London Assembly
Budget Committee

October 2003

Public Interest, Private Profit

Transport for London's Contract with Capita for the Congestion Charging Scheme

1 Executive Summary

1.1 Eight months after it commenced, the Congestion Charging Scheme has helped to reduce congestion in central London. This report does not dispute the Scheme's success in this regard. Rather, it examines the cost of achieving this ambition and the relationship between Transport for London (TfL) and the Scheme's largest contractor, Capita.

1.2 Obtaining information about this relationship has not been easy. The London Assembly pressed TfL for a year to make public key aspects of its contract with Capita for the Congestion Charge Scheme.[1] The Assembly first wrote to TfL on this issue on 11 September 2002; TfL made the contract public on 29 August 2003. It is important to reiterate that a public body, TfL, awarding a major contract to a private sector organisation, Capita – a contract from which that organisation is expected to make £35m in profits over a five year period – is very much in the public interest.

1.3 The Mayor told the Budget Committee on 11 September 2003 that he came close to terminating the contract with Capita. Our view is that the problems which led to the contract almost being terminated were in part due to deficiencies in the initial contract. This is especially remarkable given the £30m allocated by TfL in management and support start-up costs to avoid such problems occurring.

1.4 The main problem arising from the initial contract was the lack of quality related performance indicators (PIs); this hampered TfL's ability to take action when Capita delivered poor customer service.

1.5 Six months into the Scheme, a revised contract, which involved additional payments to Capita of up to £31m over the remaining four and a half years of the contract, had to be negotiated. We do not view this as a good deal, particularly because it involves:

- A one-off payment to Capita of £3.5m for IT systems; a cost which should have been met by Capita and not TfL
- A 138% increase in Capita's share of penalty charge notice (PCN) income from £2.06 to £4.90 per paid PCN.

1.7 Most surprisingly, the reason advanced for the renegotiation is not the failure of the Scheme's technological elements (as might be expected when pioneering a new approach) but problems with customer service. We note that, thus far, Capita has forfeited £1m to TfL in service credits and liquidated damages.

1.8 Risk transfer in public-private contracts remains a difficult issue. We hope that the lesson from TfL's contract with Capita – the financial necessity of getting it right first time – is widely shared.

1.9 This Committee and the Transport Committee,[2] will continue to monitor:

- The customer service offered by TfL
- How good a deal TfL has got from its share of the rights to the software developed by Capita and paid for by public funds
- TfL's financial position and any further drop in Congestion Charge income.

[1] The Mayor released the costs of terminating the contract with Capita in April 2003
[2] The Transport Committee will evaluate the Scheme's impact on 26 November 2003

2 Introduction

2.1 This report covers**:**

- Background to the contract (section 3 on page 4 of this report)
- Confidentiality and public-private contracts (section 4, pages 5)
- TfL's contract with Capita (section 5, page 6)
- Additional payments to Capita (section 6, pages 7 to 9)
- The impact on TfL's financial position (section 7, page 10).

2.2 Appended to the report is TfL's summary of the contract.

2.3 The London Assembly Budget Committee met on 11 September 2003 to discuss TfL's contract with Capita. Answering the Committee's questions were:

- The Mayor, in his capacity as Chair of TfL
- Peter Hendy, TfL Managing Director of Surface Transport
- Malcolm Murray-Clark, TfL Co-Director of the Congestion Charging Scheme.

2.4 The issue was also raised with the Mayor at Mayor's Question Time on 17 September 2003.

3. Background to the contract

3.1 Capita Business Services has been contracted by TfL to provide core, retail and image management services (known collectively as combined services) for the Congestion Charging Scheme. This includes:

- Sales channels (i.e. retail outlets)
- Discount processing and finance processing
- Validation of driver details against images
- Customer service and data storage
- Technology to underpin enforcement operations and the Penalty Charge Notice (PCN) system
- Automatic Number Plate Recognition (ANPR) system and storage of images for cross-checking/appeals.

3.2 The contract, known as the Combined Services Agreement (CSA), was signed in March 2002. The Scheme itself began operating on 17 February 2003. A Supplemental Agreement revising some of the terms of the CSA was signed in August 2003.

3.3 TfL's most recent forecast[3] was that payments to Capita for combined services over the five-year life of the contract would be £297 million[4], which represented 70% of the total operational cost of the Congestion Charging Scheme. The Mayor told the Committee that, should TfL decide to cancel the contract, it would incur costs of £81m, comprising payments to Capita of:

- £20m for items such as redundancy payments, cancellations charges for service contracts and break clauses on property leases
- £54m in outstanding funding, including IT costs incurred by Capita
- £7m for loss of profit – the figure being an average forecast profit across the life of the contract.[5]

3.4 Under the revised arrangements introduced under the Supplemental Agreement, Capita receives its payments in four principal forms:

- A standing payment of £3m per month
- A share of the revenue from drivers' payments of the Congestion Charge
- A share of the revenue from Penalty Charge Notices (PCNs)
- A payment per telephone call handled.

