

# Office of the PPP Arbiter

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## **Announcement 10/06**

**20 December 2006**

### **Metronet request for guidance on the treatment of investment at an Extraordinary Review: issues paper**

As part of his analysis to underpin guidance on the references made by Metronet on 13 November, the Arbiter has identified a number of issues concerning the general principles he might adopt in carrying out an Extraordinary Review. These are set out in the attached paper.

The Arbiter has not reached a view on any of these issues, and may identify further issues as work on the references proceeds. He has invited representations from the Parties to the references (Metronet, London Underground and Tube Lines) by noon on 19 January. In accordance with the timetable published on 1 December, he proposes to issue his draft guidance to the Parties on 29 January.

## **Announcement ends**

Doc 21307-v1

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One Kemble Street London WC2B 4AN

Tel: 020 7282 2170 Fax: 020 7282 2180 Email: [enquiries@ppparbiter.org.uk](mailto:enquiries@ppparbiter.org.uk)

[www.ppparbiter.org.uk](http://www.ppparbiter.org.uk)

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## Notes

- 1 The role of PPP Arbiter was created by the Greater London Authority Act 1999, which establishes his functions and duties. When requested by one or both of the Parties, the Arbiter determines disputes on the key commercial aspects of the PPP Agreement, in particular at the 7½ year Periodic Reviews, and gives guidance on any aspect of the Agreements. He is able to require the Parties to provide information and to carry out inspections, consult appropriate parties and do what he considers appropriate to prepare for giving directions or guidance.
- 2 Further details of the role of Arbiter are at [www.ppparbiter.org.uk](http://www.ppparbiter.org.uk).

## Enquiries

Office of the PPP Arbiter  
One Kemble Street  
London  
WC2B 4AN

020 7282 2170

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## Issues Paper

### 1 Context

- 1.1 Metronet made two references for guidance to the Arbiter on 13 November 2006. The references relate to:

"the treatment at an Extraordinary Review of the investments outlined below in terms of the proportion of costs which would be considered as being incurred by that Infraco in performing the Infraco Obligations during the first Review Period in an overall efficient and economic manner and in accordance with Good Industry Practice with regard to the extent applicable to the characteristics of a Notional Infraco.

#### **Metronet Rail BCV**

Central Line Heavy Overhaul  
Victoria Line Upgrade Low Loss Conductor Rail  
Victoria Line Upgrade Enabling Works

#### **Metronet SSL**

Track Improvement Programme  
Earls Court Station Phase II works  
Baker Street Station Modernisation  
Rail Buckling Recovery Programme."

- 1.2 In his Initial Guidance<sup>1</sup>, the Arbiter noted that Metronet's intention in submitting these references was to provide its Board with "some assurance about the extent to which Metronet's projected costs for the first Review Period might be regarded as consistent with an Infraco performing its activities in accordance with Good Industry Practice (GIP), and thus in principle eligible for remuneration through any potential future Extraordinary Review." The Initial Guidance goes on to note that the references do not require the Arbiter's guidance on the quantum of Net Adverse Effects (as would be required in the context of an Extraordinary Review) and to indicate that the Arbiter considers that, to meet the objective set out by Metronet, his guidance must cover broader issues and principles relevant to Extraordinary Review such as the application of the characteristics of the Notional Infraco.
- 1.3 This paper reviews the key issues which the Arbiter considers will be relevant to his final guidance, as a basis for representations from the Parties<sup>2</sup>. It sets out the Arbiter's initial views on contract interpretation in relation to Extraordinary Review and the application of the joint guidance given to him by the Parties<sup>3</sup>, the analysis he would be minded to adopt at any future Extraordinary Review and, in the light of that, his information requirements.
- 1.4 The paper follows the proposed approach set out in the Arbiter's initial guidance:

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<sup>1</sup> "Treatment of investment at an Extraordinary Review: Initial Guidance" (doc #20806-v2) published on 1 December 2006

<sup>2</sup> The Parties are Metronet BCV, Metronet SSL and London Underground as Referring Parties and Tube Lines as a Third Party.

<sup>3</sup> This is contained in Annex 2 to Schedule 1.9 of the PPP Agreements.

