

FINANCE

Mrs S Polson

EDINBURGH

EH4

Our Ref:

Your Ref:

Date:

Dear Mrs Polson

Thank you for your letter dated 11 December 2006.

You first point relates to the Preliminary Financial Case. As you are no doubt aware, this was prepared by **tie ltd** and their advisors on the Council's behalf. I was not involved in putting the case together, so am unable to comment as to whether the 31% optimism bias used was appropriate. However, the Preliminary Financial Case was assessed by the Scottish Parliament, as part of the two tram bills, and both bills received royal assent earlier this year.

As the draft financial business case has significant financial implications for the Council, I have carefully reviewed the document, and its optimism bias assumptions. Following this review, the Director of City Development and I have jointly recommended that the City of Edinburgh of Council approve the business case.

In assessing the appropriate level of optimism bias we have considered all project costs and the risks associated with them. The procurement strategy being employed for the tram project involves advanced design and procurement, so that costs are known **before** the final decision to build is taken. As a result of this strategy, a lot of the costs are known to a high degree of certainty. For example, the utilities diversion contract has already been let, and we have received tenders for tram vehicles. It is therefore misleading to equate, the approval of the final business case with the "decision to build" in Professor Flyvbjerg's terms.

Furthermore, the level of contingency is not a simple calculation. Every estimate has been assessed separately. Where costs are known, a low risk (or optimism bias) percentage is applied; where there is less certainty of the costs, a higher risk percentage is applied. The 12% figure quoted in the Draft Final Business Case represents an average figure and for certain costs the risk uplift is significantly higher.

The tram project has been and will continue to be subject to independent review. Transport Scotland, the project's main funder, has a rigorous gateway review process for all its major projects – the tram is no exception. In addition, independent consultants, Cyril Sweet, were employed by Transport Scotland to verify cost assumptions. Their findings were reported to **tie ltd** and have been used to inform the draft final business case.

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Your final question relates to passenger forecasts. I can confirm that the firm employed to forecast passenger numbers will not be penalised, should actual forecasts be different to those predicted. However, predicted growth is in line with that experienced by Lothian Buses over the past decade. If passenger numbers are lower than expected, there is every prospect that the reduction in revenue can be offset by cost efficiencies within the combined bus and tram business.

I hope this letter answers your questions.

Yours sincerely,

Donald McGougan
Director of Finance