SECOND INTERIM CONSULTATION REPORT BY TRANSPORT *FOR* LONDON

Transport *for* London's 21 March 2002 Interim Consultation Report, which was accompanied by a report on Value for Money prepared by Deloittes, explained at some length the basis for T*f*L's strong recommendation that the LT Board decline to proceed with PPP. The report also stated that should LT choose to proceed with PPP notwithstanding T*f*L's strong recommendation against it, certain specific changes to the transaction documents must be made before execution of share purchase agreements. Notwithstanding the apparently imminent vote as to whether to approve "commercial close" for the PPP transactions, LT has not asked a single question of T*f*L or otherwise responded to that Consultation Report.

T*f*L's 21 March 2002 recommendations are unchanged. This Second Interim Consultation Report addresses changes to the transaction documents that were presented to T*f*L on 22 March, 2002[1]. These changes, which still do not represent the "final" PPP contract terms, further erode the alleged value of PPP to the public sector and indeed, only demonstrate with even greater clarity the cost and risks to LUL should it proceed with the transaction.

Many of the changes disclosed to us by LUL on 22 March and addressed below were made to Schedule 1.9 to the PPP Contract documents, a document that LUL advised us on 11 February was in virtually its final form. The material changes disclosed to us six weeks later, on 22 March, demonstrate that advice to have been unrealistically optimistic.[2] Moreover, it is clear that key matters remain unresolved to this day, as this latest round of consultation involved not only incompletely revised key risk transfer provisions, but also repeated statements by LUL that the matters as to which we have inquired during this latest consultation period remain to be resolved and are subject to both more negotiation and future consultation.

In light of this state of affairs, it is impossible to understand the 7 February 2002 decision of the LT Board to proceed with PPP pending consultation on documents provided to T*f*L on 11 February. Moreover, given the unfinished state of key documents, the delay in modernisation of the Underground is clearly self-inflicted and cannot be attributed to anything other than the overwhelmingly complexity of the PPP contract documents.

[1] This Consultation Report is based on documents provided on 22 March 2002 and LUL's responses by 8 April 2002 to T*f*L inquiries.

[2] The changes to Schedule 1.9 between 7 February and 22 March were highly material and can be expected to have a significant effect on value for money.

1. <u>Given the state of the transaction documents, it is premature at this time to proceed to commercial close</u>

The Board of London Transport may soon vote as to whether to authorise LUL to enter into Share Purchase Agreements with the three private sector bidders, agreements that provide for the sale to the private sector of the three Infracos. This is referred to as "commercial close" of the PPP. It is premature and very risky to do so at this time[3].

Agreeing to commercial close will represent the most significant step the LT Board has yet to take towards implementing PPP. Once the Share Purchase Agreement is signed, LUL will have no choice but to proceed with the PPP unless certain conditions precedent to the transaction are not satisfied or waived in each of the three separate competitions.

Transport *for* London has not been provided with the final version of the Share Purchase Agreements, and thus has not been provided with an opportunity to provide its consultation input as to whether it is appropriate and in the public interest to enter into those Agreements.[4] The current state of drafting of this document leaves open very important questions, including the extent to which the private sector will be permitted unilaterally to waive conditions to final implementation of PPP, *conditions that were placed in the documents for the protection of LUL and the public*, such as proceeding with PPP before any necessary state aid clearance and other EU and governmental clearances have been obtained. Under no circumstances should the Board agree to proceed while there is any unilateral private sector right to waive conditions that protect the public.

Even if the documents are corrected in this regard, as they must be, so that only the public sector can waive conditions that affect the risk to it created by PPP, reasonable business judgment would still disallow approval of the Share Purchase Agreement and commercial close at this time. There are numerous matters that are critical to the very viability of LUL and the modernisation of the Underground that remain unsettled at this time. In response to T*f*L questions about these matters, LUL advised T*f*L on 4 April that these matters will be resolved between commercial close and financial close.

These matters include the circumstances under which the Lenders to the private sector will have the right to "put" the £4.3 billion in debt to LUL, <u>i.e</u>., apparently to

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[3] Proceeding to commercial close at this time is premature not only for the reasons stated in this section but, until a value for money report properly taking into account all transaction terms to date is prepared, would also be inconsistent with LT's historical position that it will not proceed unless Value for Money based on actual contract terms has been established. See TfL's 21 March Interim Consultation Report, including the accompanying report by Deloittes, as well as Section 4, below.

