



**The PPP Arbiter**

**Reference for Directions from  
Metronet Rail BCV Ltd**

**Interim level of ISC pending a direction  
on ISC at Extraordinary Review**

**Draft directions**

**16 July 2007**

## **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>

## Contents

	<b>Executive summary</b>	1
<b>1</b>	<b>The Arbitrator's draft directions</b>	2
	<ul style="list-style-type: none"><li>• Quantum of interim level of ISC</li><li>• Profile of of interim level of ISC payments</li><li>• Conditions attached to interim level of ISC payments</li></ul>	
<b>2</b>	<b>Arbitrator's approach to the reference</b>	6
	<ul style="list-style-type: none"><li>• The reference and the Arbitrator's statutory functions</li><li>• Process followed</li><li>• Contractual provisions relating to interim level of ISC</li><li>• Approach to analysis</li><li>• Financing</li><li>• Ancillary and incidental directions</li></ul>	
<b>3</b>	<b>Arbitrator's reasons for quantum and timing of interim level of ISC</b>	13
	<ul style="list-style-type: none"><li>• Overview</li><li>• Metronet BCV's statement of case</li><li>• London Underground's preliminary response to reference</li><li>• Arbitrator's assessment of Net Adverse Effects</li><li>• Interim ISC</li></ul>	
<b>4</b>	<b>Arbitrator's reasons for treatment of issues arising from funding drawstop</b>	24
<b>5</b>	<b>Arbitrator's reasons for making ancillary directions</b>	26
<b>6</b>	<b>Definitions</b>	27
	 Annex 1 Reference Application Notice and Statement of Case	  28

## **Executive summary**

Metronet Rail BCV Limited (Metronet BCV) made a reference to the PPP Arbiter on 28 June 2007, triggering an Extraordinary Review of its PPP Agreement with London Underground Limited. As part of that reference, it sought a direction on the interim level of Infrastructure Service Charge (ISC) to be paid by London Underground while the Extraordinary Review is being completed. It asked for this direction to be given within a period of four weeks from the date of the reference.

Metronet BCV initially sought an increase in ISC of £400.2 million over the 12 month period from the date of the reference. On 12 July, it made a supplemental submission which increased this figure to £551.1 million. This amount reflected its assessment of the additional costs that an Infraco which was overall efficient and economic and operating in accordance with Good Industry Practice would incur in delivering its obligations under the PPP Agreement, and the additional financing such an Infraco would require, during the Extraordinary Review period.

The Arbiter has provisionally concluded that the interim level of ISC in the 12 months from 29 June 2007 to 28 June 2008 should be an increase of £121 million (at nominal prices).

Because he has concluded that, as at the date of the reference, Metronet BCV had not incurred Net Adverse Effects in excess of the Materiality Threshold of £50 million (indexed), the Arbiter proposes to make ancillary directions as to the timing of adjustments to the current level of ISC. These directions envisage that the ISC should not increase from current levels until the four week payment period starting on 6 January 2008.

The Arbiter also considers that it is appropriate to seek some assurance that there is a probability that the Infraco will fulfil its existing obligations while the Extraordinary Review is being completed. He therefore proposes to make ancillary directions which attach conditions to the payment of the increase in the ISC.

The Arbiter is seeking representations on these draft directions by 12 noon on Monday 23 July. He proposes to issue final directions on or before 31 July 2007.

## **1 The Arbiter's draft directions**

- 1.1 This chapter sets out in the directions which the Arbiter proposes to make following the reference for directions made by Metronet BCV on 28 June 2007.
- 1.2 The Arbiter is seeking representations on these draft directions by 12 noon on Monday 23 July. He proposes to issue final directions on or before 31 July 2007.

### **Draft directions**

By reference to section 229(5) of the Greater London Authority Act 1999, the PPP Arbiter hereby gives notice to Metronet Rail BCV Limited and to London Underground Limited of his direction in respect of paragraph 1.8 of Metronet Rail BCV Limited's PPP Agreement dated 4 April 2003.

### **Quantum of Interim level of ISC**

By reference to section 229(3)(a) of the Greater London Authority Act 1999, the PPP Arbiter directs that London Underground Limited is to pay Metronet Rail BCV Limited an amount of £393.3 million (in February 2002 prices) being the PPP Arbiter's assessment of the interim level of Underlying ISC in respect of Metronet Rail BCV Limited's Extraordinary Review referred to the PPP Arbiter on 28 June 2007 that would be sufficient for a Notional Infraco to perform Metronet Rail BCV Limited's Existing Obligations under its PPP Agreement dated 4 April 2003 over the period from 29 June 2007 to 28 June 2008 (the Reference Period)<sup>1</sup>.

### **Profile of Interim level of ISC payments**

By reference to section 229(3)(b) of the Greater London Authority Act 1999, the PPP Arbiter directs that the interim level of Underlying ISC of £393.3 million (in February 2002 prices) is to be paid over the period from 29 June 2007 to 28 June 2008 in accordance with the profile in Table 1 below:

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<sup>1</sup> This figure comprises Underlying ISC for the Reference Period of £288.8 million and additional payments of £104.5 million, equivalent to £121 million at nominal prices.

**Table 1****Interim ISC for the period from 29 June 2007 to 28 June 2008 at February 2002 prices**

Payment Period start	Payment Period end	Underlying ISC (£m) <sup>2</sup>	Proportion of Payment Period falling within Reference Period	Apportioned Underlying ISC (£m)	Additional Underlying ISC determined by Arbitrator (£m)	Amended Underlying ISC by virtue of this Direction (£m)
24 June	21 July	22.1	85.7%	18.9	0	18.9
22 July	18 Aug	22.1	100%	22.1	0	22.1
19 Aug	15 Sept	22.1	100%	22.1	0	22.1
16 Sept	13 Oct	22.1	100%	22.1	0	22.1
14 Oct	10 Nov	22.1	100%	22.1	0	22.1
11 Nov	8 Dec	22.1	100%	22.1	0	22.1
9 Dec	5 Jan 2008	22.1	100%	22.1	0	22.1
6 Jan	2 Feb	22.1	100%	22.1	13.1	35.2
3 Feb	1 Mar	22.1	100%	22.1	17.9	40.0
2 Mar	31 Mar	22.1	100%	22.1	14.7	36.8
1 April	26 April	22.1	100%	22.1	12.6	34.7
27 April	24 May	22.1	100%	22.1	21.8	43.9
25 May	21 June	22.1	100%	22.1	16.4	38.5
22 June	19 July	22.1	21.4%	4.7	8.1	12.8
<b>Total</b>				<b>288.8</b>	<b>104.5</b>	<b>393.3</b>

**Conditions attached to Interim level of ISC payments**

By reference to section 229(3)(b) of the Greater London Authority Act 1999, the PPP Arbitrator directs that the following provisions are inserted into the PPP Agreement between Metronet Rail BCV Limited and London Underground Limited (LUL):

- x.1 The ISC Adjustment will, subject to x.2 to x.7 below, be added to the Underlying ISC in the instalments specified in Table 1.
- x.2 Each payment will be paid on trust for the purpose of performing the Existing Obligations of Infraco.
- x.3 LUL will pay each instalment on prior receipt from Infraco of a certificate signed by Infraco's Chairman and Chief Financial Officer stating that:
  - (i) Infraco is able to continue as a going concern and that Infraco will be able to fund any gap between the Interim ISC and Infraco's cash requirements to deliver Infraco's Existing Obligations for the remainder of the Reference Period; and

<sup>2</sup> Source of Underlying ISC figures is Appendix 1 to Schedule 4.1 of Metronet BCV's PPP Agreement dated 4 April 2003.

