Underground. The named firms account for some £18 million out of an aggregate expenditure of £26.5 million over six years, during the corporate reorganisation that preceded the PPPs and during the procurement of the three concessions. A further £4.5 million was not identified to specific firms, covering items such as the "Project Office Costs" and "External Contractors", and the balance of £4 million was spread across an additional 50 to 60 organisations and individuals.

3. The third table[20] provides supplementary information on the unsuccessful bidders' costs, naming the principal firms of lawyers and consultants involved.

The supplementary information is cross-referenced to figures in the Comptroller and Auditor General's Report "London Underground PPP: Were they good deals?" (HC 645). In that Report Figure 12 sets out the external advisers' costs and Figures 13 and 13a on pages 30 and 31 chart the progression of London Underground's costs over time.

Question 166 (Mr Trickett): He asked for an explanation of why Tube Lines, bidding for one contract, had been reimbursed more than Metronet which had bid for two contracts. The reasons why Tube Lines incurred greater costs (at £134 million) than Metronet (at £116 million) have been provided by the Department.

Tube Lines' bid was the most advanced during the later stages of the transaction process. As the contracts were negotiated, developed and completed earlier they incurred greater costs in agreeing contract principles than Metronet. This work was incorporated into the two remaining contracts thus reducing transaction costs on the Metronet bids where agreed terms could be incorporated from the Tube Lines deal. Further financial savings were also available from having a single bidder for the two final contracts which avoided some inevitable duplication in costs had separate bidders been selected.

There are two main components within the bids as paid where Tube Lines costs are substantially larger than Metronet. The first of these is the reimbursement of £7 million that Tube Lines received for their unsuccessful bid for the Sub Surface contract. Metronet received no such fees, being successful in both its bids.

The other substantial difference is in pre-contract operational activities and the creation of business plans ("Transition Team resources"). These costs were some £21.5 million for Tube Lines, compared to £2.4 million for Metronet, reflecting the different make-up of the consortia. Tube Lines were required to prepare supply contracts prior to the close of the deals and built up resources capable of letting the necessary contracts to deliver their performance obligations during their negotiations. This required Tube Lines to undertake greater preparation than Metronet to ensure that these arrangements were satisfactory before the PPP deal could be completed. Metronet, on the other hand, included their supply chain within the consortium, and were not required to undertake a similar level of preparation before deal close because contracts had already been arranged with the supply chain.

[18] *See* Ev 36-39
[19] *See* Ev 37-38
[20] *See* Ev 38-39

This does not necessarily mean that the costs for Metronet were less, because the Metronet supply chain will have incurred substantial costs pricing their respective obligations and in particular performing the necessary due diligence to be able to offer fixed prices. But those costs would be included in the overall fixed prices offered to Metronet by their suppliers. In this way those costs are also contained within the Infrastructure Service Charge paid by LUL, although not separately identifiable.

Without the PPPs, as the Accounting Officer told the Committee, London Underground would have had to negotiate separately potentially a very large number of other contracts. In most other contracts bidders' costs are not separately identified but included within the deal price.

Table 1

BREAKDOWN OF TRANSACTION COSTS SUMMARISED IN "LONDON UNDERGROUND PPP:WERE THEY GOOD DEALS?" (HC 645)

£ million	*LUL*	*Tube Lines (JNP)*	*Metronet (BCV & SSL)*
Freshfields legal advice & drafting—just over 50% in period 1[1]	29.2		
PricewaterhouseCoopers—nearly 70% in period 1[1]	21.4		
Ove Arup—75% before invitations to bid	6.0		
PA Consulting & Andersen—over 90% pre bids[2]	26.3		
Other firms (**see Table 2**)	26.5		
LUL internal costs—60% in period 1[1]	61.0		
+ add back effect of discounting (see Figure 12 in NAO Report)	10.0		
Lawyers for Bidders (Tube Lines Periods 1:2 £1.9 million: £11.7 million)		13.6	
(Metronet both BCV and SSL bids for periods 1:2 £3.3 million: £10.7 million)			14.0
Advisers (including sums due on completion)		13.1	16.4
Lawyers for banks and funding bodies		7.8	6.2
Banks technical advisor, modelling, etc		4.4	2.5
Other 3rd party advisers' costs to date—tax, audit, VAT		4.2	3.4
Balance of 3rd party costs forecast for remaining period to close		5.4	3.0
Bid team resources (Metronet reduced for cap[3])		16.6	14.3
Transition team resources[4]		21.5	2.4
Project Office expenses		1.4	3.2
Tube Lines unsuccessful SSL bid (see Table 3)		7.0	n/a
Payments to sponsors (Metronet both BCV and SSL)		39.0	50.6
Unsuccessful bidders (**see Table 3**)	25.0		
Total (£455 million)	**205.4**	**134**	**116**