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- **Stage one** – contractual interpretation: reiteration of the contractual position on bid omissions; further consideration of the application of Notional Infraco characteristics
  - **Stage two** – review of scope: development of principles for determining whether the proposed scope of works is an appropriate way of delivering Infraco Obligations in an overall efficient and economic manner and in accordance with Good Industry Practice with regard to the extent applicable to a Notional Infraco; application of those principles to the seven specified investments
  - **Stage three** – assessment of allowable expenditure: development of principles for assessing future costs and principles for reviewing past costs (if different); application of those principles to the seven specified investments; specification of information requirements for Extraordinary Review and Periodic Review.
- 1.5 Although each Party is free to make representations on any matter relating to these references, the Arbitrator particularly invites responses to the questions set out in this paper and summarised in section 5.

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## 2 Stage 1: Contract Interpretation and Notional Infraco characteristics

### (a) *Treatment of bid omissions and inheritance*

- 2.1 The PPP Agreements provide for the Parties to make references to the Arbitrator for directions in respect of an Extraordinary Review in one of three circumstances:
- by London Underground if it suffers a substantial shortfall in the performance of the services which an Infraco is required to perform under its PPP Agreement and which it is unable to cause the Infraco to remedy;
  - by London Underground if a Law Change makes it impossible for an Infraco to perform a material part of its obligations under the PPP Agreement; or
  - by an Infraco if it reasonably considers that it has suffered or will suffer cost increases or revenue shortfalls in a 7½ year Review Period above a Materiality Threshold level that an efficient and economic Infraco operating in accordance with Good Industry Practice would not have avoided (or Net Adverse Effects)<sup>4</sup>.
- 2.2 The Arbitrator published in July 2004, as part of his Procedural Framework, a Procedural Approach to Extraordinary Review. The following section draws on that document.
- 2.3 The intention of an Extraordinary Review is to ensure that an Infraco has sufficient finance to carry out its obligation under the relevant PPP Agreement until the next Periodic Review, at which point the PPP Agreement is 'rebased' in a way that should enable a well managed Infraco to earn its agreed equity rate of return going forward. At an Extraordinary Review, the Infrastructure Service Charge (ISC) profile is adjusted so that the Infraco avoids the need to finance any Net Adverse Effects in excess of the Materiality Threshold over the remainder of that Review Period. To ensure that London Underground is able to afford the revised ISC, provisions exist to enable London Underground to de-scope obligations in the PPP Agreement. The cost consequences of de-scoping also form part of the Extraordinary Review process.
- 2.4 At an Extraordinary Review, the Arbitrator is required to review the total expected costs and revenues of an Infraco over a 7½ year Review Period. The relevant contractual concepts and definitions are:
- **Expected Costs and Revenues:** the amounts included within the Baseline for Net Adverse Effects which, for the first Review Period, is set out in Annex 5 of Schedule 1.9 of the PPP Agreement;
  - **Eligible Costs and Eligible ISC:** for costs, the lower of actual costs incurred or expected to be incurred and the costs that "would be incurred in performing the Infraco Obligations during the Review Period in an overall efficient and economic manner and in accordance with Good Industry Practice with regard to the extent applicable to the characteristics of a Notional Infraco", with analogous provisions for Eligible ISC;

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<sup>4</sup> The Materiality Threshold level is generally £50m per Review Period (in April 2002 prices) for Metronet but is £200m for Tube Lines in the first Review Period.