[4] LT's statutory consultation obligations require that TfL be provided with an opportunity to consult on the final terms of this document. It has not yet done so. On 9 April 2002 LT advised T*f*L that it intends shortly to initiate another round of consultation in respect of this document. It is unclear whether this new round of consultation will actually precede commercial close.

require that LUL pay off this £4.3 billion in full. This "put" right is nothing less than a guarantee by LUL of private sector debt, a guarantee which the Government is approving and standing behind by virtue of the Comfort Letter, the latest draft of which expressly refers to this "put agreement". Should the Government not honour the implied commitments of the Comfort Letters, then it is T*f*L that must foot the bill, by raising fares or depriving other modes of transport of much needed resources, or by looking to the Greater London Authority to raise London council taxes.. Proceeding to commercial close without having firmly established the parameters of this guarantee would be a very inappropriate course of action.

Similarly, the circumstances under which the Lenders will have the right to require the Infracos to repay their debt have not yet been settled. Exercise of these acceleration rights will likely lead to Infraco bankruptcy, which in turn will lead not only to enormous disruption in the modernisation programme but also to an LUL responsibility to hold the Lenders largely harmless, i.e., to the conversion of the over £4 billion contingent liability to a £4 billion accrued liability.

Further, the Share Purchase Agreement makes clear that the terms of virtually *all* of the PPP Transaction Documents can be changed before financial close. See for example the very definition of "Transaction Documents" in the Share Purchase Agreement, which (in new language inserted only in the most recent contract drafts) refers to the Transaction Documents "in the agreed form *or in their final form as agreed between LUL and the Purchaser prior to Completion*."

It is no answer to say that if these matters are not resolved in a manner satisfactory to LUL then the deal will simply not go forward, and that further consultation will take place with TfL as to these matters. It is widely recognised that failure to resolve critical and global transaction issues before taking a large step towards committing to that transaction is a very risky course that should be undertaken only with the utmost caution. This is particularly true in this PPP transaction, where many of the lenders have been involved in the transaction for years. If material business issues have not yet been capable of resolution, i.e., if the Lenders have not to date presented LUL with acceptable terms, there is no basis for assuming that they will yield simply because the time grows nigh for financial close.

Indeed, in this particular transaction, the opposite should be considered the more likely outcome of proceeding at this time. *LUL* will likely be the party to concede to adverse final terms, as evidenced by the history of this transaction, and especially the incredible and appalling erosion of risk transfer and increase in cost since preferred bidders were prematurely appointed. It is self-evident that what little remains of LUL's leverage will be further reduced after commercial close.

The reimbursement of bid costs will also no longer provide any incentive for the private sector, if it ever did, as the bid teams will be guaranteed reimbursement towards their bid costs once the Share Purchase Agreement has been signed.

Instead, should LUL proceed to commercial close leaving material issues unresolved, a failure to agree final terms will of course mean more time will elapse and investment in the modernisation of the Underground will be at risk of further delay. Because LUL's highest priority inevitably will be to get on with the modernisation programme, and because the public will have understood from the announcement of commercial close that PPP has been completed and thus will expect that the commencement of works is imminent, the pressure on LT to proceed to financial close will be enormous and will greatly outweigh the pressure on the private sector and the lenders to concede what they have thus far been unwilling to concede. Thus further *LUL* concessions, and *not* lender and private sector concessions, are the most likely scenario.

Reasonable business judgment demands that the LT Board not approve proceeding with commercial close unless all material business terms have been resolved to LT's satisfaction and the Transaction Documents have been finalised in all material respects, with a specific, agreed-upon list (disclosed to T*f*L) of any items that remain open for discussion. If the bidders and their lenders refuse to move forward until LUL has committed itself further to this transaction by approving commercial close, then the LT Board should recognise the obvious implications of such very clear writing on the wall and itself walk away from the transaction.