- (ii) the previous instalment has been applied, and the next instalment will be applied, only to reimburse for the performance of Infraco's Existing Obligations that have already substantially been delivered or that will substantially be delivered in the period to which the instalment relates.
- x.4 A monitoring trustee shall be appointed by the Arbiter in accordance with Annex [ ] after consulting Infraco and LUL. The appointment shall be made within two weeks of these Directions. Infraco and LUL will comply with their obligations in respect of the monitoring trustee specified in Annex [ ]. The monitoring trustee will monitor Infraco's performance of its Existing Obligations and will notify the Arbiter where in the opinion of the monitoring trustee Infraco is not:
  - (i) delivering the Existing Obligations in accordance with the work profile underlying Infraco's cash flow forecasts which are the basis for the payment schedule specified in Table 1, and/or
  - (ii) having regard to past performance, achieving sufficient progress towards delivering the Existing Obligations in an economic and efficient manner and in accordance with Good Industry Practice.
- x.5 Where the monitoring trustee notifies the Arbiter under x.4 the Arbiter may vary the ISC Adjustment to reflect the principles set out in x.4(i) and (ii).
- x.6 For the avoidance of doubt, it is confirmed that the opinion of the monitoring trustee is not binding on the Arbiter with respect to directions on Interim ISC or directions at the conclusion of the Extraordinary Review.
- x.7 These directions may be reviewed and amended by the Arbiter when he consults on draft directions pursuant to paragraph 1.9(a) (Net Adverse Effects) and draft directions pursuant to paragraph 1.9(b) (required ISC changes) during the Extraordinary Review.

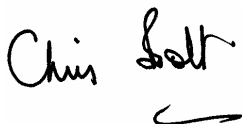
**Annex referred to in x.4**

1. The monitoring trustee shall possess appropriate qualifications and experience to carry out the monitoring trustee's functions.
2. The monitoring trustee shall be independent of Infraco and LUL and shall have no conflict of interest in relation to performance of the monitoring trustee's functions.
3. The scope and associated cost of the monitoring trustee's performance of its functions in any period shall be commensurate with the ISC Adjustment paid in that period.
4. LUL shall bear the costs of the monitoring trustee, and shall reimburse the monitoring trustee in full for all reasonable costs and expenses

reasonably incurred in the performance by the monitoring trustee of its functions.

5. Infraco and LUL shall give an indemnity to the monitoring trustee by which the monitoring trustee and any assistant appointed by the monitoring trustee is held harmless against any losses, claims, damages, liabilities or expenses arising out of or in connection with the performance of the monitoring trustee's functions except to the extent that such losses, claims, damages, liabilities or expenses shall be caused by the bad faith or gross negligence of the monitoring trustee.
6. Infraco and LUL shall cooperate fully with, and shall ensure that their employees, officers, advisers and consultants shall cooperate fully with, the monitoring trustee in the performance by the monitoring trustee of its functions.
7. Without prejudice to the generality of 6 above, such cooperation by Infraco shall include:
  - (i) the provision of such facilities as are necessary for the discharge by the monitoring trustee of its functions, including the provision of an office with a workstation, telephone, fax machine and a computer at such Infraco premises as the monitoring trustee may reasonably require; and
  - (ii) the provision of full and complete access, including access to electronic files, to all personnel, books, records, documents, facilities and information of Infraco as the monitoring trustee shall reasonably require.

Nothing in the directions above seeks to alter any amounts payable by London Underground Limited to Metronet Rail BCV Limited prior to 29 June 2007 or after 28 June 2008. And in all other respects Clause 18 [Payments] and Schedule 4.1 [Performance Payment Mechanism] of the Service Contract are unchanged.



Chris Bolt  
**PPP Arbiter**  
[● July] 2007

## 2 Arbiter's approach to the reference

2.1 This chapter sets out the Arbiter's approach to the reference. It covers:

- a description of the reference, and the Arbiter's statutory functions in relation to it;
- the process he has taken following receipt of the reference; and
- matters relating to the Arbiter's interpretation of a number of contractual provisions relevant to a direction on Interim ISC.

### The reference and the Arbiter's statutory functions

2.2 On 28 June 2007 Metronet BCV submitted a reference for direction to the Arbiter under section 229(2) of the Greater London Authority (GLA) Act. That reference sought directions on three matters<sup>3</sup>, as follows:

- (i) in accordance with paragraph 1.2 of Schedule 1.9 of the PPP Service Contract, the form and structure of the way in which the parties should proceed concerning an Extraordinary Review to give effect to and facilitate the intent of Part 3 of Schedule 1.9 of the PPP Service Contract;
- (ii) in accordance with paragraph 1.9 of Schedule 1.9 of the PPP Service Contract:
  - a. a contention by Metronet Rail BCV Limited that it has incurred Net Adverse Effects during the Review Period in excess of the Materiality Threshold;
  - b. the amount and timing of any adjustments to the level of ISC sufficient for a Notional Infraco to:
    - i. properly perform its contractual obligations during the remainder of the current Review Period; and
    - ii. to avoid the need for Infraco to finance any Net Adverse Effects during the then current Review Period as a whole that is in excess of the Materiality Threshold;
- (iii) in accordance with paragraph 1.8 of Schedule 1.9 of the PPP Service Contract, the interim level of ISC that would be sufficient to enable a Notional Infraco to perform its existing obligations pending any direction pursuant to (ii) above.

2.3 This document addresses item (iii) alone. The Arbiter will shortly publish his timetable for issuing directions on items (i) and (ii).

2.4 Under the provisions of section 229(3)(a) of the GLA Act, the Arbiter is required to give a direction in relation to a matter so referred in a PPP Agreement. Under section 229(3)(b) of the GLA Act he may also give a direction in relation to any other matter which is ancillary or incidental to the matter referred.

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<sup>3</sup> The Reference Application Notice and Statement of Case are reproduced at Annex 1.

- 2.5 In giving directions (or guidance), 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.
- 2.6 The Arbiter is also under a duty to take account of any factors which are notified to him by both Parties, or are specified in the relevant PPP Agreement, as ones to which he must have regard<sup>4</sup>. Schedule 1.9 of the PPP Agreements contains a number of matters within the scope of this duty.

### **Process followed**

- 2.7 On 16 July 2004, following consultation, the Arbiter published a Procedural Framework for giving directions or guidance under sections 229 and 230 of the GLA Act. The Procedural Framework is supplemented by a series of Procedural Approach documents on the anticipated approach to specific types of reference, including an Extraordinary Review.
- 2.8 The Procedural Framework and the associated Procedural Approach documents were reissued on 30 June 2006 and again on 4 June 2007, following consultation<sup>5</sup>. The Arbiter has followed the latest versions of the Procedural Framework and Procedural Approach document in this reference.
- 2.9 On 28 June 2007 Metronet BCV submitted to the Arbiter its Reference Application Notice. Attached to that Reference Application Notice were Metronet BCV's:
- Statement of Case;
  - Initial Submission; and

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<sup>4</sup> Section 231(6) of the GLA Act.

<sup>5</sup> Arbiter's Procedural Framework for Use in the Giving of Directions and Guidance Under the Greater London Authority Act 1999 and PPP Agreements, 4 June 2007, at [http://www.pparbiter.org.uk/files/uploads/g\\_proceduralFrameWork/2007651842\\_Procedural%20Framework,%20June%202007.PDF](http://www.pparbiter.org.uk/files/uploads/g_proceduralFrameWork/2007651842_Procedural%20Framework,%20June%202007.PDF) and Procedural Approach to Extraordinary Review, 4 June 2007, at [http://www.pparbiter.org.uk/files/uploads/g\\_proceduralFrameWork/200765183341\\_Procedural%20Approach%20to%20Extraordinary%20Review.pdf](http://www.pparbiter.org.uk/files/uploads/g_proceduralFrameWork/200765183341_Procedural%20Approach%20to%20Extraordinary%20Review.pdf).

