The Way Out

An Alternative Approach to the Future of the Underground

by

Stephen Glaister, Rosemary Scanlon and Tony Travers

LSE LONDON Discussion paper no. 1

The London School of Economics

Houghton Street, London WC2A 2AE. 020 7955 6522

ISSN 0 7530 1295 2

20 March 1999

Executive Summary

The Government's plan for the Public Private Partnership (PPP) for the Underground is flawed in principle, and impracticable. The long-term capital needs of the Underground are of paramount importance to London and to the future of its economy. Before it is too late, the Government should alter its plans and modify the GLA Bill to allow the new Mayor and Assembly the freedom to choose the best solution from amongst a range of available alternatives.

It is now apparent that the PPP as proposed will meet few of the promises made when it was announced exactly one year ago. The PPP threatens to impose burdensome long term pressures on Underground operating revenues, including the prospect of continually rising fares, in order to pay back up front investment by private contractors.

The members of Parliament who are charged with scrutinising the current provisions of the Bill, as well as the public at large and later the elected Mayor and Assembly, are being given little part in determining the investment scheme for the next thirty years. Parliament is even being denied - on grounds of commercial confidentiality - access to the technical work prepared by consultants, on which the Government rests its projections.

In addition, the technical difficulties with the PPP will cause delay in securing finance and transferring powers. Underground transport operations and planning could be plunged into a no-man's land of management confusion and a chaotic disintegration of transport policy. The long-term nature of any contracts agreed between the Government and private contractors could make it very hard for the Mayor of London – who will have responsibility for delivering an integrated and sustainable transport strategy for London - to determine the pattern of investments in the Underground for the next thirty years.

There is a better way to secure long-term financing for the Underground, made possible by two Government actions in June of 1998, three months following the announcement of the PPP proposal. First, the Government moved to eliminate the requirement that capital investment meet the "PSBR test". Second, in the solution reached on the revised financing structure for the Channel Tunnel Rail Link, the Government outlined a more logical approach to financing those long-term capital investment needs, through the issuance of guaranteed bonds.

We recommend that the GLA Bill be amended to allow the Mayor and Assembly the freedom to choose from amongst a range of alternatives. These could include:

- maintaining the current system of capital financing by a combination of surplus revenues and government grant, but organised in a separate capital budget with a five-year planning horizon;

- adopting the "Fourth Way" approach, recommended in this paper, of enabling Transport for London (TfL) or a new Underground trust mechanism to issue bonds secured by dedicated revenues such as: congestion charges and fees, agreed

commitment of government grant, precepts on the council tax, or a levy on the non-domestic business rate;

- pursuing leasing options;

- accepting the Government PPP proposal, if that were deemed to be the preferable option.

At present there is the risk that the attempt to make the PPP work at any price will be both costly to the fare-payer and the taxpayer, and damaging to the new GLA. The London electorate will see little point in creating their new government in London if the Mayor and Assembly do not have control of the Underground. The new Mayor will be placed in an almost impossible situation.

What matters now is that the best decisions are made for the long-term future of the Underground. The matter is urgent.

Contents

Executive Summary **ii**

Introduction **1**

Recent Problems with the PPP. **4**
Constraints on the Mayor 4
A better option 8

The Inherent Hazards of the PPP **9**
Uncertain profitability of London Underground 9
Inability to complete risk transfer 9
Fares increases under the PPP 10
The attempt to remove subsidy from the Underground 11
Lack of funding or finance for new capacity 12
Accountability to the local electorate 12
Lack of scrutiny of the PPP by Parliament or local electorate 13
Legal complexity of separation 14
Economic regulation 14
The public sector comparator 16

A Better Alternative: the Government's own Prototype **17**
How the CTRL was re-structured 17

The Bonding Alternative **18**
The lessons from New York 18

Urgency of Action **20**
The "Fourth Way" suggestion 21

Conclusion **22**

About the Authors **25**

Introduction

The Government's existing plan for the Public Private Partnership (PPP) financing of the Underground is flawed in principle and impracticable. Before it is too late, the Government should alter its plans. It should modify the GLA Bill to allow the new Mayor and Assembly the freedom to choose the best solution for financing the long-term capital needs of the London Underground. The PPP would not be abandoned but instead would simply become one of several alternatives from which the Mayor could chose. If it is a good idea now then it will remain a good idea after the Mayor is elected and it could be implemented on the Government's own current timetable. Nothing would be lost. In campaigning for the election for Mayor, candidates could set out their intentions and the matter would then be debated as a normal part of the democratic process.

In the months that have elapsed since we first raised concerns over the perils inherent in the PPP proposal[1], no circumstances have emerged to mitigate those concerns. Indeed, the practicability is now being more generally questioned. It is now apparent that the PPP as proposed will meet few of the objectives set for it when it was announced exactly one year ago[2].

The GLA Bill contains provisions that will hold the Mayor accountable for virtually all transport policy affecting London. Members of Parliament who are charged with scrutinising the current provisions of the Bill, as well as the public at large, and later the elected Mayor and Assembly, are being given little part in determining the investment scheme for the next thirty years for the Underground. The Tube, of course, is the most important element in the capital's transport system. Parliament is even being denied – on the grounds of commercial confidentiality - access to the technical work prepared by consultants on which the Government rests its projections.

