



London Underground Public-Private Partnership Facts and Analysis

FACTS AND ANALYSIS RELEVANT TO THE GOVERNMENT'S STATEMENT ON A PUBLIC-PRIVATE PARTNERSHIP FOR LONDON UNDERGROUND

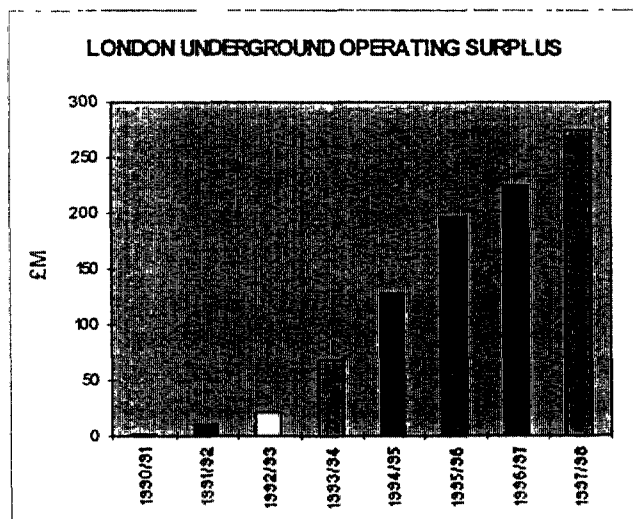
Introduction

1. This note sets out the key facts and analysis underlying the Government's policy on a public-private partnership (PPP) for London Underground.

Background

2. London Underground Ltd is a wholly owned subsidiary of London Transport, a nationalised industry with statutory powers and duties set out in the London Regional Transport Act 1984. London Underground is responsible for running the world's oldest underground railway and one of the largest. The Underground serves over 260 stations, running trains over some 244 miles of track, around 42% of which is in tunnel. There are twelve different lines, seven of which are "deep tube" lines and five of which are "sub-surface" lines.¹ Around 800m journeys were made on the Underground in 1997.

3. In 1997/98 London Underground is expected to generate an operating surplus of some £275m. This figure has risen steadily from break-even in 1990/91. The graph below shows this trend.



4. However, London Underground's operating surplus does not take account of the business's investment needs. It makes no allowance for:-

¹ "Deep tube" lines (Bakerloo, Central, Jubilee, Northern, Piccadilly, Victoria and Waterloo & City) were bored at a level deep enough to go below sewers, water mains etc.. "Sub-surface" lines (Circle, District, East London, Hammersmith & City and Metropolitan) have wider tunnels, mainly created using the "cut and cover" technique and their tunnels are closer to the surface.

- the backlog of past under-investment, which means that assets are still in use beyond their design life, with consequent increases in maintenance and inspection costs and increasing unreliability. London Transport estimates that this backlog is currently £1.2bn;
- the annual capital investment requirement that would be needed to maintain the network in a "steady state", even assuming that there was no investment backlog. London Transport estimate that this on average needs to be around £350m a year (£400m once the Jubilee Line Extension is completed).

5. The Underground's investment requirement is spread between asset types and lines. LT forecast that the asset types requiring most investment over the next ten years (in descending order of value) are rolling stock, stations, signalling, civil engineering structures and track. The lines with the greatest investment need over the next ten years (in descending order of value) are the Metropolitan and Circle Lines, Victoria Line, Northern Line, District Line and Piccadilly Line.

6. Very few of the projects in London Underground's investment programme earn a financial return. In general, they are justified by the wider benefits they provide to Tube users and, by encouraging people not to use their cars, their road congestion relief and environmental benefits. The Underground has a strong market position in much of the London transport market. Demand for its services is mainly determined by GDP, employment in the London area and fare levels.

7. In order to increase the funds for investment, London Transport receives grant from the Government, which it then allocates between its businesses. The Table opposite shows grant to London Transport and investment in the existing London Underground network over the past 5 years, and forecasts of grant and investment for this year and the next two years, based on the 1996 Budget settlement which the Government inherited from its predecessor.