- Warranty.

Metronet BCV's "Notional Infraco cost model" was not submitted at this point and only became available to the Arbiter (and to London Underground) on 4 July.

- 2.10 Metronet BCV's Initial Submission included its claim for Interim ISC. Metronet BCV indicated in that submission that the level of Interim ISC that it was seeking, in excess of Underlying ISC, was £400.2 million in respect of the 12 months from the date of the reference. This sum represented £340.6 million in respect of Net Adverse Effects in excess of the Materiality Threshold during the 12 months from 1 July 2007 (which Metronet uses as an approximation for the date of the reference). It also included a claim for up front funding of £59.6 million to replace the bid assumed debt drawdowns if the drawstop is still in place on the date of directions in respect of Interim ISC.
- 2.11 On 29 June the Arbiter published on his website a paper (the "issues paper") setting out his proposed approach to certain contractual matters relevant to the Extraordinary Review and in particular this request for a direction on Interim ISC<sup>6</sup>. That paper sought responses from the Reference Parties (being Metronet BCV and London Underground) and other interested parties by 12 noon on 9 July.
- 2.12 On 4 July Metronet BCV and London Underground each separately presented their Initial Submissions on the whole Extraordinary Review process to the Arbiter's Office and his professional advisers. In addition Metronet BCV explained its submission on the Interim ISC being sought. Following these presentations, Metronet provided its Notional Infraco cost model and various other electronic data that was omitted from its Initial Submission.
- 2.13 Later on 4 July, London Underground submitted its Preliminary Response to Reference. As a consequence of London Underground's view that Net Adverse Effects incurred and to be incurred by Metronet BCV over the first 7½ year Review Period do not exceed the Materiality Threshold of £50 million (indexed), London Underground made no specific representation about the level of Interim ISC in that document. However, it submitted representations on this issue on 12 July, in which it reiterated its position that no additional ISC was payable over the whole Review Period, and that Metronet's claim for Interim ISC should be rejected.
- 2.14 On 11 July, Metronet provided a preliminary response to London Underground's Response to Reference, and on 13 July a further response in relation to London Underground's representations on stations costs. It submitted on 12 July a Supplemental Submission which corrected some minor errors in its Initial Submission but more importantly identified some additional items affecting the financing of

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<sup>6</sup> Extraordinary Review: Contractual interpretation and assessment of Interim ISC: Arbiter's proposed approach, 29 June 2007, at [http://www.pparbiter.org.uk/files/uploads/i\\_pressNotices/200762994957\\_Announcement\\_02\\_07.pdf](http://www.pparbiter.org.uk/files/uploads/i_pressNotices/200762994957_Announcement_02_07.pdf).

Metronet BCV. The overall effect was to increase the increase in ISC claimed during the Reference Period from £400.2 million to £551.1 million. London Underground responded to this on 13 July, reiterating its position that no Interim ISC was payable.

### **Contractual provisions relating to Interim level of ISC**

2.15 Metronet BCV and London Underground made representations on the matters raised in the issues paper, and other matters relating to the reference, by 9 July as requested. Metronet's further representation of 11 July also related in part to matters covered by the issues paper. Representations were also received on the issues paper from Tube Lines and Martin Blaiklock. The Arbiter's approach to matters in the issues paper particularly relevant to the determination of Interim ISC, taking account of these representations, is set out below.

#### **(a) Time period covered**

2.16 In the event of an Extraordinary Review Infraco has the ability<sup>7</sup> to ask for a direction on the "... interim level of ISC that would be sufficient to enable a Notional Infraco to perform its existing obligations... pending any direction pursuant to paragraph 1.9(b)...".

2.17 This paragraph must be read in the context of the Schedule as a whole since a direction under paragraph 1.8 cannot be sought independently of the broader Extraordinary Review process. The purpose of paragraph 1.8 is therefore to provide a bridge until a final direction on "the amount and timing of any adjustments to the level of ISC" under paragraph 1.9(b) is given.

2.18 The Arbiter considers that his direction on Interim ISC should cover the period up to the expected date of his final directions under paragraph 1.9(b). Although the Arbiter has yet to publish his administrative timetable for the Extraordinary Review, he has indicated that he would expect to publish draft directions on Net Adverse Effects, pursuant to paragraph 1.9(a) before Christmas 2007. Given the stages required following draft directions on Net Adverse Effects, including the possible need for London Underground to consider changes to obligations on affordability grounds, the Arbiter has concluded that that period covered by Interim ISC should be 12 months from the day following the Reference Application Notice ie from 29 June 2007 to 28 June 2008. For the purposes of this document that period is referred to as the "Reference Period".

2.19 In the event that final directions on ISC under paragraphs 1.9(b) are not made by 28 June 2008, nothing in this direction prevents Metronet BCV from seeking a further direction on Interim ISC. Should the Extraordinary Review be concluded earlier than 28 June 2008 then the final directions on ISC will supersede the levels specified in these directions.

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<sup>7</sup> Paragraph 1.8(b) of Schedule 1.9 to the PPP Agreements.

**(b) Basis of assessment**

- 2.20 Paragraph 1.8 refers to the “interim level of ISC that would be sufficient to enable a Notional Infraco to perform its existing obligations”. Similarly, in the context of the full Extraordinary Review, paragraph 1.9(b) refers to “the level of ISC sufficient for a Notional Infraco ...” The focus is on the Notional Infraco rather than the actual Infraco and it was on this basis that Metronet BCV assembled its Interim ISC submission.
- 2.21 However, in assessing Net Adverse Effects, the Arbiter has to assess, among other matters, the level of Eligible Costs. These are defined as the lower of:
- “the aggregate costs that Infraco actually incurred in performing the Infraco Obligations during a Review Period”; and
  - “the aggregate costs that Infraco would have incurred in performing the Infraco Obligations during a 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.”
- 2.22 The Arbiter considers that the definition of Eligible Costs requires him to compare the actual costs incurred or to be incurred by Infraco in the Review Period in delivering Infraco Obligations with the estimated costs of delivering the same obligations at the same time as Infraco (to the extent that this is later than would be achieved by a Notional Infraco), but with the scope of works and costs that represent in all other respects performance in an overall efficient and economic manner and in accordance with Good Industry Practice.
- 2.23 Where the Infraco’s programme differs from that of a Notional Infraco, for example if obligations were being delivered late, then some of the associated cost – such as additional costs incurred in accelerating a deferred programme – may not be deemed efficient and economic.
- 2.24 Similar principles apply in respect of the assessment of Eligible ISC. Where the actual Infraco is delivering obligations later than envisaged in the contract and the Notional Infraco would have delivered earlier than the actual Infraco, then the assessment of Eligible ISC would be based on the abatements or bonuses that the Notional Infraco would have experienced, if any.
- 2.25 The reference in paragraph 1.8 to ‘existing obligations’ of the Notional Infraco suggests to the Arbiter that Interim ISC is not intended to enable past obligations to be financed. Accordingly, the Arbiter considers that his direction in respect of Interim ISC should not include funding for any Net Adverse Effects in excess of the Materiality Threshold incurred before the date of the reference.
- 2.26 However, as part of the determination of Interim ISC in the Reference Period, the Arbiter considers that he needs to reach a view on whether Net Adverse Effects in advance of the reference date have or have not exhausted the Materiality Threshold. If he concludes that Infraco has not incurred Net Adverse Effects in excess of the Materiality Threshold by

the date of the reference, any Interim ISC would only be payable from the date during the Reference Period at which Net Adverse Effects exceed the Materiality Threshold.

- 2.27 For these purposes, the Arbitrator considers that the Materiality Threshold should be indexed using relevant indices on the basis described in Schedule 4.2 of the PPP Agreement, to the date that the Materiality Threshold is expected to be exhausted.