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- **Qualifying Costs and Revenues:** the difference between Eligible and Expected Costs (and analogously for ISC); and
  - **Net Adverse Effects:** the sum of Qualifying Costs and Qualifying Revenues.
- 2.5 In his Annual Metronet Report 2006, the Arbiter noted that Metronet has classified a significant part of the cost variances identified in the remainder of this Review Period as bid omissions, or attributes them to the effects of the asset inheritance being different from that expected at the time of the bid. The Arbiter's understanding of the contract provisions as set out above is that they provide for additional costs to be remunerated, in excess of the contractual Materiality Threshold to the extent that they constitute Eligible Costs, irrespective of what was provided for in the bid. So the relevant question in respect of projected future costs and revenues is whether they are consistent with operating in an overall efficient and economic manner and in accordance with Good Industry Practice with regard to the extent applicable to the characteristics of a Notional Infraco, not whether they were included in the bid (or whether the bid under-estimated those costs).
- 2.6 Notwithstanding this, the Parties' joint guidance to the Arbiter indicates<sup>5</sup> that he is to have regard to the "Infraco's costs, budgets and programmes of activities proposed as part of the original bidding process". The Arbiter considers that this means that he may refer to these data in giving any guidance or directions. For example, the level of disaggregation at which bids were prepared and the categories of cost used in bidding are potentially relevant to his consideration of the approach that a Notional Infraco might take in re-pricing its obligations at a Review, and therefore to the submission requirements for an Extraordinary Review.
- (b) Notional Infraco characteristics**
- 2.7 The characteristics of a Notional Infraco are the relevant basis for reaching conclusions on the costs and revenues of the actual Infraco at an Extraordinary Review<sup>6</sup>. The Notional Infraco is defined as carrying out its activities in an overall efficient and economic manner and in accordance with Good Industry Practice and, in addition, having various characteristics some of which are discussed further below<sup>7</sup>.

***Characteristic (a): "by the time of any Periodic Review, [the Notional Infraco] has performed the activities that an efficient and economic Infraco would have performed in prior Review Periods so as to be***

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<sup>5</sup> Paragraph 8.2(x) of the joint guidance.

<sup>6</sup> This contrasts with the annual Metronet Report, where the concept of the Notional Infraco is not directly engaged. The key differences are that the Notional Infraco is defined to have the same contractual obligations to Third Parties and the same financing arrangements as the actual Infraco.

<sup>7</sup> The characteristics considered here are a subset of the overall characteristics identified in the PPP Agreement, and are the ones that the Arbiter considers relevant in the context of an Extraordinary Review. Characteristic (b) repeats the wording for characteristic (a) but in respect of the next Review Period, and for the purposes of this paper it is considered within characteristic (a). Characteristic (d) relates to funding arrangements and is not considered here as this is not relevant to Extraordinary Review.

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***reasonably certain of its ability to perform obligations that are due for performance in that and subsequent Review Periods.”***

- 2.8 The Arbiter would expect that the Asset Management Strategy (AMS) and Annual Asset Management Plan (AAMP)<sup>8</sup>, produced by the Infracos as a requirement of Schedule 3 of the PPP Agreements, would be key documents for setting out an Infraco’s expected expenditure programme and for explaining how this reconciles with the expectations of a Notional Infraco in terms of whole-life planning. In particular, he would expect to see evidence that the Board of the Infraco had accepted the AMS as a basis for the Infraco’s activities and had reviewed and signed off the assumptions underlying each AAMP in terms both of the scope of work and the costs expected to be incurred. Accordingly, he would expect to review both the methodology for developing the AAMP and the assumptions underpinning it as part of any Extraordinary Review.
- 2.9 **Question 1: do the Parties agree that the AMS and AAMP should be key documents in any Extraordinary Review, and that it is appropriate for the Arbiter to review the basis on which the Infraco’s Board has signed off those documents?**
- 2.10 The AAMP does not cover revenue projections, although the Arbiter would expect to see a clear audit trail between the performance implications of the AAMP programme and projections of performance bonuses and abatements compared with bid assumptions.
- 2.11 In the context of planning, the Arbiter also considers that the Notional Infraco would not start its delivery of the contract from a zero knowledge base at the time of Transfer. Rather, the Notional Infraco would have carried out sufficient due diligence and preparation to ensure that it could introduce any necessary changes to policies and organisation from day one. Indeed, the actual Infracos have given an undertaking in clause 52.2 of the PPP Agreements which deems them to have full knowledge of any matters which would be revealed by an investigation, inspection and/or survey (whether or not made) which a Notional Infraco would have undertaken.
- 2.12 The Arbiter accepts that this does not mean that a Notional Infraco would achieve good practice in all areas of activity from day one. The Arbiter considers that there would be a period after Transfer, the duration of which would vary according to the position inherited, during which the Notional Infraco would not necessarily achieve good practice by comparison with other well-established companies carrying out similar asst management activities. Nonetheless, a Notional Infraco could in the view of the Arbiter be expected to have in place at the Transfer Date a plan to address its inheritance, and would begin immediately addressing the shortfall in performance taking a prioritised approach.
- 2.13 The PPP Agreements are not explicit as to the glidepath which a Notional Infraco might expect to experience in moving to Good Industry Practice, although the joint guidance to the Arbiter is for him to make allowance for uneconomic and inefficient pre-Transfer working practices and undischarged pre-Transfer liabilities not specifically dealt with under the Share Purchase Agreement<sup>9</sup>. In his annual Metronet Report 2006, the Arbiter recognised that

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<sup>8</sup> These are supplemented by the Asset Group Strategies, which are likely to be particularly relevant in the assessment of individual expenditure programmes.

