



**The PPP Arbiter**

**Reference for Guidance from  
London Underground Ltd**

**Issues Paper**

**16 July 2008**

## **Role and approach of the Arbiter**

The role of PPP Arbiter was created by the Greater London Authority Act 1999 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 PPP 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 Context

- 1.1 On 14 April 2008, London Underground Limited made a reference to the Arbiter for guidance pursuant to section 230(1)(b) of the Greater London Authority Act 1999 ('the Act') in relation to its PPP Agreement with Tube Lines Limited ('Tube Lines'). The reference seeks the Arbiter's guidance on the costs that Tube Lines could incur in the second Review Period and on associated performance levels. Part A of the Reference Application Notice has been published as an attachment to the Arbiter's Press Notice of 15 April 2008<sup>1</sup>.
- 1.2 On 23 April, following representations from Tube Lines the Arbiter announced his intention to proceed with the reference<sup>2</sup>. Both Parties made submissions to the Arbiter on Monday 2 June. Since then, in line with the Arbiter's timetable and procedures for this reference, trilateral meetings and clarification meetings have been held and each of the Parties has made a supplementary submission which responds to the main submission of the other party.
- 1.3 Information sharing with the Arbiter is now complete and the Arbiter is reviewing and analysing the data and arguments received. This paper seeks the Parties' views on a number of issues that have emerged from the analysis to date.
- 1.4 The paper is structured as follows:
- Section 2 asks the Parties to confirm the figures that they have provided in their respective submissions;
  - Section 3 raises matters of contract interpretation;
  - Section 4 considers how disagreements between the Parties on the scope of work for the second Review Period will be handled in the guidance;
  - Section 5 discusses the Parties' access requirements; and
  - Section 6 sets out the Arbiter's approach to various aspects of the analysis that he is undertaking.
- 1.5 The paper does not raise issues in respect of questions 2 and 3 of the reference which relate to performance.
- 1.6 The Parties are asked to make any written representations on this paper by 5 pm on Wednesday 23 July.

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<sup>1</sup> Press Notice 01/08: Arbiter confirms receipt of reference from London Underground on future costs for Tube Lines, 15 April 2008, at [http://www.ppparbiter.org.uk/files/uploads/i\\_pressNotices/20084151331\\_Press\\_Note\\_01\\_08%20and%20reference%20application%20notice.pdf](http://www.ppparbiter.org.uk/files/uploads/i_pressNotices/20084151331_Press_Note_01_08%20and%20reference%20application%20notice.pdf).

<sup>2</sup> Arbiter's decision on whether to give guidance, 23 April 2008, at [http://www.ppparbiter.org.uk/files/uploads/n\\_guidance/2008423165535\\_Decision\\_on\\_giving\\_guidance.pdf](http://www.ppparbiter.org.uk/files/uploads/n_guidance/2008423165535_Decision_on_giving_guidance.pdf).

## 2 Confirmation of submissions

- 2.1 For the purposes of this reference, the Parties were asked to submit all of their numeric data to the Arbiter in a data breakdown structure (DBS) prescribed by the Arbiter. However the preparation period for the reference was short and the clarification process and supplemental submissions have identified a number of areas where there were minor errors or where a party wished to amend its data.
- 2.2 The Arbiter has updated his model to reflect these amendments and corrections as described in annex 1.
- 2.3 Despite making significant efforts to comply with the DBS, there are differences between the approach taken by each of the Reference Parties for instance in the treatment of risk and efficiencies. The Arbiter's model builds total costs from base costs in February 2007 prices by adding overlays for differential inflation, efficiencies, tolerance<sup>3</sup> and corporate risk. In order to make base costs comparable, adjustments have been made to the Parties' figures to identify corporate risk, differential inflation and efficiencies separately.
- 2.4 A summary of both the updated submission DBS and base costs (after adjustments) is being provided for each Party electronically as described in annex 2 to this paper. The annex includes details of the assumptions underpinning the adjustments.
- 2.5 The Parties are asked to confirm that the figures in the updated submission DBS are correct and in accordance with their reference submission as modified by the clarification process. The Parties are also asked to confirm that they agree with the Arbiter's estimate of base costs and that this is consistent with the revised submission DBS.