**(c) Baseline**

- 2.28 The definition of Qualifying Costs (and Revenues) includes reference to revising the Baseline for Net Adverse Effects "...to reflect all subsequent agreements or determinations pursuant to the terms of the Transaction Documents concerning costs that are eligible for recovery from LUL"<sup>8</sup>.
- 2.29 The costs that are used to calculate Net Adverse Effects are, in all cases, the costs of performing the Infraco Obligations<sup>9</sup>. These therefore include all Exceptional Amounts that are paid by London Underground to Infraco in undertaking, for example, Specified Rights<sup>10</sup>, Major Enhancements and Intermediate Works since these are obligations under or pursuant to the PPP Agreements.
- 2.30 The Arbitrator sought confirmation from the Parties of an agreed revised Baseline for Net Adverse Effects and statement of Infraco Obligations. However, the Parties have not been able to provide an agreed Baseline. The Arbitrator has therefore made his own assessment of the relevant Baseline, by taking the Baseline as previously supplied to him (currently, in the case of Metronet, based on Financial Model NAE60c<sup>11</sup>) and applying those changes to it which he considers necessary to enable the Baseline to be on a consistent basis with the known obligations of the Infraco, reflecting known variations made under Schedule 5.8 and any other relevant changes enabled by the PPP Agreement such as the exercise of Specified Rights and payment of other Exceptional Amounts.

**Approach to analysis**

- 2.31 The Arbitrator recognises that, in advance of completion of the Extraordinary Review, the information available to him to reach a judgement on the efficient and economic level of costs of a Notional Infraco in order to make a direction on Interim ISC is limited. His approach has therefore been to start from the Metronet BCV's actual and projected scope, costs and programme for the period from Transfer to the date of the reference and during the Reference Period and consider what

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<sup>8</sup> Master Definitions Agreement (MDA) definition of Qualifying Costs and Qualifying ISC.

<sup>9</sup> "Infraco Obligations means the Services and all other obligations and liabilities of Infraco under and pursuant to its PPP Contract or any document entered into pursuant to it (other than the Funding Agreements)" (MDA).

<sup>10</sup> Referred to as "LUL Specified Rights" in the MDA.

<sup>11</sup> NAE60c contains the same revenue and expenditure totals as in Annex 5 of the PPP Agreement, but provides a different cost breakdown reflecting revisions in Metronet BCV's cost allocations compared with those used in the bid.

adjustment should be made to costs (and revenues) in respect of amounts judged not to be efficient and economic.

2.32 The results of this analysis are set out in chapter 3 of this document.

### **Financing**

2.33 In relation to financing, the Arbiter considers that he should only take account of restrictions imposed by funders on drawdown of financing in determining Interim ISC to the extent that he considers that a Notional Infraco would have experienced the same restrictions. His conclusions on this matter, and the reasons for these conclusions, are set out in chapter 4 of this document.

### **Ancillary and incidental directions**

2.34 The Arbiter considers it appropriate that any direction for Interim ISC should include provisions relating to the timing of payment of ISC and provisions to ensure that the amounts payable are utilised for the delivery of the identified Existing Obligations pending the outcome of the Extraordinary Review. The reasons for this are explained further in chapter 5 of this document.

### 3 Arbiter's reasons for quantum and timing of interim level of ISC

#### Overview

- 3.1 The Arbiter's Procedural Approach to Extraordinary Review<sup>12</sup> indicates at para 3.18 that the timetable for a direction on Interim ISC should be dependent on circumstances of the request.
- 3.2 Metronet BCV's Reference Application Notice seeks a direction on Interim ISC under paragraph 1.8 within four weeks of the date of the reference. This timetable provides little scope for the Arbiter to perform any of the detailed analysis that will be performed in reaching a direction of the full Extraordinary Review particularly given the requirement<sup>13</sup> to consult London Underground, Metronet BCV and their stakeholders<sup>14</sup> on provisional conclusions prior to issuing final conclusions.
- 3.3 Information and analysis used in this assessment has included:
- information provided by Metronet BCV to the Arbiter and to London Underground in advance of the reference, including Financial Model FM 68 and an Agreed Upon Procedures Report prepared by Deloitte for Metronet BCV;
  - representations from Metronet BCV and London Underground as set out in their Initial Submission and Preliminary Response to Reference, and subsequent clarifications;
  - the assessment of the Metronet BCV's performance in the Arbiter's 2006 annual Metronet Report (aMR 2006)<sup>15</sup> and further guidance on the Treatment of Investment at an Extraordinary Review<sup>16</sup> and an analysis of how this position has changed in the period between that guidance being issued and this Extraordinary Review being triggered; and

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<sup>12</sup> See [http://www.ppparbiter.org.uk/files/uploads/g\\_proceduralFrameWork/200765183341\\_Pr ocedural%20Approach%20to%20Extraordinary%20Review.pdf](http://www.ppparbiter.org.uk/files/uploads/g_proceduralFrameWork/200765183341_Pr ocedural%20Approach%20to%20Extraordinary%20Review.pdf).

<sup>13</sup> Paragraphs 3(d), 3(e) and 3(f) of Annex 2 to Schedule 1.9 (PPP Parties' joint Guidance to the Statutory Arbiter), at [http://www.ppparbiter.org.uk/files/uploads/j\\_pppAgreementExtracts/200621014240\\_BC V%20Schedule%201.9%20of%20the%20PPP%20Agreement%20Service%20Contract %20\(01\\_04\\_03\)%20DM11279v1.PDF](http://www.ppparbiter.org.uk/files/uploads/j_pppAgreementExtracts/200621014240_BC V%20Schedule%201.9%20of%20the%20PPP%20Agreement%20Service%20Contract %20(01_04_03)%20DM11279v1.PDF).

<sup>14</sup> London Underground's stakeholders include its holding company, Transport for London, the Mayor and any Minister and, in the case of Metronet BCV, its stakeholders include its five shareholders (Atkins, Balfour Beatty, Bombardier, EdF and Thames Water) and its providers of debt finance (paragraph 3(b) of Annex 2 to Schedule 1.9).

<sup>15</sup> Annual Metronet Report 2006, 16 November 2006, at [http://www.ppparbiter.org.uk/files/uploads/n\\_guidance/2006112012398\\_aMR%202006 %20final%20guidance.PDF](http://www.ppparbiter.org.uk/files/uploads/n_guidance/2006112012398_aMR%202006 %20final%20guidance.PDF)

<sup>16</sup> Treatment of Investment at an Extraordinary Review, 13 March 2007, at [http://www.ppparbiter.org.uk/files/uploads/n\\_guidance/200731217517\\_Final%20Guidan ce%20on%20Treatment%20of%20Investment%20at%20an%20ER.pdf](http://www.ppparbiter.org.uk/files/uploads/n_guidance/200731217517_Final%20Guidan ce%20on%20Treatment%20of%20Investment%20at%20an%20ER.pdf)

- a technical report from the Arbiter's advisers, Halcrow, which is being provided in confidence to the Parties to the reference, which includes analysis, in respect of stations costs, of information provided by Tube Lines.
- 3.4 Assessment of the sufficient interim level of ISC at such an early stage in an Extraordinary Review has required the Arbiter to make judgements on the basis of limited information and place a degree of reliance on Metronet BCV's period by period projections. This information will be more thoroughly reviewed in the course of the Extraordinary Review as a whole, and the Arbiter's final directions on ISC for the remainder of the Review Period may therefore reflect a different assessment of the ISC required in respect of the period covered by this Interim ISC direction.