<sup>9</sup> Paragraph 8.3 of the joint guidance.

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the full benefits of improvements in asset and risk management processes would take some time to feed through to actual performance.

- 2.14 **Question 2: do the Parties have further evidence they wish to draw to the Arbiter's attention in respect of the speed with which a Notional Infraco might be expected to introduce changes in processes and organisation following Transfer, and on the period required for such changes to feed through into improvements in costs and performance?**

***Characteristic (c): "[the Notional Infraco] has the same contractual commitments to third parties as Infraco actually has to the extent that these relate to (i) performance of the Infraco Obligations; or (ii) performance of obligations that LUL modifies or discontinues through the Restated Terms, and, in either case, such contractual commitments are consistent with Infraco performing its obligations in an overall efficient and economic manner and in accordance with Good Industry Practice;"***

- 2.15 The issues raised here are particularly relevant to Metronet given the comments that the Arbiter made about the form of certain of its supply chain contracts and its management of them in his Annual Metronet Report 2006. Understanding Metronet's emerging approach to renegotiating these contracts and to its management of them will be an important issue in any Extraordinary Review of the Metronet PPP Agreements.

***Characteristic (e): "[the Notional Infraco] assesses operating and capital costs as it would when entering into a contract after a competitive tendering process in respect of the relevant activities and having regard to: (x) the risks associated with individual activities (including the risk of cost overruns and ISC Adjustments); (y) the risk that it may have to undertake activities which it has not expected to have to carry out; and (z) the probability that in the management of a portfolio of activities, the actual cost of some individual activities will exceed the costs allowed, and the actual cost of other individual activities will be less than the costs allowed;"***

- 2.16 The Arbiter considers that the interpretation of this characteristic is of particular importance in determining the appropriate basis for assessing Notional Infraco costs at any Extraordinary Review, in particular in terms of the appropriate allowance for risk. His provisional interpretation of these provisions is as set out below.
- 2.17 At an Extraordinary Review, the Arbiter would expect Notional Infraco cost projections to represent the out-turn cost that would be achieved by a company which was overall efficient and economic and operating in accordance with Good Industry Practice, which would accordingly include a provision for 'programme' risk. This provision would assume good practice in risk management, and take account of the expectation identified in characteristic (e) that a programme of the size represented by the PPP would demonstrate a mix of adverse and positive variances compared with initial expectations.
- 2.18 However, he would not expect cost estimates to contain any provision for unspecified risks (eg arising from a catastrophic event) which would not be avoided by a Notional Infraco. The Arbiter notes that the "risk that a Notional Infraco may have to undertake activities which it has not expected to have to carry out" is capped by the Materiality Threshold (given that the resulting costs are likely to qualify as Net Adverse Effects). He therefore considers that, both at any Extraordinary Review and at Periodic Reviews, there should be no additional unspecified contingency provision to reflect such risks.

