



The PPP Arbiter

Analytical approach to calculating ISC

Consultation draft

17 December 2009

Role and approach of the PPP Arbiter

The role of PPP Arbiter was created by the Greater London Authority Act 1999 (the GLA Act) to give guidance or directions on matters relating to the London Underground PPP Agreements. Although appointed by the Secretary of State for Transport, the Arbiter is independent of Government and of the Parties to the PPP Agreements.

In giving guidance or directions, the Arbiter is under a statutory duty to act in the way he considers best calculated to achieve four objectives:

- to ensure that London Underground has the opportunity to revise its requirements under the PPP Agreements if the proper price exceeds the resources available;
- to promote efficiency and economy in the provision, construction, renewal, or improvement and maintenance of the railway infrastructure;
- to ensure that if a rate of return is incorporated in a PPP Agreement, and taking into account matters specified in the Agreement, a company which is efficient and economic in its performance of the requirements in that PPP Agreement would earn that return; and
- to enable the Infracos to plan the future performance of the PPP Agreements with reasonable certainty.

The Arbiter is also under a duty to take account of any factors which are notified to him by both Parties to an Agreement, or are specified in the relevant PPP Agreement, as ones to which he must have regard.

Following consultation, the Arbiter has adopted the following aim for his work, and that of his Office:

The aim of the PPP Arbiter and his Office is to give sound and timely guidance and directions on relevant aspects of the PPP Agreements when this is requested, and to work constructively with the Parties to the PPP Agreements in support of their key objective of providing to the public a modern and reliable metro service in a safe, efficient and economic manner.

We seek to achieve this by:

- *working within a clear, transparent and consistent framework;*
- *giving reasoned guidance and directions which are based on well developed analysis shared with the Parties and procedures which achieve predictability in process and outcome;*
- *establishing effective dialogue with the PPP Parties and other stakeholders to facilitate timely response to requests for guidance or direction, while maintaining our independence; and*
- *operating to high standards of accountability in all our actions.*

Further information on the functions, duties and approach of the Arbiter can be found on the Arbiter's website <http://www.ppparbiter.org.uk>

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1 Introduction

- 1.1 In his March 2009 Analytical Approach to Periodic Review¹, the Arbiter stated that he would consult with Tube Lines and London Underground on his intended approach to calculating the Infrastructure Service Charge and publish a separate document setting out both his approach and his conclusions on key issues arising from this consultation. This document forms that which the Arbiter anticipated in his March 2009 Analytical Approach document.
- 1.2 The Arbiter's consultation with Tube Lines and London Underground, which preceded the production of this document, focused mainly on the interpretation of those parts of the contract which are relevant to the calculation of the Infrastructure Service Charge. There remain some areas where certain ambiguities in respect of interpretation remain. In this document, the Arbiter presents his interpretation in these areas, which is consistent with the approach he has adopted in his initial thoughts on ISC setting and financing ('initial thoughts') contained within his 17 December 2009 draft directions document ('draft directions').
- 1.3 Unless otherwise stated, any reference to 'paragraph' in this document refers to Schedule 1.9 of Tube Lines' PPP Agreement.

¹ See paragraph 5.2 of the Arbiter's Analytical Approach to Periodic Review, 2 March 2009, at: <http://www.ppparbiter.org.uk/output/page25.asp?DocTypeID=10>

