

### XIII. TERMINATION IN THE PUBLIC INTEREST VERSUS TERMINATION IN THE PRIVATE INTEREST

In its report, Ernst & Young wrote: “Transport *for* London has raised the issue about the absence of the right for the public sector to terminate on a voluntary basis... This issue has become known as the public interest termination. It is the case that most PFI/PPP contracts, in our experience, contain this type of provision... Under the proposed PPP contracts, no express right exists to accommodate voluntary termination... In our view, it would be a lower risk option for London Underground to have an express right to seek voluntary termination with an agreed mechanism in line with Treasury Task force guidance.”<sup>207</sup>

LUL has rationalised omitting this commonplace provision, which even E&Y recommends be included in the documents, as follows:

“LUL did not originally propose such a right because it is vital, in LUL’s view, to ensure that Infracos take a genuine 30-year view of their obligations in order to achieve the objective of proper whole-life asset management. *Anything which might make the Infracos believe that the contract might terminate early, even if they were performing adequately, would compromise this. Nor is it easy to see why LUL would need such a right in circumstances where Infraco were meeting all its obligations, and where changes to the contract could be made through the existing periodic review mechanism to deal with any amendments LUL thought desirable.*”<sup>208</sup>

The view that it is difficult to understand why LUL would need a public interest termination right rests on several questionable premises and assumptions. First, the periodic review mechanism does not allow LUL to implement any amendments it thinks desirable. LUL’s view also rests on the assumption that the right would only be used when all was proceeding very well under the Contract. The naivete of that assumption rests on 1) apparent ignorance of the workings of the remedies and termination clauses of the contract, which render highly possible a scenario whereby Infraco will not be performing its obligations but LUL will have no meaningful recourse (either because the non-performance does not quite amount to the very low standard before a termination for default can be implemented or because proving the default may be difficult, and 2) denial of the fact that the PPP arrangements may, even if performance is delivered, *simply cost a great deal more than it is necessary to pay for the performance in question*. Lastly, performance may be wholly inadequate for LUL’s purposes (though perhaps will not be so bad as to trigger a right to terminate for default) because of a confluence of events: shortcomings in Infraco performance, PFI non-performance or intolerable excess costs under PFI contracts, and force majeure for example.

As shown by the quotation above, the FAR focuses also on the potential negative effect of a public interest termination on the goal of whole life asset management. This sentiment was echoed in LUL testimony before the Parliamentary Select Committee in answer to a question as to why the public interest termination right was not included in the Contract:

---

<sup>207</sup> E&Y Report, pp. 60-61.

<sup>208</sup> FAR, pg. 82, emphasis added.

“[I]t would represent a fundamental weakness in the [PPP] structure if it were very likely that the contract would come to an end earlier than 30 years, because it would create exactly the wrong incentives. It would create the incentives in the public sector to guess that the contract would end early, and then try to optimise their position over a shorter period of time... So what we have done is to say, “If it works, provided the private sector are delivering what the Underground needs, there is no reason to bring it to an end, and therefore, the only circumstances in which it would come to an end is if the private sector do not deliver.”<sup>209</sup>

Putting aside the unfounded assumption that because a public sector termination right exists it is “very likely to be utilised”<sup>210</sup>, LUL posits that whole life asset management cannot be achieved unless the Contract is expected to continue for its intended 30 year term. Thus, a termination in the public interest, *a termination that could only be triggered if the Underground and the Government agreed that it was essential to the public’s interest to do so*, could not be allowed – it would undermine the very likelihood that the PPP would achieve its most essential goal – rebuilding of the Underground based on the principle of whole life asset management.

Yet, in spite of the danger to the programme as a whole that apparently can exist if there is any exit opportunity associated with the PPP, the latest draft of the documents provides the *private* sector with a new right to terminate the arrangement if it is in its best interest to do so and LUL refuses to pay more or reduce scope in order to relieve the Infracos of their finance obligations.

The draft Schedules 1.9 to the PPP Contract documents provided to Transport for London are far from complete. As a result of material matters still to be addressed, it is impossible to discern the full scope of the “Termination in the Private Interest” that LUL has provided to the Infracos, both in terms of when it can be exercised and what its exercise will cost LUL. However, this much is known:

If at the 7 ½ year mark, continuation of the contract without change will entail the procuring of finance by the Infracos (something which is a virtual certainty, and is fully expected by all parties, in order to implement the scope of improvements in the FAR Chapter “What PPP Delivers”), then under various scenarios will have the right to require LUL either to reduce the scope of the work, increase the price it will pay for the work, or buy the Infracos out at a price which will not only pay off their debt but which will “result in the shareholders substantially recovering their original equity committed”<sup>211</sup> less projected returns to date adjusted for actual performance.

The situation is far worse should LUL attempt to change the Contract at the 7 ½ year mark in order to take advantage of the purported flexibility it is afforded via Periodic Review. In that situation, the price of the Infraco buyout includes full equity and projected profits until the

---

<sup>209</sup> Testimony of the Underground before the Parliamentary Select Committee, 27 February 2002.

