



ETN Strategic Review - Truncation or Termination

1. INTRODUCTION

This Note considers the consequences of two courses of action in relation to the Edinburgh Tram Project ("ETN") which we are instructed CEC wishes to study as part of a strategic review. This Note cannot evaluate the economic outcome of these two scenarios but it sets out the foreseeable contractual consequences and related legal liabilities, entitlements and risks.

TRUNCATION

We understand from instruction that truncation would involve either (i) a part omission from the ETN as envisaged under the contracted scope of work or adjustments to the system specification or (ii) a smaller tram fleet resulting in reduced services during operational phase aimed in all cases at reducing out-turn cost in a controlled manner. This approach is examined in section 2.1 below.

TERMINATION

There are essentially six circumstances in which the Infraco Contract (and thereby the ETN Contract Suite) could be brought to an end before its term. It is axiomatic that there are very important variables which would impact the predictable financial and practical consequences following from a termination. In summary, these are:

- the timing of a termination decision during the implementation phase of the Infraco Contract;
- the desired eventual technical and commercial outcome: i.e. would the termination be the closure and cancellation of the ETN or merely the removal of the BSC Consortium as incumbent supplier?
- the precise purpose, extent, and effect of any instructed omission/scope or tram service reduction;
- the commercial attitude of the BSC consortium; and
- progress of the ETN works up to the date of the truncation or termination and its notification.

Relevant termination scenarios are examined in Sections 2.2 to 2.5 and 4 below.

2. ANALYSIS

2.1 Truncation

Reduction in scope (truncation) would need to be implemented using the Infraco Contract's change provisions. The design and time and cost implications of removing contracted work or supply from the existing scope would require stringent evaluation and agreement to establish the Infraco's entitlements. There is no restriction on when or by how much **tie** may reduce or truncate the ETN scope or recalibrate tram services, but were this to result in the Infraco incurring demobilisation expenditure or



sub contract breakage costs, those would be recoverable by the Infraco. Very significant scope reduction would almost certainly result in BSC seeking to be compensated for loss of profit, overheads and all indirect costs or, in an extreme case, alleging a tie Default. Before any part of the ETN scope was excised, a careful analysis of the level of legitimate claim from Infraco would be advisable. The decision to omit by variation is therefore a decision required to be supported by technical and financial analysis rather than contractual justification. It should be remembered that Clause 80.12 contains grounds on which variation can be refused. Of these, risk of non compliance because of the change, technical infeasibility or financial infeasibility of maintenance services might be used by BSC to refuse truncation or negotiate its terms.

2.2 Termination

The Infraco Contract provides for termination under six situations:

- A. tie Default (leading to suspension or termination with cause);
- B. tie voluntary termination;
- C. Infraco Default;
- D. Force Majeure;
- E. Corrupt Gifts and Fraud; and
- F. Persistent Breach (during post Service Commencement Phase).

It is also important that the parties' compensation remedies for termination are stated to be exclusive in the Infraco Contract.

2.3 For the purposes of this Note, Scenarios D, E and F are not examined, since the circumstances each envisages are not material to our instructions. The financial consequences of a termination (after due notice) under A and B as opposed to C can be distinguished as follows:

SCENARIO A

If tie accepted (or it were determined) that the Infraco Contract was legally at an end because of a tie Default, the Infraco's entitlements to compensation are set out in Clause 88:

- the value of all work carried out to the date of termination;
- the value of preliminaries carried out and any partially carried out;
- the value of goods and materials reasonably ordered or which are committed;
- removal costs for equipment;
- all other reasonably incurred and demonstrable expenses (including subcontract breakage costs) provided these are on reasonable terms; and



- prior to Service Commencement: loss of profit of 10% for civils and 17% for track and systems as a percentage of demobilisation costs; or, after Service Commencement, one month's Maintenance Services fee (this is in the order of £250,000).

For clear reputational and financial reasons, a termination under **tie** Default is not desirable. It should be understood however that **tie** Default is restricted essentially to either: non payment of £250,000 in excess of 30 days; a serious breach by **tie** preventing due performance; **tie** insolvency; unpermitted assignment by **tie**; or Change of Law preventing the ETN project continuing.

2.4 SCENARIO B

tie Voluntary Termination can be effected by notice at any time after three years from the date of Service Commencement. Its financial consequences are the payment of one month's full Maintenance Services fee. This early termination right has no relevance to the ETN construction phase.