**Metronet BCV's statement of case**

- 3.5 Metronet BCV's submission argues that a Notional Infraco would have incurred Net Adverse Effects of £1,047 million (at nominal prices) over the first Review Period, from 4 April 2003 to 3 October 2010. In addition, it contends that Net Adverse Effects incurred by the date of the Extraordinary Review reference exceed the Materiality Threshold. Accordingly, it argues that all Net Adverse Effects during the Reference Period should be reflected in the direction on Interim ISC.
- 3.6 Metronet BCV's submission indicated that the level of ISC that it was seeking in total, in excess of Underlying ISC, was £400.2 million in respect of the 12 months from the date of the reference. This sum represented £340.6 million in respect of Net Adverse Effects during the 12 months from 1 July 2007 (which Metronet uses as an approximation for the date of the reference). It also includes a claim for up front funding of £59.6 million to replace the bid assumed debt drawdowns if the drawstop is still in place on the date of directions in respect of Interim ISC.
- 3.7 As noted in chapter 2, Metronet BCV subsequently revised its claim to correct some minor errors and to identify additional factors relating to financing and working capital, making its total claim for Interim ISC £551.1 million
- 3.8 The phasing of the revised claimed increase in ISC is set out in Table 2 below.

**Table 2****Metronet BCV claim for additional ISC in Reference Period**

<b>Payment Period start</b>	<b>Payment Period end</b>	<b>Proportion of Payment Period to apply<sup>17</sup></b>	<b>Interim ISC being sought (£m)</b>
24 June	21 July	75%	198.3
22 July	18 Aug	100%	38.6
19 Aug	15 Sept	100%	60.5
16 Sept	13 Oct	100%	25.5
14 Oct	10 Nov	100%	4.6
11 Nov	8 Dec	100%	19.4
9 Dec	5 Jan 2008	100%	26.1
6 Jan	2 Feb	100%	20.1
3 Feb	1 Mar	100%	25.2
2 Mar	31 Mar <sup>18</sup>	100%	47.5
1 April	26 April	100%	18.1
27 April	24 May	100%	31.4
25 May	21 June	100%	23.8
22 June	19 July <sup>19</sup>	25%	11.8
<b>Total</b>			<b>551.1</b>

3.9 Metronet BCV contends, in support of its claim for Interim ISC that, over the period 1 July 2007 to 30 June 2008:

- Metronet BCV will incur a net cash outflow of £423.3m before taking account of financing costs or tax but after working capital movements;
- of that £423.3m, Metronet BCV itself considers that £54.0 may be disallowed representing costs that would not be incurred by a Notional Infraco;
- the Baseline for Net Adverse Effects over that period shows a net cash outflow of £32.2m; and
- the brought forward balance of the Materiality Threshold is nil reflecting Metronet BCV's contention that Net Adverse Effects prior to 1 July 2007 significantly exceed the Materiality Threshold.

<sup>17</sup> Metronet BCV has calculated proportion of Payment Period to apply by weeks.

<sup>18</sup> In Metronet BCV's Interim Determination of ISC submission, the end date for period 13 is incorrectly shown to be 29 March 2008.

<sup>19</sup> Metronet BCV notes that the payment date for this final interim ISC payment falls outside the Reference Period.

3.10 Table 3 below summarises Metronet BCV's assumptions for its recovery rate of costs and revenues over the period from 1 July 2007 to 30 June 2008 as compared between Metronet BCV (sourced from FM68) and Notional Infraco by spend category (all amounts in nominal prices).

**Table 3**

**Metronet BCV recovery rates by cost category**

	<b>Actual Infraco (£m)</b>	<b>% re-recovery</b>	<b>Notional Infraco costs (£m)</b>	<b>NAE60C (£m)</b>	<b>Interim ISC being sought (£m)</b>
Underlying ISC	329.5	100%	329.5	327.1	(2.4)
Performance	10.1	201%	20.3	34.7	14.4
Non PPP Income	19.2	100%	19.2	19.2	nil
<b>Total Revenue</b>	<b>358.8</b>	<b>103%</b>	<b>369.0</b>	<b>381.0</b>	<b>12.0</b>
Rolling Stock Opex	(55.0)	98%	(53.8)	(41.7)	12.1
Rolling Stock Capex	(28.9)	100%	(28.9)	(5.3)	23.6
Signals Opex	(21.6)	102%	(22.0)	(10.9)	11.1
Signals Capex	(13.8)	99%	(13.7)	(5.3)	8.4
Track Opex	(30.2)	99%	(29.8)	(16.9)	12.9
Track Capex	(54.0)	99%	(53.3)	(63.8)	(10.5)
VLU Upgrade	(112.7)	91%	(102.3)	(49.2)	53.1
Power	(5.2)	100%	(5.2)	(3.3)	1.9
Civils	(51.5)	93%	(48.0)	(41.7)	6.3
Stations Opex	(47.6)	100%	(47.7)	(38.2)	9.5
Stations Capex	(250.2)	81%	(203.8)	(76.5)	127.3
Risk	(46.1)	95%	(43.6)	(7.5)	36.1
Admin	(60.5)	152% <sup>20</sup>	(91.9)	(38.6)	53.3
Non ISC Costs	(15.1)	101%	(15.2)	(15.1)	0.1
<b>Total Costs</b>	<b>(792.5)</b>	<b>96%</b>	<b>(759.3)</b>	<b>(414.0)</b>	<b>345.3</b>
Working capital	22.7	n/a	26.0	0.7	(25.3)
<b>Total including working capital</b>					<b>332.0</b>
Cash flow implications of draw-stopped debt					219.1
<b>Total</b>					<b>551.1</b>

**London Underground's preliminary response to reference**

3.11 London Underground's preliminary response to reference makes no reference to the interim level of ISC required by a Notional Infraco as it is London Underground's contention that there are no Net Adverse Effects in the Reference Period. However, it has provided additional information in its Initial Interim ISC response which enables its assessment of

<sup>20</sup> This figure is higher than 100% because of Metronet BCV's treatment of additional pension costs.

efficient and economic costs to be broken down by time period, in particular to cover the period from Transfer to the date of the reference and for the Reference Period.

3.12 London Underground' assessment of efficient and economic costs and revenues, which follows a somewhat different asset categorisation to that of Metronet BCV and covers the whole of the first Review Period, is summarised in Table 4 below.

**Table 4**

**London Underground recovery rates by cost category**

	<b>2007-08 Metronet BCV AAMP (£m)</b>	<b>Competent Infraco<sup>21</sup> costs (£m)</b>	<b>Variance (£m)</b>	<b>"Recovery"</b>
Stations	1,221	907	314	74%
Track	672	547	125	81%
Line Upgrades	658	574	84	87%
Rolling Stock (excluding Line Upgrades)	571	408	163	71%
Signalling (excluding Line Upgrades)	172	116	56	67%
Lifts & Escalators	186	154	32	83%
Civils Infrastructure	203	159	44	78%
Administration	576	404	172	70%
<b>Total before Risk and Uncertainty</b>	<b>4,259</b>	<b>3,269</b>	<b>990</b>	<b>77%</b>

**Arbiter's assessment of Net Adverse Effects**

3.13 As noted in chapter 2, the Arbiter's approach in considering the appropriateness of Metronet BCV's Statement of Case has been to start from Metronet BCV's actual and projected programme of delivery, scope of works and costs for the period from Transfer to the end of the Reference Period and consider the potential scale of Net Adverse Effects. For the purposes of the direction on Interim ISC, he has done this by considering what adjustments should be made to reflect uneconomic and inefficient costs and revenues.

**(a) Costs**

3.14 The Arbiter has taken a view, reflecting review of the representations from the Parties, his own analysis and advice from his technical advisers, Halcrow, on the extent to which Metronet BCV's costs are

<sup>21</sup> London Underground use the term 'Competent Infraco' to refer to the infraco which has performed its obligations 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.

uneconomic and inefficient, on a year by year basis. In addition, he has taken account of the conclusion in the aMR 2006 that Metronet BCV's performance in respect of asset management and risk management in the period from Transfer to 31 March 2006 was rated as D in respect of Good Industry Practice, that is that its performance did not reflect Good Industry Practice.