[3] As at 31 December 2002
[4] Appendix 9.2, TfL Finance Committee, 12 February 2003
[5] TfL letter to Chair of the Budget Committee, 26 September 2003

4. Confidentiality and public-private contracts

4.1 The Assembly has repeatedly requested details orally and in writing about the contract with Capita – specifically regarding exit costs (see paragraph 3.3) and performance indicators (see paragraph 5.3). The table below lists the Assembly's correspondence on this subject.

Assembly correspondence on TfL's contract with Capita

1. Transport Committee to TfL – 11 September 2002 (response 9 & 10 October)

2. Transport Committee to TfL – 22 October 2002 (response 13 November)

3. Transport Committee to Capita – 29 October 2002 (response 25 November)

4. Transport Committee to TfL's external auditors, KPMG – 25 February 2003 (response 28 February & 29 April)

5. Transport Committee to TfL – 6 March 2003 (response 3 April)

6. Transport Committee to TfL – April 2003 (response 22 May)

7. Budget Committee to TfL – 6 & 29 August 2003 (response 12 & 29 August)

4.2 The table illustrates that the Assembly's first letter was sent on 11 September 2002. The contract was made public a year later on 29 August 2003.

4.3 There is a strong parallel between the Assembly's attempts to get TfL to reveal key aspects of its contract with Capita and the Mayor's attempts to get the Government to make public the Tube Public-Private Partnerships (PPP).

4.4 The Committee acknowledges that defining the boundary between the public interest in these types of contracts and the private sector's need for commercial confidentiality is not an easy task. However we trust that events of the past year with the Congestion Charge contract have shown that there is a legitimate public interest in key performance data being made publicly available at an early date.

5. TfL's contract with Capita

5.1 It is difficult to assess TfL's contract with Capita without being privy to the negotiations between the parties and the options considered.[6] In this sense the contract is not a stand-alone document; it is the outcome of a series of negotiations which took account of a wide range of information. TfL's summary of the contract is appended to this report.

5.2 The Mayor told the Assembly at Mayor's Question Time on 17 September that:

"Their (Capita's) customer service was completely unacceptable … "

5.3 TfL's normal recourse in the case of poor performance would be to its contractual agreement with Capita and to apply either a financial penalty or to impose a timetable for service improvement. However it has emerged that TfL's initial contract with Capita failed to set in place a sufficiently robust performance management framework. The subsequent addition of quality related performance indicators (QPIs) to the revised contract sought to correct this omission.

5.4 According to TfL, a 'substantial service credit regime' forms part of the contract with Capita.[7] One of the success criteria of the Congestion Charging Scheme is zero service credits with Capita – i.e. Capita has achieved the performance indicator targets set by TfL.[8]

5.5 In a letter to the Chair of the Committee dated 26 September 2003, TfL states that:

"The sum recovered from Capita for liquidated damages and service credits to date is approximately £1 million."

5.6 This is further evidence of Capita's underperformance. The £1m forfeited by Capita forms a sizeable proportion of average annual profit forecast of £7m (see paragraph 3.3).

5.7 TfL has been granted a non-exclusive licence for the Capita software. It is still too early to test this point, but the question remains as to whether TfL has secured sufficient rights of veto over and of exclusivity in intellectual property, particularly should the Scheme be introduced in another city in a similar form. Members will continue to monitor this part of TfL's contractual arrangement with Capita.

5.8 The Mayor said at 17 September Mayor's Question Time:

"With hindsight, it would have been better if the contract had been drafted as it now stands but that is with hindsight."

5.9 The Mayor is right to point out that hindsight is a great advantage. However, this must be set alongside the £30m TfL allocated in start-up costs to management and support for the Scheme.

[6] Note that TfL have not made public Capita's financial modelling for the contract.
[7] Section 3, Contract details and risk allocation, TfL CCS submission to scrutiny, 26 March 2002
[8] *2003/04 Budget Support Information*, TfL Finance Committee, 11 March 2003, p.17

6. Additional payments to Capita

6.1 According to a TfL press release of 29 July 2003 "a series of financial incentives will be put in place … up to some £31m over 4.5 years" under the Supplemental Agreement for Capita to improve its performance. Subject to Capita meeting certain milestones, the £31m includes:

- A one-off payment of £3.5m for Capita IT systems
- £4.90 for each penalty charge notice (PCN) paid from 20 October 2003
- £77,833 per month for management of novated contracts.