2.5 SCENARIO C

Instructions are to analyse termination on the basis that Infraco is in compliance. However it is instructive to consider whether **tie** would have points of leverage based upon grounds for termination with cause.

Infraco Default has nine distinct heads. For the purposes of analysing financial consequences of the termination, no distinction needs to be drawn. The termination grounds can be summarised as:

- serious breach of contract;
- insolvency of BSC or a constituent member;
- unilateral suspension of the works by BSC for more than 15 business days;
- failing to commence works or abandonment of works;
- the long stop date of 12 months after planned service commencement is reached and no extension of time or relief has been awarded; or LADs are not increased where there is serious delay on tram supply; or
- the Infraco's legal status changes adversely.

The financial consequences of a termination for Infraco Default are that:

- the Infraco is paid (upon application) for all works performed up to termination; and
- **tie** is entitled to claim the cost of the completion of the ETN works and all other expenses properly incurred, less the amount which would have been payable to the Infraco for ETN completion and any amounts recouped by **tie** selling Infraco's equipment or temporary works (where termination was because of Infraco insolvency).



tie has received detailed advice from DLA Piper analysing the type of breach of contract which Infraco has committed during the first year of ETN implementation. This advice concludes, at present, that these breaches and related BSC course of conduct stop short of sustainable grounds for termination (with cause).

3. MITIGATION

Both Parties' rights with regard to recovery of expenses and costs following a contractual termination are subject to the duty of proper mitigation and to tests of reasonableness and demonstrability. In the case of payments to the Infraco, this obligation would also clearly be subject to a full audit and accounting for all contractual milestone and advance payments made, but for which **tie** had not yet received fully certified and equivalent supply value.

4. NEGOTIATED TERMINATION

If there were a real possibility that the ETN was to be cancelled (as opposed to a truncation of scope / tram service), the optimal approach would be a negotiated termination. This would need to address many elements of the BSC costs and expenses requiring evaluation under a **tie** Default termination (SCENARIO A), but these ought to be capable of presentation and verification in a non-adversarial environment. It is, however, unrealistic to suppose that BSC might be persuaded to engage in negotiation unless BSC perceived an appreciable threat that a formal termination would occur, and might result in any contractual compensation being significantly delayed and/or subject to an unpredictable risk of being reduced below a tolerable level by contest under DRP.

In any termination, **tie** will continue to hold 'on demand' performance securities from sureties up to the point of termination, and beyond in the appropriate circumstances. The key significance of the performance securities (on demand instruments) and the parent company guarantees (which permit claims a number of months after termination) is their availability to **tie** were BSC to (i) refuse to comply with reasonable instructions regarding truncation or preparation for termination; and/or (ii) manifestly fail to mitigate the costs of any plan for termination.

5. KEY SUBCONTRACTS

The design and tram supply and maintenance contracts form part of Infraco's responsibilities. Under Clause 88.8.4 of the Infraco Contract, one head of recovery for the Infraco where a **tie** Default termination arises, or there is a voluntary termination by **tie**, is *'any amounts which the Infraco is required to pay to its subcontractors... in order to terminate any subcontracts relating to this Agreement'*. Consequently, in addition to subcontracts which BSC has placed (or will have placed) itself in connection with the civil engineering component of the ETN Project, BSC would be responsible for the negotiation of any termination arrangements and payments to Parsons Brinkerhoff and to CAF.

Independently, **tie** is in Contract with Transdev under the DPOFA contract and with Carillion under the MUDFA contract. Given our understanding that the utilities diversions are due to be completed in July this year, this Note does not address any consequences of a MUDFA contract termination. The other subcontracts are reviewed in turn by the sections which follow.



SDS Provider Contract

SDS Provider Default

The Infraco (as Client under the novated SDS Contract) is entitled to terminate the SDS Provider in circumstances where an SDS Provider Default arises. In the event that **tie** were to seek to terminate the Infraco Contract for an SDS-related default, it may be that the Infraco can terminate the SDS Provider for SDS Provider Default under Clause 19 of the SDS Contract. In that scenario, the Infraco may argue that they have removed their underperforming sub-contractor and, subject to reasonable Infraco attempts to procure a new designer, the Infraco Contract itself should not be terminated.

For this reason, we would advise that any Infraco Default termination, or suggestions that one might be raised as part of a negotiated termination, should be restricted, where possible, to Infraco Defaults which rest with the Infraco itself, rather than those which are managed by the Infraco as head contractor, but are the responsibility of subcontractors for execution.