2 Definition of Infrastructure Service Charge

- 2.1 In establishing an approach to calculating the Infrastructure Service Charge, it is important firstly to be clear of the definition of the Infrastructure Service Charge which the Arbiter intends to calculate. There are several relevant definitions included either in the Master Definitions Agreement ('MDA'), or in the contract, as follows:
- *Infrastructure Service Charge* – the MDA defines the Infrastructure Service Charge as the Baseline ISC for a Payment Period as adjusted by the matters in the relevant ISC Adjustment Statement.
 - *Baseline ISC* – the MDA defines the Baseline ISC as having the meaning given to it in Appendix 1 of Schedule 4.1. Appendix 1 defines the Baseline ISC as 'an amount equal to the Underlying ISC for such Payment Period after applying indexation'.
 - *Underlying ISC* – the MDA defines the Underlying ISC as having the meaning given to it in Appendix 1 of Schedule 4.1. Appendix 1 sets out the Underlying ISC in £ amounts, by semi-annual period, with effect from the Transfer Date.
 - *Performance Adjusted ISC* – the MDA defines the Performance Adjusted ISC as the Underlying ISC as adjusted in accordance with paragraph 1.2 of Schedule 4.1, which specifies that adjustments should be made for the Capability Adjustment, Availability Adjustment, Ambience Adjustment, Service Points Adjustment and Specific Projects Adjustment.
- 2.2 Paragraph 1.5(b) of the contract describes ISC requirements in the context of a matter referable to the Arbiter. This paragraph states that the ISC should be stated "in the form set out in Appendix 1 of Schedule 4.1" and that the ISC should be stated "in such amounts as to take into account that indexation will be applied to those amounts".
- 2.3 The Arbiter interprets paragraph 1.5(b) to mean that the ISC which he is required to calculate should be prior to any adjustment for performance amounts (as is the form of the ISC set out in Appendix 1 to Schedule 4.1) and that it should be prior to the effects of indexation (to take into account that indexation will be applied to these amounts when invoiced). Using the terminology in paragraph 2.1 above the output of the Arbiter's ISC calculation should be the Underlying ISC.
- 2.4 However, given the basis of the calculation to be performed the Arbiter considers that all inputs to his ISC calculation are to be expressed in nominal terms. Therefore, the Arbiter's first step in calculating the Underlying ISC will be to calculate the nominal ISC requirement which, by definition, includes projections of both general and differential inflation. Using the terminology referred to in paragraph 2.1 above, this means that the Arbiter will calculate the projected Baseline ISC, which he intends then to deflate, using his own projections of general inflation (ie RPIX), into Underlying ISC.

3 Approach to calculating Infrastructure Service Charge

- 3.1 Paragraph 1.5(b) states that the ISC to be paid by London Underground should be “on the basis set out in paragraph 7.4” and the Arbiter intends, therefore, to calculate the projected Baseline ISC requirements by applying an approach consistent with that described in paragraph 7.4.
- 3.2 More specifically, paragraph 7.4 states that the payment obligation to be assumed by London Underground should be such that “the negative cashflows (as directed pursuant to paragraph 1.5(a)) are funded by the positive cashflows (as directed pursuant to paragraph 1.5(a)) without the need to draw on other finance”. Therefore, the Arbiter intends to net off the sum of positive cashflows from the sum of negative cashflows to calculate the ISC amount to be included in his directions.
- 3.3 Paragraph 1.5(a) refers to cashflows which are “the best estimate of payment and receipt of each of the cashflows as referred to in paragraph 7”. Therefore, the negative and positive cashflows which the Arbiter intends to input to his projected Baseline ISC calculation are those set out in paragraph 7.2 and paragraph 7.3 of the contract respectively. The Arbiter’s interpretation of the cashflows identified in paragraphs 7.2 and 7.3 are described more fully in sections 4 and 5.
- 3.4 Paragraph 7.4 requires London Underground’s payment obligation to be determined for the period from the Review Date, or the date upon which Restated Terms take effect, up to the Expiry Date. Therefore, the Arbiter intends to calculate projected Baseline ISC for a period of up to 22½ years. He intends to express this ISC in semi-annual amounts as required by paragraph 1.5(b) for the first Review Period after the Review Date and in 7½ year totals for the remaining Review Periods.

4 Paragraph 7.2 negative cashflows definitions

- 4.1 The negative cashflows identified by paragraph 7.2 are as follows:
- paragraph 7.2(a) – Fixed Amounts;
 - paragraph 7.2(a/b) – Grey Assets operating and capital costs;
 - paragraph 7.2(b) – other operating and capital costs;
 - paragraph 7.2(c) – amounts to achieve equity rate of return;
 - paragraph 7.2(d) – amounts required to service new debt;
 - paragraph 7.2(e) – any payments agreed between the Parties; and
 - paragraph 7.2(f) – any uncompensated Net Adverse Effects.
- 4.2 The Arbitrator's interpretation of each of the negative cashflows identified by paragraph 7.2 and his intended source of these cashflows in calculating projected Baseline ISC are described in the remainder of section 4.