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<sup>3</sup> The Arbiter draws a distinction between 'tolerance', which reflects potential variability in the costs of delivering specific work packages, and 'corporate risk', which is an overlay reflecting additional factors which may affect the costs for a Notional Infraco of delivering the contract.

### **3 Contract interpretation**

#### **(a) Payment profiles**

- 3.1 The PPP Agreements are output based and, within limitations such as compliance with standards, permit an Infraco to decide how to go about delivering its obligations. It also sets an expectation<sup>4</sup> that Infraco will take a whole life approach to delivery notwithstanding the impact of Periodic Review.
- 3.2 A clear area of difference between the Parties' submissions is the approach to and more particularly timing of the delivery of the Piccadilly Line Upgrade (PLU). London Underground's submission indicates its view that a Notional Infraco would undertake and pay for significant work in the first Review Period. Its costs are therefore lower in the second Review Period than those in the Tube Lines' submission.
- 3.3 Tube Lines' view by contrast is based on the assumption that that while some work will be undertaken in the first Review Period by Thales, its signalling contractor, the costs will not be chargeable until the second Review Period. (By contrast, in-house work in the first Review Period is assumed to be paid when incurred.)
- 3.4 In the case of rolling stock, procurement is underway but a supplier has not yet been selected. For the purposes of its submission Tube Lines has assumed that it will buy (rather than lease) the fleet but that no payments will be made to the manufacturer until the start of the second Review Period.
- 3.5 The Arbitrator is of the view that it is for Infraco to establish its approach to the upgrade providing it can demonstrate a whole life approach. He also notes that at Transfer there were no material costs in the Baseline for Net Adverse Effects for PLU work in the first Review Period, and that costs were assumed to be recovered in the second Review Period.
- 3.6 In taking a view on the costs associated with the Upgrade, the Arbitrator will consider separately whether the programme of works is consistent with that of a Notional Infraco, or whether re-timing introduces costs over and above those that would be incurred by a Notional Infraco as a result of the programme being compressed or through additional risk provisions. Any such costs would be disallowed. He will separately consider what payment profile would be appropriate, taking account of the basis of the original bid and the contractual incentives on a Notional Infraco in respect of cost recovery, but is currently minded not to assume any material payment to contractors in the first Review Period.

#### **(b) Performance**

- 3.7 The Arbitrator will assess the impact of the proposed programme of works on performance. He will assess the revenue effects of this performance level, in particular to establish whether the plans proposed by London Underground and by Tube Lines are broadly cost neutral (excluding

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<sup>4</sup> Paragraph 2.1 of Schedule 3.1

capability) and to understand the quantum of the capability revenues arising from the line upgrade programme. This will enable him to assess whether the plans put to him are appropriate for a Notional Infraco when applying the performance incentives regime within the contract.

- 3.8 London Underground has not provided a revenue forecast, and the Arbiter's model will be used to calculate this.
- 3.9 The contract drafting does not anticipate that capability revenues as delivered through the Line Upgrade programme will be broadly cost neutral. The Arbiter's model indicates that the revenues arising from capability are significant and ongoing. The Arbiter's understanding of the relevant provisions is set out in annex 3.
- 3.10 The Arbiter notes that the implication of his interpretation of the contract in this regard is that line upgrade costs will be largely recovered through the ongoing capability payment in the second Review Period rather than through ISC. However, this reference does not explicitly consider ISC, but a common understanding on this will be important at Periodic Review.

**(c) Administration and Other Costs**

- 3.11 London Underground's central costs submission includes elements based on Tube Lines' Schedule 1.9 Annex 5 projections set out at Transfer.
- 3.12 The Arbiter acknowledges that in preparing its submission, London Underground did not consider that it had sufficient information to reach an alternative view to the figures in Annex 5. However, it is the Arbiter's view the figures in Annex 5 have the singular purpose of acting as the Baseline for Net Adverse Effects in the event of an Extraordinary Review. Given the purpose for which these numbers were put together and the known changes which have occurred since Transfer, the Arbiter does not consider that these figures are an appropriate basis on which to project A&O costs for the second Review Period.

