

## **TfL's submission to the Lyons Inquiry into Local Government Funding**

TfL welcomes the opportunity to submit this written response to the Lyons Inquiry into Local Government Funding.

As one of the most visible local government entities within the Greater London Authority and one of the largest regional transport authorities in the world, TfL is a leading example of devolved government services in the UK. Since its creation in 2000, TfL has experienced the limitations of local accountability in its funding and plans for investments in long-term infrastructure. The Spending Review 2004 settlement has temporarily addressed the problems of uncertain funding, and has enhanced local accountability in funding and delivering of long-term infrastructure to 2009/10. However, improvements in the balance of funding may be considered to make these arrangements more permanent and to give TfL greater capacity to take on the risk of major projects at the local level.

### **1. Achieving devolution with accountability**

The Government has stated its support for devolution in terms of placing decisions closer to the level of delivery and in increasing local accountability. The direct election of the Mayor for London is a clear sign of this, with transport as the major part of his responsibilities. The Mayor's manifestos and the steady press coverage of TfL demonstrate that devolution has shifted accountability for fares and charges and for the overall performance of the system to the local level. The challenge has been to harness this accountability to deliver the full range of service improvements needed for a population increasing by of 800,000 and for 640,000 new jobs in London by 2016.

The Mayor's control of fares cannot drive investment plans on their own. Fares make up only half of TfL revenues; the rest is Transport Grant, set at the Government's discretion. When the proportion of national funding is so high and discretionary, even the largest fare and charges increases can be frustrated by a corresponding reduction in Grant. The political risks faced by local leaders for groundbreaking initiatives, like the congestion charging system or fare increases to support long-term investment, are high. The threat that any cash that they raise may be "abstracted" through reduced Grant only raises the political risks of these decisions and can discourage local leadership on long-term issues.

As a final disincentive to local accountability and delivery, London's low share of local funding gives it little flexibility to take on project risk (whether under private or public delivery). This leaves project management and the costs of risk unaligned. The Jubilee Line Extension is a recent example of how an absence of local participation in project management and the inability of fares to absorb risk leave the Treasury exposed to locally managed projects.

### **2. Important steps have been taken in London within the current fiscal structure; the five-year grant simulates key benefits of local control of funding**

In the past year, arrangements have been put into place which effectively (in the short term) mitigate many of the disadvantages of TfL's underlying fiscal structure up to 2009/10. The settlement is unique in its five-year term. Previous settlements had been for two years, with a third year indicative and in practice variable. The settlement provides assurances that local revenues will not be offset by reductions in Grant. This encourages local decisions to raise

incremental fare and congestion charging revenues, since these amounts will translate pound-for-pound into investment.

A final unique feature of the settlement is its multi-year approval of TfL's borrowing plans (provided they remain consistent to requirements on affordability and prudence within the Prudential Borrowing regime). Taken together, these features mean that TfL can now fund capital projects such as increases to transport capacity, new links in transport areas identified for regeneration and the renewal of assets that otherwise have been delayed due to short-term funding constraints.

Although the settlement is a statement of intent and not legally binding, the certainty it creates makes £3.3 billion of debt for the programme attractive to the financial markets. TfL is now accountable to private investors as well as to the voters and businesses of London.