7.2(a) – Fixed Amounts

- 4.3 Fixed Amounts are the only set of inputs to the ISC calculation which are specified in the contract. These amounts, which can be found in Annex 3 to Schedule 1.9 (as amended by a Schedule 5.8 change agreed between the Parties since the issue of Restated Terms to reflect the impact of the refinancing) are broken down in the following way:
- Approved Debt principal repayment (Table 1.0);
 - Approved Debt interest payment (Table 1.0);
 - Approved Mezzanine Debt principal repayment (Table 2.0);
 - Approved Mezzanine Debt interest payment (Table 2.0);
 - Shareholder loan principal repayment (Table 3.0);
 - Shareholder loan interest payment (Table 3.0);
 - Dividends (Table 3.0); and
 - Tax paid (Table 3.0).
- 4.4 Fixed Amounts are expressed in nominal terms and can therefore be imported directly into the ISC calculation.
- 4.5 The only potential point of ambiguity is that of a mismatch between the ISC calculation periods, which include 3 month part periods at the start and end of each Review Period, and the semi-annual periods in which Fixed Amounts are specified in Annex 3 to Schedule 1.9. This misalignment of periods requires the Arbitrator to allocate Fixed Amounts to the 3 month part periods.
- 4.6 The funding agreements state that debt principal repayments are due on 31 March and 30 September each year. Therefore where there is a 3 month part period in the ISC calculation period, the Arbitrator intends to

assume that the full semi-annual repayment will fall in the part period which contains either 31 March or 30 September and that no repayment will fall in the other 3 month part period. This approach is consistent with that which Tube Lines has advised the Arbiter it is applying in its financial modelling.

- 4.7 The Arbiter intends to apply the same assumptions for allocating debt principal repayment Fixed Amounts to 3 month part periods to allocating interest payments on debt Fixed Amounts, Shareholder Fixed Amounts and Dividends to 3 month part periods. For Tax, the Arbiter will assume an equal split between the April to June and July to September and the October to December and January to March periods in allocating Tax Fixed Amounts. This approach is again consistent with that which Tube Lines has advised the Arbiter it is using in its financial modelling.

7.2(a/b) and 7.2(b) – Grey Assets and other operating and capital costs

- 4.8 The largest element of the relevant cashflows used to calculate ISC is the paragraph 7.2(a/b) and 7.2(b) cashflows which are ‘the operating and capital costs of the Notional Infraco in performing its activities after the Review Date.’ Reflecting the two stage process he has established for the current Periodic Review, the Arbiter intends to reflect his final directions on these costs in his draft directions on the level of ISC. Hence for the purposes of calculating the ISC the Arbiter will use the amounts he has previously directed for costs.
- 4.9 As with all other cashflows, all capital and operating cost inputs to the projected Baseline ISC calculation are intended to be in nominal terms and on a cash basis. The Arbiter’s intended approaches to calculating inflationary amounts and working capital requirements for his own cost estimates are described in sections 6 and 7.
- 4.10 The Arbiter notes that paragraph 7.2(b) specifies that the other operating and capital costs of a Notional Infraco should include:
- ‘commitment and arrangement fees...in respect of any liquidity and standby facilities....and.... the amounts of finance referred to in sub paragraphs (c) and (d)’ (of paragraph 7.2);
 - ‘such Taxation as arises as a direct result of a Qualifying Change of Law that is a Discriminatory Change in Tax Law’; and
 - ‘where...there has been an increase in risk...or that Eligible Finance is required...costs and fees associated with any termination or prepayment of existing finance...in addition to the costs and fees of putting new finance in place.’
- 4.11 In the particular circumstances of this Periodic Review, the Arbiter’s expectation is that the costs and terms, including fees, of any new finance raised at Periodic Review will be a matter on which he receives advice from the Financial Adviser of International Repute (‘FAIR’)..

7.2(c) – amounts to achieve equity rate of return

- 4.12 In the circumstances that any affordability gap is to be financed by Infraco raising Required Finance, the terms of that finance, including any

proportion to be raised as new equity, will be a matter on which the Arbiter will receive advice from the FAIR.

7.2(d) – amounts required to service new debt

4.13 In the circumstances that any affordability gap is to be financed by Infraco raising Required Finance, the terms of that finance, including any proportion to be raised as new debt, will be a matter on which the Arbiter will receive advice from the FAIR.