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- 2.19 This approach is, in the Arbiter's view, consistent with the joint guidance to him<sup>10</sup> to determine ISC "on the basis consistent with the pricing that would be agreed by a Notional Infraco in a competitive tender in respect of the activities covered by the PPP Agreement".
- 2.20 The Arbiter considers that it is important that an Extraordinary Review does not change the intended balance of risk between the Parties (except where this is agreed between them), and that there continue to be effective incentives on an Infraco to out-perform the Notional Infraco standard during the remainder of the Review Period. It would, in his view, be undesirable for the Extraordinary Review outcome to change the operation of the PPP Agreement towards cost recovery, rather than incentive payments which reflect the efficient expected costs of delivering outputs.
- 2.21 Accordingly, if costs turn out higher than determined by the Arbiter at an Extraordinary Review (or Periodic Review), the Arbiter considers that the burden of proof should be on the Infraco to demonstrate that this was not simply the result of its failure to manage risk properly at the programme level (and to get the expected benefit of positive and adverse variances across its overall programme). If, on the other hand, costs turn out lower than determined by the Arbiter at an Extraordinary Review, he considers that presumption should be that this is the result of outperformance and that savings should not automatically be clawed back<sup>11</sup>.
- 2.22 Since the Infraco will not have funding available to manage costs above the profile directed by the Arbiter at Extraordinary Review, the Arbiter is inclined to the view that his directions will need to allow the Infraco an element of 'working capital' to ensure that a further Extraordinary Review is not required for minor cost fluctuations or timing differences. However, the total quantum allowed by the review will be the amount that the Arbiter considers a Notional Infraco could deliver. This could, for example, be achieved if the working capital is refundable, by means of a deduction from the ISC, at the end of the Review Period<sup>12</sup>.
- 2.23 If costs exceed the level set in the Arbiter's Extraordinary Review direction, so that the 'working capital' is utilised, the onus will be on Infraco to demonstrate, through a further Extraordinary Review, that the Notional Infraco would also have spent these funds. If its case were not accepted, and the excess costs were judged to be inefficient and uneconomic, the amount spent would be for Infraco's account with the end of period ISC deduction still being made.
- 2.24 In the case of outperformance of the Extraordinary Review direction, the Arbiter considers that there is a case for allowing London Underground to make a reference for a further Extraordinary Review in circumstances where there have been systematic factors which are not the result of an Infraco's own activities reducing scope and/or costs. However, if this change was introduced, the Arbiter considers that it should be subject to a materiality test (although not necessarily the same as the Materiality Threshold currently defined in the Extraordinary Review provisions of the PPP Agreement)

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<sup>10</sup> Paragraph 6.8 of the joint guidance.

<sup>11</sup> This already applies if there is no Extraordinary Review within a Review Period: the ISC is not adjusted retrospectively if out-turn costs are lower than those determined at Transfer or at a subsequent Periodic Review.

<sup>12</sup> This approach is akin to 'flooding the ISC' which was used for other reasons immediately post Transfer.

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- 2.25 These contractual adjustments could be introduced by the Arbiter as ancillary directions to an Extraordinary Review direction.
- 2.26 **Question 3: do the Parties agree with the Arbiter’s proposed approach to the appropriate inclusion of risk provisions within the costs of the Notional Infraco at any Extraordinary Review? If so, do the Parties agree with the Arbiter’s suggestions as to the basis on which subsequent Extraordinary Reviews in a Review Period should be handled? What would the appropriate level of ‘working capital’ be and what materiality test might be applied before a Party could make a further Extraordinary Review reference within a single Review Period?**

**(c) Joint guidance from the PPP Parties**

- 2.27 In a number of areas the Parties give the Arbiter guidance that is relevant to an Extraordinary Review process. This guidance expands upon the definition of the Notional Infraco, deals with Net Adverse Effects specifically and relates to partnering. The Arbiter has indicated<sup>13</sup> that he would generally anticipate following the guidance except where his overall statutory duty is best achieved in another way. In such circumstances he would explain why he had come to this view, and give proper opportunity for representations.
- 2.28 Some relevant aspects of the guidance are discussed below.
- 2.29 The joint guidance from the PPP Parties is that a competitive tender is to be considered as a fair reflection of the market<sup>14</sup>. This clearly raises questions about whether there are circumstances in which a competitive tendering exercised carried out by an actual Infraco might not be an appropriate basis for determining Notional Infraco costs. It also leaves open the question of the basis of costing to be used where there has not been a tender. These issues are discussed further below, in the context of stage 3 of the analysis.
- 2.30 The guidance also addresses factors to which the Arbiter should have regard in estimating costs<sup>15</sup>. This includes guidance on the use of benchmarks. The guidance indicates that when considering the future overall ISC, the Arbiter should not base his views on expected levels of efficiency that represent a target unlikely to be reached by a Notional Infraco and should not assume that the financial performance of the best Infraco could be achieved by all the Infracos unless there is a clear reason for doing so. The use of benchmarks is discussed further in the context of stage 3.
- 2.31 The Arbiter is guided to have regard to the environment in which the actual Infracos operate, for example in terms of contract structure and to the impact on costs of it having commitments to third parties, labour agreements, constraints of the funding agreements which are less good VFM than terms available at the time of the Review<sup>16</sup>. The Arbiter is also guided to take into account the impact on existing commitments of London Underground changing the obligations.