Source:
London Transport Board approval November 2002 and NAO analysis.

[1] The first time period closes with selection of Preferred Bidders (May and September 2001). Detailed break-down over time in Figure 13 of the NAO Report.

[2] Fees to Arthur Andersen and PA Consulting principally covered reorganising London Underground into three Infracos and one operating company.

[3] Further Metronet bid costs after November 2002 were 50% reimbursable subject to a £3 million cap—applied to the bid team resources line. Final legal fees took Metronet's out-turn to £117.9 million after completing their financing in April 2003.

[4] "Transition team" activities include a early operational activities during the extended period before closing the transactions and the creation of Business Plan.

COMMENTS ON TABLE 1

Legal advice and drafting:

Work by Freshfields for London Regional Transport and the Department for Transport is further described as follows:

- providing input to the overall design of the PPP contracts including evaluation of the options and ensuring the appropriate provisions were included in the GLA Act 1999 eg in relation to tax, protection of railway assets, and the role of the PPP Arbiter;
- supporting LUL in reorganising into four separate businesses and the preparation of information to support the bid process;
- development of PPP documentation in parallel with design of the Infracos and LUL (and reworking the documentation as elements of the design changed or developed);
- supporting negotiations with Railtrack;

- — restructuring of the Northern Line Train Services Contracts in preparation for transfer to Infraco JNP and supporting protracted negotiations with Alstom;
- — supporting LUL's negotiations with PFI contractors in relation to transfer of their contracts to TfL;
- — supporting the tender process and LUL's negotiations with all bidders;
- — advising on judicial reviews; and
- — advising on the competition aspects of the transaction including state aid clearance.

Financial advice and negotiating:

Work by Price Waterhouse, and subsequently by PricewaterhouseCoopers included the following:

- — review with London Underground of the procurement options open to London Underground and detailed presentation of alternative models to Government;
- — providing input to the overall design of the PPP;
- — development of the PPP structure, including design of the Infracos and LUL interfaces;
- — supporting LUL in reorganising into four separate businesses and the preparation of information to support the bid process;
- — development of the London Underground output requirements and performance measurement regime;
- — continual updates on LUL performance and determining benchmark levels of performance;
- — review of the PFI arrangements and their interfaces with the PPP;
- — supporting negotiations with Railtrack;
- — supporting the tender process and LUL's negotiations with all bidders;
- — financial review of bids in conjunction with LUL bid evaluation team; and
- — assisting LUL with financial close and interest rate risk management.