8. In announcing the Government's PPP policy, the Deputy Prime Minister also promised an extra £365 million of additional funding to London Transport over the next two years for investment in the core Underground network and for preparing for a public/private partnership. The Table above shows the situation that London Transport would have faced without this extra money. Investment this year and in the next two years would have averaged only £348m. This additional funding will help prevent the investment backlog increasing to some £1.5bn by 2000/01, which London Transport believe would otherwise have happened.

GRANT TO LONDON TRANSPORT CORE BUSINESS & INVESTMENT IN LONDON UNDERGROUND CORE BUSINESS¹

£ million in cash prices

	Actual					Previous Plans	
	93-4	94-5	95-6	96 7	97-8	98-9	99-00
Government grant to LT core business ²	572	370 ³	442	386	313	354	136
Investment in London Underground core network ⁴	485	506	561	626	611	385	312

1. All figures exclude ringfenced projects such as the Jubilee Line Extension and Croydon Tramlink. All figures assume carry forward of £100m of core business grant from 1997-98 into 1998-99. All figures are in outturn (cash) prices.

2. All grant figures are for grant to LT's core business only and do not include additional ringfenced grant for projects such as the Jubilee Line Extension. Because of cost overruns on the Jubilee Line Extension project, a substantial amount of investment in the project is being funded from LT's core grant in the years 1996-97 and after. Therefore, the amount of grant which is actually used for LT's core business in these years is significantly below the levels shown.

3. In addition to grant, LT benefitted in 1994-95 from proceeds from the sale of London Buses Limited subsidiaries (£133 million).

4. The investment line includes estimates of PFI investment by the private sector in the core Underground.

9. In summary:

- London Underground faces an investment requirement over the next 15 years of some £7bn;
- some 75-80% of this total comprises the "steady state" replacement of life-expired assets, and the rest is either needed to make up for past under-investment or for enhancements to the network;
- very few of the investment projects in the Underground's investment programme are commercially viable in their own right; most are justified by their wider benefits;
- but London Underground believes that the business as a whole can become commercially viable within the next decade, through increases in patronage and some improvements in efficiency;
- major changes in policy, such as the introduction of congestion charging in London, would further improve the long term financial prospects of London Underground.

Policy context

Summary of the options considered

10. The Labour Party's election manifesto said:-.

"The Conservative plan for the wholesale privatisation of London Underground is not the answer. It would be a poor deal for passenger and taxpayer alike. Yet again, public assets would be sold off at an under-valued rate. Much-needed investment would be delayed. The core public transport responsibilities of the Underground would be threatened. Labour plans a new public/private partnership to improve the Underground, safeguard its commitment to the public interest and guarantee value for money to taxpayers and passengers."

11. The Government appointed Price Waterhouse in July 1997 to consider a range of potential options, only excluding wholesale privatisation, as well as taking advice from London Transport and the Health and Safety Commission.

12. The options considered were debt funding with public ownership; partnership structures which could include a trust, a joint venture concession or partial sale of the business, or a full concession; and operational structures which could involve a single business, vertically integrated line businesses or separating infrastructure from operations (known as a horizontal split).

Assessment criteria

13. The options were assessed against the following key criteria:-

- to safeguard and improve service to passengers, with guaranteed safety standards. As part of this assessment, the Government sought the views of the Health and Safety Commission, as well as those of its advisers, Price Waterhouse and Mott MacDonald, and of London Transport.
- quickly to reduce or eliminate the Underground's "investment backlog";
- to attract private investment, with genuine transfer of risk to the private sector;
- to provide value for money for the taxpayer through improved efficiency and management;
- to contribute towards an integrated transport policy for London.