#### **4 Treatment of disagreement over scope**

- 4.1 The Arbiter's view is that the PPP Parties are best placed to define the scope of work to be undertaken in the second Review Period. Accordingly where the Parties' agree on this scope, he will reflect the agree position in his guidance.
- 4.2 However the current position is that in a number of areas there is significant disagreement on the appropriate scope of work. Where this is the case, the Arbiter will set out his assumptions on scope in the guidance.
- 4.3 As part of his analysis, the Arbiter will indicate areas where the contract drafting might need to be reviewed as part of the development of Restated Terms to provide clarity on scope and to provide contractual certainty for Tube Lines if the assumed scope is subsequently changed.
- 4.4 In addition, there are a small number of areas such as costs in respect of deep tube tunnel condition and implementation of the Rail Vehicle Accessibility Regulations where neither party yet has a full understanding of scope although it is common ground that some costs will be incurred in the second Review Period. The Arbiter's view is that the cost range that he gives in the guidance should be as inclusive as possible and he will therefore include an amount for such items. The guidance will, however, note that the estimate is particularly uncertain and will suggest that the Parties undertake further work to refine their positions.

## 5 Treatment of access requirements

- 5.1 It is clear from the Parties' submissions that their approach to calculating access requirements for the second Review Period is markedly different. Tube Lines has adopted a largely unconstrained approach which has been developed independently for each asset area. At this stage the figures produced do not include efficiencies that might be delivered by the sharing of possessions (although Tube Lines indicate that options for "piggy backing" have proved to be limited in the first Review Period) or other optimisation. As a result Tube Lines' proposals exceed the existing contractual allowance for Minor Closures by a factor of six.
- 5.2 London Underground has applied an operational perspective centred on maintaining services and balanced with an expectation that a Notional Infraco would seek to minimise the costs of Access (which apply to time taken over and above the contractual allowances and engineering hours). This is a modelled approach which makes significant allowance for synergies and other optimisation.
- 5.3 Clearly there is scope for significant further work here as part of developing Restated Terms which the Parties are already planning to undertake. The questions for this reference are:
- what approach might reasonably be adopted; and
  - how should it be priced for the purposes of the reference.
- 5.4 The Arbiter considers that operational concerns have to be considered alongside the benefits to the work programme that significant access permits. He also considers that it is appropriate to set challenging targets in this area to encourage Infraco to maximise the efficient use it makes of engineering time and Minor Closures.
- 5.5 For the purposes of the reference, the Arbiter considers that Tube Lines' approach is insufficiently developed to form the basis of pricing. London Underground's submission is based on an allowance of 21 million Lost Customer Hours (LCH) for Minor Closures (compared to the current contractual allowance of 16 m LCH). London Underground's total before optimisation is 30m LCH. The Arbiter is minded to use these two London Underground totals as the upper and lower limits for access. He would then consider the achievability and cost implications of applying this range.
- 5.6 In relation to the cost of access, the Arbiter would expect an Infraco to take a commercial stance and price within its bid any access required over and above the contractual allowances. He will take this approach in developing cost ranges for this reference. However given that the cost of access over and above the contractual allowances is significant the Arbiter would expect London Underground to consider, in developing Restated Terms, whether a more cost effective approach would be to increase the amount of time available for works at no cost to Infraco.

## **6 Arbiter's approach to specific aspects of the reference**

6.1 As indicated above, the Arbiter's model will provide an incremental overlay onto base costs for each of these items such that there is transparency about the approach taken in the guidance. This section of sets out the approach being taken to each of these overlays.

### **(a) Differential inflation**

6.2 Differential inflation is the amount over and above RPIX<sup>5</sup> that the Parties consider should be included in their cost projections to insulate Infraco from such factors as increases in component prices or labour costs above general inflation.