3.15 The Arbiter's analysis results in the percentage recoveries of Metronet BCV's actual and projected costs for the period from Transfer to the end of the Reference Period in Table 5 below.

**Table 5**

**Arbiter's assumed recovery rates by cost category**

	Year 1	Year 2	Year 3	Year 4	(Part) Year 5	During Reference Period
Rolling Stock Capex	100%	100%	99%	97%	97%	98%
Rolling Stock Opex	100%	100%	100%	100%	100%	100%
Signals Capex	98%	86%	99%	95%	99%	100%
Signals Opex	100%	100%	100%	100%	100%	100%
Depots	100%	100%	100%	100%	100%	100%
Track Capex	55%	55%	55%	74%	90%	97%
Track Opex	96%	87%	85%	79%	83%	83%
Civils	100%	100%	100%	100%	100%	100%
Stations Capex	81%	81%	81%	74%	81%	83%
Stations Opex	95%	90%	85%	90%	90%	90%
Admin & Other	100%	100%	78%	69%	73%	92%
Risk	100%	100%	100%	100%	100%	100%
Variations	100%	100%	100%	100%	100%	100%

3.16 In reaching these conclusions, the Arbiter has taken the preliminary view that a Notional Infraco could have had the same supply chain arrangements as Metronet BCV except, as explained below, in respect of track capex. However, he has yet to reach a final view on this matter and will wish to consider this matter further as part of the full Extraordinary Review.

3.17 Given the request by Metronet BCV for an early direction on Interim ISC, the analysis of costs has started from that undertaken by the Arbiter's staff and advisers on the aMR 2006 and on the reference for guidance on the Treatment of Investment at an Extraordinary Review and considered whether the Metronet and London Underground submissions for this reference changed the conclusion of the previous analysis. In general, the concerns expressed previously remain, although it has generally been assumed that the efficiency improvements identified at the end of the period covered by the aMR 2006 have continued.

- 3.18 Halcrow has in particular reviewed expenditure relating to track capex and opex and stations capex and opex. Its approach has been to quantify the impact of factors identified as adversely affecting delivery in an efficient and economic manner. It has applied a 'top down' approach, with identification and assessment of elements of expenditure in each cost area which are considered not to be efficient and economic. These cost elements have been deducted from total expenditure in each asset area to determine the expected costs of an infraco which is efficient and economic and operating in accordance with Good Industry Practice.
- 3.19 In relation to stations capex, Halcrow has considered the following categories of cost which are not judged efficient and economic, based on its analysis for the Arbiter on earlier references for guidance:
- abortive work and avoidable costs arising from poor initial planning and scope development;
  - avoidable premiums to staff and labour costs due to the need to accelerate implementation programmes to meet contract deadlines; and
  - avoidable premiums where the reduced time for design development and tendering leads to additional risk being factored into overall costs. This is applied to the non-labour element of costs.
- 3.20 In coming to a year by year profile, Halcrow has taken into account the changes that Metronet BCV has made to its approach for delivering the stations programme including greater control of its subcontractor Trans4M, but has assumed that there is a time lag associated with implementation of a more efficient approach so that an element of costs to date remain inefficient and uneconomic.
- 3.21 A similar approach has been applied to track capex. However, in this instance the start point has not been adjustment to the costs that Metronet BCV incurred since the Arbiter considers that an efficient and economic Infraco which is acting in accordance with Good Industry Practice would not have had the original Balfour Beatty track contract at Transfer.
- 3.22 The unit rates applied to track are therefore based on Halcrow's professional judgement and on Metronet BCV's expected achievable delivery costs. As for stations, the level of assumed efficiency improves over time reflecting the changes that Metronet BCV is making to its track capex programme.
- 3.23 In relation to opex the review has again focussed on areas of concern identified at aMR 2006. In relation to stations these are:
- poor management of contract interfaces for subcontract maintenance providers;
  - poor management of interfaces with the Stations Modernisation and Refurbishment Programme (SMRP) programme and optimising the 'whole life' approach to maintenance; and
  - failure to meet performance targets for Service Points and Ambience.

3.24 The profile of inefficient costs reflects in particular the ongoing impact of delays to the SMRP programme and, in the early years, poor management of contract interfaces.

3.25 In relation to track opex Halcrow raised the following areas of concern in its technical report in respect of aMR 2006:

- poor management of delivery and quality with a improvement notices issued for access planning and removal of outstanding defects;
- poor management of resources and management requiring re-organisation of resources, use of contract labour at short notice to manage peak workloads;
- interfaces with the renewals programme and optimising the “whole life” approach to maintenance, particularly with delays to delivery of renewals plans; and
- failure to meet performance targets for Service Points and Availability.

An element of cost disallowance has been made in relation to each of these factors.

3.26 At aMR 2006, Halcrow also expressed concerns about the costs associated with the non supply chain elements of the Victoria Line Upgrade works. This view was strengthened in the reference for guidance on the Treatment of Investment at an Extraordinary Review, when Halcrow reviewed the Victoria Line enabling works and reported that, prior to the rebaselining of the costs of this project, it had not seen evidence of effective application of development control processes. Halcrow also indicated that even after the rebaselining it considered that there was scope for further improvement.

3.27 In the time available Halcrow has not had the opportunity to revisit this area but the Arbiter considers that evidence of previous references strongly suggests that there is a component of inefficient cost. A conservative cost reduction profile has therefore been applied by reflecting Metronet BCV’s acknowledgement of shortcomings in this area and the concerns expressed in previous guidance from the Arbiter.

3.28 In the aMR 2006, the Arbiter concluded that Administration and Other costs were probably efficient and economic in the period to 31 March 2006, in large part because costs were broadly in line with bid, although Metronet BCV was probably not following Good Industry Practice. It was also noted that projections for the remainder of the first Review Period were significantly in excess of bid. The latest projections confirm this position.

3.29 The Arbiter’s view remains broadly as set out in the aMR 2006. Accordingly, while no adjustments are made to Administration and Other costs in years 1 and 2, he considers that an Infraco which was overall efficient and economic and operating in accordance with Good Industry Practice would have achieved savings compared with initial cost levels

from year 3 onwards, in line with bid profiles<sup>22</sup>. The Arbiter has therefore assumed that the efficient and economic level of Administration and Other costs are in line with bid from year 3 onwards.

- 3.30 Metronet BCV's risk provision in the Reference Period has not been reduced. London Underground argues in its Initial Interim ISC Response that no such provision should be allowed. The Arbiter will want to review the provision for risk in the remainder of the Review Period in his directions on Net Adverse Effects and on revisions to ISC in the full Extraordinary Review, and will take account in those directions of any unused balance. In respect of the directions on Interim ISC, he takes the view that the conditions he proposes to attach to the payment of Interim ISC provide protection against the misuse of these funds.

**(b) Revenues**

- 3.31 In line with the approach set out in chapter 2, the Arbiter has considered the likely performance of a Notional Infraco in terms of its timing of delivery of projects such as station modernisations and refurbishments and in terms of the measures relevant to the performance regimes for availability, capability and ambience.
- 3.32 With one exception, the Arbiter has not been convinced that a Notional Infraco would have had performance revenue below the levels reflected in Metronet BCV's bid. However, the Arbiter notes that London Underground and Metronet BCV have agreed a revised profile of delivery of station works, under which Metronet BCV accepts 90.5% of the abatements against the original profile from year 3 onwards. The Arbiter has therefore reduced the performance revenues in Metronet BCV's bid to reflect the 9.5% of abatements from year 3 onwards for which London Underground has agreed to absorb.

