EDINBURGH TRAM PROJECT
FINANCIAL CLOSE PROCESS AND RECORD OF RECENT EVENTS

COMMERCIAL – IN CONFIDENCE
EXEMPT FROM DISCLOSURE UNDER FOISA

Executive Summary

Since selection of the preferred bidders in October 2007, tie Limited has been involved in complex and lengthy negotiations with the bidding consortium to conclude the contractual arrangements for the delivery of the tram system. During this period, the governance machinery has been applied to ensure that the approval requirements of the Council are fulfilled.

Most recently, the Council received a report for its meeting on 1st May 2008 which described the progress made. The final contracts are now concluded and ready for signature. The final terms differ marginally from those anticipated in the recent report of £508.0m, with the capital cost now standing at £512.0m, a sum which remains well within the available funding of £545.0m.

As was noted in the recent Council Report, underlying costs have been subject to the firming up of provisional prices to fixed sums, currency fluctuations and the crystallisation of the risk transfer to the private sector as described in the project's Final Business Case. The finalisation of the contracts required further amendment for similar reasons and supply chain pressure on the bidding consortium has been accommodated in the marginal increase over the most-recently reported cost estimate. Offsetting the increased cost is a range of negotiated improvements in favour of tie and the Council, in the areas of programme delay mitigation, cost exposure capping and more advantageous contractual positions.

In addition and as is normal in these circumstances, there is an imperative to bring the contractual matters to an efficient near-term close in order to mitigate against potential cost exposure and programme delay, which could represent a material risk. Tie has recommended that the final terms negotiated represent the best result achievable for the public sector and that the council should authorise tie now to proceed with the contract close.

Tie Limited has maintained a focus on the competitiveness of the developing contract terms to ensure they remain best value and are fully aligned with relevant regulations. They have confirmed to Council officials that the final terms of the contract meet these parameters.

Works on utility diversion works continue on time and to budget. Works in Leith Walk are now coming to a close and earlier than planned completion is anticipated for the works in Shandwick Place. The construction programme for the tram system remains as previously reported with revenue service planned for July 2011.

(1) Background and record of events

This document is intended to be an objective synopsis of the evolution of the Infraco contract suite negotiations in order to put on record in one place the key events and to support approval of the final negotiated position.

Preferred bidder selection, business case approval and Wiesbaden

BBS were appointed preferred Infraco bidder in October 2007 along with CAF as preferred Tramco bidder. The procurement process and evaluation was conducted under normal rules of public procurement and the appointment decisions were approved within the project governance structure.

In December 2007, the Final Business Case was approved by the Council and appropriate delegated authorities created to execute the project. A series of negotiations culminated in a meeting of senior representatives at Wiesbaden when the contract price was concluded within the business case budget of £498m, supporting revenue service in Spring 2011. This became known as "the Wiesbaden Agreement". The anticipation was that Close would be executed within a few weeks allowing for the Xmas break.

Continuing negotiations, Rutland Square and Award Notification

Negotiations in the period from October to December 2007 were conducted in a constructive if robust manner. However, from January 2008, it became increasingly concerning that the BBS consortium was operating in a manner which militated against an efficient Close. The behaviours included lack of competent senior commercial management involvement, leadership on commercial as well as legal issues by BBS's lawyers, lack of a cohesive approach between the consortium partners and their use of different law firms, consistent re-opening of apparently agreed positions and lack of focus on important matters in favour of volumes of detailed points.

A consistent additional problem was the under-performance and unhelpful approach of PB. This was critical as PB needed to enter into the tri-partite Novation of their design contract. CAF played a more constructive and passive role.

Extended negotiations took place in which the prevailing theme was the attempt by tie to remain close to the draft terms which supported preferred bidder selection in the face of attempts by BBS to improve their position. These negotiations led to a further summit meeting in March 2008, when a further series of lines were drawn. This "Rutland Square Agreement" included different (offsetting) cost and risk transfer terms which drove the overall cost to £508m. The delay in reaching close meant that revenue service could not now commence until July 2011. The negotiations at this stage were substantially driven by Siemens.

Both the Wiesbaden and Rutland Square Agreements were documented and signed by senior representatives of the parties. Tie proceeded to report to the Council that terms were agreed and that Notification of intent to award letters could be sent to the unsuccessful bidders. This was duly approved and the letters were issued on 18th March 2008. De-briefs with Tramlines and Alsthom were held in early April, which were based on the terms agreed at Rutland Square.