6.2 The funds will be used for[9]:

- The recruitment of call centre staff, further training and new data checks to achieve an improved call response and management of data
- Improved data management and processing to avoid PCNs being issued in error and to better target evaders
- Further improvements in the handling of representations and subsequent reduction in the number of appeals
- Improved management information systems for TfL to measure what is happening so that it can identify weaknesses and respond as quickly as possible.

6.3 The revised arrangements are in part a result of a review instigated by TfL[10]:

> "An independent and confidential audit carried out by Deloitte & Touche for TfL has indicated that Capita will not make a profit on the congestion charging scheme under the current contract and existing traffic conditions."

6.4 We are surprised that TfL is making additional payments to Capita. When asked about further payments to Capita, Derek Turner, the TfL executive in charge of the Scheme at the time, told the Assembly's Transport Committee on 10 September 2002:

> "Well they (Capita) can ask for more money. Contractors frequently ask me for more money and they get very short shrift."

6.5 Peter Hendy, Managing Director of Surface Transport, defended the decision to make additional payments to Capita, telling us that TfL had 'comprehensively rejected' Capita's first proposals to amend the contract in favour of a more balanced deal.[11] In our view, this agreement is still far from 'very short shrift'.

[9] 'Improvements on the way for congestion charge customers', TfL Press Release, 29 July 2003
[10] 'Improvements on the way for congestion charge customers', TfL Press Release, 29 July 2003
[11] Minutes of Budget Committee, 11 September 2003. p.26

£3.5m for IT systems

6.6 We are particularly concerned by the one-off additional payment of £3.5m to Capita for IT systems. The Mayor told the Assembly at 17 September 2003 Mayor's Question Time that:

"Capita's creation of the software and the computer systems was excellent."

6.7 The quality of Capita's IT work may well have been 'excellent', but it is the cost which presents a problem. It does not strike us as a good deal for Londoners that TfL is now making an additional payment of £3.5m for an area of work – the creation of IT systems – which was Capita's responsibility under the initial contract.

6.8 We therefore dispute the Mayor's claim, made in a letter to the Chair of the Committee and dated 29 August 2003, that the revised contract "will not impose any additional burden to taxpayers".

Penalty charge notices (PCNs)

6.9 Technical difficulties, administrative problems and human error have undermined enforcement of the Scheme over its first few months.[12] Although 441,000 PCNs have been issued and 209,000 have been paid (on average at the discounted rate of £40), 129,000 have been disputed. At present, 66% of disputed claims are accepted (i.e. the PCN is cancelled). This means that in the first five months of the Scheme, leaving aside accepted representations, only 59% of PCNs were paid. Although cheating the charge through non-payment has been more widespread than expected, we remain concerned that Capita is using the appeals system to avoid dealing with complaints effectively.

6.10 Under the new arrangements in Supplemental Agreement, Capita will receive £4.90 for each PCN paid – this represents a 138% increase on the initial figure, under the Combined Service Agreement, of £2.06. This does provide Capita with an incentive to achieve a higher proportion of paid PCNs, but it also reduces by £2.84 the amount that goes to TfL from each paid PCN.

Risk transfer

6.11 The Mayor told the Committee on 11 September that:

" … the reality of transferring risks to the private sector. Theoretically this looks wonderful. In practice it is an awful lot more difficult to achieve."

6.12 Yet in the Mayor's letter of 29 August 2003 to the Chair of the Committee, he states that the Supplemental Agreement:

"Involves Capita offering 'greater risk transferral'."

6.13 We agree with the Mayor that risk transferral in public-private contracts is a difficult issue. We are therefore sceptical that the revised contract can offer much in the way of a greater risk transferral to Capita, particularly given the problems already experienced with this contract.

[12] According to TfL at Transport Committee meeting on 1 May 2003, the major cause of the misreading of number-plates was human error by both operators and drivers when registration numbers were inputted into the database. Problems had been caused by the different formats of numbers and letters on number plates. Manual checks (as in the contract specification and promised by the Mayor) had been made but due to the high volume of checks needed there had been some mistakes. Problems had also been caused by customers entering the wrong date for the day on which they wanted to travel

Best value

6.14 The Mayor said in an oral answer at 26 February 2003 Mayor's Question Time:

> "I never quite shared the worries that other people did about Capita because I took the view that this was a contract Capita could not afford to have go wrong. Given the problems in the past they had to get this one right. I think they have borne down and done it."