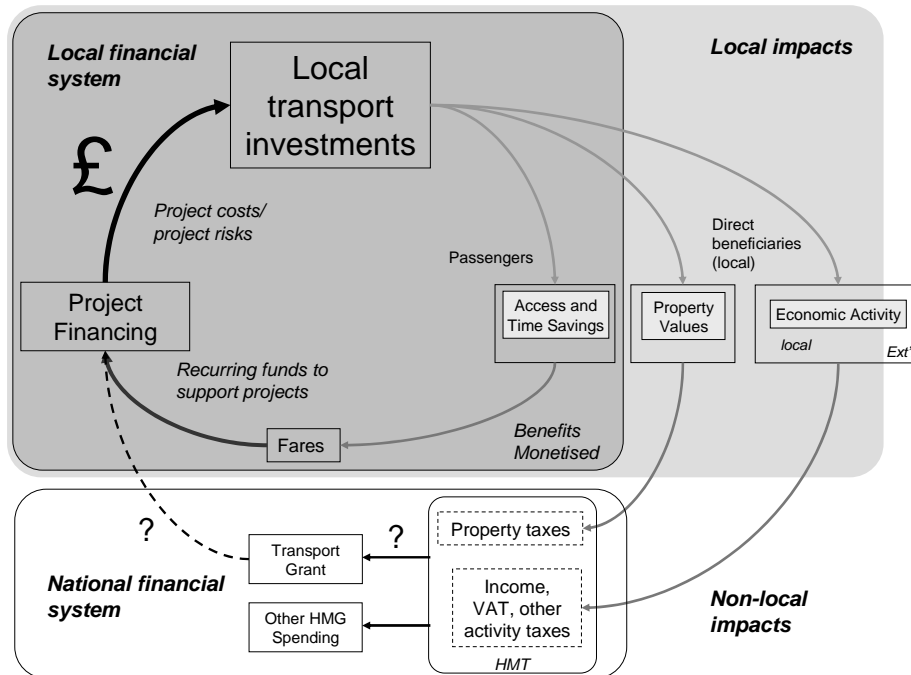
Despite the benefits that the settlement brings to funding and local accountability, the agreement covers just one phase of our long-term investment plans. Many of the investments needed to meet the job and population growth forecasts of 2016 will extend beyond 2009/10. These include most of the line upgrades and capacity improvements for the Underground under the PPP, as well as further extensions of the DLR and the West London Tram.

### **3. Despite improvements through 2010, TfL's fiscal structure does not fully align beneficiaries of investment to funding**

Two premises of efficient public financial policies are that they align burdens with beneficiaries and that they create a virtuous circle of benefits generating project funding.

The benefits of Local transport projects can extend beyond their immediate service areas. In most cases, their impacts are predominantly, even entirely local. This local impact is represented by the light grey area in chart 1. Transport for London, as the authority responsible for funding and delivering the works, can look only to passenger fares to support and to help manage the risks of its projects; but its investments also increase property values and economic activity, which generate higher tax revenues. These taxes are controlled nationally and have no direct role in local funding or assumption of risk.

**Chart 1. Local impacts of transport investments and the local financial system**



This mismatch of responsibility for investment without control of funding affects not just London. Under the current local government funding system, all key decisions on local transport investment, like that of the Manchester Metro, are taken at a national level.

#### 4. Business rates are an opportunity to match local funding with accountability

Transport for London is not proposing that local governments control the full tax base within their regions. National priorities require a strong national share of total taxes and centrally driven redistribution between regions. An intermediate step to improve local accountability would be to grant London control over its National Non-Domestic Rates (NNDR or “commercial rates”), the taxes assessed on business property.

The NNDR includes an RPI cap, which neutralises commercial rates as a source of investment funding. When property prices nationwide rise above inflation, the tax rate adjusts downward to keep collections constant. And whenever local transport investment creates large gains in property values (as the Jubilee Line did for Canary Wharf), it further depresses the multiplier. Rather than helping to support local government’s costs for these investments, the extraordinary local gains are converted into small tax windfalls for commercial property holders across the country. Over the long term, the NNDR will continue to shrink as a share of local funding and place greater strain on discretionary funding from the Government.

London’s business rates could, however, be harnessed to improve the balance of funding and provide more stability to long-term investments. Adding some control of rates would also allow local government the flexibility to assume incremental project costs and risks. Government’s risk as the funder of last resort would decline.

It is likely that some central Government funding for London’s transport system would remain appropriate, where investment improves GDP, meets other national priorities, or reflects risks beyond TfL’s management control<sup>1</sup>. When taken to its extremes, a shift toward local funding

<sup>1</sup> Approximately half of TfL’s Transport Grant relates to the funding of the PPP and the Underground. The risk of this funding is carried by the central government and remains appropriately funded by this route.

capacity (whether from NNDR or any other source) could enable the remaining Government contributions to become more formula- or contract-based.

Crossrail is an example of a project which would benefit from the additional source of funding and from the improved ability of the local government to take risk by adjusting business rates and fares. Such changes would support local Government's aspiration to take the leading role as project sponsor and manager, with clearer accountability for its delivery.

### **5. International comparisons**

The transport systems in New York and Paris have enjoyed a more stable balance of funding and stable investment than has London. New York has also enjoyed a more complete range of tools to set its investment plans, raise revenues and manage the risk of its projects. The regional government in Paris will formally gain similar powers in July of this year.

The Paris and New York cases are discussed in appendices A and B, respectively.