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<sup>13</sup> The PPP Arbiter: Role, approach and procedures – A policy statement, 19 January 2004, at [http://www.ppparbiter.org.uk/files/uploads/g\\_proceduralFrameWork/200621015957\\_The%20PPP%20Arbiter:%20Role,%20Approach,%20Procedures%20-%20Policy%20Statement%20\(19\\_01\\_04\)%20DM6577v1.PDF](http://www.ppparbiter.org.uk/files/uploads/g_proceduralFrameWork/200621015957_The%20PPP%20Arbiter:%20Role,%20Approach,%20Procedures%20-%20Policy%20Statement%20(19_01_04)%20DM6577v1.PDF).

<sup>14</sup> Paragraph 6.6 of the joint guidance.

<sup>15</sup> Paragraph 6.7 and 6.8 of the joint guidance.

<sup>16</sup> Paragraph 6.9(c) of the joint guidance.

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- 2.32 The Arbitrator recognises that there will be a potential cost to Infracore of changing the way in which it approaches the delivery of its obligations. However, the Arbitrator considers that the Notional Infracore would keep its supply chain arrangements under review in order that it would be able to take a view on changing market conditions, and would actively consider the costs and benefits of changing its approach. He would therefore expect to see evidence that the actual Infracore has carried out such a review at appropriate intervals, and that decisions were based on the improvements of efficiency and economy and achievement of Good Industry Practice.
- 2.33 In the context of their views on partnering, the Parties give guidance on the sharing of information. The Arbitrator's views on the information requirements of an Extraordinary Review, and the basis of sharing this information, is considered in the context of stage 3 of the guidance.

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### 3 Stage 2: Review of scope

- 3.1 The current references seek a view from the Arbiter on seven investments made or proposed by Metronet. The Arbiter indicated in his initial guidance that the conclusions that could be reliably drawn from an analysis of these proposals in the context of the aggregate nature of the Extraordinary Review provisions would be limited. He indicated instead that he would use his analysis as a means of developing principles for determining whether the proposed scope of works was consistent with the Infraco Obligations and in accordance with the approach taken by a Notional Infraco.
- 3.2 To date the analysis has focussed on whether the Infraco is obliged to undertake the works and the emerging conclusion is that they do have obligations that cover all seven proposals. What is more difficult is establishing whether the approach is one that a Notional Infraco would take for the individual investments.
- 3.3 The Arbiter considers that a Notional Infraco would view these particular investments as part of an overall programme of works: for example, the Victoria Line Upgrade Low Loss Conductor Rail (LLCR) investment and Victoria Line Upgrade Enabling Works investment would be considered as part of the overall Victoria Line Upgrade (VLU) programme and the works at Baker Street and Earls Court stations would be considered as part of the overall station modernisation and refurbishment programme. Similarly, consideration of the Track Buckling Recovery and Track Improvement programmes should be considered as part of the overall planning and implementation of the track renewals and maintenance programme.
- 3.4 Analysis of individual projects raises questions about planning, integration and optimisation of works and the allocation of risk and contingency allowances that cannot sensibly be addressed at a low level of detail. Indeed the Arbiter considers that attempting to do so is unhelpful and outside of the spirit of the PPP Agreements which generally ask him to consider costs in aggregate. An example of this would be in the risk allowances for access included within the VLU LLCR investment, where consideration of access and its impact on delivery, cost and risk can only be optimised at programme, or indeed line, level.
- 3.5 In this context the Arbiter's submission requirements and subsequent analysis need to be set at a level which ensures that sufficient detail is provided to demonstrate that the Infracos are following due process in planning their activities and can demonstrate robust links between activities performance, cost and risk while maintaining the integrity of taking the aggregate view required by an Extraordinary Review.
- 3.6 As noted in paragraph 2.8 above the Arbiter considers that the Infraco's AMS (supplemented by the Asset Group Strategies) and AAMPs should provide this perspective and as such will form a central component of Infraco submissions. However, he also takes the view that there are significant shortfalls in the data and analysis currently contained within these documents for the purposes of Extraordinary or Periodic Review and these shortcomings will therefore need to be addressed for any Extraordinary Review and for Periodic Review. This issue is considered further below in relation to stage 3.