6.3 The DBS required each of the Parties to provide an estimate of this for the second Review Period. Tube Lines' estimate totals £1.2 bn or seventeen percent over 7<sup>1</sup>/<sub>2</sub> years. London Underground's initial submission included no estimate.

6.4 Subsequent analysis by London Underground is limited because it asserts that it is too difficult accurately to project these costs based on readily available current data. However, the Arbiter considers that a Notional Infraco would include differential inflation in its costs and he will therefore provide an overlay for differential Inflation in developing costs estimates for this reference. The corporate risk provision will additionally include for the uncertainty in this projection.

6.5 Sources of evidence that will be considered by the Arbiter include the information submitted as part of this reference and submissions by Network Rail to ORR as part of its current Periodic Review<sup>6</sup>.

6.6 The Arbiter notes that Tube Lines' forecast of differential inflation is higher than the high level estimates set out by NERA for the second Review Period<sup>7</sup> and the projections for the London and South East region submitted by Network Rail to ORR for its Periodic Review, although the Tube Lines estimate is within the wide range of uncertainty in Network Rail's estimates.

6.7 If the Parties are agreed that there is considerable difficulty with projecting differential inflation for the second Review Period, it may be appropriate for alternative indexation provisions for the ISC to be developed as part of Restated Terms.

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<sup>5</sup> ISC is indexed by RPIX in the PPP Agreements.

<sup>6</sup> Input Price Trends: Summary Report – Refresh, LEK Consulting, February 2008 ([http://www.networkrail.co.uk/browse%20documents/StrategicBusinessPlan/Update/Input%20price%20trends%20summary%20report%20\(LEK\).pdf](http://www.networkrail.co.uk/browse%20documents/StrategicBusinessPlan/Update/Input%20price%20trends%20summary%20report%20(LEK).pdf)).

<sup>7</sup> High Level Efficiency Estimates for the Second Review Period, Report for the Office of the PPP Arbiter, NERA, March 2006. [http://www.ppparbiter.org.uk/files/uploads/d\\_benchmarking/200661592945\\_High%20level%20efficiency%20final%20report%20\(150606\)%20DM15712%20.pdf](http://www.ppparbiter.org.uk/files/uploads/d_benchmarking/200661592945_High%20level%20efficiency%20final%20report%20(150606)%20DM15712%20.pdf)

**(b) Efficiencies**

- 6.8 The Parties have drawn upon work prepared by NERA for the Arbiter to estimate efficiencies. Tube Lines generally applies a 1% per annum reduction for efficiency, whilst London Underground applies 3% (although no provision is made in areas where London Underground assumes that the procurement process will already have captured efficiencies).
- 6.9 The Arbiter's approach on efficiency will consider the scope for both 'catch-up' efficiency, if any, where current cost levels are materially above relevant benchmarks as well as the scope for 'frontier-shift' efficiency (annual productivity improvement). He will consider at the DBS level whether the work programme and working practices are in line with relevant benchmarks and will also make allowance for the fact that good practice will improve over time.
- 6.10 The estimates provided for frontier shift by Tube Lines for are similar to the estimates that NERA set out in its 2006 report for the Arbiter and the assumptions that ORR used in its recent draft determinations in its Periodic Review. However, Tube Lines does not assume any catch-up efficiency, which is why there is a material variance between its proposals and London Underground's assumptions.
- 6.11 An important part of this reference will therefore be to consider whether there is scope for catch-up efficiency or whether this has all been exhausted through the PPP competition and improvements made during the first Review Period. Information collected from joint and international benchmarking will help to inform this view. The Arbiter will review asset based costs, and a separate view of the efficiencies which should be applied to A&O costs will be developed.
- 6.12 Since NERA undertook its 2006 study, ORR's Periodic Review has generated a range of work on the scope for catch-up efficiency improvement on the mainline railway and this evidence will be considered in the context of Periodic Review and the different circumstances of the PPP.
- 6.13 The Arbiter is of course mindful of the need to ensure that any top down efficiency assumption does not double count efficiency savings included at the more granular level. Assumptions applied in both processes will be transparent.