**Annex A: Paris**

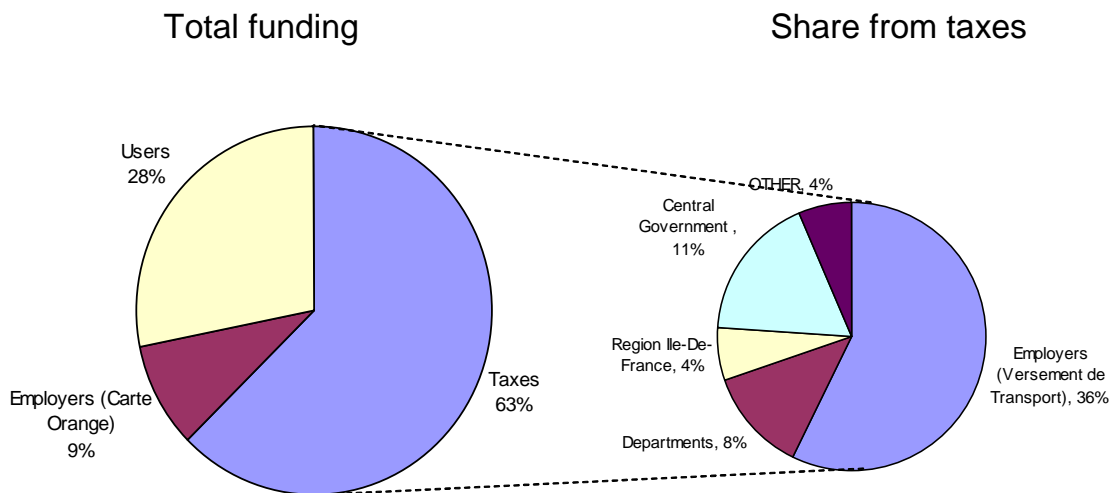
**Summary of the funding regime for transport in Paris**

The transport system for Paris has historically enjoyed both strong national support and a high level of local funding (90% for operations and 66% for capital investment). These factors have contributed to stable funding of operations and system renewal. Major investments are agreed under seven year plans, which conform to urban development plans set by the national government. Transport investment is seen as a high priority by all local stakeholders and by the national government, which sees a particular role and places a specific emphasis on transport in Paris.

Even though funding has been overwhelmingly generated at the local level, the central government had until recently been the dominant player in Paris’s transport. Beginning 1 July 2005, the central government will withdraw from the policy and fare setting decisions. The government is expected to follow its precedents in the devolution of other regional transport authorities in France, where it has agreed to convert its share of support into formula-based payments, benchmarked against historical levels.

**Chart 1.**

**Paris: Financing of Operating Expenses 2002**



source: Fitch Ratings

The central government will continue in its role as the guarantor of the national urban transport companies providing service on the Metro (RATP) and the railways (SNCF), which

manage the renewals and network extension projects in Paris. The central government is also expected to maintain a substantial role in capital investment (although less than that of the UK Government in London), with direct subsidies to RATP and SNCF for some portion of their capital renewal works and particularly for network extensions.

## **Structure**

Transport in Paris is directed by STIF (Syndicat des Transports en Ile-de-France), set up by the central Government in 1959 in order to co-ordinate mass transportation for the Greater Paris Area. STIF sets service and fare levels. It also receives the appropriations of Region Ile-de-France and various departments of the service region (including those of the City of Paris), the direct contributions from the State (paid by national taxes), and the Transport Levy ("*Versement de Transport*" – or VT). The *Versement* is a payroll tax assessed by the State within the STIF service region.

The operations of transport are managed under service contract with RATP (covering the Metro, the bus network, and parts of the RER parts of the high-speed underground railway) SNCF, which manages the suburban commuter-train services, and other bus services provided by a grouping of small bus companies called OPTILE. The capital investment programme is agreed under a "*Contrat de Plan*" co-financed mainly by the region and the Central Government. RATP, SNCF and OPTILE, as the operators of their respective systems, provide (and are reimbursed for) the investments and project management for infrastructure works. In this role, the national companies take on financing, predominantly for new rail cars.

Beginning 1 July 2005, Region Ile-de-France will have the shareholder control of STIF. This will unify the responsibilities of setting service policies, agreeing costs, and raising funding through local taxes and fares all at the local level.