In addition, the technical difficulties with the PPP will cause delay in securing finance and transferring powers. This delay will be unacceptable to the London electorate and will lead to

[1] *A Fourth Way for the Underground*? Greater London Group, LSE, June 1998.
[2] Deputy Prime Minister, House of Commons, March 20, 1998.

a chaotic *dis*-integration of transport policy in London. Because of the insistence on completing the PPP before handing over the Underground to the GLA, the creation of the new Authority, far from achieving integration and accountability, will create a political control structure in London that will be even less co-ordinated and less capable of public comprehension than the complex system operating today.

There is a better way. The Government has recently made possible other options for securing long-term capital financing for the Underground, which were not available when the PPP proposal was first introduced on 20 March 1998:

- the Government has moved to eliminate the requirement that capital investment meet the "PSBR test", with its new guidelines issued on 11 June 1998;

- with its solution of 3 June 1998 to the financing structure of the Channel Tunnel Rail Link, the Government has outlined a more logical approach to financing long-term capital investment needs through the issuance of guaranteed bonds, which has culminated in the successful placement in February of its first £1.6 billion tranche of bonds.

We recommend that the GLA Bill be amended to provide the Mayor and Assembly the freedom to choose from amongst a range of alternatives those which would best serve the long-term capital financing needs of the Underground. These alternatives could include:

- maintaining the current system of capital financing from a combination of surplus revenues and government grant, but organised in a separate capital budget with a five-year planning horizon;

- enabling Transport for London (*TfL*) or a new Underground trust mechanism to issue bonds secured by dedicated revenues such as congestion charges and fees, agreed commitment of government grant, precepts on the council tax, or a levy on the non-domestic business rate;

- pursuing leasing options;
- adopting the Government PPP proposal, if that were deemed to be the preferable option.

The Underground PPP, announced within ten months of the election of the new Government, was an unsatisfactory compromise put together in haste. The urgency of an immediate rethink and change in direction is clearly manifest in the timetable for adoption of the GLA Bill. The long-term capital needs of the Underground are of paramount importance to London and to the future of its economy. Without this change in direction, which the Government clearly now has made possible, it is unlikely that proper reform can be achieved for the capital financing structure of the Underground.

If the Bill is not suitably amended, the new GLA will be held in a straitjacket of commitment for the thirty years imposed by the PPP proposal, rather than the promised lifeline of financial resources proffered by the PPP. This is a particularly severe restraint on the new Mayor and Assembly, given the demands for accountability over transport strategy, which are already included in the GLA Bill.

In the end, the London public is left to question why the Government would show any reluctance to change a proposal in favour of clearly better alternatives, particularly in view of the commitment to give London a separate and accountable government.

An elaboration of these points is presented in the paper that follows.

Recent Problems with the PPP.

The discussion in the Standing Committee on the Greater London Authority Bill on 23rd and 25th February 1999, subsequent press reports and the publication of a *Progress Report*[3] on 15 March 1999 revealed a number of serious problems with the implementation of the proposed PPP.

Constraints on the Mayor

The creation of a Greater London Authority (GLA) was a major proposal in the Labour Party's manifesto in 1997. Subsequent consultative papers outlined the details of the new system. In his Foreword to the White Paper[4] the Deputy Prime Minister stated that the GLA would "provide strong strategic leadership and restore accountability" within London government. It is on the basis of this White Paper that the Greater London Authority Bill (now before Parliament) was drawn up. The Government's objectives remain unchanged.

The GLA will consist of a directly-elected Mayor and a separately elected assembly. The Mayor will be responsible for a number of London-wide services, including transport. Direct day-to-day responsibility for services will be in the hands of a number of Mayor-appointed boards, one of which will be called Transport for London (*TfL*). The Mayor will set policy and budgets for *TfL* and other agencies.

There is little doubt, on the basis of the White Paper, that the Government intended a radical shift of accountability to take place. Paragraph 3.32 stated "The Mayor must be accountable to Londoners, and holding the Mayor to account will be the principal role of the Assembly". A number of arrangements to ensure accountability and openness were outlined in paragraph 3.36, including an annual State of London debate, a monthly 'question time' at which the Assembly could question the Mayor, and an annual 'people's question time'.

[3] *PPP for London Underground Progress Report,* London Transport, March 1999
[4] *A Mayor and Assembly for London: the Government's Proposals for Modernising the Governance of London,* Cm 3897, London: HMSO 1998, page 5

Transport, according to the Government's White Paper, is the single most important element in the GLA's responsibilities. Paragraph 5.13 outlined three key aims for GLA transport policy:

- to deliver an integrated and sustainable transport strategy in London;
- to unify the presently fragmented responsibility for transport in London by creating a body which can tackle issues at a London-wide level; and
- to define clear boundary lines between the responsibilities of government, the GLA and boroughs.

Thus, in short, the new system of government for London is intended to make decision-making more accountable and to end the notorious fragmentation that affects transport planning and implementation in the capital. *TfL* is to be the instrument of change .

TfL will therefore be the object of Mayoral appointments, policies and budgets. It will be responsible for the services listed below and be subject to oversight by the Assembly. It is evident from the White Paper and other ministerial statements that the Government sees *TfL* as a powerful transport utility. Compared with the arrangements in New York or Paris (where State or regional appointed bodies are responsible), the proposed system in London will indeed give the elected city government direct responsibility for most elements of the city's transport system.