Period to Financial Close

Negotiations over detailed documentation continued, although BBS's approach continued to cause concern and delay. On 14th April, senior representatives of BB and S visited tie and marginal residual issues were agreed. The meeting concluded with confirmation that all terms were agreed and the final documents should proceed to final legal quality control and then signing on 2nd May.

On 30th April 2008, in a telephone call to Willie Gallagher, BB (Richard Walker) requested a last minute and largely unsupported price increase of £12m. This was at the final point before the pre-agreed timing of contract approval for signature. No such request had emerged from Siemens or from CAF or indeed SDS. The anticipation had been that the contracts would be signed on 2nd May and a preparation period of 36 hours was needed.

An emergency meeting of those members of the Tram Project Board who were available plus tie / TEL / CEC representatives was held on 30th April. The options available were discussed and it was concluded that we should deploy tough tactics, but not stonewall the BB request completely as it was felt that the alternatives were likely to be worse notwithstanding the intense frustration at BB's tactics.

Final process

BB senior management visited Edinburgh on 5th May 2008, met by messrs Gallagher, Mackay and Bell. Their support for the price increase was sketchy and confused, focussing around an admitted failure on their part to assess or control their supply chain prices, £ / € movement and a claim for underwriting of central demobilisation cost which they had allocated to their bid for Phase 1B in the light of a more cautious view on the execution of 1B.

All signs pointed to last-minute unprofessional brinkmanship. BB claimed their costs were actually £17m wrong, but that they had reworked internally to arrive at £12m, casting further doubt on their credibility. There were veiled threats that failure to meet the demand now would force BBS to seek every opportunity to create claims during the construction period to achieve their financial target. As a matter of record, tie is comfortable with its contractual position and the experienced people recruited to manage the contract effectively.

The 5th May meeting culminated in a proposal from tie that tie would :

- Absorb £3m of additional cost in return for tangible contractual and risk improvements ;
- Agree to meet BBS allocated demobilisation costs of £3.2m in event that Phase 1B does not proceed

The BBS response on 6th May was disjointed (different responses from different senior people in the BB team). A series of meetings involving messrs Gallagher, Mackay, Bell, Fitchie and Bissett concluded that a formal latter to BBS in the form of an ultimatum was needed to bring matters to a close. In addition to the continuing delay and attendant costs, and the unpalatable alternatives to concluding with BBS, there were concerns that Siemens, CAF and PB may also seek price increases if BB were seen to be making inappropriate progress.

A letter was sent to BBS late on 6th May which reiterated the tie proposal described above. A response was received on 7th May which proposed :

- A payment of £9m to BBS
- Further examination of the contract terms surrounding the design management process, which although unclear pointed to an extended design and consent programme with potentially material adverse consequences for the construction programme.

The letter was silent on tie's contractual requirements.

A combined meeting of the TPB and tie Board was held (as scheduled) in the morning of 7th May. The meeting reviewed the position thoroughly and concluded that the approach which best protected the public sector's position would be to seek a conclusion with BBS within their demand for £12m.

Conclusion to negotiations

Further negotiations were conducted on 7th, 8th and 9th May and an acceptable conclusion reached. The final terms negotiated reflect agreement by tie to increased consideration and contingent cost underwriting in return for early progress to contract signing, improvement in terms and capping of cost exposures.

The specific terms are as follows :

Financial amendments :

1. Incentivisation bonus – tie will pay a series of incentive bonus payments over the life of the contract on achievement of specified milestones. The aggregate cost will be £4.8m.

2. Phase 1B cost allocation – tie will underwrite demobilisation costs allocated to Phase 1B in the BBS bid in the event that Phase 1B doesn't proceed. The quantum is £3.2m and this will not be paid if Phase 1B does proceed.

3. Loss reserve – tie has agreed to waive its interest in any residual value from the £3m BBS pot for settling uninsured third party economic and consequential loss claims. This is a theoretical concession of one-third of £3m but has never been accounted for in project cost estimates and is therefore neutral to tie.