7.2(e) – any payments agreed between the Parties

4.14 Whilst the Arbiter has yet to be notified of any costs that fall within this category, for the purposes of estimating the affordability gap within his initial thoughts the Arbiter has included certain on-going finance related fees, including treasury fees, as if these amounts were an amount agreed between the Parties. The Arbiter asks that the Parties inform him as part of their representations on initial thoughts whether the amount of £18m which he has included is an amount which has been agreed between the Parties under this paragraph.

7.2(f) – any uncompensated Net Adverse Effects

4.15 For the purpose of estimating the affordability gap within initial thoughts, the Arbiter has not included any amount under this paragraph. However, as set out in chapter 6 of his draft directions, he considers that the total level of Net Adverse Effects for the Notional Infraco in RP1 would not be in excess of the Materiality Threshold.

5 Paragraph 7.3 positive cashflows definitions

5.1 The positive cashflows identified by paragraph 7.3 are as follows:

- paragraph 7.3(a) – drawdown of new finance;
- paragraph 7.3(b) – unused clause;
- paragraph 7.3(c) – payment by London Underground on contract expiry;
- paragraph 7.3(d) – amount related to delivery of line upgrades;
- paragraph 7.3(e) – extra income amounts agreed between Parties;
- paragraph 7.3(f) – effect of indexation; and
- paragraph 7.3(g) – 50% gain from any net gain from an equity sale.

5.2 The Arbitrator's interpretation of each of the positive cashflows identified by paragraph 7.3 and his intended source of these cashflows in calculating projected Baseline ISC are described in the remainder of section 5.

7.3(a) – drawdown of new finance

5.3 In the circumstances that any affordability gap is to be financed by Infraco raising Required Finance, the terms of that finance, including drawdown, will be a matter on which the Arbitrator will receive advice from the FAIR.

7.3(b) – unused clause

5.4 This clause is unused in the JNP PPP Agreement.

7.3(c) – payment by London Underground on contract expiry

5.5 The Arbitrator has not been notified of any amounts that fall within this category.

7.3(d) – amount related to delivery of line upgrades

5.6 Paragraph 7.3(d) specifies that this positive cashflow amount should reflect the amount of any increases to be made to the ISC in relation to the Delivery into Service of the Specified Line Upgrades with a Latest Implementation Date falling after the Review Date. Therefore, one interpretation of the definition of the amount to be captured by paragraph 7.3(d) is that which relates only to the uplift in ISC in respect of increases in performance payments attributable directly to the completion of certain line upgrades, thereby excluding those revenue amounts which relate to line upgrades completed in the first Review Period as well as any other performance related payment.

5.7 However, the Arbitrator intends to take a purposive approach to interpreting this part of the contract. His view is that by excluding revenues from line upgrades completed prior to the Review Date and other likely performance payment amounts within the calculation of ISC, there is a risk that the Notional Infraco will be paid twice by virtue of it receiving contractually derived revenue associated with improved performance

levels as well as the Baseline ISC determined by netting of costs and revenues following a non-purposive interpretation of this provision. Therefore, to avoid a Notional Infraco potentially earning in excess of its agreed rate of return due to this drafting, the Arbiter intends to include within his ISC calculation all performance revenue that he considers that a Notional Infraco would receive consistent with the analysis contained within the draft directions.

- 5.8 The Arbiter notes the position agreed by the Parties which amends certain contractual performance benchmarks and thresholds in a way that is intended to reduce the amount of performance payments for the assumed levels of performance. The Arbiter's approach to assessing the performance revenues of a Notional Infraco is set out in his draft directions.
- 5.9 Furthermore, the Arbiter notes that London Underground has included certain performance revenues in setting its Affordability Constraints. Given his purposive interpretation of this cashflow paragraph, the Arbiter will consider London Underground's treatment of performance when setting its Affordability Constraint when setting the level of ISC. Section 8 describes in more detail the Arbiter's approach to the Affordability Constraints and the ISC Profile.

7.3(e) – any extra income amounts agreed between parties

- 5.10 The Arbiter has not been notified of any amounts that fall within this category.