Analysis of the options

Structural Options

14. The assessment of structural options made two important assumptions:-

- that all options would be required to improve the quality of service to passengers, especially through higher investment to eliminate the "investment backlog" and to carry out other improvements to the network;
- that all options would be required to maintain and develop the safety of the network. The Health and Safety Commission was consulted as part of the assessment of options and concluded that none of those being considered presented insuperable problems from a safety perspective. However, the Commission also noted that, as a general rule, the more complicated the structure and the greater the number of interfaces, the more difficult and expensive it would be to devise a suitable safety regime. The difference between options on safety grounds is therefore that some would require more effort and money than others in order to maintain and develop safety standards.

15. Against the other relevant criteria, Price Waterhouse's assessment of structural options suggested the following strengths and weaknesses:-

- integration could be protected under any of the options, but would be easier to maintain with a unified structure or a horizontal structure with one operator;
- the best incentives to manage costs and increase revenue would arguably be created by restructuring into a number of different entities, thereby encouraging different ideas and approaches. This could be achieved either with vertically integrated line businesses or a horizontal structure with a number of infrastructure managers and operators;
- but creating more than three entities for operations or three for infrastructure businesses would not be worthwhile. There is little scope for direct competition between Underground lines; the scope for yardstick competition to compare the relative performance of businesses is limited by the lines' different characteristics and investment needs; and the potential benefits of competition would be constrained by the need for network-wide control and co-ordination;
- there would be a healthy level of investor interest in any option, but this would be somewhat higher in a horizontal structure because separating infrastructure and operations would focus specialist investors in their own areas;

- investor interest might be maximised by having more than one infrastructure entity, but, against that, the fewer entities involved, the easier a structure would be to implement;
- a horizontal structure is likely to be the best way to attract capital for investment and to get efficient management of the investment programme, but it will be necessary to specify investment requirements carefully in terms of performance and outputs;
- a horizontal structure also provides more potential for market testing because it would allow long term infrastructure contracts to be let with shorter term partnerships for operations if desired.

Ownership options

16 As stated in its manifesto, the Government ruled out the wholesale privatisation of London Underground.

17. The Government considered the case for retaining all of London Underground fully within the public sector, as now. These were the key issues -

- Tube users value many aspects of the existing Underground system, especially its integrated nature (eg. ticketing, Travelcard, the Tube map and roundel), the importance given to safety and the knowledge that it is run as a public service, so socially worthwhile services are not perceived as under threat. This meant that there was a particularly strong case for operations to be in the public sector;
- many criticisms of London Underground's performance can be traced to under-investment, which in turn is the result of past under-funding;
- experience over many years has shown that high and stable levels of Government grant for London Underground have not been achieved;
- an alternative approach would be to allow London Underground to borrow on the markets, but the measure of public sector borrowing which the Government uses, the PSBR, would increase in the same way as if it were Government borrowing to fund grant to London Underground,
- market borrowing by London Underground would also be more expensive than borrowing in the normal way for public corporations, through the National Loans Fund;
- it would be possible for the Government to adopt a different target for public sector borrowing, as other European countries do, but such a step could be seen as a relaxation of the Government's monetary and fiscal policies;

- it is arguable that such a relaxation in policy would not have this effect if any borrowing by London Underground were to be entirely commercial and without any form of Government guarantee;
- however, it is questionable whether such an arrangement could be established because, whilst London Underground remained a nationalised industry, it would be very difficult for the Government **not** to stand behind it.

18 The Government also considered various forms of trust option:-

- a trust option would involve a wholly private sector organisation which was established with a constitution focused on the stewardship of the Underground's assets and the improvement of services to passengers, not on profits;
- the trust would need to be outside Government control, otherwise the trust's borrowing would be classified to the public sector (see above);
- as the Government (or the Greater London Authority, GLA, in future) would be unable to control the trust, important questions would remain as to how the public interest and public accountability would be safeguarded;
- regardless of how the trust's borrowing was classified, it would be more expensive than Government borrowing, and the markets would still almost certainly seek some assurance that loans would be repaid by Government if the trust defaulted. (The borrowing might be classified as Government borrowing if there was a likelihood that the guarantee would be called);
- in addition, London Underground does not operate in a competitive market, nor does it have a concentrated customer base which can exert substantial influence on the running of the trust, so it is arguable whether a trust would be subject to sufficient discipline on quality or cost;
- concerns about the efficiency of a trust could arguably be addressed by requiring the trust to market test some or all of its activities.