2. The very real possibility that LUL will be forced to buy out the Infracos on a lump sum basis that can exceed £5 billion represents an intolerable risk to the public sector

While it is imprudent to approve commercial close without final contract terms, the LT Board *is* in a position at this time to reconsider its 7 February decision as to the desirability of proceeding in light of the terms that *have* been agreed. As discussed in the 21 March Interim Consultation Report, scrutiny of the terms as they stood on 7 February provided no reasonable basis on which to conclude that PPP is an acceptable approach to modernising the Underground. Changes to the draft Contract documents underscore this conclusion.

A. *The £4 Billion Risk*. There are multiple scenarios under which LUL (and T*f*L through its Guarantee) will be obliged to pay off *in a lump sum* the bulk of the £4.3 billion private sector PPP debt and in many of those scenarios, far *more* than that £4.3 billion.[5] These can arise in the following circumstances, *among others*:

- Infraco default of its obligations to LUL
- Infraco default of its obligations to its lenders , obligations *which have not yet even been agreed*
- Infraco "inability" to put in place by a certain date finance for second period scope obligations, *even scope obligations known at this time and purportedly "required" by the Contracts*

[5] In referring to £4.3 billion, we are addressing *only* first period private sector debt. Should currently contemplated second period debt, for scope obligations currently stated in the contract, also be incurred, the aggregate debt which LUL may have to repay as a lump sum will be materially (more than 20%) higher.

- Infraco *refusal*, in certain circumstances, to proceed with the Contract in the Second Period
- Cost overruns and revenue abatements in the first period that are deemed "economic and efficient" (including by way of example, the cost of addressing latent defects) that require Infraco to obtain additional finance which it is "unable" to obtain
- The requirement for finance beyond first period finance (a virtual certainty), coupled with an inability to obtain full refinancing of first period finance

The complete list is lengthy, and we know of no presentation that has been made to the LT Board that sets out the full range of termination possibilities known to date[6], and what the cost to LUL might be under each scenario. The LT Board cannot possibly proceed with this transaction if a detailed presentation to this effect has not been made.

It is no answer to state that for some (but not even all) of these buy-out triggers, LUL will have the opportunity to reduce scope or provide debt or equity financing itself. First, the circumstances under which LUL can exercise the equity financing right "remain outstanding and will be dealt with" between commercial and financial close.[7] Thus it is not clear that this option has any viability.

Second, and more importantly, further scope reductions, *beyond what has already been eliminated or deferred for affordability reasons*, represent an appalling prospect. The Underground modernisation programme has already been decimated by scope reductions. Relying on further scope reductions to avoid acceleration of what can easily be a £5 billion liability shows the absurdity of the PPP contract arrangements. These arrangements *create* the multi-billion pound contingent liability. Under circumstances that are anything but remote, LUL can temporarily side-step acceleration of the liability only by giving up on modernising, and perhaps even giving up on maintaining, the Underground. And that is only to temporarily side-step the debt burden. LUL and T*f*L will always remain the guarantors of that debt.

The cost to LUL of these acceleration events can now be estimated with some assurance. Should LUL "simply" be responsible for the "95% Amount" (<u>i.e.</u>, should the acceleration event be <u>default</u> by the private sector) , then the cost of the guarantee at the 7 ½ year point will be approximately **£4.1 billion** <u>plus</u> accrued interest, fees, hedging costs, breakage costs <u>and</u> a gross-up for tax purposes.[8] And this amount is to be guaranteed by T*f*L and possibly by the Government to the extent required by the comfort letters.

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[6] As discussed above, additional circumstances requiring an LUL buyout are expected to be finalised between commercial and financial close. Thus a complete report on this subject would require update before financial close.
[7] LUL Response dated 4th April to Questions raised in email from T*f*L dated 2 April 2002.
[8] The estimated amounts for which LUL may be responsible stated in this paragraph and in the following two paragraphs assume that the private sector will draw on only about 50% of their stand-by debt facilities. The numbers will thus vary slightly depending on the extent to which the £430 million stand-by debt facilities (as reported by LUL) are actually used.