6.15 We think events have proved otherwise. We dispute the Mayor's frequently made claim that TfL's contract with Capita represents 'best value' for Londoners. It has not proved to be a good deal for taxpayers.

7. The impact on TfL's financial position

7.1 On 29 July the TfL Board noted that gross income from the congestion charge and Penalty Charge Notices (PCNs) for 2003/04 would be reduced from £214.5m to £150.5m:

> "Due to lower than expected traffic volumes and payment levels, income is now to be significantly reduced. TfL's 'best estimate' at this time is that revenues will be £64m lower than expected in this year's budget."[13]

7.2 Effectively, this reduces TfL's expected net profit from the Congestion Charging Scheme by 50 per cent.

7.3 In this financial year, TfL face other cost pressures of £51m (£46m of which is in Street Management). The Board agreed to amend the 2003/04 Budget by re-phasing certain projects and committing to cost savings and efficiencies (totalling £124m) designed to offset the loss in income and other pressures.[14]

7.4 In a submission to the Budget Committee's 12 June 2003 meeting, TfL stated that the 2005/06 funding gap stands at £563m. This will be partly reduced by the additional income forecast for fares, which is expected to amount to £81m in 2004.

7.5 In a document accompanying a TfL press release on fares on 19 August 2003, a letter to stakeholders states that:

> "Ministers have decided that the spending plans for the first year of the period (2005-06) which were set in the last Spending Review will not be revisited."

7.6 While a reduction in Congestion Charge income of £64m is unlikely to have a material effect on TfL's overall financial position (TfL's gross annual expenditure currently amounts to approximately £4bn), it does add to the budgetary pressures already in place.

[13] TfL Board Meeting, 29 July 2003, p.2
[14] Minutes of TfL Board Meeting, 29 July 2003, p.3

Appendix

TfL's summary of the contract

Summary of the commercial terms of the Combined Services Agreement (CSA) Contract and Supplemental Agreement with Capita as requested by Budget Committee in September 2003

A1. Summary of the commercial deal under the CSA

A1.1 Under the CSA, Capita receives the following Charges in return for its management of the Congestion Charge Scheme (the "Scheme"):

(A) Fixed Charge Per Satisfactorily Processed Telephone Enquiry of £0.96 (terminating 16 August 2003);

(B) Fixed Charge Per Fully Recovered PCN of £2.06 (terminating on 17 August 2003);

(C) Fixed Charge Per Fully Recovered PCN of £2.06 over a threshold level of 5,600 PCNs recovered per Working Day (from 17 August 2003);

(D) Percentage Revenue Charge of 8.4892% of the revenue generated by customers paying the congestion charge; and

(E) Fixed Monthly Charge of £2,928,700 per month.

A1.2 Capita also receives additional payments for other services under the CSA including Novation Fees for its management of Novated Contracts with sub-contractors.

A1.3 The Charges described in paragraph 1.1 and 1.2 are, to some extent, at risk depending on the quality of Capita's performance of the Services under the CSA. This is because Capita's performance is monitored against certain Key Performance Indicators ("KPIs") which are designed to penalise Capita for failure to meet performance targets in respect of certain aspects of the Services. Where Capita fails to perform in accordance with the KPIs, Capita becomes liable to pay Service Credits which have the effect of reducing the Charges payable to Capita. In the event of Persistent Service Level Failure where 3,000 Service Credit Points are incurred in any 3 month period, or where the aggregate Service Credit Points accrued and Incidents occurring in any 3 month period results in deductions from the Total Monthly Charges equal to or greater than 150% of the Maximum Deduction Limit, Capita becomes liable for Partial Termination.

A1.4 The maximum deduction which can be made by way of Service Credits under the KPI Regime is 60% of the Net Monthly Charge. The Net Monthly Charge consists of all of the Charges referred to in paragraphs 1.1 and 1.2 above **LESS** £1,508,600. The payment of £1,508,600 per month is not at risk. The mechanism is included in recognition that Capita has invested substantial capital in excess of £50m in developing the systems and entering term property and equipment leases.

A2. Summary of the commercial deal under the Supplemental Agreement

A2.1 In return for Capita's agreement to improve and enhance the quality of its systems and delivery and the provision of additional services, TfL has agreed to pay increased Charges to Capita (the "Quality Linked Charges").

A2.2 The Quality Linked Charges payable to Capita under the Supplemental Agreement break down as follows:-

(A) an increased novation fee of £54,833 per month for the management by Capita of the Novated telecommunications and camera maintenance Contracts;

(B) a further novation fee of £23,000 per month in respect of additional engineering resources until October 2003;

(C) a one off capital payment of £3,500,000 (payable subject to achievement of the milestones) which is a contribution by TfL towards the capital investment which Capita needs to make in systems development (estimated to be in excess of £5,000,000 in total); and

(D) an increased Fixed Charge of £4.90 Per Fully Recovered PCN (commencing on 20 October if milestone 1 is achieved) paid over the remaining four and a half years of the contract.