In terms of financial consequences, an SDS Provider Default termination will result in less compensation being payable to the SDS Provider than under a Client (BSC) termination. Nevertheless, given that the SDS Services are close to completion, sums under either scenario should be relatively low and assessable.

Client (BSC) Termination

On novation of the SDS Contract from **tie** to the Infraco, a new Clause 20.1 was inserted which provides that *'In the event that the Infraco Contract is terminated, this Agreement shall terminate. Such termination shall be deemed to have occurred under this Clause 20 unless the Infraco Contract is terminated as a result of... (one of the SDS Provider defaults)'*. Clause 20 deals with termination, abandonment or suspension of the services by the Client, and termination of the Infraco Contract is to be dealt with under this clause, rather than under the Client (BSC) Default provisions in Clause 21.

Clause 20 also provides the option for the Client to postpone or abandon any part of the Services, which would enable **tie** to instruct the Infraco look at further options which are perhaps less serious and less costly than a full termination in respect of the SDS Provider.

Following any notice of termination, abandonment or suspension under Clause 20 of the SDS Contract, the SDS Provider is required to down tools in a manner which is orderly but with all reasonable speed and economy and meet with the Client within 7 days of receipt of said notice to assess the costs arising.

Following such meeting, the Client (BSC) is required to make a termination payment to the SDS Provider within 30 days of termination and following receipt of a valid VAT invoice. That payment will consist of:

- any undisputed sums owing;
- any demobilisation costs; and



- any sums due to the SDS Provider in respect of work in progress (to the extent that the Client (BSC) and **tie** are satisfied to certify the same).

It can be expected that the Infraco, being faced with termination itself, will simply pass on the SDS assessment of termination costs for **tie** to pay without making significant inquiry and reduction in the SDS claims. We expect **tie** would need to be heavily involved in the assessment process in order to be satisfied that the termination costs were appropriate.

Tram Supply Agreement ("TSA")

There are a number of customary provisions for termination for default under the TSA; the most appropriate for the purposes of this note being the provision in terms of Clause 58 (*No Fault Termination*). This provision allows **tie** to give 30 days written notice to terminate the TSA for whatever reason, provided the Client (BSC) offers to novate the Agreement to **tie**.

The Client (BSC) will be subject to payments on termination including costs for demobilisation, undisputed sums, potential works in progress. Under Clause 6.2.3.3 these costs will include:

- demonstrable committed costs; and
- loss of profit fixed at 19% with reference to demobilisation costs.

Demobilisation costs require to be demonstrably and reasonably incurred by the Tram Supplier, and they have a duty to minimise and mitigate costs in this respect.

Any truncation of the ETN will have to be done through the Client Change mechanism at Clause 20 (*Changes*). The cost implications for this would have to be negotiated with the Tram Supplier.

The Client Representative has the ability to suspend the progress of the Tram Works under Clause 54 (*Suspension of Works*) of the TSA, provided it has the requisite permission from **tie**. This will be considered a Compensation Event under the Agreement with the relevant evaluation and payment applicable. It is important to note that this does not apply to the manufacture of trams by the Tram Supplier.

Subject to certain stipulations the Tram Supplier can, after 6 months, request to restart the Tram Works. Further provision under this clause allows the Tram Supplier to treat suspension of the tram works as an omission or abandonment. However, the manufacture of the trams is expressly excluded from this provision. Any costs for the manufacture of the trams shall continue to be payable, notwithstanding the any such suspension.

A negotiated termination of the TSA is likely to be required unless it can be shown that the Tram Supplier is in breach of the terms of the TSA to a degree where it can be terminated. The negotiation should allow identification of costs to be minimised and mitigated by the Tram Supplier. If the Infraco Contract were to be terminated before any agreement is reached with the Tram Supplier, then this may exacerbate **tie's** position to the extent that the Infraco would have little incentive to deal with the matter.



The Tram Supplier also provides on-demand performance security at 5% of the Tram price which could potentially be used in the appropriate circumstances to enhance recovery by **tie** on termination.

Development Partnering and Operating Franchise Agreement ("DPOFA")

DPOFA controls the terms of appointment of Transdev as the potential operator of the ETN, **tie** is the Client counterparty. DPOFA contains interface obligations on Transdev regarding the Infraco. A reduction in the planned size of the ETN or tram services resulting, for example, in a smaller tram fleet would change Transdev's responsibilities and require a change to the scope of operational services. Whether such an adjustment would be cost neutral or cost beneficial for **tie** would depend upon the timing and nature of the ETN truncation and associated specification changes.

