Connect: money down the tube?

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Financing was signed on April 17, 2000, for the Connect Communications Project, the largest and most technologically complex PFI to close for the London Underground. The £360 million ($594 million) financing supports a complete overhaul of the communications system for the transport network. It has been a long haul, at least in terms of bringing the contract to close, but the prospects for the sponsors are amongst the most exciting for PFI.

In the short term the contract involves the assumption of responsibility for the operation of the London Underground's communications network. The next stage is the installation and operation of an enhanced network wide radio service using a combination of radio and fibre-optic technology. The estimated value of the contract over its entire life has been put as high as £1.2 billion. The invitation to tender was put out in early 1997, with two consortia replying: Gensys, made up of Logica, Cubic Transportation Systems, Smith Systems Engineering and GPT; and Citylink Telecommunications, made up of Racal, Motorola, Charterhouse, Hyder Investments and Fluor Daniel.

The project was scheduled to be awarded in the first quarter of 1998, but was delayed, largely so that London Underground could be seen to have observed the proprieties of the bidding process. During the latter stages of the negotiations, and after close, the unsuccessful bidder came back with a lower bid, which London Underground was obliged to re-evaluate. Signing and close between the banks and Citylink happened on October 20 1999. According to sources close to the deal, London Underground was surprised that a bid had been submitted that was substantially lower than the six to seven years that they had estimated. It is likely that this kept the contract in Citylink's hands since they had estimated four.

Four banks are providing financing: Bank of America, Bank of Scotland, Bayerische Landesbank and Toronto-Dominion Bank. Bank of America had come in as Fluor's relationship bank after the Nations take-over. The bank facilities are predicated on an 88:12 debt/equity split, and consist of a main commercial facility of £315 million, a contingency facility of £14.9 million and a change-order facility of £22 million. The contingency facility is designed to take care of cost overruns and changes in inflation. The change-order facility is a feature unique to London Underground PFIs in that it is designed to take care of any additional functionality that London Underground's management might request.

The contract structure has similarities with the earlier Prestige ticketing system that had been done with London Underground, although the funding requirements are different, largely because of the higher operations costs over the life of the concession. Moreover, the recent huge advances in optical and radio technologies mean that whilst the most basic part of the network ? the Terrestrial Trunked Radio (Tetra) system ? is technologically robust and proven, added functionality is a grey area.

One case in point is the potential to add on consumer-friendly features to the Underground itself. The most current issue is the potential for the use of mobile phones under the surface. Further waves could be created by the addition of moving image advertising. This would be a bandwidth-intensive application, but has the potential to add a lucrative upside to the project's streams, although it is not factored into the financing. Needless to say, there have been tentative discussions about potential revenue-sharing with LU, and the sponsors have ensured that there is adequate spare capacity on the fibre-optic network backbone.

The technology involved, however, is not entirely unfamiliar ? having been used extensively in the US. Bank teams involved with the deal consisted of a varied mix of telecoms and PFI teams, advised by consulting firms Arthur D. Little. In this case a thorough understanding of the risks involved in the project was married to a knowledge of PFI contractual provisions such as force majeure.

The contract is essentially a services-based contract, albeit tempered by the requirement to meet certain levels of network performance. Payments, based on certain levels of operational efficiency for each line on the underground, will step up once the integration and performance of the network has been proved. The previous communications system on the underground was largely analogue, copper wire and radio-based.

Over the next four years, Fluor, as project managers and overall EPC contractors, will begin to replace the telecoms infrastructure line by line. Motorola will be supplying the radio equipment with Racal providing the transmission equipment as well as operating the system. The property structure is complex, however, including both movable an immovable equipment. Leases have been structured on the buildings (essentially the operations centres) and some other equipment, although this is more to increase capital allowance efficiency that pure tax-driven reasons.

The final area of uncertainty is the compatibility with the proposed public-private partnership for the Underground. The UK government has determined that the contract is not likely to create any conflicts with its favoured model of a parcelling out of the various lines to private sector operators. This is based on the contract structure that treats, for performance purposes, each line as a separate entity. However, even if the present political uncertainty over LU's funding future is resolved an a way unfavourable to the Labour administration, Connect is certain to survive. This is thanks, in no small part, to customary letter of support from the Department of Environment, Transport and the Regions.