**(c) Risk**

- 6.14 As indicated above, the Arbiter distinguishes between 'tolerance' – essentially a measure of variability around individual asset cost estimates – and corporate risk.
- 6.15 In reaching a view on asset risk the Arbiter will consider the level of tolerance that it would expect to see in the estimates based on the submissions and relevant comparators on approaches to project pricing.
- 6.16 Corporate risk will be identified separately. In developing the corporate risk amount, the Arbiter's approach will be to:

- adopt an independent stance by forming an opinion on risk before reference submissions were made and creating a risk register with risks identified and rated but not quantified;
- reflect the behaviours of a Notional Infraco including the behaviours of management in a competitive bidding environment;
- carry out an unbiased assessment of the submissions, and compare them with the opinion developed earlier. This involved applying the same set of questions to each submission in the process of the assessment, conducting a review of each submission's Risk Register against the Risk Register previously developed whilst maintaining the mindset of the Notional Infraco throughout.

Further details of the Arbiter's proposed approach are at annex 4

6.17 The approach adopted has taken note of the Extraordinary Review process (and Materiality Threshold in the second Review Period) but has taken the view that a Notional Infraco would not rely on this mechanism to cover it for the majority of risks. As such the Risk Register will be developed and quantified so that there is sufficient amounts allowed for to seek to make the need for an Extraordinary Review unlikely,

6.18 At Periodic Review the Arbiter would consider carefully whether, given the asymmetric nature of Extraordinary Review, this level of corporate risk creates a significant possibility of over compensation. If in his view the risk of this outcome materialising was high he would consider reducing the amount if it remained large, unless the Extraordinary Review process was made symmetrical.

## Annex 1

### Adjusted DBS

Revised DBS workbooks for each of Tube Lines ("TLL Updated DBS") and London Underground ("LUL Updated DBS") are provided electronically.

Each of the changes which have been made to the respective DBS workbooks submitted on 2 June 2008, which are reflected in the respective electronic updated DBS workbooks, are described in the tables below.

#### Tube Lines

	DBS sheet	Change
1	Contractual Performance	Updated with revised 'LCH Other Lines' information
2	Contractual Performance	Updated with revised Station FR Service Points of 16,662 per semi-annual period for the whole of the second Review Period
3	Contractual Performance	Updated with revised capability projections
4	Asset Specific Cost	Data in line 3.1.5.2 ('Conductor rail like for like) for the second Review Period for Jubilee Line only deleted and replaced with data in line 3.1.5.3 causing a decrease of £2.48m.
5	Asset Specific Risk	20% (of base costs) or 16.67% (of total costs) risk amount for 3.2.6 'Bridges and Structures - Costs arising from assessment of Grey Assets' added in
6	Asset Specific Risk	Risk amount for 2.3.1.3 'All remaining refurbishment' set to 0%
7	Asset Specific Cost	Civils opex increased by £0.182m to allowing for the inclusion of DTT costs
8	Asset Specific Cost	Escalator opex reduced by £15.71m to remove the effect of double counting
9	Asset Specific Cost	Signalling capex reduced by £0.213m to reflect revised split between Jubilee and Northern lines
10	Asset Specific Cost	Subtotal for Section 3.2 has been corrected to overcome an error in the templates
11	Asset Specific Cost	'Fees' line which is driven by underlying cost amounts has been updated for changes to these amounts specified in this table
12	Asset Specific Risk	Risk percentages included as a percentage of total costs as opposed to a percentage of base costs
13	Asset Specific Volumes	Updated with revised civils volumes as per point

	<b>DBS sheet</b>	<b>Change</b>
		7 above
14	Additional Items	Total performance £ amount assumed to be a net abatement (it was shown as a negative number in the DBS implying an income).
15	Additional Items	Differential Inflation (and efficiency amounts) have been recalculated post all other required revisions to asset specific and central costs and risk amounts described in this table. The effect of the changes in costs generates a £2.85m reduction in the cost amount for Inflation and Efficiency
16	Additional Items	Performance £ amount updated from TLL - 1365079 to take account of changes to underlying performance projections as noted in this table