## **Local Funding**

As the following graphic demonstrates, operating funding has been raised overwhelmingly from the local level. Fares make up 37% of revenues, and of the 63% of tax subsidies for operations, all but 11% is from the regional governments or the locally assessed and collected *Versement de Transport*. Until the 2005 reform, the rate on VT was decided at national level. After the reform, the rate will be set by STIF, up to a legal ceiling set by the national Parliament (currently most major networks in the Provinces are already at the ceiling; and a national bill for transport aiming at increasing the ceilings was rejected last year) Paris's local and regional governments with voting control of the STIF have independent tax-raising powers, which give them discretion in the amount and type of funding that they may provide.

Most capital funding is locally generated as well. The following chart shows that Metro and commuter rail funding is predominantly local, with bus capital funding split evenly between the regional and national governments.

The regional government and departments may enter into debt, and the service providers (SNCF, RATP, and OPTILE) have in the past taken on corporate financing, mostly for rolling stock. STIF, as the planning and co-ordinating entity has not incurred debt. It may, however, consider changing its status under the new localised regime and borrow like other transport authorities. In its new status, STIF would therefore be more comparable to MTA than to planning and service providers in France.

**Chart 2.**

**Capital Expenditure – Contrat de Plan 2000-2006: €2.5bn**

*Overall 66% of capital funding is provided by Region Ile-de-France*

(%)	State	Region	
	Subsidies	Subsidies	Loans
RATP	30	50	20
SNCG	30	60	10
Bus Co.s (Optile)	50	50	0

*Source: Fitch Ratings, May 2003*

Major line extensions are funded under separate negotiation, with the central government playing the leading role both in direct payments and through its ownership position of the urban transport companies.

In 2003, the Central Government announced it would no longer fund urban transport in the Provinces. Some observers fear this could also apply to Paris area once STIF becomes the sole responsibility of the Paris region

Features

**Benefits of local and regional funding**

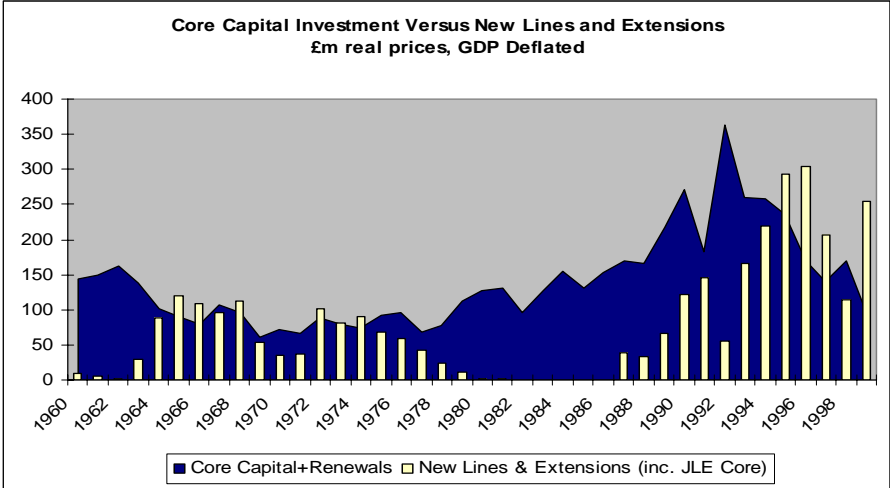
- As of July 2005, there will be local accountability on price as regional leaders control the fares.
- The region and departments will also determine how much they will subsidise the system from taxes under their control (they will have a power, though capped by legal ceiling, to vary the VT).
- They will also be accountable for delivery, in that they set the quantity and quality of service. The French national government will bear no direct responsibility for price and daily operating service.

**Benefits of dedicated taxes and tax surcharges in the transportation district**

The large portion of subsidies from the VT and local taxes from the regions and departments create a consistent funding baseline to maintain the system. Unlike the support for London Transport, which has shown significant volatility for basic reconstruction and renewal (chart 3), investment in Paris has shown marked stability over the same period (chart 4).

Chart 3.