Should LUL be responsible at the end of the first period for what is referred to in the documents as "new for old" buyouts (triggered by Infraco "inability" to obtain second period finance for scope obligations identified in the documents now, or a simple refusal to proceed at Periodic or Extraordinary Reviews under various scenarios, including a scenario where the private sector believes it is headed for default), T*f*L now understands that LUL's liability will exceed approximately **£4.6 billion** plus accrued interest, fees, hedging costs, breakage costs less "one year's margin" on senior debt but *plus* various termination costs and other add-ons. And this amount is to be guaranteed by T*f*L and by the Government, again to the extent required by the comfort letters.

Should LUL be responsible for "new for new"[9] buyouts at the end of the first period (and this can be triggered by something as simple as the requirement for new finance for upgrading "gray" assets that are incapable of being identified now because LUL has failed to complete an asset review, coupled with Infraco inability to fully refinance the debt), liability can exceed £5.4 billion *plus* accrued interest, fees, hedging costs, breakage costs and various termination costs and other add-ons. This amount is to be guaranteed by T*f*L and by the Government to the extent required by the comfort letters.

Lastly, there is the "LUL Default Price", which is payable in many more circumstances than was the case when PPP was conceived. In this situation, the buyout price will be even higher than under the £5.4 billion "new for new" scenario. This higher amount is also to be guaranteed by T*f*L and by the Government to the extent required by the comfort letters.

Proceeding with PPP means assuming the risk that LUL may well have to release the Infracos from the deal, at enormous cost to LUL, T*f*L, and the taxpayer, simply because needed finance is not available (among other situations). *Any* finance beyond what is to be incurred to pay for scope in the first 7 ½ years, may trigger this requirement. Clearly PPP does not provide the assurance of long-term, stable finance, a basic premise of LT's 7 February decision to proceed with PPP. Instead, it provides LUL with a huge bill to pay should long term finance not materialise. At the minimum, the Infracos' right to exit the deal at enormous public cost adds greatly to the monopoly leverage that already exists at Review points.

B. *The Dilution of Incentives for Whole Life Asset Management*. As LUL has repeatedly stated, the incentive scheme for modernising the Underground using principles of whole life asset management, a central goal of PPP, is *dependent* on the bidders' belief that once the PPP contracts are signed, the bidders will be responsible for 30 years of maintenance costs. It is this long-term commitment that will provide an incentive for the Infracos to upgrade and renew the Underground, rather than to resort to patch and mend techniques. Yet, the private sector has numerous opportunities to be relieved of their obligations under the Contract, including in some cases if they simply elect not to proceed. If these rights are exercised, *the private sector will walk away virtually*

[9] "New for new" refers in part to new finance required for scope items added at Review, or payment for increased risk perceived in connection with the original scope.

unscathed, leaving LUL not only with the huge bill described above, but also with an even more urgent need to recover deferred Underground investment requirements.

Moreover, the Lenders will have as yet unspecified powers to require the transaction to be unwound, and also to be held harmless from the exercise of those powers.

Bidder participation in PPP for 30 years is nothing more than a hope, in light of the recent changes, and the anticipated future changes, to the transaction documents.[10]

These rights defeat the incentive to engage in whole life asset management. Thus, so long as the private interest termination rights introduced in the 8 February draft of contract documents, and costed out in the 22 March draft, survive, and so long as Lender rights to bring down PPP are broader than the original, limited termination events, and so long as each is accompanied by what is essentially a "hold harmless" clause for the party triggering the termination, then a second fundamental rationale for proceeding with PPP –achieving the modernisation of the Underground via principles of whole life asset management– cannot be relied upon as a basis to proceed.

3. Any Remaining Semblance of Risk Transfer has been Eviscerated by Last Minute Bidder Demands to which LUL has Acceded.

Transport *for* London's 21 March 2002 Consultation Report addressed in some detail the erosion of risk transfer since PPP was first conceived, which apparently accelerated greatly in the later stages of negotiations, presumably as it became apparent to the bidders that LUL's overriding priority was for contract terms to be "transactable" (i.e. to keep the Preferred Bidders in the deal). This included, among other things, the reduction of private sector cost overrun/revenue shortfall risk to £50 million from £200 million per 71/2 year period.

