

**Report to Mayor Ken Livingstone regarding the Feasibility
of the PPP Structure as Currently Proposed**

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You have asked me, as Commissioner of Transport for London (TfL), to review the London Underground's proposed PPP for the underground railway system. You stated that you would be guided by the advice given, either withdrawing your expressed opposition if, after study, I were to conclude that it could provide a feasible means to effect the requisite capital improvements to the Underground and achieve the necessary enhancements in performance and service or, maintain opposition if that were my recommendation. Accordingly, my colleagues and I have carefully studied the information available to us regarding the PPP. We have been refused access to substantial material, mainly relating to the current negotiations between London Underground and the prospective bidders, on the ground that it is "proprietary". This has hampered our ability to provide a comprehensive analysis. However, on the basis of the information so far made available to me, I have concluded that the basic structure of the PPP is fatally flawed, that it is not an effective way to restore the London Underground to a state of good repair, and that it will not promote an improvement in the service being offered to Londoners. This conclusion reinforces the case for TfL, which will ultimately be responsible for all of London's transport system, being provided with all of the information required in order to evaluate fully the current version of PPP.

Background

Under LUL's PPP scheme, the twelve Underground lines are to be divided into three groups. New private consortia have been established ("Infracos"), primarily by traditional vendors to the Underground, to bid on long-term (30-year) contracts, which would shift to them all London Underground functions except for the actual operation of the trains and the staffing of the stations. London Underground staff are currently negotiating these contracts, which if completed will convey the infrastructure of the Underground to the consortia for 30 years.

The PPP's Performance Measurement

The key to the PPP scheme, as first reflected in the Invitation to Tender, is a series of performance and payment arrangements, which are intended to give the private consortia appropriate incentives to deliver good service to the Underground's customers. No one can quarrel with the goal of good service, but the PPP performance standards which determine the Infracos' incentive compensation are proposed to be measured against a level of service that is worse than the customers are getting today, a level most customers understandably find unacceptable. The Industrial Society has reported that under the PPP, if the Infracos deliver a level of service that is 5% worse than currently prevails, they will earn the full profit agreed in the contracts (that is, the Infrastructure Service Charge). If they achieve improvement above this low water mark, they receive bonuses. Only if service falls below this unacceptably low benchmark are the consortia, even in theory, penalised in any way.

But an even more disturbing flaw is that the PPP performance scheme shifts the emphasis away from what the Underground truly needs: the fundamental refurbishment of the neglected infrastructure. The thoroughgoing inventory of the state of the physical plant—the tunnels, track, signalling and stations that should have been the starting point of this exercise—simply does not exist. Meeting the PPP's criteria means rejecting the requisite long-term programme in favour of short-term measures that do not address what

must be the overriding objective of infrastructure reinvestment and renewal. It was precisely such a preference for quick fixes over responsible long-term solutions that helped produce the series of tragic circumstances now facing Railtrack and the rail network. When confronted with the devastating problems facing the rail network, Railtrack tried to justify its conduct by asserting it had met performance measurements in their contract similar to those established under the PPP. But they have been forced to recognise – as we must here – that achieving a reliable and *safe* system requires emphasis on less glamorous measures: the structure must be secure, the signals must work and the track must safely handle the trains. And to be sure, fixing the track and signals will disrupt service; but they must be done nonetheless. Under the PPP scheme, the consortia could be penalised for the service disruptions, rather than praised for making the long-term investments essential to the convenience and safety of the passengers. And even if a consortium decides to make appropriate investment in infrastructure renewal, the PPP scheme will lead to inevitable conflict between the consortium seeking to perform capital work and the LUL seeking to operate service. And it is simply impractical to think this conflict can be readily resolved by the PPP's default mechanism of arbitration.

The Monopolies Created Mean that the Public Will Pay an Artificially High Price

Proponents of the PPP scheme as now structured claim that the Infracos will carry out their functions properly because of the profit motive: the better their performance, the higher their fees. This sounds good in theory, but is simply wrong. What motivates private entities to perform well is *competition*, not the profit motive. In a true competitive environment, the desire to make a profit (the "profit motive") means that companies are forced to offer the best products or services at the lowest price. If they do not, their sales and profits will quickly erode. But after the award of the PPP contracts there will be no effective competition: each Infraco will be granted a 30-year monopoly over its portion of the underground system. *Without competition, the*

“profit motive” has just the opposite effect: since losing the sale will no longer be a risk, the desire to maximise profit will mean offering the least expensive product or service at the highest price. There is nothing in the PPP structure that will avoid this inevitable result of the monopoly position that is being granted.¹