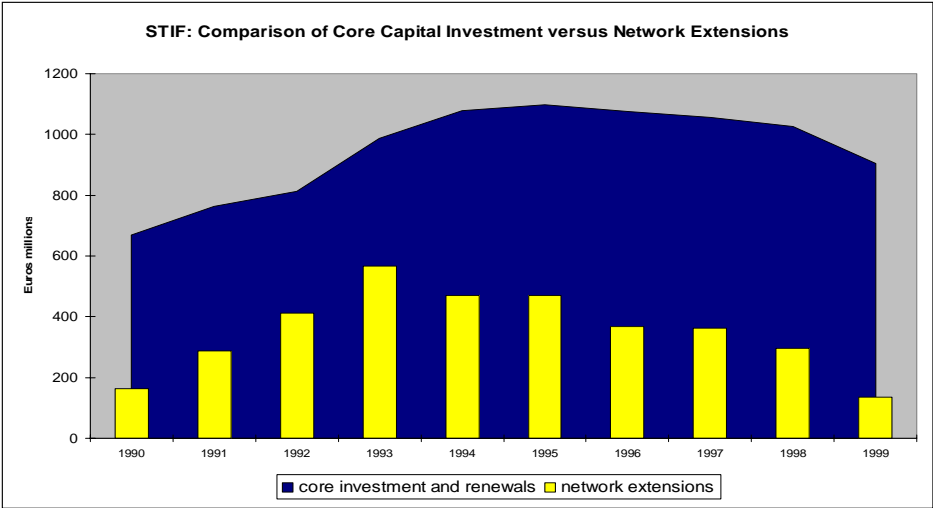
**Funding for London Transport, core investment and extensions**



Core investment has tended to fall during periods of network extension

Chart 4.

**Funding for Paris STIF, core investment and extensions**



## **Annex B: New York**

### **Summary of the funding regime for transport in New York City**

Like Paris, New York has a transport funding framework which provides broad local accountability and incentives, taps local economic benefits for revenue and better aligns costs to beneficiaries. With the consent of its Legislature, the State Government has the power to add new taxes or change rates on existing taxes, and has often done so to coincide with new phases of capital investment.

#### *Background*

After a lengthy period of disinvestment in the 1970's, which drove all parts of the public transport system into disrepair, regional business and political leaders decided that a broader and more stable system was needed for funding public transport. In the early 1980s, the Metropolitan Transportation Authority (MTA) was created to integrate the management and funding of the different service providers. This brought together New York City Transit (NYCT, which provided bus and subway services) and the State-run Metro-North Commuter Rail Corporation (MNCRC) and Long Island Rail Road (LIRR). To improve funding stability, it added the Triborough Bridge and Tunnel Authority (TBTA), which generates substantial tolls from the bridges and tunnel it owns and operates within New York City. To further bolster the finances of the new authority, the State approved a series of regional taxes..

MTA sets fares, provides the operating services, sets the plans, raises the financing, and bears the responsibility for delivering capital improvements. For the past 25 years, the MTA has undertaken five-year investment plans. These programmes have replaced all of the track, the rail cars and rail yards, buses and depots, renewed the bridges and tunnels, and have completed renewals and modernisations over 300 stations, many of which had not seen overhaul since their construction nearly 100 years ago.

Since the MTA's inception, its leadership has effectively lobbied to increase funding for new levels of investment, although in recent years the MTA has increasingly mirrored the fiscal priorities of the Governor (who appoints the majority of members and the Chairman). The Mayor of New York City names a minority of the Board members and has a relatively minor and diminishing role, as City funding to the Authority has declined.

#### *Regional funding for operations and debt service*

All operating costs are met by fares, local or regional taxes. These amounts include provisions for the payments on almost all of debt issued to fund costs of the Capital Program<sup>2</sup>. The debt structure comprises bonds backed exclusively by bridge and tunnel tolls (S&P rated AA-), dedicated taxes (AA-), fares and general operating funding (A). There is a separate class of debt repaid by dedicated State appropriations (AA-). These revenues are pledged to repay investors before any residual is used for the operating requirements of the system. In practice, these structures securitisation revenues and produce similarly low financing costs. Debt has traditionally made up a third of all capital investment, which is

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<sup>2</sup> The remaining debt is funded by direct appropriations of general New York State tax revenues.