Transport for London - key responsibilities

Existing provider	Service
London Transport	Underground, bus provision, river services
Docklands Light Railway	Docklands Light Railway
Public Carriage Office	Taxi regulation
Highways Agency	Major roads
Traffic Director for London	Red Routes/enforcement
Traffic Control Systems Unit	Traffic lights/controls
Traffic Commissioner	Bus route regulation
Government Office for London	Transport Policies and Programmes funding
London boroughs	Taxicard
DETR	Woolwich Ferry
Metropolitan Police	Traffic regulation
Office of the Rail Franchise Director	Suburban train services (upgrades)

The main limitation on the Mayor and Assembly's capacity to *deliver* improved public transport in London is the relatively weak financing arrangements for the GLA. The overwhelming majority of GLA resources will come from government grants. There will be a small council tax precept, probably in the range of £300 to £500 million[5]. By comparison, grants would total £2 to £3 billion. Capital finance would - as for all other local authorities - be wholly controlled by Whitehall.

Some freedom to raise resources for transport would be available from London Transport fares (currently raising revenue of about £1 billion) and from the proposed new congestion charge and/or off-street parking levy. The Mayor will be free to set fares and, within rules to

[5] *Capital Choices Funding the GLA, Essays on the new government for London*, Tony Travers, London: Association of London Government, 1997, paragraph 3.9

be approved by the Government, to raise resources from a congestion charge and/or off-street parking levy.

But regardless of the extent of freedom to raise revenue resources, capital finance will be subject to watertight central government control. Moreover, local authorities are legally required to keep their revenue and capital accounts separate. The *Progress Report*[6] notes that "For funding purposes *TfL* will be a local authority in its own right". Although revenue funding of capital projects by local authorities is not subject to any limits, it is illegal (except for cash-flow management purposes) for councils to finance revenue spending from borrowing, asset sales or other capital-related sources.

The GLA, in common with all other British local authorities, will only be able to become involved in credit arrangements up to an annual limit determined by Whitehall. Because of continuing limits on the willingness of the Treasury to sanction additional capital expenditure on the London Underground (whether controlled by central or local government) there will be insufficient resources to rebuild the Tube. It is because of these limits on capital spending that the Government has found itself saddled with the complexities of the PPP.

Delay and Disintegration of transport policy

The PPP was supposed to provide a rapid resolution of the long-standing uncertainty about the funding of the Tube. The deal was to have been completed by April 2000, in time to hand over to the incoming Mayor and Greater London Assembly the following month. But, unsurprisingly, the technical difficulties have rendered this infeasible. The Government's new position is that it "will not be pushed into announcing a detailed timetable for the PPP publication"[7].

This has an unavoidable consequence: the need to delay the transfer of part or all of London Underground to GLA control beyond 3 July 2000. The Progress Report indicates that if all

[6] *Progress Report*, paragraph 16.
[7] *Hansard*, House of Commons Standing Committee A, 23 February 1999.

goes to the current plan, "the PPP transactions will be completed in late 2000 or 2001"[8]. It appears likely that the delay will apply to the whole of the Underground, i.e., infrastructure *and* operations. This could mean that for the first year or more of the GLA's existence *TfL* would be responsible for all the services listed in the table above except London Underground.

The constraints implied for the Mayor, Assembly and *TfL* would be extraordinary. The Tube, with its problems of breakdowns, strikes and overcrowding is perhaps the single aspect of London governance that the public expects to be improved by the creation of the GLA. The Government's own desire for greater accountability and integration (as quoted above) cannot conceivably be achieved if the Underground remains the responsibility of the Secretary of State beyond July 2000. LU managers will continue to report to the Government, while the buses will transfer to *TfL*. For the first time since the Tube and buses were combined together in the early 1930's, the two elements of London Transport will be answerable to different political authorities.

A better option

If the Government were to leave the PPP as just one of the several options a Mayor could take up, then it could become one of the elements in the democratic franchise earned during the process of the elections for the Authority. This would give real substance to the Deputy Prime Minister's promise:

> "When the Greater London Authority is established, the Underground will, with the rest of London Transport, transfer to it. It will then be not only publicly owned, but properly accountable to the people of London, through the Mayor and the assembly. Mrs. Thatcher nationalised London Underground: we will return it to the people of London. That is a statement of fact."[9]

[8] *Progress Report*, paragraph 14.
[9] *Hansard*, 20 March 1998.

The Inherent Hazards of the PPP

There are several areas of concern here.

Uncertain profitability of London Underground

In the financial structuring of the PPP, it appeared from the financial estimates presented in our June 1998 paper[10] that the payback provisions to the private contractors would depend heavily on significant annual profits being earned by London Underground. We estimated these to be approximately £450 million per year, although this still left a gap of about £90 million per year to be covered by grant. While LUL has generated significant gross operating revenues in the most recent years - of £210.1 million in 1996-1997, and £264.7 million in 1997-98[11] - these have been notably lower than our estimate of what would be required in the future repayment schedule of the PPP.