A2.3 The additional funds payable to Capita will be taken from additional revenue generated due to the Supplemental Agreement arising from increased charge and penalty charge payments. There will be no direct additional burden on the tax payer.

A2.4 In return for the Quality Linked Charges Capita have signed up to a number of additional obligations under the Supplemental Agreement, including:

(A) A requirement to invest in excess of £5 million in the development of new IT systems and software in accordance with certain agreed New Milestones and to use the £3,500,00 to be paid by TfL to achieve those developments.

(B) A failure by Capita to meet these New Milestones by the agreed dates will render Capita liable to pay New Liquidated Damages to TfL of between £2,500 and £20,000 per day for a maximum of 30 days.

(C) On the achievement of New Milestone 1 Capita will receive 50% of the Fixed Charge Per Fully Recovered PCN, the remaining 50% of the charge will be retained by TfL pending the achievement of New Milestone 2.

(D) Capita must also deliver all the Scheme Documentation to TfL by 28 May 2004. On the achievement of New Milestone 2 TfL shall be entitled to retain £100,000 of the New Milestone 2 retention pending the delivery of any documentation describing the functionality of the software. This will aid TfL in maintaining business continuity in the event of termination of part or the whole of the services.

(E) A new quality control regime (the "QPI Regime") which imposes more or greater requirements on Capita regarding the services it performs and against which 100% of the new Fixed Charge Per Fully Recovered PCN will be at risk (see paragraph 2,2 (D) above).

(F) An agreement to rebate to TfL any profit made by Capita over a margin of 12% over the life of the contract with the contribution to losses to date being limited to the sums included in the original CSA.

(G) A swifter and more effective dispute resolution clause will enable disputes to be resolved by a jointly appointed Expert much quicker than under the existing regime which requires the parties to go to court if commercial negotiations fail.

A2.5 In addition, Capita has granted TfL additional rights under the Supplemental Agreement. In particular, TfL would receive:

(A) An additional right of termination for Material or Persistent Service Level Failure under the QPI Regime;

(B) An enhanced right of Partial Termination which would entitle TfL to take over failing Sub-Services in the event of default by Capita; and

(C) A requirement that Capita develops, within 3 months of a request from TfL, detailed Interfaces and Interface Specifications to enable TfL or a New Service Provider to operate and manage such Sub-Services.

A3. Key Contract Terms

A summary of the key contract terms for CSA and SA is provided in Annex 1.

Key Contract Terms

Feature	Combined Services Agreement (CSA)	Supplemental Agreement
3.1 **Terms** Estimated Contract value	 £230m	 £31m
Fixed Monthly Change	£2.93m per month (£175m over contract)	N/A
% Revenue	8.49%	N/A
Change per Enquiry	£0.96 UP TO 16/08/03	N/A
Change per PCN collected	£2.06 up to 16/08/03	£4.90 from 17/08/03
Novation Fee	5% of novated contracts	£54k per month from mid 08/08 + (£23K per month from mid 08/03 to end 10/03
3.2 Systems Development	N/A	£3.5m subject to investment in systems (Capita estimate £5m)
3.3 **Revenues at Risk** Super KPI (measured daily)	 50% or 100% of the total daily change	 N/A
KPI (measured over month)	Up to 20% of net monthly charge - equals to approximately £0.5m	
Maximum Deduction limit	60% of net monthly charge – approximately £1.5m	
QPI (measured over month)	N/A	100% of Quality Linked Charges (approx £500k per month)
Milestones	Liquidated damages against achievement of specific milestones	Potential of £1.42m under liquidated damages for new milestones <u>plus</u> delays to cashflow for payment of 50% of Quality Linked Charges.

Remedies leading to Partial or Full Termination Material Service Level Failure Persistent Service Level Failure	 Total Service Credits exceed 2,200 in month or Deductions due to Service Credits in excess of Deduction Limit Total Service Credits exceed 3,000 in three contiguous months or Deductions due to Service Credits in three contiguous months exceeds 150% of Maximum Deduction Limit	 Deduction of Quality Linked Charges exceed 40% in month Deduction in excess of 30% of Quality Linked Charges in three contiguous months.
Limits on Profit	Excess profits would be shared on a 50:50 basis	Profit capped at 12% of the Total Monthly Charge plus the Quality Linked Charges for the purpose of calculating the margin, the loss to 16 July 2003 is limited to the sums forecast in the CSA.