The PPP contracts provide, at least theoretically, for renegotiation every seven and a half years. However, when the contract is back on the table seven years after initial contract award only the original Infraco will have the staff and management resources to maintain performance at whatever level is then being provided. Since neither TfL nor any other private entity will realistically be able to step in and replace the Infraco, the Infraco will likely be able to force TfL to accede to its demands. To be sure, the PPP scheme provides an arbiter to ensure the renegotiation is fair. But even the arbiter cannot force the Infraco to stay on the job, so that form of protection for the public, attractive in theory, is unlikely to work very effectively in practice.

Finally, there is the fact that the primary motivation of most consortium members is to create a captive market to sell their manufactured products, not to earn a return on their limited investment in the consortium. To our knowledge, none of the members have a meaningful equity stake. Thus, since the individual stakes of the consortia members are inconsequential, the financial performance of the consortia is correspondingly meaningless, particularly in comparison to the profits each member can make by selling products to his or other consortia. For example, if a consortium member can charge the consortium 10% over the market price on a £500 million contract, the fact that the consortium as a whole may make less money is relatively unimportant to them. They would much rather make the extra £50 million on their product (which they keep 100%) and give back a little in consortium losses. This opportunity can and likely will be replicated in the thousands of specialised materials required to be purchased to keep the trains running.

Inadequate Control over the Infracos

The proposed PPP contracts lack many of the basic protections invariably found in standard construction and equipment contracts in the public transportation sector. Instead, the Infracos are able to place the Underground in a “heads I win, tails you lose” situation. For example,

- An owner’s right to withhold funds in the event of material failure to perform is a critical contract management tool. But under the PPP, the right to withhold funds for poor performance appears to be initially limited to only 10% of the amount payable, until such time as an arbiter determines that a greater amount may be withheld (which could be years).
- An owner must be able to remedy serious mistakes by substituting a new contractor selected by the owner or by changing the programme entirely. Under the PPP, there is no such right. Instead, all TfL can do is ask an Infraco to sell its rights under the contract within 12 months, with the defaulting Infraco keeping any residual profit from the sale.
- When an owner like TfL is responsible for delivering an essential infrastructure service to the public, it is typically afforded the contractual right to change the programme to respond to unforeseen changes in circumstances. Thus, it must have the right to direct immediate changes to a contractor’s performance, or to terminate a contract notwithstanding the absence of default. These protections are not available to TfL. Instead, if TfL desires at any time during the 30-year term of the PPP to change performance requirements, it must propose those changes at least one year in advance; the Infraco will not be obligated to implement any such changes until its demands for more money have been agreed to or determined by an arbiter.

These are just a few examples of the way the PPP arrangements are weighted heavily in favour of the PPP and against TfL.² The Infracos are free to depart from their contractual obligations and still be advanced at least 90% of contract payments.

If their violations are so great that removal is the best remedy, the defaulting Infraco can remain in place for at least a year and retain whatever money it can make selling its interest, while the additional cost (not to mention service impairment) must be borne by the taxpayers and the fare paying passengers. And if it becomes clear that major changes to the capital programme are in the public interest, they must be presented to the Infracos a year in advance and cannot be implemented until agreement is reached on the extra amounts it will be paid.

In short, TfL lacks the basic tools typically afforded to public owners to influence and direct contractor performance. And since the Infracos can default and still be paid a guaranteed amount for at least some time, it is hard to see how they are assuming material risk. If the Infracos fail to bring the project in on time and on budget and require more money and time, TfL must either grant the demand and pay the additional money, or go through the cumbersome and expensive process of arbitration at the minimum, or, in the worst case, ousting the Infraco and completing the project. Either way, *virtually the entire financial risk is borne by the taxpayers and the passengers*. What will be the result if the Infracos fail to pay their lenders and cannot continue to function? We understand that the consortium members are not offering parent guarantees to secure their performance obligations, and there can be no effective TfL recourse against shell entities. Consequently, TfL will be forced to assume responsibility, and to spend what it takes to finish the job. Is this a transfer of risk?