Perhaps anticipating the consternation that would inevitably accompany disclosure of these concessions, LUL began an attempt to recharacterise its intentions at tender, claiming that the primary risk that was being transferred was not intended to be cost overruns generally, but cost overruns attributable to project mismanagement by the Infracos. Transport *for* London's consultation report pointed out that this revisionist interpretation of history could not be reconciled with public statements on PPP. More importantly, T*f*L's report explained why proving project mismanagement would be a virtually impossible task, thus rendering even this degree of risk transfer meaningless[11]. First, shadow running did not involve testing the process of distinguishing between Economic and Efficient ("E&E") and non-E&E behaviour, so the LT Board can have no comfort based on experience that the basic framework is workable in practice. Next, LUL can have no confidence that it will ever be able to prove project mismanagement,

[10] As discussed in some detail in T*f*L's 21 March Consultation Report, in light of the private sector rights to terminate the arrangements, there is no justification for refusing to include a public interest termination right as repeatedly urged by Transport *for* London and recommended by Ernst & Young.
[11] See also the text of Mr. Kiley's address to the Board of London Transport, dated 8 April 2002, which provides additional support for this conclusion.

due to (1) the absence of project budgets and schedules, (2) Infraco control of information, (3) the highly amorphous boundary between the "economic and efficient" behaviour and its "opposite," (4) the loophole created by a definition that focusses on Infraco behaviour and not, for example, the behaviour of its affiliated subcontractors (leaving open the possibility that an affiliate can take the blame for mismanagement, with the result that LUL and not the Infraco will foot the resulting bill) , and (5) procedural mechanisms and scarce resources that will impair LUL's ability to prove non E&E behaviour.

For these reasons, even before T*f*L received revised contract documents on 22 March, T*f*L advised London Transport that it simply could not predict with any reasonable assurance that the Infracos would have responsibility even for their own non E&E behaviour.

As TfL further explained in its 21 March Consultation Report, the ambiguous boundary between E&E and non-E&E behaviour could easily give rise to the result that LUL would be responsible for cost overruns and payment abatements triggered by subcontractor default and failures of the technology selected by the private sector: "Thus, for example, the cost overruns caused by uneconomic and inefficient behaviour of the subcontractors selected by the Infracos (including subcontractors who may also be owners or affiliates of the Infracos) may well constitute *LUL's* risk so long as Infraco takes reasonable steps to mitigate those costs. Similarly, failures of technology selected by the Infracos to work as planned, and the cost fallout from those failures (a parallel situation to what caused a material part of overruns on the Jubilee Line Extension) may well turn out to be *LUL's* risk under PPP."[12]

The possibility that LUL might bear these risks has increased dramatically by virtue of further contract changes. Since the purportedly final 8 February contract documents, the private sector bidders have been busily ensuring that the risks they face for non E&E behaviour will be reduced even further, *and to make perfectly clear, in the case of one Infraco, that LUL is assuming the very risk of technology failure that PPP was designed to avoid.*

To this end, all three bid teams have succeeded in pre-empting LUL's ability to assert that certain very critical private sector courses of action are non-E&E.

One Infraco has succeeded in largely blocking any future questioning of its decision to pursue transmission based signalling (an unproven technology) for two of the three Tube lines for which it is responsible. This remarkable concession on LUL's part shifts back to LUL a material portion of the risk associated with a failure of that system. This is nothing less than LUL agreeing to retain a large portion of the types of risks and cost overruns it bore in connection with the Jubilee Line Extension *and retaining performance risk in connection with Infraco work.*

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[12] See T*f*L's 21 March Interim Consultation Report, at pg.11.

This is inconsistent with the claimed essence of PPP – Infraco responsibility for performance outcomes. The provision must be eliminated if there is to be any coherence whatsoever underlying a decision to proceed with PPP.

The other two bid teams have succeeded, in a two step offensive, in imposing a remarkably anti-competitive procurement scheme on LUL that may well result in LUL facing excess costs and a lack of technological improvement for years, even after Infraco termination. LUL is agreeing that a procurement strategy consisting of long-term supply contracts (of as long as 12 years) *on a pre-agreed pricing basis* for virtually all work to be done under PPP - the supply of new trains and signalling, the maintenance upgrading and renewals of civil assets, track renewal, and the maintenance, refurbishment and modernisation of stations-- *cannot later be challenged as non E&E*, apparently even if the pre-agreed pricing associated with those long term contracts proves to be disadvantageous to LUL. Moreover, the terms and conditions of contracts procured as part of the original bidding process are to be assumed to be economic and efficient.