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- 3.7 The Arbitrator's view, as expressed in his Initial Guidance, that only limited conclusions could be drawn from an analysis of the specific projects that are the subject of these references has been strengthened by a review of the projects themselves. He therefore concludes that in terms of an Extraordinary Review his analysis will consider scope, cost and performance at the programme level.
- 3.8 **Question 4: do the Parties agree that an Extraordinary Review should focus on programmes rather than individual work packages within programmes?**

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#### 4 Stage 3: Assessment of allowable expenditure

- 4.1 The purpose of an Extraordinary Review is to provide a mechanism whereby the relevant PPP Agreement survives until Periodic Review, at which point the obligations and pricing will be rebased in a way that should allow a well managed Infraco to earn its agreed rate of return going forward.
- 4.2 The first step toward this objective of this is to calculate Net Adverse Effects (NAEs), that is the efficient and economic component of the actual or projected overspend. For the reasons set out in section 3 of this paper, analysis of NAEs in respect only of the seven projects in the references would be inappropriate, given that NAEs are defined at an aggregate level. Instead the work being undertaken by the Arbiter is focussing on the principles of assessing actual and projected costs.
- 4.3 As indicated earlier in this paper the Arbiter considers that his analysis should start at reasonably aggregate level, for example at a level akin to that provided to London Underground for the purposes of PPP bid evaluation. The data provided in the PPP Agreements<sup>17</sup> is presented at this level and the Annual Asset Management Plans have broadly continued in this format.
- 4.4 However, in analysing the data, the Arbiter takes the view that some bottom up analysis will be used to validate and calibrate the more aggregate data. For instance, data for the stations programme might be presented at the aggregate level but the Arbiter would expect to consider both the assumptions upon which actual data on costs incurred to date has been extrapolated to the programme level and benchmarking data. This process might require detailed consideration of a sample of individual projects.
- 4.5 **Question 5: do the Parties agree that a combination of top down and bottom up analysis is the right approach to maintaining the integrity of taking the aggregate view required by an Extraordinary Review?**
- **If so, what is the appropriate level of disaggregation?**
  - **What evidence should be provided on assumptions and Board endorsement?**

##### (a) Analysis of costs

- 4.6 In considering costs, the Arbiter is guided by the Parties that he should assume that, where there has been a competitive tender, the resulting pricing and terms would be a fair reflection of the market for such a contract. It is anticipated that, where a Party wishes to rely on such data, it will provide sufficient evidence to demonstrate that an effective competitive procurement has been conducted. In particular evidence of the processes used at each stage of the tender, from selection of candidates through to final contract award, will need to be provided alongside scope of works, an analysis of risks passed to the contractor and those retained, and relevant financial information.

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<sup>17</sup> For example the information supporting the baseline for Net Adverse Effects in Annex 5 to Schedule 1.9.

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**4.7 Question 6: what evidence would the Parties consider provides sufficient justification for the outcome of a competitive tender to provide a fair reflection of the market?**

- 4.8 Equally, consideration will need to be given to validating costs that have not been the subject of a tender. The start point for this will be the internal benchmarking carried out by the Infracos and London Underground. But the Arbiter considers that it is essential that external benchmarks are also reviewed, as indeed he is guided to do.
- 4.9 At this stage, there will inevitably be gaps where there has not been a competitive tender and where benchmarking data is not yet available and or cannot be made collected on any reliable basis. The Arbiter considers that the onus should be on the Infracos to demonstrate how they have assessed their costs in order to meet the standard required of the Notional Infraco. In the absence of a robust internal process for developing and challenging costs, he would expect to place reliance on benchmarking information, even if this is only available at a high level. However, he would also expect London Underground to maintain sufficient knowledge of Good Industry Practice to challenge Infracos costs.