What is more, there would be the necessity of generating a high level of profit during each year of the thirty years of the contract. This would leave no margin for decline when and if the London economy suffers a downturn, as has happened to Underground revenues in previous recessions.

Inability to complete risk transfer

The benefits of private sector management of the infrastructure can only be achieved if the private sector is given the correct incentives – and this must imply that they bear an appropriate share of the risks. If the private sector is asked to assume liability for maintaining the infrastructure it must carry out due diligence in order to assess the magnitude of the liabilities they are offering to assume.

Much of the Underground is old, of uncertain physical condition. Inspection is a costly, time-consuming, and inconclusive operation. The Government has now made concessions that

[10] S. Glaister, R. Scanlon and T. Travers, *A Fourth Way for the Underground*, Greater London Group, LSE, June 1998.
[11] London Transport Annual Report 1997/98

certain liabilities will reside with the state[12]. They have also decided not to attempt to transfer revenue risk to Infracos[13].

Whilst this may well be a sensible allocation of the risks it does imply that, even on the Government's self-financing aspiration for the PPP, the public sector will continue to carry a substantial funding liability for the Underground.

Fares increases under the PPP

In the modelling work on which the PPP is founded passenger numbers are assumed to continue to grow, and fares are assumed to continue to rise by 1% above inflation each year for a number of years[16] – even though this may conflict with a Mayor's policy for London Transport and it certainly conflicts with policy on commuter rail fares and the spirit of the Government's overall Integrated Transport Policy. In the response to the Select Committee the Government said "It is not our policy to see large increases in public transport fares and our proposals are not based on such increases... the PPP will not be dependent on significant increases in fares"[17].

There is a fine point of interpretation here, which must hinge on the Government's view of whether a 1% per annum increase above inflation is "significant". The Minister for Transport in London has made it clear to the Standing Committee that the self-funding aspiration of the PPP does rely on continued real fares increases and if the Mayor were to reduce fares or increase them less rapidly then there would be a financial deficit to be made up either from *TfL*'s funds or from grant.

[12] *Progress Report*, paragraph 24.
[13] *Progress Report*, paragraph 32.
[14] Cm 4093, October 1998, paragraph 38
[15] Minister for Transport in London (Ms. Glenda Jackson) House of Commons Standing Committee A, 25 February, 1999.
[16] Minister for Transport in London (Ms. Glenda Jackson) House of Commons Standing Committee A, 23 February, 1999.
[17] paragraph 34 .

The attempt to remove subsidy from the Underground

There are no provisions in the Government's plans for central government subsidy after the year 2000, as is clearly stated in the Government's response to the Select Committee *Report on London Underground.*

> "It is [the Government's] aim to let contracts which are affordable from the Underground's own resources, on the basis of projected cash flows. The advice we have received is that this is a realistic and achievable objective. Unless it represents poor value for money, payments to the contractor(s) will be profiled so as to avoid the need for subsidy in any year". [18]

This suggests that any revenue shortfalls, cost overruns or unforeseen emergency maintenance work for which liability has not been transferred to the private sector would need to be met either out of general operating funds of the Transport for London budget or, as now, conceded a possibility[19], by persuading Central Government to make *ex post* grants.

One of the main reasons for the PPP deal was that it was supposed to be self-financing, so that the funding of the Underground capital programme was to be taken out of the public finances. The Deputy Prime Minister said when he announced the deal, "My concern is to ensure adequate levels of investment. I do not think that we are likely to get that under the PSBR and Treasury rules at the moment".[20] The Government says it is still confident that its modelling work gives reassurance that further subsidy will not be necessary, yet it has now conceded that "if it represents good value for money, central Government grant to *TfL* will be based on the assumption that part of the total will be needed to meet London Underground's payments to the PPP contractor"[21].

[18] Cm 4093, October 1998, paragraph 38
[19] Minister for Transport in London (Ms. Glenda Jackson) House of Commons Standing Committee A, 25 February 1999.
[20] *Hansard*, 20 March 1998.
[21] Ms. Glenda Jackson, *Hansard*, House of Commons Standing Committee A, 23 February 1999.

This is new and important in that it changes the previous policy that there would be no central Government funds for the Underground after 2000-01. That the Underground PPP could be made entirely self-financing was, in our view, always an ambitious aspiration. Once this possibility is acknowledged the financial segregation of the Underground from central government is breached. Taken together with the acceptance that it will not be feasible to transfer the major commercial risks to the private sector (see below) and that the Underground will be under the control of a public sector body the PPP could fall within the conventional definition of public expenditure.

Lack of funding or finance for new capacity

The proposed PPP is targeted to the reinvestment needs of the Underground. It does not provide for investment in route extensions, or for construction of new lines during the thirty-year life of the contracts. This point is also clearly made in the Government's October 1998 response to the Select Committee[22]. Thus, there is no foreseeable source of Government funds to accommodate growth in passenger traffic, and/or construction of lines in London's under-served markets such as the long-discussed Chelsea-Hackney Line.

The PPP, as proposed in outline, offers what is basically a one-shot, up-front infusion of cash investment, which requires a payback period that will stretch out for thirty years. As such, the investment programme will be directed towards those needs identified for the earliest stages of the plan. Combined with the absence of funding provision for extensions or new lines, and the inherent pressures to produce large profits for payback each year, the PPP proposal poses as many financial constraints as solutions for the problems arising from the need to expand capacity on the Underground.