<sup>210</sup> We note that LUL does not make the same assumption when it evaluates private sector termination rights under the PPP contracts. The assumption further ignores that there would be a material cost associated with exercise of any such right.

<sup>211</sup> Draft Schedule 1.9. See also, FAR at pp. 73-74. Strangely, purportedly only a non-E&E Infraco is to have the benefit of this right. The FAR says that Schedule 1.9 only allows the Infracos to recover half their base equity. TfL does not see how that limitation on LUL’s exposure can be read into the documents in their current form.

Sale Date. To clarify, if LUL only wants the Infraco to deliver the currently anticipated scope, the Infraco can get out of the deal with their equity largely intact less profits projected to be earned to the date of the sale. If LUL wants to change the scope, the Infracos can escape with anticipated profits through the Sale Date.

Moreover, though this point is not acknowledged in the FAR and is quite difficult to discern from the draft PPP documents, this private sector right to exit from the PPP arrangements can arise even in the first 7 ½ years of the contract, if the Infracos' performance falls short of what is required by the Contracts<sup>212</sup> and also if the reasonable cost of performing the work exceeds projections by more than £50 million in the first 7 ½ years.<sup>213</sup>

Put aside for the moment the question of the effect on the Underground should the Infracos deploy this exit strategy. By the Underground's own analysis, the inclusion of this clause severely undermines any likelihood that the PPP will achieve its very objective – turnaround of the Underground based on the principle of whole life asset management. Either the Infracos can require a reduction of their Underground improvement obligations (via eliminating a whole life asset management approach for affordability reasons or otherwise), or they may exit the arrangement.

The answer that LUL can always simply increase the price (*i.e.*, provide the financing itself) to avoid this result is not satisfactory. Proceeding with the PPP on these terms is quite simply imprudent by the standard set in the FAR by LUL itself.

And what is LUL, and the public of London, left with *should* the Infracos exercise the right to be bought out from the contract? A lot of works in progress (perhaps) and a good deal less money to pay for those works, since so much money will have already been expended in connection with buying out the lenders and the shareholders from the first failed experiment.

We note that we saw no quantification of these excess costs in the FAR nor are these amounts taken into account in the Value for Money analysis. The FAR simply says that it was “clear from discussion with bidders and their lenders that the PPP would not be transactable without changes of the sort set out here, the terms of which were the subject of extensive negotiation.” The Value for Money analysis conveniently assumes that the problem will never occur.

If the PPP Contract terminates, whether as a result of Infraco default<sup>214</sup> or as a result of a termination in the private interest, the cost of carrying out the required work on the Underground will no longer be simply the massive costs ordinarily associated with that effort. The price to buy out the failed PPP contract will have to be added to the overall cost. If an Infraco defaults, LUL will theoretically “only” be required to pay the cost of the Underground improvement works plus up to 95% of senior debt in order to accomplish the work that the defaulting Infracos

---

<sup>212</sup> See LUL Responses to TfL Consultation Queries, revised 7 March 2002.

<sup>213</sup> On average, for Tubelines. The £50 million corridor can also be narrowed as a result of revenue shortfalls.

<sup>214</sup> The latest draft of contract documents make clear that it is not necessarily LUL's choice whether it should terminate the Infraco due to Infraco default. Should LUL take over the Infraco's obligations via its step-in rights for a period of a year, without the Infraco having tabled a reasonable plan to take back performance of its obligations, then Infraco can now require termination of the arrangements. Service Contract, Section 41.2.

failed to perform (or under certain circumstances a higher amount capped at 100% of senior and mezzanine debt).<sup>215</sup> This is only theoretically the limit because the Infracos can avoid this limit by triggering a buyout under the higher price payable under Schedule 1.9: as even the FAR notes, if an Infraco sees a default coming, it may well choose to trigger a buyout under Schedule 1.9:

“There is a theoretical possibility that Infraco would make no attempt to raise the new money in circumstances in which it could foresee itself being in default shortly after a periodic review”<sup>216</sup>.

Compare LUL’s position should TjL’s tested method of improving the Underground be employed. Should a contractor default, LUL would not have to stem the losses of the Contractor – LUL would in fact have the right to look to the contractor (or its bonding company or its parent) to stem the losses suffered by LUL as a result of the contractor’s default.

The Contracts should not contain an expensive termination in the private interest clause. However, it is critical that they contain a public interest termination clause.

---

<sup>215</sup> In a typical public works contract, if a contractor fails to deliver what it promises, it is obligated to reimburse the owner for the excess costs of getting that work done. Here, LUL must not only pay most of those costs, it must incur the cost of much of the breaching Infraco’s debt.

<sup>216</sup> FAR, pp. 73. The FAR understates the risk to LUL of this way for the Infracos to protect their equity in the face of a default, by (among other things) failing to address the fact that the backdoor is also available via the Extraordinary Review process.