7.3(f) – effect of indexation

- 5.11 Paragraph 7.3(f) allows for 'the effect of indexation pursuant to Schedule 4.2 (Indexation)' as a separate positive cashflow. As indicated throughout this document, however, the Arbiter intends to undertake the calculation of ISC in nominal terms and to deflate the calculated projected Baseline ISC into a price base which is consistent with that assumed in Schedule 4.2 for the purpose of applying indexation.
- 5.12 The Arbiter considers that the magnitude of the amount by which it is necessary to deflate projected Baseline ISC can be calculated only once the projected Baseline ISC requirements have been established, hence the effect of indexation is an output of the process rather than an input.

7.3(g) – 50% gain from any net gain from an equity sale

- 5.13 The Arbiter has not been notified of any amounts that fall within this category.

6 Approach to calculating indexation

- 6.1 As indicated above, the Arbiter intends that all inputs to his projected Baseline ISC calculation be expressed in nominal terms.
- 6.2 The Arbiter's cashflow inputs, as described above, will include an inflationary amount which reflects his inflationary expectations in respect of both general inflation (for which the PPP Agreement uses RPIX) and, where relevant, differential inflation. In establishing RPIX projections, the Arbiter intends to adopt those RPIX projections developed by his economic advisers for the purpose of calculating differential inflation. These estimates have been developed by referencing well established inflationary forecasts and expert advice, consistent with the approach which the Arbiter described in his March 2009 Analytical Approach.
- 6.3 The Arbiter intends that his nominal cost and revenue inputs will reflect inflationary expectations which are applied on a semi-annual basis, assuming end of period cashflows. The Arbiter will, however, deflate his projected Baseline ISC in accordance with Schedule 4.2, which requires that indexation is applied annually.
- 6.4 The Arbiter notes that paragraph 1.5(d) of Schedule 1.9 refers to the Arbiter's RPIX assumptions and requires him to provide "a statement of the value of RPIX applicable to the relevant Contract Year which has been used to state the ISC". Although not relevant to the Arbiter's draft cost directions, a statement in the form that he would propose to include in his ISC draft and final directions is included in a technical note which supports the Arbiter's draft cost directions. The Arbiter's RPIX projections differ to the Parties' corresponding respective projections.
- 6.5 In the Restated Terms version of Schedule 4.2, the form of ISC to which inflation shall be applied is to be in February 2010 prices, which is assumed by paragraph 10.2(a) of the Schedule 4.2 to include inflation for the whole of the 2010 financial year. Furthermore, Schedule 4.2 specifies that Fixed Amounts should be indexed separately from other Underlying ISC amounts. The Arbiter will take these provisions in to account when expressing the calculated ISC in real terms.
- 6.6 The Arbiter is aware that discussions between the Parties in respect of replacing the existing Schedule 4.2 indexation mechanism with an alternative mechanism are on-going. In particular, the Arbiter understands that the Parties intend to make a change to Schedule 4.2 of the contract to remove Fixed Amounts from the scope of indexation. If an alternative approach is adopted, the Arbiter's approach to deflating the projected Baseline ISC will be adjusted accordingly.

7 Approach to calculating working capital

- 7.1 As indicated above, the Arbiter intends that all inputs to his projected Baseline ISC calculation be expressed in cash terms. This requires a net working capital adjustment to be included for operating and capital cost cashflow inputs and for performance revenue cashflow inputs.
- 7.2 One option available to the Arbiter is for him to calculate the working capital allowance at a level of granularity which is consistent with cost types which are identifiable in the Data Breakdown Structure i.e. operating costs, capital costs and central costs. In practice, this means that the Arbiter would apply a creditor days assumption which represents the lag between costs being incurred and payments being made by a Notional Infraco to its creditors in respect of these costs.
- 7.3 The Arbiter could then apply separate assumptions in respect of specific types of capex, for example in respect of a Notional Infraco's signalling sub-contracts for line upgrades, which may be based on a series of milestone payments.
- 7.4 For performance related revenues, a net working capital adjustment may also need to be applied. The Arbiter might calculate this working capital allowance by applying a debtor days assumption which represents the lag between performance revenue being due and payments being made to a Notional Infraco by its debtors (i.e. London Underground).
- 7.5 For the purpose of assessing the affordability position within initial thoughts, the Arbiter's assumption is that these working capital adjustments net out over a Review Period and hence the cost inputs to the affordability calculation included in initial thoughts are equivalent to cash inputs such that no additional working capital allowance need be made.