Accountability to the local electorate

In the past, if London Underground suffered a financial shortfall because of poor management - or any other reason - it fell to the national taxpayer to make it good. The line of accountability was poorly defined. It is inevitable that the State will continue to be responsible

for any Underground rescue funding, even under the PPP. The delay in implementing the PPP has already created a new call on the Exchequer for bridging funding. However, if our proposals were adopted the Authority's responsibilities for capital funding for transport infrastructure would be clearly circumscribed. Management failures would lead to calls on the local charge and taxpayers. The public would be able to hold their elected GLA representatives to account much more directly.

Lack of scrutiny of the PPP by Parliament or local electorate

The reluctance to reveal the detail of the modelling underlying the PPP raises another issue. The Government is asking Parliament to approve the signature of binding contracts that would commit the national taxpayer to a financial liability for thirty years[23]. Yet, on grounds of "commercial confidentiality" the Government is refusing to reveal to Parliament for scrutiny the technical material on which the Government says it is relying to form its own judgements. So far as we know, this work has not been subject to any independent scrutiny. The Minister for Transport in London has said:

> "I know that Committee members would like to see the financial modelling… in order to judge for themselves whether the PPP is likely to be affordable. We have thought carefully about releasing the information… To be of any use we would need to release a large amount of material, much of which would be helpful to bidders. That would prejudice London Underground's negotiating position in the PPP competition, so we shall not release that modelling"[24].

So neither Parliament nor the general public has any means of assessing the nature of the risks they are being asked to take on. We can see no justification for this coyness about publishing the technical modelling.

---

[22] Paragraphs 47 and 62.
[23] When it was first introduced the contract length was expected to be between twenty-five and thirty years, to be determined as part of the bidding process. In the Standing Committee the talk has been firmly of thirty years. London bus service contracts last five years. Most Train Operating Franchise contracts last seven years. The fifteen-year franchises were regarded as being exceptions to deal with special circumstances.
[24] Minister for Transport in London, *Hansard*, House of Commons Standing Committee A, 23 February 1999.

Legal complexity of separation

To separate operations from management of the infrastructure and further separate the infrastructure into more than one owner, under commercial and binding contracts lasting up to thirty years is, unsurprisingly, proving slow work. This is one reason that the contracts cannot be ready for signing until a number of months after the Mayor has been elected.

In previous utility privatisations, the argument for separating the ownership of the essential network facility (a natural monopoly subject to strict economic regulation) from operation of service over that network was to facilitate competition in those parts of the business where it made sense. The benefits from this competition were judged to be sufficient to offset the costs of the separation. In the case of the Underground there is no suggestion that there would be competition over the tracks, so the economic motive for separation of infrastructure from operations is absent. Yet the costs of creating and then managing this separation are considerable.

The proposed separation appears to be an unhappy compromise resulting from the tension between the commitment to keep part of the Underground in the public sector and a wish within parts of Whitehall to secure efficiency gains from private sector management. Yet, the extent of efficiency gains is compromised by commitments made to preserve terms and conditions of the entire workforce, which the unions will be vigilant in enforcing.

Economic regulation

If the PPP were to proceed, some measure of regulatory scrutiny would clearly be required. Full consideration has not yet been given to the economic regulation of these contracts, as evidenced by the discussion in Committee on the deliberation of the GLA Bill on February 23. In their October 1998 reply to the Select Committee, the Government records that "current thinking is that where it is not possible for the parties to reach agreement, the matter would be referable to an independent third party, such as the Rail Regulator, to arbitrate. The third party's role would be limited to defined areas (we are not envisaging a role such as that

played by the economic regulators for the privatised utilities)".[25] At the Standing Committee on 23rd February the Minister for Transport in London spoke of the need for a periodic review every seven and a half years to be carried out by an "arbiter" in a "spirit of partnership". This arbitrator would be appointed by the Secretary of State on the request of either the Mayor or a PPP contractor.

The amendment concerning the arbiter is to be introduced later, at the Report stage. The duties and powers of the position will be :

- To secure the provision, maintenance, renewal and improvement of the Underground's infrastructure, having regard to what T*f*L can afford;
- To promote efficiency in the provision, maintenance, renewal and improvement of the Underground's infrastructure;
- To enable an efficient Infraco to finance its activities at a rate of return which it bid in the initial competition;
- To enable Infracos to carry out their obligations with a reasonable degree of certainty."[26]

Periodic reviews will be conducted every seven years or so. The Minister said that the arbiter will "have a role that lies somewhere between the arbitrator of a contractual dispute and a utility style regulator". However, it seems to us that what is described and the needs of the situation are not materially different from the "standard" system of full-time, independent regulation to be found in the privatised utilities like telecommunications, gas, electricity, water and railways. There are several matters in this list that require the exercise of judgement against public interest criteria, in the light of circumstances many years after the contracts were signed. The Mayor will wish to vary the contract from the very beginning, and there will be endless opportunities for dispute. Further, once awarded, the winner(s) of the proposed contracts would obtain considerable monopoly power over an essential facility for the provision of transport services in London. The outcome of the periodic reviews will

[25] Select Committee (Paragraph 53)
[26] *Progress Report*, paragraph 28.

directly affect the wealth of shareholders and others, and it is unrealistic to expect that they would be settled in a spirit of partnership, rather than hotly contested.