A change in the tram specification of infrastructure could, for example, require the Transdev tram driver to take on additional functions. It may also impact on run-times throughout the scheme and the level of long-term maintenance required.

tie may terminate DPOFA in part, where project development is still in Project Phases A, B and C1 under the terms of Clause 32 (*Termination During Development Phase*). For the purpose of termination in the context of a termination in the next few months, C1 is the relevant Project Phase, which comprises of functions such as Transdev advice and support to **tie** about certain aspects of the detailed design and construction of the Infrastructure and Equipment. **tie** are required to provide 30 days notice to terminate the Agreement during this Phase.

The consequences for such a termination are limited from **tie's** perspective, but are subject to Clause 41 (*Effect Of Termination*) which provides for payment of undisputed sums due from **tie**. Under Clause 40 (*Compensation On Termination*), demobilisation costs may also be applicable (particularly during the Service Period), such costs being subject to the test of them being "demonstrably and reasonably incurred". Transdev is also under a duty to minimise and mitigate any applicable demobilisation costs.

There may also be a number of contracts entered in to by Transdev that may have to be honoured in terms of cancellation cost: for example additional consultancy agreements and the like. Once the testing and commissioning phase commences, Transdev would have personnel redundancy costs arising from operating staff and drivers.

6. THIRD PARTY ARRANGEMENTS

It is not possible to affirm that both a termination or a scope reduction would be cost and liability neutral to CEC and **tie** without conducting an analysis of third party agreements (forming part of the Infraco Contract), the parliamentary undertakings (of lesser order but nevertheless binding upon CEC and **tie**) and any CPO activities and requirements. If the extent of a proposed reduction in ETN scope or specification or final objective of a termination were known, the level and likelihood of exposure to liabilities to affected Third Parties could be evaluated. This would need to capture:



- consents/permission from or agreements with a third party for works on or alterations to its property to accommodate tram infrastructure or operations which proved abortive and/or inconvenient if no tram works or services ever eventuated;
- money paid or contribution in kind committed by a third party on basis that tram infrastructure and services will benefit its business;
- where a third party has refrained from a course of action for the benefit of **tie**/ETN incurring a demonstrable irrecoverable cost or suffering a proven detriment;
- potential property blight;
- the consequential impact (as opposed to a liability) of reliance upon tram services as a component of public transport (i.e. Lothian Bus fleet size).

7. TRAM ACTS

Neither a scope reduction nor a contractual termination would generate any additional contractual liabilities or exposure for **tie** or for CEC under the Acts themselves. Ending the ETN project early or truncating its scope carries a risk that these decisions could be judicially reviewed through a challenge over the appropriate discharge by the Authorised Undertaker of its statutory authority under the Tram Acts. What was presented by **tie** to the Scottish Parliament in terms of commitment to the installation of an entire system might be of relevance if such a challenge happened. Analysis of this risk is beyond the scope of this note.

One of the main obligations for restorative works is listed under Section 11 of the Tram Acts. This requires that if the authorised undertaker permanently ceases to operate the tramway, all on-street works, equipment and apparatus which have become redundant must be removed and the roads which carry the tramway must be restored to the reasonable satisfaction of the roads authority. These obligations must be satisfied as soon as reasonably practicable. There is an ability to reach agreement with the roads authority for a different approach than is expressed by this Section. Potentially, that could include the ability to agree that no restoration is required.

Under Section 7, the authorised undertaker would no longer have reason to temporarily stop up, alter, or divert any road, and so that provision could be constructed as meaning that **tie** would need to restore any such temporary arrangements within a reasonable time.

Similarly, Section 26 provides that where there has been temporary possession of land, the authorised undertaker shall, before giving up possession, remove all temporary works and restore the land to the reasonable satisfaction of the owners of the land. The work required in such instances would therefore vary, dependant on the attitude of the owner.

In terms of land which has been permanently acquired, Sections 29 and 30 allow the authorised undertaker to dispose of land which is surplus to requirements. The authorised undertaker must follow the 'Critchel Down Rules' in doing so in relation to land which has been subject to compulsory purchase.



Any compensation calculations based upon Sections 31 to 33 in respect of permanent and temporary land acquisition, or rights of way interference, might need to be revisited.

8. **DRP**

The contractual provisions governing dispute resolution would continue to apply post termination where these differences regarding entitlement to compensation or exercise of residual rights. Any dispute regarding rights / entitlements under the Tram Acts are subject to an arbitration regime.

DLA Piper
22 April 2009