8 Calculation process

- 8.1 As indicated above, the Arbiter intends to calculate projected Baseline ISC for each semi-annual period, by netting off the sum of the positive paragraph 7.2 cashflows from the sum of the negative paragraph 7.3 cashflows following the Arbiter's purposive approach to the treatment of performance revenues as described above.
- 8.2 Paragraph 7.4 of the contract obliges the Arbiter to calculate ISC that is "in accordance with the profile for payments that LUL has stated pursuant to paragraphs 2.2 and 4.2...". Paragraphs 2.2 and 2.4 relate to the profile of payments included in London Underground's Restated Terms Notice dated 8 December 2008. Paragraph 7.4 makes no reference to the Affordability Constraints also set out in London Underground's Periodic Review Notice.
- 8.3 Therefore, once the Arbiter has deflated the projected Baseline ISC into a form which takes into account indexation to be applied under Schedule 4.2 (i.e. into the Underlying ISC requirements), the Arbiter will need to compare the profile produced to the profile of payments (the ISC Profile) included in the Restated Terms Notice.
- 8.4 Having considered representations made by the Parties to his issues paper of 14 October 2009, the Arbiter remains of the view that nothing in Schedule 1.9 obliges him to set a level of Baseline ISC that is no higher than the Affordability Constraint, as he is referred to profile rather than quantum.
- 8.5 The Arbiter will only decide on the quantum of ISC once he has considered the Parties' representations on affordability and financing issues set out in initial thoughts.
- 8.6 The Arbiter notes that ISC Profile set out in London Underground's Restated Terms Notice is expressed in February 2008 prices whilst his projected Baseline ISC will be in February 2010 prices. The Arbiter intends to address this by inflating the ISC Profile to February 2010 prices using his understanding of London Underground's inflation assumptions to preserve the consistency with London Underground's Affordability Constraint.
- 8.7 Within initial thoughts the Arbiter estimated the affordability gap by comparing the relevant cashflows identified in the draft directions to the nominal Affordability Constraint in order to enable the Parties to make representations on affordability and financing issues.

9 Credit rating

- 9.1 The Arbiter notes that paragraph 6.3 of Schedule 1.9 states that the Parties attach 'great weight' to the Arbiter having regard to 'the desirability ... of Infraco having a credit rating at the end of a Periodic Review not less than the lower of its credit rating at the Transfer Date, and its credit rating immediately before the Review Process...'. Furthermore, he notes that paragraph 6.3(a) states that the quality and quantity of information available to the Arbiter may be 'greater than that available to the ratings agencies'.
- 9.2 In the course of consultation with the Parties, it has been indicated to the Arbiter that it is considered important that he has regard to paragraph 6.3 in setting the ISC. However, the Arbiter is of the view that nothing within paragraphs 7.2 to 7.4 allows him to have regard to either paragraph 6.3 or to the credit rating itself in setting ISC. He does not, therefore, consider it appropriate for him to have regard to the Infraco credit rating in calculating the ISC.
- 9.3 Instead, the Arbiter is of the view that paragraph 6.3 of the contract is applicable when he is setting the level of costs and the financeable level and terms of Base and Eligible Finance. The Arbiter considers that the manner in which costs and risks are determined has the potential to impact on the credit rating and it is in this area that he intends to consider his directions in light of the Parties' concerns on credit rating.

10 Cover ratios

- 10.1 The Arbiter notes that cover ratios are referred to in paragraph 2.2(f) of Schedule 1.9, which states that the Restated Terms should 'in stipulating any payment profile for the ISC with effect from the Review Date, have due regard to doing so in a way that would enable a Notional Infraco to maintain its cover ratios'. However, the Arbiter is of the view that nothing within paragraphs 7.2 to 7.4 requires him to have regard to the requirement to preserve cover ratios in calculating ISC.
- 10.2 It is not the Arbiter's intention to consider directly the extent to which the ISC profile preserves cover ratios in calculating ISC. However, cover ratios will be affected indirectly by the terms of any Required Finance and particularly by whether any Base or Eligible Equity is subscribed. Furthermore, the Arbiter will need to give indirect consideration to preserving cover ratios in his consideration of Infraco's credit rating in the setting of the level of costs and the financeable level and terms of Base and Eligible Finance.