No Mechanisms for Coordination

The last problem we will address is that of coordination. The twelve lines of the Underground system can and should form an integrated network. Indeed, one challenge for TfL is to improve the degree of integration, eliminating unnecessary duplication of effort. The PPP would chop up the network into three parts, based on the notion that somehow this will promote “competition”. Dividing up the system in such a manner will result in a variety of inefficiencies. For example,

– There are no uniform standards for Management Information Systems (MIS) or reporting obligations (although reporting approaches are to be mutually agreed-upon). Each Infraco would thus appear to be free to maintain its data in its own way, with its own proprietary system. TfL will have to develop the capacity to process information from each system, even if that means setting up three systems of its own. *But more than money is at stake*. In order to meet its safety responsibilities, TfL must be in a position to monitor carefully and consistently the information flowing from the Infracos about the infrastructure.

– Similarly, the PPP programme would in effect require each Infraco to develop its own training scheme for Underground personnel. The benefits of a uniform training system will thus not be available, and duplicative costs will likely be incurred and passed through to TfL.

– To the extent certain facilities such as track, communications, and stations are shared between lines, there is no assurance that work will be undertaken on a co-ordinated basis,³ or that the overall system integrity will be afforded necessary priority.

Conclusion

At the heart of the case for the PPP is the claim that “risk” would be transferred to the private sector. However, proponents are never entirely clear as to precisely what this means; *i.e.*, what risks are being transferred and how the transfer is accomplished.

Any assessment of risk transfer must begin with one inescapable reality: *the trains must run*. Without a functioning Tube, London itself cannot function. Thus, in a worst case scenario, the Government (or the GLA) will be forced to pay what is necessary to keep the system going. This overriding obligation to ensure service means that the entire risk can never be transferred. And when coupled with the absence of provisions for meaningful supervision or contractual enforcement of the Infracos by TfL, it means that the transfer of risk is largely illusory.

The consortia themselves have suggested to us that they have made no comprehensive assessment of the work required to restore the facilities to a state of good repair and that they have not been provided with such an assessment by the Underground. The Underground staff have confirmed that their internal assessments are inadequate. If neither party to the PPP negotiation has comprehensive information as to the actual existing state of the infrastructure nor the scope and schedule of the renewal work that will be required, how can they conceivably agree to any binding agreement to carry out the job at a specified price? Whatever the parties may claim to have agreed now, if conditions are not as expected, the consortia will be back for more money, more time, and then even more money. And because the trains must run, the Government will inevitably pay.

Moreover, it is perhaps not too surprising that the specific provisions of the proposed contracts with the Infracos are completely ineffective in achieving any of the principal stated purposes of the PPP arrangements:

- Because they provide for virtually no day-to-day supervision or regulation, *the PPP contracts are most unlikely to produce the performance necessary to restore the system to a state of good repair.*
- Because the Infracos are free to ignore the constraints of the contracts without risk of meaningful commercial consequence, *the PPP contracts are not effective in transferring the risk of performance failure to the private sector.*
- Because they stifle rather than promote competition, *the PPP contracts will not provide the claimed efficiency savings; they in fact will result in higher costs.*

As a new agency, TfL can benefit from careful review of the experience of other units of government, perhaps particularly in the area of sound working arrangements with the private sector. Indeed, TfL's capital programme relies heavily upon such relationships. But, simply put, there is nothing sound or workable about the

public/private relationship that the LUL's PPP would impose. If the PPP proceeds in its current form, TfL, as the owner and operator of the Underground would be unable to carry out its responsibility to provide a safe and efficient mass transport service. Can the PPP be salvaged? Of course. As we have repeatedly said, we firmly believe we can work in productive partnership with the private sector. But we need the opportunity to participate directly in establishing the terms of that partnership so that it achieves the long-term results that the stewardship of public assets requires.

Footnotes

¹ We wish to make clear that in describing our concerns, we do not mean to impugn the integrity of the Infracos or their shareholders. All of them are honourable business people. But every economic school of thought recognises that a monopolist, if unregulated and left to its own devices, will take all lawful measures to maximise its profits and will be constrained only by the desire to avoid the loss of its monopoly position.

² We can only speculate, but it seems likely that the Infracos must have claimed they needed such flexibility to satisfy potential lenders. The Underground negotiators must have believed that the Infracos' agreement in writing to act in a certain way was sufficient to insure they would do so, without meaningful enforcement mechanisms. It is not clear why other mechanisms normally used to satisfy lenders, such as parent company guarantees or infusions of equity capital, were not demanded by the negotiators. In its own contract negotiations, TfL will demand that vendors put forth substantial performance guarantees and agree to stringent enforcement provisions.

³ This is, of course, already a familiar problem to Londoners, who see the same streets dug up time and again by the same companies, each time installing a different type of cable or pipe. The absence of any central authority to coordinate such work is to blame.