The incentivisation bonus should support programme adherence. In return for the financial amendments, tie has secured a range of improvements to the contract terms and risk profile. The elements of the aggregate risk contingency of £32m which are relevant to the improved position are :

General programme delay	£6.6m
Delay due to design & consents	£3.3m
Contamination risk	£3.4m
Road reinstatement – direct costs	£2.0m

1. Immediate contract close on preferred terms - all of tie's preferred positions in the Infraco contract which were under query by BBS and their lawyers would be accepted. As a consequence, the contract execution can proceed forthwith. The documents concluded include the Review and Design Management Plan arrangements which assist management of the design and consents risk and which carries a £3.3m allowance in the QRA. The attempt by BB to revise the design process in a manner which would have created delay was also successfully rebuffed. The early close also stifles extended legal and management costs which are a component of the £6.6m QRA allowance for overall programme delay. The running rate of management and legal costs is £0.8m per month, so a saving of £0.6m would arise over a 3 week period. The risk of any further price increases from the bidder side is also mitigated.

2. Elimination of risk of claims arising from works underway - closing out the Mobilisation and Advance Works Contract and waiving any entitlement to claims or relief gives tie a clean financial start to the contract management of the InfraCo contract. This creates an immediate forward-looking focus and the avoidance of difficulties in dealing with immediate claims, spurious or otherwise. Tie has not been notified of any claims to date, but there have been some difficulties in the early works which could have given rise to claims in the hands of a determined contractor. An outline might be in the range of £1.7m. This would be resisted, but the new agreement eliminates the risk.

3. Capping of road reinstatement cost exposure – for reasons that have been well-rehearsed previously, an exposure exists in relation to the roads reinstatement pricing assumption. The QRA allows for £2m above the bid price to cover the exposure. BBS have agreed to cap their claim under this heading at £1.5m resulting in a saving of £0.5m.

4. Capping of roads related prolongation – the consortium will take the risk on prolongation beyond 8 weeks enabling the contingency to be limited to that level and reducing the need for provision by £1.3m. Other improvements affecting contamination and design & consents risk are evaluated at £0.5m.

5. Entry of CAF into Consortium – while welcoming the entry of CAF into the consortium because of improved consortium cohesion, tie had concerns about the potential implications of aspects of the mechanism. BBS have now confirmed they will follow the terms requested by tie, removing excessive negotiation timescales and costs. Specifically, the terms of the BB and Siemens PCGs will be amended to reflect CAF's entry into the consortium, express amendments will be made to the two bonds provided by the BBS sureties and an additional indemnity up to £8m will be provided by BBS covering contingent adverse consequences of CAF joining the consortium (note this indemnity is over and above the full set of existing security arrangements). There is no change to the CEC guarantee in any respect but CEC will be requested confirm no objection to and knowledge of CAF's entry into the consortium in a letter.

In summary, the late price pressure from Bilfinger Berger arising from their claimed supply chain pressure has been contained at £4.8m with a further agreement that tie will underwrite contingent 1B demobilisation costs of £3.2m if Phase 1B does not proceed with BBS. Some £4.6m of exposures have been removed acknowledging that their evaluation is judgemental. £0.5m is explicitly reflected in the QRA and can be reduced and the balance represents elements of the other provisions noted above. Tie recommends that c one-third of the remaining specific evaluated risk improvement be reflected in the risk contingency, reducing it by a further £1.3m. A range of additional unquantifiable exposures are also eliminated.

Although the funding challenge surrounding Phase 1B remains, there is an intention to pursue this aggressively, sustaining confidence that Phase 1B can be funded and delivered. The balance of evaluated risk improvement amounts to £2.8m which implicitly offsets the risk that the Phase 1B demobilisation payment should become due. It should be borne in mind that Phase 1B design costs of £3m sit outside the Phase 1A budget and other Phase 1B costs may be authorised before it is certain that the phase will proceed. It is therefore logical that the contingent demobilisation costs should be shown separate from the Phase 1A budget for consistency.

Finally, tie recommends that a general risk provision of £1m be included to provide a final level of cushion.

Taking all these matters together, the net result is that tie has negotiated a cash and contingent price amendment in favour of exposure elimination which substantially offsets the majority of the price amendment. tie would recommend that the budget be increased to accommodate the agreed cash amendment of £4.8m ; and that the risk contingency be reduced by a total of £1.8m reflecting a conservative portion of the improved specific risk positions, then augmented by an increased general provision of £1.0m resulting in a net increase to the headline budget of £4.0m. This will result in the overall budget moving from £508m to £512.0m. The underlying base cost is now £480.8m and the risk contingency is £31.2m. Although a case could be made for further reduction in the risk contingency, it would be tie's recommendation that the balance be retained.