These LUL concessions are exacerbated by an earlier concession obtained by these two bid teams, requiring that in most cases long-term supply contracts for rolling stock with the affiliates of these two bid teams *must be left in place* even if the Infraco has been terminated for its own default or otherwise. Throughout the long history of the PPP contract negotiations, LUL has always had the right to terminate Sponsor supply contracts if it was terminating the Infracos themselves. Now, some Sponsors have not only succeeded in making sure that long term supply contracts are acceptable, but that even if the Infraco they own is terminated, they will still have the benefit of those long term supply contracts with pre-agreed pricing. It is small wonder that some of the Sponsors have been publicly announcing that, in addition to the very high rates of return they will receive as owners of the Infracos, they stand to make millions from the work the Infracos will subcontract to them.

Approving long-term supply contracts for trains, signalling, and construction projects is nothing more than approving a monopoly for the Sponsors, and ensuring that LUL will bear the higher pricing and the impediments to technological advances that inevitably accompany monopolistic power. These provisions must be eliminated from the transaction documents to avoid this anti-competitive result. Should the provisions not be eliminated, at a minimum, T*f*L must review and approve the contracts before they are formally approved by LUL, as T*f*L will bear ultimate responsibility for the costs of these contracts.[13] *This is particularly imperative in the case of any rolling stock contracts that are to survive Infraco termination*.

4. Pre-requisites to Financial Close.

Section 1 of this Consultation Report addresses why it is premature to proceed to commercial close at this time. London Transport must also take steps to ensure that LUL

[13] As a general principle, T*f*L objects to the significant impingement on its contract administration authority created by these last minute limitations on what Infraco activities can be challenged at a Review.

cannot prematurely be forced into financial close, particularly if that close would result in an outcome inconsistent with enunciated LT policy.

A. Value for Money Analyses. First, as was shown by the Deloittes report on value for money, it is clear that any determination that PPP represents value for money at best turns on "Wider Factors", including most importantly the degree of risk transfer represented by PPP and the cost of the various termination rights negotiated by the private sector. For the reasons previously given by T*f*L, a revised value for money analysis is required even prior to commercial close, as (among other things) many risk transfer and termination related factors were not fully taken into account by the original Value for Money work that formed the basis for the Board's 7 February decision. Now, based on the 22nd March document revisions, there are additional material risk-related matters that must be considered as part of the equation, including the cost to LUL of contract termination and the risks presented by new provisions blessing transmission-based signalling and long-term supply contracts. The probability that LUL will bear costs not currently accounted for in the Value for Money Analysis must be considered and added to the Value For Money analyses.

Further, since it has now been revealed that the transaction documents are not yet finished, and that the risks to LUL may increase *further* based on truly final terms and based on the LUL-Lender Put Agreement (which TfL learned about only by reviewing the draft Comfort Letters the Secretary of State laid in the House of Lords), the LT Board must require that financial close also be preceded by a final value for money analysis. This non-waiveable right must be incorporated into the Share Purchase Agreement if LT wishes to be assured that value for money can indeed be found in the final contract terms. Failure to do so could lead to a situation in which LUL is contractually required to proceeds notwithstanding the absence of Value for Money even under LUL's flawed methodology.

B. Conditions Precedent to Financial Close. All conditions precedent to financial close, including EU merger approval and clearance of any state aid created by the PPP, must be waiveable *only* with the consent of LUL as well as the bidders.

C. Avoiding the Inadvertent "Mixed Solution". A new condition precedent to financial close must be added to the Share Purchase Agreement, requiring that all three transactions close simultaneously. To do otherwise may result in one Infraco satisfying the conditions to close, while others do not. This "mixed solution" has not been analysed in any detail (see Section 23.4 of LUL's Final Assessment Report) and has certainly not been subject to an LT request for consultation from T*f*L. Without a full analysis and discussion of the implications of such a result, including a full value for money and safety analysis as well as a detailed review of the practical implications of the mixed solution, the result must not inadvertently be imposed on London.