Table 2

OTHER FIRMS USED BY LONDON UNDERGROUND

Company	*Spending levels*	*Activity*
Up to £100,000		
Arnold & Boston	£20,000	Architects
Symonds	Over £20,000	Project management—Windsor House
"Mystery shopper"	£30,000	Setting up and testing ambience measurement
Cazaley	£30,000	Construction work—Windsor House
Dearle & Henderson	£50,000	Cost management (asset knowledge)
Aslan	Over £50,000	Support on engineering standards work
Kvaerner	Over £50,000	Engineering support (asset knowledge)
Eurica consulting	£60,000	Consulting
Touchstone Renard	£60,000	Technical review of asset data
Soil Mechanics	Over £80,000	Survey information
Between £100,000 and £1 million		
Harris & Porter	Over £100,000	Project management—accommodation
Haswell	Over £100,000	Bid evaluation—technical support
Kennedy & Donkin	Over £100,000	Engineering support (asset knowledge)
Mellish & Lynch	Over £100,000	Quantity Surveyor—support on cost databases
Osprey	Over £100,000	Project management
Steer Davies Gleave	Over £100,000	Customer survey
TFPL Ltd.	Over £100,000	Reorganisation of deeds room, etc
William Dick Partnership	Over £100,000	Commercial managers—Windsor House
WS Atkins	Over £100,000	Eng support (asset knowledge)
Bacon & Woodrow	£150,000	Pensions services and advice
Nigel Rose and Partners	Over £150,000	Bid evaluation—quantity surveyors
Decision Focus	Over £170,000	Modelling early PPP structural options
Slaughter and May	Over £200,000	Legal services
Royal Bank of Canada/ Ernst & Young	Over £200,000	Advice on interest rate hedging strategy
Opteama	Over £200,000	Engineering consultants (process mapping)
Metro Consulting	Over £250,000	Bid evaluation—train operations
Computercenter Limited	Over £300,000	Computers and accessories
ITNET	Over £400,000	IT services

Company	*Spending levels*	*Activity*
Cap Gemini	Over £400,000	Information technology services
AEA (and Risk Solutions)	Over £500,000	Design/test safety management structure
Marsh (formerly Sedgwick)	£520,000	Insurance services and advice
Hobley Nesbit	Over £570,000	Commercial/management support to H&H
PML Ltd.	Over £700,000	Bid preparation and checking
Field, Fisher, Waterhouse	£750,000	Legal advice to LRT on transfer to TfL
Over £1 million		
Bank and legal fees	Over £1 million	PPP interface with Northern Line PFI deal
Richard Ellis	Over £1 million	Property services and advice
ICL (and others)	Over £1 million	IT services
Overbury	Over £1.2 million	Office refurbishment
Pugh Roberts (to end March 2001)	£2,200,000	Dynamic Simulation Modelling
KPMG	£2,400,000	Audit and review of Public Sector Comparator methodology
Hornagold & Hills	Over £2.5 million	Project management and related services

Source:
Project records provided to the NAO support the stated estimates. Precise figures could be compiled, but only after confirming the amounts with each individual firm to eliminate errors in data interpretation, such as possible double counting.

Table 3

UNSUCCESSFUL BIDDERS COSTS

£ million	*Tuberail (JNP)*	*LINC (BCV and SSL)*	*Tube Lines SSL Group (SSL)*
Internal costs	4.9	10.9	5.4
External costs—legal	3.7	2.0	1.2
External costs—other	2.4	6.9	1.5
Total Bid	*11*	*19.8*	*8.1*
Total Paid	11	14	7

Internal Costs for all bidders

Staff Costs, including accommodation, clerical support, expenses and printing.
Tuberail

External Costs

Includes Asset Management, Financial, Legal, Technical, Public Relations, Human Resources, Risk Assessment and other Due Diligence.

Lead firms include Linklaters, Allen & Overy, Arthur Anderson, S&P and Moody's.

Amount Paid

Following a claim by Tuberail in September 2002, the London Transport Board agreed to full payment of the £11 million requested. This was based on accepting that Tuberail had diligently followed London Underground's instructions during a prolonged bidding process.

LINC

External Costs

Lead firms include Schroder Salomon Smith Barney (part of Citigroup), Slaughter and May, Clifford Chance, Ernst & Young, Symonds Group, Steer Davis Gleave and CJ Associates.

Amount Paid

£7 million was paid for each unsuccessful bid making a total of £14 million.

Sub Surface Lines (Tube Lines Group)

External Costs

Includes LSA (public relations), AON (insurance advice), APM Ltd (asset management consultancy), Capita (technical advice), Chapman & Company (Property advice), Claire Howard Consultancies (Property), KPMG (Tax), Lovells (legal advice), Norton Rose (lenders' legal advice), PKF (audit of financial model), Scott Wilson Kirkpatrick (lenders' technical advisor), VST Comeco Rail Ltd (technical advice).

Amount Paid

As Tube Lines owed Tuberail £7 million for their unsuccessful bid for Infraco JNP, Metronet paid the £7 million they owed Tube Lines direct to Tuberail.

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