(2) Alternative approaches

The last minute demand by BBS was the worst form of unprofessional negotiating conduct. However, an evaluation of tie's alternatives concluded that there was no commercial alternative which would better protect the public sector's interests. The evaluation was performed with input from DLA.

A summary of the alternatives is as follows :

A. Siemens to restructure consortium by incorporating a new civils contractor
B. Tramlines re-introduced
C. Full-scale re-procurement
D. Project termination

Tie would have been entitled to terminate the BBS consortium's preferred bidder status because BBS were seeking to materially change the price.

(A) Siemens led consortium

The process would involve :

- Siemens exiting BB from the consortium
- Identification and presentation by Siemens of a new consortium
- Re-qualification by tie of the new consortium
- Re-engagement on the contract suite

The implications included :

- The timescale is likely to be around +3 months if matters progressed reasonably well. Programme will move out by this extent.
- There will be important changes to the current Infraco contract terms to accommodate 1) passage of time (eg programme, design & consents, MUDFA interface) ; 2) requirements of new contractor (unknown).
- No guarantee that the revised consortium would adhere to previous deal and a strong likelihood that both consortium members would seek increments for inflation and other factors
- Probable need to re-assess SDS Novation Agreement (driven by SDS)
- Presumption that CAF will happily go along with this and not seek incremental costs

Although unpalatable, this was the best alternative to completion with BBS and we could reasonably expect both CEC and TS to be supportive given the level of investment already made.

A financial evaluation pointed to cost risk of c£9m but with material risk to the downside.

(B) Reintroduce Tramlines

Tramlines were an entirely credible partner and the preferred bidder decision was close. There were no knock-out defects in the Tramlines bid. However, Tramlines have recently won the Manchester extension work and may not have been willing or able to execute Edinburgh simultaneously.

The process would best involve :

- Tie terminating BBS
- Tie revising the original Tramlines contract to accommodate tie's preferred (and reasonable) position as reflected in the current Infraco contract, but with all undesirable concessions removed
- Agree a one-month "hot review" by Tramlines to confirm all material contract terms or flag variations ; if parties in the same ballpark -
- Finalise all material terms

The implications included :

- The timescale is likely to be around +6 months if matters progressed reasonably well. Programme will move out by this extent.
- There will be important changes to the current Infraco contract terms to accommodate 1) passage of time (eg programme, design & consents, MUDFA interface) ; 2) requirements of Tramlines (unknown)
- Introduction of entire Tramlines Proposal replacing BBS's version and need to align with design and ER's
- Loss of other advantages perceived to be in BBS proposal which supported their selection as preferred bidder.
- No guarantee that Tramlines would adhere to previous deal and a strong likelihood that they will require increments for inflation and other factors ;
- Probable need to re-assess SDS Novation Agreement (driven by SDS)
- Presumption that CAF will happily go along with this and not seek incremental costs

A financial evaluation pointed to cost risk of c£22m but with material risk to the downside.

(C) Full re-procurement

This is the worst-case alternative short of termination. The procurement programme would extend out to around +1 year, adverse programme and cost ramifications are inevitable and it may be difficult to generate sufficient market interest from the limited number of possible players, including those rejected under the current procurement programme. Notwithstanding the extent of public investment already made, it is highly questionable whether the public pound is best protected by embarking on an immediate full-scale re-procurement. CEC and TS's support for this approach is unlikely.

A financial evaluation pointed to cost risk of c£28m but with material risk to the downside.

Recommendation

A range of second order issues was identified, further reinforcing the relative unattractiveness of the alternative options. Over and above all of the analysis, is the loss of revenues from delayed service commencement and the delayed flow of economic benefit.

Against this background, tie's rationale for supporting the final deal is set out below.

- The late price pressure from Bilfinger Berger arising from their claimed supply chain pressure has been contained at £4.8m. Some £4.6m of specific exposures have been removed, of which £1.8m is explicitly reflected in the QRA. The balance relates to general programme risk and other factors reflected in the QRA and which are prudently retained as risk provision. A further £1m has been added as a general risk contingency. A range of additional unquantifiable exposures are also eliminated.