### London Underground

	<b>DBS sheet</b>	<b>Change</b>
1	Asset Specific Volumes	Rows 2.13 - 2.1.9 updated with revised stations volumes

The Arbiter has noted that there are some areas where Tube Lines has assumed cost rows in the DBS to be opex, although they were designated as capex in the DBS schedule. These rows are:

2.2.1.3. Lifts All remaining refurbishments (£9.39m)

2.3.1.3 Escalators All remaining refurbishments (£39m)

It is the Arbiter's intention to recognise these reallocations from capex to opex in his analysis. The Arbiter notes that while Tube Lines agreed through the clarification process that the risk amount for 2.3.1.3, as per point 6 in the table above, should be set to 0%, no such agreement was reached in relation to 2.2.1.3 and a risk amount remains in Tube Lines' updated DBS for this line.

The Arbiter acknowledges that Tube Lines has also assumed that the following lines are opex, whilst being designated as capex in the DBS.

1.3 Depot Refurbishment

3.1.6 Track Other

The Arbiter does intend to recognise these reallocations in his analysis.

TLL submission treats the following items as Opex though they are classified as Capex in the template

### 3.1.6 Track Other

## **Annex 2**

### **Summary of base costs**

A summary of the unadjusted and adjusted London Underground and Tube Lines data, based on the data within the respective updated DBS workbooks, is provided electronically (“Updated Unadjusted and Adjusted Comparison of Submissions”).

The adjustments made to the updated data in the columns ‘TLL (excluding Project Risks)’ and ‘LUL (Including Efficiency and Excluding P50 Tolerance)’ of the ‘Adjusted Updated Submissions’ worksheet are described below:

- Efficiencies have been added back into London Underground’s asset specific and central costs using the schedule of compounded efficiency percentage assumptions provided by London Underground as part of the clarification process.
- The P50 tolerance amounts have been removed from London Underground’s costs by applying the asset specific risk percentages provided in London Underground’s DBS and deducting the amounts from total asset specific costs.
- The project risk amounts have been removed from the Tube Lines’ asset specific costs using the risk percentages included as a percentage of total costs provided by Tube Lines as part of the clarification process.
- Efficiencies have been separated from the net differential inflation figure provided in Tube Lines’ Submission by applying the compounded differential inflation percentage assumptions provided in Tube Lines’ submission and calculating the difference between total differential inflation and the net figure provided in the Submission

### Annex 3

#### Arbiter's interpretation of the contractual provisions relating to payment for capability (Line Upgrades)

To model capability revenues for the second Review Period, it is necessary to understand what happens to the capability benchmark following the completion of a Line Upgrade. The Arbiter's approach is based on the following interpretation of the existing contract provisions:

- Table 1 of Appendix 3 to Schedule 4 of the contract specifies the Target Journey Time Capability Score to be achieved by the Line Upgrades along with the earliest and latest implementation dates for the Line Upgrades.
- Paragraph 1.5.5 to Schedule 2.1 (Service Outputs) of the contract states that paragraph 1.1.1 (Journey Time Capability) of Schedule 2.1 'shall be amended to reflect the Journey Time Capability scores.....as set out in Table 1 of Appendix 3 to Schedule 4.1 of the PPP Contract'.
- However, paragraph 1.5.5 goes on to state that 'the benchmarks set out in Appendix 2 of Schedule 4.1 (which contains the contractually defined cap, benchmark and unacceptable capability levels) of the PPP Contract shall not be affected.'
- Making no adjustment the capability benchmarks following completion of a Line Upgrade appears consistent with target scores following completion of the Line Upgrades, for the other components of capability, Service Control and Service Consistency, not being specified in the contract. However, the calculation of performance revenues while continuing to use the capability benchmarks in Appendix 2 of Schedule 4.1 post delivery of a Line Upgrade (assuming that the Line Upgrade is delivered by the latest implementation date and that the Target Journey Time Capability scores are achieved or exceeded) results in a substantial capability bonus payable as part of the Performance Adjusted ISC ("PAISC").
- Given the potential for a substantial capability bonus as part of PAISC, and the way that the ISC is to be set in the second and subsequent Review Periods under paragraph 7 of Schedule 1.9, then (ignoring paragraph 7.3(d) in the first instance) this would mean that to the extent that the cost of the Line Upgrades are included within cost projections (as is the case in the Initial Ranges submissions) and reflected ultimately in the ISC, Infracore is funded twice for the Line Upgrade (once through the capability bonus and once through the reset ISC as part of the Periodic Review process).
- Paragraph 7.3 (d) of Schedule 1.9, states that the positive cashflows are to include 'the amount of any **increases** to be made to the ISC in relation to the Delivery into Service of the Specified Line Upgrade'. This drafting implies that the amount paid through the ISC in relation to a Line Upgrade is an increment only (i.e. that element of cost not met through capability performance revenues).