**(c) Net Adverse Effects**

- 3.33 The Arbiter's assessment of Net Adverse Effects resulting from this analysis, following the definitions set out in the PPP Agreements, is set out in Table 6 below.

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<sup>22</sup> Although the components of Infraco's bid have no particular status in the PPP Agreements, the Arbiter notes that, in considering the aggregate costs that Infraco would have incurred in performing the Infraco Obligations during a 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, the Arbiter is guided to have regard, inter alia, to Infraco's costs, budgets and programmes of activities proposed as part of the original bidding process (paragraph 8.2(x) of Annex 2 to Schedule 1.9).

**Table 6**

**Arbiter's assessment of Net Adverse Effects to end of Reference Period**

<b>£m (nominal)</b>	<b>Source</b>	<b>Transfer Date to Reference start</b>	<b>Reference Period</b>	<b>Cumulative to end of Reference Period</b>
A: Actual costs	Arbiter analysis	2,303	782	3,085
B: Notional Infraco costs	Arbiter analysis	2,013	708	2,721
C: Eligible Costs	Lower of A and B	2,013	708	2,721
D: Expected Costs	Baseline for NAE (adj)	2,080	439	2,519
<b>E: Qualifying Costs</b>	<b>C – D</b>	<b>(67)</b>	<b>269</b>	<b>202</b>
F: Actual revenues	Arbiter analysis	1,352	342	1,694
G: Notional Infraco revenues	Arbiter analysis	1,364	359	1,723
H: Eligible ISC	Higher of F and G	1,364	359	1,723
I: Expected ISC	Baseline for NAE (adj)	1,364	359	1,723
<b>J: Qualifying Revenues</b>	<b>I – H</b>	<b>0</b>	<b>0</b>	<b>0</b>
K: Adjustment for net movement in working capital	Metronet's figure used	3	(26)	(23)
<b>L: Net Adverse Effects</b>	<b>E + J + K</b>	<b>(64)</b>	<b>243</b>	<b>179</b>
M: Materiality Threshold	Arbiter calculation			(58)
<b>Net Adverse Effects less Materiality Threshold</b>	<b>L – M</b>			<b>121</b>

**Interim ISC**

3.34 Paragraph 1.8 of Schedule 1.9 requires that the Arbiter make directions as to the interim level of ISC that is “sufficient” to enable the Notional Infraco to perform its existing obligations. The Arbiter considers that in determining the adjustment to Underlying ISC, all of the estimated Net Adverse Effects should be paid as the ISC Adjustment. However, the phasing of the payment should assume that as the Net Adverse Effects are in excess of £50 million the Cash Contingency Account, which is the funding put in place to cover the Materiality Threshold, is drawn down before Underlying ISC is increased.

3.35 Table 7 below allocates the amount of Interim ISC after deduction of remaining element of Materiality Threshold across the thirteen Payment Periods in the Reference Period, expressed at February 2002 prices.

**Table 7**

**Interim ISC for the period from 29 June 2007 to 28 June 2008 at February 2002 prices**

Payment Period start	Payment Period end	Underlying ISC (£m) <sup>23</sup>	Proportion of Payment Period falling within Reference Period	Apportioned Underlying ISC (£m)	Additional Underlying ISC determined by Arbitrator (£m)	Amended Underlying ISC by virtue of this Direction (£m)
24 June	21 July	22.1	85.7%	18.9	0	18.9
22 July	18 Aug	22.1	100%	22.1	0	22.1
19 Aug	15 Sept	22.1	100%	22.1	0	22.1
16 Sept	13 Oct	22.1	100%	22.1	0	22.1
14 Oct	10 Nov	22.1	100%	22.1	0	22.1
11 Nov	8 Dec	22.1	100%	22.1	0	22.1
9 Dec	5 Jan 2008	22.1	100%	22.1	0	22.1
6 Jan	2 Feb	22.1	100%	22.1	13.1	35.2
3 Feb	1 Mar	22.1	100%	22.1	17.9	40.0
2 Mar	31 Mar	22.1	100%	22.1	14.7	36.8
1 April	26 April	22.1	100%	22.1	12.6	34.7
27 April	24 May	22.1	100%	22.1	21.8	43.9
25 May	21 June	22.1	100%	22.1	16.4	38.5
22 June	19 July	22.1	21.4%	4.7	8.1	12.8
<b>Total</b>				<b>288.8</b>	<b>104.5</b>	<b>393.3</b>

<sup>23</sup> Source of Underlying ISC figures Appendix 1 to Schedule 4.1 of Metronet BCV's PPP Agreement dated 4 April 2003

#### **4 Arbiter's reasons for treatment of issues arising from funding drawstop**

- 4.1 Metronet BCV had full access to its main debt financing facilities, following utilisation of its initial bond proceeds, until March 2007. From March 2007 Metronet BCV's facilities have had a drawstop in place, reflecting the concern of its funders about the scale of the Net Adverse Effects recovery needed to preserve the ratios in the financial model and the uncertainty surrounding the outcome of an Extraordinary Review. As a result Metronet BCV contends that it is unable to access £59.6m of debt draw downs scheduled to be made during the Reference Period.
- 4.2 Metronet BCV has to date continued to pay all its debts as they fall due through management of working capital, drawing down in advance all outstanding shareholder loans and receiving payments from Trans4M under its settlement agreement.
- 4.3 Metronet BCV has noted that, before making a reference for an Extraordinary Review, it first:
- undertook a robust validation of the emerging cost variances; and
  - sought to negotiate a way forward with London Underground to resolve such variances in an attempt to avoid the need for an Extraordinary Review.
- 4.4 Metronet BCV argues that a Notional Infraco would also have sought to achieve a negotiated settlement with London Underground in order to avoid:
- substantial costs incurred by all Parties associated with the Extraordinary Review process;
  - detrimental impact to the relationship with London Underground which could result from an adversarial Extraordinary Review;
  - diversion of management attention from managing the business to managing the Extraordinary Review process;
  - instability with the funders arising from uncertainty of the process and the outcome, including the impact of downgrading from investment grade; and
  - increased staff churn through ensuing media coverage and uncertainty over their futures.
- 4.5 Metronet BCV also contends that the Notional Infraco would encountered the same level of uncertainty amongst its funders as has Metronet itself and that the financial projections of the Notional Infraco would also result in very substantial non-compliance with financial ratios and funding bands, such that a shareholder distribution block and funding drawstop would also have resulted for the Notional Infraco.
- 4.6 The Arbiter recognises that a Notional Infraco might seek a negotiated settlement before triggering an Extraordinary Review. However, he considers that a Notional Infraco would in parallel have made fuller use of other contractual provisions. In particular, the Arbiter considers that a

Notional Infraco with the BCV PPP Agreement would not have sought and obtained waivers from its lenders with respect to the annual Metronet Report process in 2005 covering the two years from Transfer to 31 March 2005 (aMR 2005), and would, as part of the aMR process have sought guidance or direction from the Arbiter, as provided for in paragraph 1.9(aa) to Schedule 1.9 of the PPP Agreement, on the level of Eligible Costs and/or Eligible ISC that it had incurred during the Review Period to date.