- If Phase 1B proceeds there is no exposure to the £3.2m demobilisation payment; if 1B doesn't proceed the payment will become a real cost, in line with a principle already established. Some Phase 1B sunk costs (management and legal) are absorbed by the Phase 1A budget, but others (design costs of £3m by 31 March 2008 and potentially utilities works) are not incorporated into the capex budget for Phase 1A. The demobilisation costs would be an extension of the latter category. Although the funding challenge surrounding Phase 1B remains, there is an intention to pursue this aggressively, sustaining confidence that Phase 1B can be funded and delivered.

- There is substantial, if unquantifiable, benefit in enabling the contracts to be signed in the near term.

- Alternative options exist but are highly risky in programme and cost terms.

Accordingly, it was tie's recommendation that the deal be concluded with BBS.

(3) Procurement regulation compliance

In addition to the commercial and public pound considerations described above, it was necessary to assess whether the conclusion to the negotiations was in compliance with procurement regulation and in particular whether there could be credible grounds for a challenge.

The threat of a challenge arises from under-bidders but also from any interested third party. The latter can never be discounted and the question then becomes whether there are credible grounds for challenge which an investigating body could found on.

In support of the Rutland Square deal which resulted in a revised budget of £508m and the issue of the Notification letters, tie performed a detailed evaluation of the risk of a challenge by the under-bidders. This included the examination of the movement since preferred bidder selection and a shadow comparison of the under-bidder's position. The conclusion was that there was no basis for a credible challenge. This was documented and was the subject of review for legal validity by DLA.

The Notification letter to Tramlines highlighted the following differentials in BBS' favour:

- Capex assessed at 4% lower
- Programme shorter due to MUDFA overlap
- Stronger financial liability caps
- Approach to Network Rail immunisation and lower public sector risk
- Maintenance costs lower by 16%

In addition, although not mentioned in the letter, the assessment highlighted the BBS trackform construction as being materially better. The assessment noted that the fully-normalised capital cost difference at the time of preferred bidder selection was c£8m in favour of BBS. The analysis of changes since selection identified that a small percentage of the differential could be challenged based on the changes.

The final deal is described above. The incentivisation bonus of £4.8m is substantially offset by £4.6m of evaluated risk improvement. Although not all of this is reflected in a reduced final risk contingency, the full quantum is relevant to the assessment of the bid value. The contingent nature of the Phase 1B demobilisation cost makes it difficult to evaluate in this context, but even if full allowance were made for the £3.2m payment, there would remain price headroom in favour of BBS. The other advantages of the BBS bid – programme, liability caps, technical (trackform and approach to NR immunisation), lower maintenance costs - would sustain their preferred position.

Accordingly, it is not proposed that any further communication be made to the under-bidders.

The entry of CAF into the consortium after the conclusion of matters with BBS was anticipated at the time of the preferred bidder selection and would be as likely to be beneficial to Tramlines as BBS.

In summary, the final negotiated changes imposed by BBS, although unwelcome, do not constitute a credible basis for procurement challenge.

(4) Future relationship with BBS and contract management

The final matter addressed by tie and discussed at the TPB / tie Boards on 7th May 2008 is the suitability of BBS as a contract partner in view of their behaviour during the negotiations. There are three reasons why this concern should not be a barrier to entering into the contracts :

1. Tie has established a strong commercial team to manage the contract obligations and risks. These experienced operators have had a lengthy period to familiarise themselves with the contract and to anticipate where and how disputes may arise in future.

2. Tie will have the strength of the contract terms as support in future disputes, which will provide a considerably stronger defence against unsupportable positions taken by BBS; in addition, tie is in position to pursue recompense against BBS under the contract, where no such leverage exists pre-Close

3. A considerable degree of uncertainty currently arises from the activities of SDS, which will become much less of a feature after 3-4 months once all design work is complete.

A fourth reason is that BBS is the devil tie knows, there is no guarantee that other contractors would be a more amenable partner.

(5) Conclusion

The process to reach Financial Close has been tortuous and a partnerial approach from BBS has been notable by its absence. However, the final terms are within 2.8% of the business case budget of £498m and 0.8% of the budget most recently notified to the Council.

The programme points to a construction period some 3 months longer than the 39 months envisaged in the business case. The project risk profile remains broadly in balance with the business case and the scope of works is unchanged.

On this basis tie recommends that Close be executed.

tie Limited
12.05.08