The public sector comparator

In the bidding process the Government is duty-bound to ensure "best value". The Government has itself recognised this in its response to the Select Committee Report*:* "Clearly, it is only possible conclusively to demonstrate that the current proposals represent best value once bids have been received. At that stage we will need to satisfy ourselves that the deal is really right"[27].

It is significant that in that same paragraph the Government commits itself to developing a public sector comparator using conventional funding: "This will help to assess the bids and ensure that we actually obtain the value for money we expect." There is no explicit statement that the result will be published nor any promise to be bound by the outcome. However, it is unlikely that the Government could go ahead with the PPP if it were to be demonstrated unequivocally that the public sector alternative would provide better value for money.

The Minister for Transport in London made an even clearer statement to the Standing Committee on 25th February:

> "...the public sector – namely London Underground, which will remain in the public sector, as it is now – will be the benchmark against which all private bids will be measured... we will not be awarding contracts irrespective of the value of the bid. Best value will be the watchword."

The disclaimer Notice in the *Progress Report*[28] draws attention to the possibility that no PPP be awarded. The implication appears to be that if no bid offers value for money, then London Underground would continue as an integrated operation, wholly within the public sector – which is an option a Mayor might choose in any case if given a free choice.

[27] Paragraph 21.

A Better Alternative: the Government's own Prototype

The Underground PPP was a quick solution, put together before the plans for London government were finalised and before the revised financing structure of the Channel Tunnel Rail Link (CTRL) was secured. The method developed for the CTRL is superior to the PPP proposed for the Underground and should be considered as a prototype for financing the capital needs of the Underground.

How the CTRL was re-structured

When, in the spring of 1998, London and Continental Railways (LCR) revealed that they were unable to meet their previous commitment to finance and build the fast rail link between central London and the Channel Tunnel, the Government decided to provide financial support rather than risk failure of the project.

The Government announced its revised proposal on 3 June 1998. Construction of the first of two phases will be financed by commercial debt and bonds, backed by direct government guarantees covering £3.75 billion, so as to reduce the cost of financing. Once completed, Railtrack is to buy the first phase of the Link from LCR. The costs of construction will then be reimbursed as access charges paid by Eurostar to Railtrack. The Government[29] will also guarantee these access charges.

The Government's guarantee of commercial borrowing was deemed not to count towards the public sector borrowing requirement, because, the Deputy Prime Minister said, the chances of a call being made on the guarantee were less than 20 per cent[30].

The guaranteed bonds have received AAA ratings by three rating agencies, and on 10 February 1999 £1.225 bn of bonds maturing in 2028 and £425 million maturing in 2038 were

[28] *Progress Report*, page 1.
[29] DETR press notice no 148, 18 February 1999
[30] *Financial Times* 5 June 1998.

issued. The issues were heavily oversubscribed, with the markets regarding them as "gilt proxies". The coupon on both issues was 4.5 per cent[31] .

This is a striking example of how commercial debt can be used to finance a commercially non-viable piece of infrastructure, given the appropriate support from the state. The Government is confident that the existing Underground is viable as a long term business and certainly more so than the CTRL, so they think that the chance of a guarantee being called is low. There is every reason to conclude that London Underground or T*f*L could be treated in a similar way.

The Bonding Alternative

In our judgement, the financing needs of the London Underground would be best met by granting London Transport, and later T*f*Lthe authority first, to establish a capital budget that would be separate from the operating budget, and second, to issue bonds that would be secured by pledged revenues. This would give London the financial structure to carry through the re-investment program, as well as provide the ongoing the capacity to fund any major extensions or new lines to the Underground system.

The lessons from New York

The financial restructuring of the New York Metropolitan Transportation Authority (the MTA) in 1981 also offers a prototype for London, both in the example of establishing an agreed capital needs statement and a capital budget that could be approached in five-year intervals; and in structuring a financial framework which would give the MTA authority to issue its own bonds directly to the capital markets.

This financial framework has enabled the MTA to fund over $23 billion in capital spending for the city's transit authority, and over $5.7 billion for the commuter rail and bus network,

[31] *Financial Times* 11 February 1999.

since 1982. Bonds outstanding have covered over $14 billion of these investments, with direct government subsidy or pay-as-you go funding the balance.

The bonds issued are backed by a layer of revenues that are guaranteed for each five-year plan. These revenues include: subsidies from the federal, state and local governments; farebox revenues; surplus toll receipts of the Triborough Bridge and Tunnel Authority (TBTA), and dedicated taxes. The tax sources have varied somewhat over the two decades, but generally include one quarter of one percent of the city and suburban sales tax; certain petroleum-based taxes; a portion of a 'long-lines' tax on telecommunications and transport companies, and a temporary surcharge on certain businesses in the MTA District. This is shown in the following table.