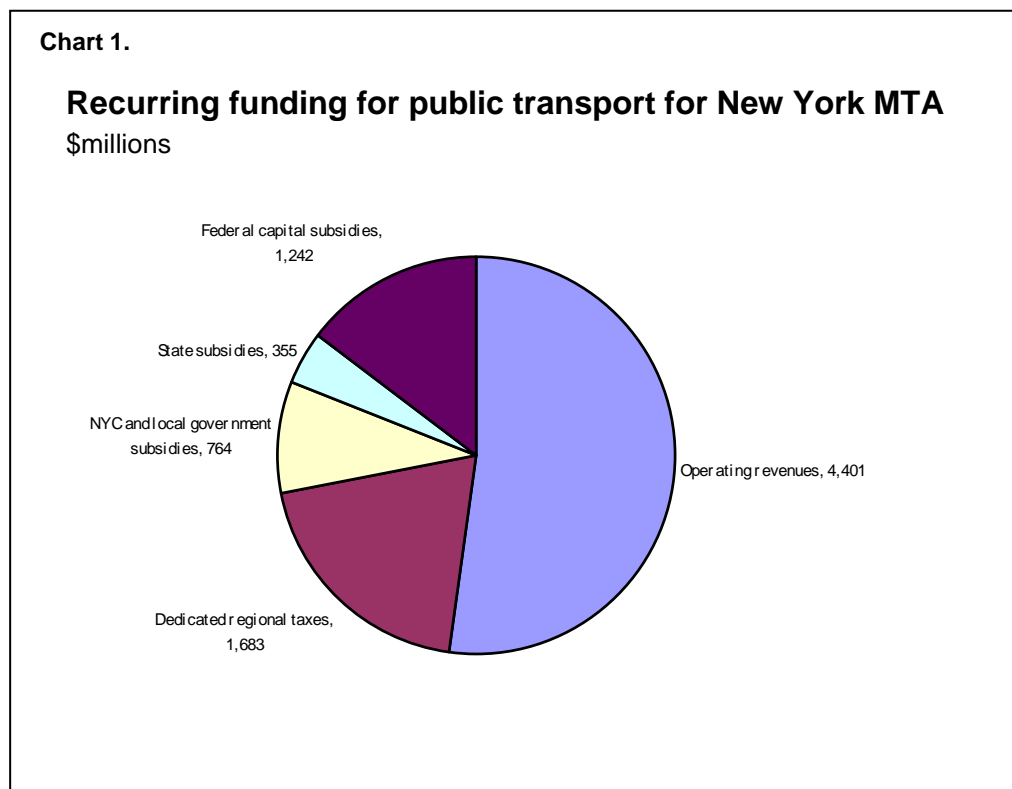
approximately the same ratio it holds as TfL's plans. In recent years, however, debt has taken on a greater share of capital funding. With some controversy it has risen to 57% of the funding for the most recent plan, and debt service has risen to approximately 15% of total revenues.

*Federal funding is limited to capital grant and is a small part of annual funding*

Federal funding is approved on a multi-year basis and is limited to capital expenditures. These amounts are provided under formula and can be applied against a wide range of qualifying works. Certain special Federal appropriations are also available for projects of particular environmental and regional mobility benefit. While Federal funds maintain a significant role in capital investment, they amount to just 15% of the \$8.4 billion of MTA's recurring funding<sup>3</sup> and have been declining for the past decade.

The remainder of the authority's annual resources come from a mix of operating revenues (52%) and from the allocation of tax revenues (33%) that are generated within the State, the service region, or within New York City.

Key elements of the MTA's annual funding regime, including operating subsidies and capital grants, is set out in the chart and discussion below.



The dedicated regional taxes of \$1.683bn is received via appropriation of the New York State, which approves, collects, and allocates such taxes.

<sup>3</sup> Recurring funding counts fares, tax subsidies, other appropriations, and Federal grants. Debt is not included, as its costs are met from all recurring funds except Federal Grants.

They include:

- operating assistance through a portion of the revenues derived from certain business privilege taxes by the State on the petroleum businesses
- a portion of the motor fuel tax on gasoline and diesel fuel
- a portion of certain motor vehicle fees
- a quarter of one percent regional sales tax
- a temporary regional franchise tax surcharge
- a portion of taxes on certain transportation and transmission companies
- an additional portion of the business privilege tax imposed on petroleum businesses

Features

- **Benefits of local and regional funding.** There is local accountability on price as state and local leaders control the fares and tax decisions needed to pay for 85% of the expenditure. There is local accountability on delivery as state and local leaders are ultimately responsible for the quantity and quality of service. In contrast, the Federal Government, which distributes smaller, generally formula-based funds restricted to capital investment, has effectively limited its accountability so that it has no responsibility for price and daily operating service.
- **Benefits of dedicated taxes and tax surcharges in the transportation district.** The large portion of MTA subsidies from dedicated taxes and tax surcharges within the region creates a firm funding baseline to maintain the system. These rates can be varied without increasing the burden on taxpayers outside the service area, and they have been a main contributor to debt financing over the past 20 years.