- The Arbitrator's interpretation of this sub-paragraph is that when setting the ISC under paragraph 7 he is to determine his expectation for the amount and timing of capability bonus to be achieved by Infracore for Line Upgrades that are due (in his estimation) to be Delivered into Service after that Review Date but before the end of the contract and to reflect that in the positive cashflows (i.e. sources of income) which are to offset the relevant negative cashflows (i.e. determined costs, Fixed Amounts etc) when coming to the ISC required.
- This interpretation of Paragraph 7.3 (d) of Schedule 1.9 also suggests that failure by Infracore to meet the Target Journey Time Capability Scores to the extent and on the timing assumed by the Arbitrator will also result in Infracore suffering a penalty, since if the increment to be paid through ISC is calculated on the assumption that Target Journey Time Capability scores will be met by the Latest Implementation Date, then failure to the Arbitrator's assumptions will result in less revenue through the performance regime and less income overall.

## **Annex 4**

### **Arbiter's approach to corporate risk**

In developing its view of the Risk Register for corporate risks the Arbiter considers that the mindset of the Notional Infraco would reflect:

- a consortium which has multi-faceted corporate governance procedures;
- previous (a minimum of 5 years) and current experience of the PPP contract and knows the condition of the assets;
- an expectation to tender competitively over a 7.5 year timeframe (recognising that notwithstanding the Contract has a further 22.5 years to run, value for money and whole life costing considerations are (under the present contract terms and conditions) in effect limited to each 7.5 year period);
- not trying to recover lost profit from the first Review Period in the second Review Period;
- a responsible attitude towards its shareholders and expects to provide an adequate return and make allowances for downside risk;
- in relation to straddling projects, expect all claims arising from the first Review Period to be met in the first Review Period;
- cognisant of the concept of Net Adverse Effects and the Materiality Threshold;
- take into account developments such as current economic instability, labour/contract market, events relating to Metronet, the 2012 Olympics and developments in legislation (e.g. DDA, RVAR);
- the Active Risk Manual is up to date and 'accurate';
- adopted a procurement strategy which delivers economy and efficiency over a portfolio of works, benefits commensurate with the scale of its undertakings and the opportunity to off-set some Risk to 3rd parties through sub-contracting;
- experience of London Underground's application and interpretation of the PPP contract and the role of the OPPPA; and
- accepts the terms of the PPP contract as they exist today.

In addition, the entity would face the following challenges:

- the difficulties relating to frustrated access;
- the complexity of the upgrade programmes and the exceptionally high level of Capex measured in £billions;
- the age of the existing system with increasing passenger and asset usage;
- dependency on a number of single source suppliers for critical systems e.g. signalling;

Confidential to London Underground and Tube Lines until publication of final guidance

- how to get more efficiency out of Opex, and retain current efficiency into the period ahead, and to achieve required performance given the current condition of assets and the need to upgrade them;
- to achieve the upgrade milestones; and
- in managing stakeholders' expectations, London Underground's in particular.