Funding Sources for the MTA Capital Programs
(Percent of Total Program)

	1982-86	**87-91**	**92-96**	**95-99**
Government Subsidies				
Federal	26%	38%	40%	29%
State	20	11	0	<1
City	9	15	14	11
Subtotal	**55**	**64**	**54**	**40**
Revenue Bonds				
Fare-backed	20	5	11	n.a.
TBTA	14	14	6	n.a.
Dedicated Taxes	0	6	17	n.a.
Subtotal	**34**	**25**	**34**	**42**
Pay-As-You-Go	0	4	2	13
Other	11	7	10	4
Total	100%	100%	100%	100%

Source: Metropolitan Transportation Authority

These bonds provided 34 percent of total capital plan funding in the first and third plans, and are expected to provide over 40 percent of the capital funds in the 1995-99 plan.

The assurance of these revenue sources and the rating of the bonds by the rating agencies (at, or above investment grade) allow the bonds to be issued without direct call on the resources of the state or city governments. Also, the MTA, as a public benefit corporation, remains fully in the public sector, with the Chairman and five board members of the Authority appointed by the state governor, and with four other appointments to the board made by the Mayor of New York City.

In summary, the New York approach has several features which could be of value to London: the *clearly defined investment horizon* to provide the necessary scope for planning and procurement; the *issuance of dedicated bonds* which have been clearly separated from other public sector needs; the *public-private commitment* to use a combination of public funds and dedicated taxes to support the bonds; and the *public benefit organisation structure*, which has retained public control of the transport system as a public trust, with full accountability to the travelling public, the business community, and elected officials.

Urgency of Action

The PPP proposal is expensive as well as difficult. It prejudices the Mayor's options and blocks the new Mayor of London from achieving the full statutory control over Transport that is implied in the GLA Bill.

The compelling questions on the problems inherent in the PPP proposal suggest strongly that the Government should pause on its PPP proposal and instead present a series of options that could be considered as part of the next stage of the GLA Bill.

These options could include a range of approaches:

- maintaining the *status quo*, with the Mayor assuming full control of the Underground as part of the newly formed Transport for London, with the

implication that capital financing would be secured from congestion charges as well as from any improvement in efficiency in operations;

- giving Transport for London/London Underground the power to issue bonds, either directly, or through the creation of a special trust as existed in the years 1933-47, for long term financing of reinvestment and any new construction (our "Fourth Way" alternative[32]);
- pursuing a long-term leasing arrangement of the Underground as an integrated operation with one private sector firm, with conditions required for investment needs[33];
- or, offering to the Mayor the most salient elements of the PPP proposal, which could be structured under a firm regulatory system, and firm commitment from the Government for ongoing subsidy to mitigate unforeseen risks.

The "Fourth Way" suggestion

We maintain that the "Fourth Way" alternative, presented in our paper of June 1998, is the preferable approach for long term financing of the Underground. This alternative included the following components:

- bond issues backed by pledged revenues derived from fees, charges, and/or dedicated taxes;
- an agreed level of government grant;
- a realistic and agreed level of operating profit.

An agreed level of Government grant, guaranteed over specified intervals, would seem to be a reasonable request, based on the precedent of the seven-year commitment of Government grant to the train-operating companies following the privatisation of British Rail. Nor does such a level of support loom as exceptional, were the government in any case to guarantee a risk premium to private contractors in the PPP proposal.

[32] S. Glaister, R. Scanlon and T. Travers, *A Fourth Way for the Underground*, Greater London Group, LSE, June 1998.
[33] As suggested by the *Financial Times*, 18 March 1999.

Also, a realistically-targeted level of operating profit from the system would be a source of revenue, as London Transport has recently achieved. The risk of recession in London could weaken or even eliminate all profits in a given year, but the establishment of a reasonable target could allow benefits to accrue during successful years. It would also ensure the discipline of maintaining ongoing cost efficiencies in operations.

The Government's intention is to give the Mayor powers to levy new charges on the use of vehicles in London and to make a levy on private non-residential parking spaces. These powers would be much more valuable if the Mayor had the matching powers to fund bond issues from the income stream. Without that guarantee it would be hard to convince the electorate that there will be sufficient up-front improvement in the public transport infrastructure to warrant acceptance of the new charges.

Over time, other sources of dedicated revenues could be raised to help finance the transport bonding structure. With strong support from the business community, these sources could include a surcharge on the non-domestic rates paid by London businesses, or a dedicated transport levy on businesses.

Conclusion

It is extraordinary that Britain's Labour Government, which is committed to promoting public transport and reducing the use of cars, is moving in London towards a point where the Underground and bus system will receive no public subsidy at all. When and if the PPP is fully operational, the tube and buses will be wholly financed (including re-investment in the existing infrastructure) from fare income.

Compared with public transport systems in cities that are often quoted as London's competitors, this position is amazing. In New York, Paris and virtually all the smaller European cities the public transport system receives significant subsidy. It will have been

possible to achieve this position only by exploiting the Underground's virtual monopoly position within the city's transport market.

We have argued that the PPP is problematic in its own right. In addition, the delays caused by adopting this particular way of funding London Underground infrastructure have undesirable consequences for the new Greater London Authority. Yet the need for immediate and massive investment in the Tube is not open to doubt. The only question is how best to fund such investments.

The Deputy Prime Minister adopted the PPP because the Treasury (which, like the DPM, is part of the Government) has refused to provide sufficient – possibly any – future resources to re-build the Underground. A way had to be found of raising private sector resources that did not conflict with the Labour Party's manifesto commitment to keep the Tube in the public sector. The PPP is the awkward vehicle that has been selected for this purpose. There is, as yet, no confidence that it can be made to work.