19 The Government considered the best way for the private sector to be involved, either as a partner in a joint venture or as a concessionaire. These were the main considerations:

- London Underground does not operate in a competitive market, nor are most of its investments commercially viable, so any private sector involvement would need to be properly regulated so that it worked in the public interest;
- it would not make sense for London Underground to borrow from the private sector without also involving the private sector in the management of the investment their borrowing was funding, as the Government could borrow more cheaply on its own account (see above);

- however, a public-private partnership could be funded with a range of different funding structures;
- but in the short term the flotation of a concession or joint venture company probably would not be viable;
- it is also arguable that the private sector would be more effective in finding further efficiencies, both in the day-to-day operations of the Underground and in the management of its investment programme.

The Government's chosen option

20. The Government's preferred option has the following key features:-

- London Underground will remain as a unified public sector operating company, and will let between one and three infrastructure contracts;
- the public sector operating company, which, subject to the forthcoming referendum on the Government's proposals for the future governance of London, will eventually pass with the rest of LT to the GLA, will be responsible for employing the train drivers, station staff and line and network controllers;
- this company will award one, two or three contracts to maintain and modernise the infrastructure. The number of contracts is yet to be decided, but if there are to be two or three contracts they will be based on groups of lines, not types of asset;
- the position of the infrastructure contractors will have important differences from the privatised Railtrack's position on the national rail network. For example, assets will not be sold off, instead the public sector will own the freehold and at the end of the contract assets will return fully to the public sector; there are no plans for competition between train operators; the operation of signalling will be for the operating company, not the provider of the infrastructure; a contractor will be responsible for providing rolling stock as well as providing tunnels, track, signalling, stations and escalators; the public operator will be in a strong position in relation to the infrastructure contractors and will be responsible for safety.
- a contractor will maintain and modernise the infrastructure, and will be paid by the operating company. There will be a performance regime with incentives and penalties designed to ensure that the contractor delivered the improvements specified by the operating company,
- The majority of Underground staff will remain employees of London Underground. Protection will be put in place for staff who transfer to the contractor.

21. The Government believes that its chosen option has the following advantages:-

- it will preserve the elements of the existing system which Tube users value - a single public sector company responsible for running the trains, managing the stations, marketing the network and ensuring safety. The "public face" of the system - the network, the Tube map and roundel, unified ticketing, Travelcard, etc. - will be preserved in the public sector;
- it will address the root cause of most problems with the network - past under-funding and under-investment - by bringing in private sector funds to pay for the modernisation of the Underground. This investment will be remunerated by appropriate returns over time, provided the contractor(s) delivered the specified outputs and levels of performance;
- it will improve the service the Underground provides to London for the new Millennium - higher reliability, refurbished stations, improved trains, upgraded signalling, faster journey times.
- the number of contractors - one, two or three - will be chosen so as to strike the best balance between competitive bidding for the contract to modernise the infrastructure and minimising cost and complexity;
- the private sector contractor[s] will be subject to tough contractual terms with built-in periodic reviews, and the public sector operating company will be able to ensure that the promised improvements are delivered;
- the freehold of all assets will remain with the public sector Underground operating company and assets will return fully at the end of the contract[s];
- under the Government's proposals for the Greater London Authority, the Underground operating company would be owned by the proposed GLA and would therefore be accountable to the people of London through the Mayor and Assembly.

Government Office for London

20 March 1998.