- 4.7 The Arbiter considers that by making timely use of these contractual provisions, Metronet BCV would have reduced the uncertainty for its funders and would have provided a more robust basis on which Metronet BCV could have sought a negotiated settlement with London Underground. If London Underground had been unwilling in those circumstances to negotiate, an Extraordinary Review could in the Arbiter's view than have been triggered well before June 2007, and before a drawstop was considered necessary by funders.
- 4.8 In this context, the Arbiter would note that:
- he had received an indication from Metronet that it was considering seeking a direction under paragraph 1.9(aa) as part of the aMR 2006, an action he had not sought to discourage;
  - London Underground and Transport for London have made it clear publicly since 6 February 2007 that they do not consider it possible to reach a negotiated settlement and that Metronet BCV should use its contractual right to seek an Extraordinary Review;
  - the aMR 2006 indicated that "the Arbiter considers that each Metronet Infraco has grounds to trigger an Extraordinary Review"; and
  - the further guidance published in March 2007<sup>24</sup> set out in some detail the approach and possible timetable for an Extraordinary Review.
- 4.9 For the reasons outlined above, the Arbiter considers that a Notional Infraco would have achieved greater clarity on the potential outcome of a negotiated settlement or an Extraordinary Review than has Metronet BCV and in that way either gained further waivers on drawstop or triggered an Extraordinary Review before the consequences of a drawstop became so material. Hence he does not agree with Metronet BCV's contention that a Notional Infraco would not have access to its debt facilities and that Interim ISC should include an allowance to replace expected drawdown of those facilities.
- 4.10 The Arbiter has therefore made no allowance for the £59.6m to replace debt drawdowns subject to a drawstop that Metronet BCV has sought to include in its application for Interim ISC. For similar reasons, the Arbiter has made no allowance for the additional items identified in Metronet's Supplemental Submission of 12 July.

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<sup>24</sup> Reference

## **5 Arbiter's reasons for making ancillary directions**

- 5.1 Under section 229(3)(b) of the Greater London Authority Act 1999 the Arbiter has powers to make directions in relation to any other matter which is ancillary or incidental to a matter referred to him for direction.
- 5.2 The Arbiter considers that where he makes a direction on an interim level of ISC which is in excess of the current Underlying ISC, it is appropriate that he should make ancillary directions on the timing of the ISC payments. This is particularly important where, as in the current situation, the Arbiter concludes that Net Adverse Effects only exceed the Materiality Threshold during the Reference Period.
- 5.3 In addition, the Arbiter considers that it is appropriate to seek some assurance that there is a probability that the Infracore will fulfil its Existing Obligations during the Reference Period. He therefore considers that he should make ancillary directions which attach conditions to the payment of the increase in the ISC.

## 6 Definitions

6.1 The following phrases used in the direction in chapter 1 and in this document have the same meaning as set out in the Master Definitions Agreement dated 31 December 2002 between London Underground Limited, Infraco BCV Limited and others:

- Baseline for Net Adverse Effects
- Eligible Amounts
- Exceptional Costs
- Extraordinary Review
- Good Industry Practice
- Infraco Obligations
- Intermediate Works
- ISC
- LUL Specified Rights
- Major Enhancements
- Materiality Threshold
- Net Adverse Effects
- Notional Infraco
- PPP Contract and applicable PPP Contract
- Review Period
- Transaction Documents
- Underlying ISC

6.2 The following words and expressions shall mean:

- Existing Obligations: the existing obligations referred to in paragraph 1.8 of Schedule 1.9 to the PPP Agreement
- Interim ISC: the amount to be determined under paragraph 1.8 of Schedule 1.9 to the PPP Agreement
- ISC Adjustment: the difference between Underlying ISC and Interim ISC
- Issues paper: the meaning ascribed in paragraph 2.11 of this direction
- Parties: Metronet Rail BCV Limited and London Underground Limited
- Reference Period: the meaning ascribed in paragraph 2.18 of this direction

## Annex 1

### Reference Application Notice and Statement of Case



## REFERENCE TO THE ARBITER FOR DIRECTIONS

### REFERENCE APPLICATION NOTICE

Dated: 28 June 2007

Philip Pacey of Metronet Rail BCV Limited (the Referring Party)

Wish to apply to the Arbitrator for directions relating to:

- (i) in accordance with paragraph 1.2 of Schedule 1.9 of the PPP Service Contract, the form and structure of the way in which the parties should proceed concerning an Extraordinary Review to give effect to and facilitate the intent of Part 3 of Schedule 1.9 of the PPP Service Contract;
- (ii) in accordance with paragraph 1.9 of Schedule 1.9 of the PPP Service Contract:
  - a. a contention by Metronet Rail BCV Limited that it has incurred Net Adverse Effects during the Review Period in excess of the Materiality Threshold;
  - b. the amount and timing of any adjustments to the level of ISC sufficient for a Notional Infraco to:
    - i. properly perform its contractual obligations during the remainder of the current Review Period; and
    - ii. to avoid the need for Infraco to finance any Net Adverse Effects during the then current Review Period as a whole that is in excess of the Materiality Threshold;
- (iii) in accordance with paragraph 1.8 of Schedule 1.9 of the PPP Service Contract, the interim level of ISC that would be sufficient to enable a Notional Infraco to perform its existing obligations pending any direction pursuant to (ii) above.

We are applying for directions because:

Metronet Rail BCV Limited considers that it has incurred Net Adverse Effects in excess of the Materiality Threshold and seeks to recover such Net Adverse Effects through the Extraordinary Review process.

In accordance with paragraph 14 of Schedule 1.9 of the PPP Service Contract Metronet Rail BCV Limited served a notice upon London Underground Limited



on 21 June 2007 instigating an Extraordinary Review on the grounds that it reasonably considers that Net Adverse Effects arising in the Review Period have exceeded the Materiality Threshold.

The parties met on 27 June 2007 in accordance with the provisions of paragraph 17 of Schedule 1.9 of the PPP Service Contract and have failed to agree the form and conduct of the Extraordinary Review.

Attached to this Reference is:

- (i) Statement of Case
- (ii) Initial Submission

In accordance with Article 4.3, we confirm that a copy of this reference and any documents and information comprised or referred to in it has been provided to:

Sarah Atkins  
Director of Reviews and Legal  
London Underground Limited  
55 Broadway  
London  
SW1H 0BD

Subject to the terms of the attached Warranty we confirm that to the best of our knowledge and belief that the contents of this Reference and any documents and information comprised or referred to in it are true and accurate.

Signed

A handwritten signature in blue ink, appearing to be "S. Atkins".

Authorised Signatory  
Director/Secretary

Dated

28/6/07

Communications about this reference should be sent to:

Philip Pacey  
Templar House  
81-87 High Holborn  
London  
WC1V 6NU

Information for the Arbitrator:

Identity of any Responding Party, Third Party or PPP Stakeholders likely to be involved in the conduct of the reference.

*London Underground Limited.*

2. Has the subject of this Reference or any ancillary matter or matter material to the Reference been (or is currently being) considered elsewhere in another forum and if so where?

*No.*

3. Is it intended that this Reference or any such ancillary or related matter be considered in another forum in the near future?

*No.*

4. By what date is the Arbitrator's decision requested?

*In relation to the direction under paragraph 1.8 (Interim ISC), a decision is requested within 4 weeks of the date of this Reference. With regard to the remainder of the Reference, MRBCV is content with the timetable set out in the Arbitrator's Procedural Approach to Extraordinary Review, save that in any event a decision is required within 12 months of the date of this Reference.*



## STATEMENT OF CASE

MRBCV makes this Reference on the basis of the provisions of clause 27.1 and Schedule 1.9 of the PPP Service Contract.

Where MRBCV reasonably considers that it has incurred Net Adverse Effects in excess of the Materiality Threshold in the Review Period it is entitled to instigate an Extraordinary Review and to seek direction from the Arbiter as to this contention, as well as the amount and timing of any increase to the level of ISC. In addition MRBCV is entitled to seek a direction in relation to Interim ISC payments pending the outcome of the Arbiter's final determination.

The justification for MRBCV's contention that it has incurred Net Adverse Effects in excess of the Materiality Threshold, as well as the full detail of its case, is more fully particularised in the Initial Submission document.

Signed

A handwritten signature in blue ink, appearing to be "K. G. G." or similar.

Authorised Signatory  
Director/~~Secretary~~

Date

28/6/07