Among the most obvious drawbacks considered in this paper is the virtual impossibility of drawing up acceptable contracts between the Government/London Underground and the companies that would re-invest in the Tube: risks cannot be quantified and service standards are difficult to describe. There is a possibility that the bidder or bidders will put in a bid that the Government would find too expensive and poor value for public money.

But the long-term nature of any contracts signed between the Government and private companies would make it impossible for the Mayor of London to determine the pattern of investments in the Underground. This impossibility would devalue the office of Mayor. Worse still, there would be a real risk that Londoners, who have had their expectations raised by the debate surrounding the creation of the GLA, will be disappointed by the Mayor's incapacity to control Underground stations, tunnels, tracks, signals and, crucially, line capacity. Even the operational side of the Tube, i.e. train services, may not transfer to the Mayor's control until 2002.

A passenger who has a problem with the Underground will have to contact the Secretary of State. A complaint about the buses will be the responsibility of *TfL* and thus the Mayor. Suburban railways will be in the hands of the new Strategic Rail Authority. Thus, an issue concerning the integration of trains, tubes, buses and taxis at, say, Paddington Station might require a member of the public to contact Railtrack, the Strategic Rail Authority, one or more train operating companies, *TfL*, the Department of the Environment, Transport & the Regions, Westminster City Council and, in some cases, BAA (the operators of Heathrow Express).

At present there is a risk that the attempt to make the PPP work at any price will be both costly to the fare-payer and the tax-payer and damaging to the new GLA. The London electorate will see little point in creating a new layer of government in London if it does not have control of the Underground. The alternative outlined in this paper fulfils the Government's commitments concerning the Underground, involves greater local autonomy for the Mayor and provides better long-term funding value. There are financial and political reasons for considering this paper's proposals as an alternative to the PPP.

About the Authors

STEPHEN GLAISTER is Professor of Transport and Infrastructure at Imperial College, London. He was a member of the first Advisory Committee on Trunk Road Assessment and he has been Specialist Advisor to the Parliamentary Select Committee on Transport. He developed models for the Department of Transport for the cost benefit assessment of urban public transport subsidies. He has worked on urban transport evaluation for the World Bank. Professor Glaister was a non-executive director of London Regional Transport from 1984 until 1993. He is currently an Economic Advisor to the Rail Regulator and to Ofgas. He is a member of the London First Transport Initiative. He has published widely on public transport, roads and on regulation in the transport, telecommunications, water and gas industries.

ROSEMARY SCANLON is a Visiting Research Fellow at the London School of Economics during 1997-99. She served as New York State Deputy Comptroller between 1993-97, with the assignment to monitor the budget and economy of New York City. Among the reports issued by her office was, "Review of the Operating and Capital Plans for New York City Transit and the Commuter Railroads" in March 1996. Prior, Ms. Scanlon was the Chief Economist of the Port Authority of New York & New Jersey, where she initiated a wide range of research programs on the economy, demography, labor force, investment, infrastructure, trade, tourism and the arts of New York City and its metropolitan region. She has authored a wide range of publications and has been an invited speaker in China, Australia, France, Spain, the United Kingdom, and Canada.

TONY TRAVERS is Director of the Greater London Group at the London School of Economics. He is Expenditure Advisor, House of Commons Select Committee on Education & Employment, and he has been a Member of the Audit Commission, and an Advisor to the House of Lords Committee on Central-Local Relations. He has extensively researched issues concerning local government and London for 20 years. Recent research on London and other major cities has included studies of the London economy, transport, arts & culture and governance issues. During 1996 he undertook a major research project for the Corporation of London on *Business Improvement Districts New York and London.* Two recent reports are *Transport and the London Mayor* (with Stephen Glaister) and a detailed study of *The New Government of London* (with George Jones).

LSE London: Urban and Metropolitan Research

In 1998 the London School of Economics established **LSE London** as a centre of multi-disciplinary research excellence on urban and metropolitan regions, with a special concentration on the economic and social issues of the London region. It includes **The Greater London Group**, directed by Tony Travers.

LSE London's **discussion paper series** includes the initial output from research projects undertaken at the Centre as well as contributions to urban policy debate, especially on London-related themes. This paper is the first in our series:

1. S. Glaister, R. Scanlon and T. Travers, *The Way Out: An Alternative Approach to the Future of the Underground*, LSE London Discussion Paper No. 1, March 1999.

2. A. Thornley. *Urban Planning and Competitive Advantage: London, Sydney and Singapore*. LSE:London Discussion Paper No.2, May 1999.

3. M. Kleinman. *A More Normal Housing Market? The Housing Role of the London Docklands Development Corporation 1981-1998*, LSE London Discussion Paper No. 3, May 1999.

4. T. Travers, C. Whitehead, A. Holmans and I. Gordon. *Housing in London: Future Perspectives*, LSE London Discussion Paper No. 4, May 2000.

Copies of these papers are available on request; please contact 020-7955-6522 or lselondon@lse.ac.uk.❖ *Papers cost £5. Checks should be made payable to the London School of Economics.*