**4.10 Question 7: how do the Parties see their joint benchmarking work evolving and to what timetable? What evidence would the Parties expect to rely on in the absence of such data and of a competitive tender?**

- 4.11 It is anticipated that the Arbiter's view of risk pricing will involve the assessment of risk at an aggregate level for programmes, thus incorporating the portfolio effects that will be present within the various projects within a programme. However, risks for significant external or unanticipated events will not be addressed, with the assumption being that such risks would be recompensed via a further Extraordinary Review.

**(b) Analysis of performance and revenues**

- 4.12 At Extraordinary Review, the main objective of the Arbiter's analysis of performance would be to ensure that future projections are robust and sufficiently stretching. This would require Infracos to understand and demonstrate the link between work undertaken and its impact on the PPP performance regime.

**(c) Information requirements for Extraordinary Review**

- 4.13 In terms of submission requirements the Arbiter is minded to follow in broad terms the approach used in bid evaluation and in the development of the Public and Private sector comparators. This approach has the advantage of building upon the previous work in the context of the PPP not least given that certain mechanisms used for bidding are included within the Agreements, such as the AAMP cost tables.
- 4.14 The AMS and AAMP documents are also helpful in that they combine details of the Infracos' approach to whole life asset management, with programme, cost and performance data. The Arbiter therefore envisages that the submission will be built around these documents.

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- 4.15 However, the Arbiter currently has concerns about the degree to which the suite of documents could support the analysis that he envisages undertaking and has commissioned a review by Halcrow which he will share with the Parties early next year. He would expect to combine his analysis of the data in these documents with bottom up analysis of the type discussed above and where possible he would prefer the Parties to provide data to facilitate this e.g. results of benchmarking although he would also expect to commission analysis of his own as necessary.
- 4.16 A key issue in developing the AMSs and AAMPs will be the need to ensure that they are presented on a consistent basis. The variance analysis work carried out to date has illustrated how much effort is required to achieve this. The Arbiter is now considering how to take this forward and has commissioned work from Ernst & Young on developing submission requirements which he will share with the Parties early in 2007. Amongst other things Ernst & Young are considering the processes used by regulators to facilitate consistent regulatory returns including the use of Reporters as employed by ORR/Network Rail and others.
- 4.17 In the context of partnering the Arbiter also intends to consider further the issue of information sharing given his view that, in the context of Extraordinary Review and Periodic Review, greater transparency than is achieved now would benefit the process.
- 4.18 **Question 8: do the Parties agree that greater transparency is essential at Extraordinary Review (and Periodic Review) and that a reporter type role might facilitate this?**

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## 5 Questions for the Parties

- 5.1 Question 1: do the Parties agree that the AMS and AAMP should be key documents in any Extraordinary Review, and that it is appropriate for the Arbiter to review the basis on which the Infraco's Board has signed off those documents?
- 5.2 Question 2: do the Parties have further evidence they wish to draw to the Arbiter's attention in respect of the speed with which a Notional Infraco might be expected to introduce changes in processes and organisation following Transfer, and on the period required for such changes to feed through into improvements in costs and performance?
- 5.3 Question 3: do the Parties agree with the Arbiter's proposed approach to the appropriate inclusion of risk provisions within the costs of the Notional Infraco at any Extraordinary Review? If so, do the Parties agree with the Arbiter's suggestions as to the basis on which subsequent Extraordinary Reviews in a Review Period should be handled? What would the appropriate level of 'working capital' be and what materiality test might be applied before a Party could make a further Extraordinary Review reference within a single Review Period?
- 5.4 Question 4: do the Parties agree that an Extraordinary Review should focus on programmes rather than individual work packages within programmes?
- 5.5 Question 5: do the Parties agree that a combination of top down and bottom up analysis is the right approach to maintaining the integrity of taking the aggregate view required by an Extraordinary Review?
- If so, what is the appropriate level of disaggregation?
  - What evidence should be provided on assumptions and Board endorsement?
- 5.6 Question 6: what evidence would the Parties consider provides sufficient justification for the outcome of a competitive tender to provide a fair reflection of the market?
- 5.7 Question 7: how do the Parties see their joint benchmarking work evolving and to what timetable? What evidence would the Parties expect to rely on in the absence of such data and of a competitive tender?
- 5.8 Question 8: do the Parties agree that greater transparency is essential at Extraordinary Review (and Periodic Review) and that a reporter type role might facilitate this?