



SHEPHERD+ WEDDERBURN

Note of Consultation

City of Edinburgh Council (CEC)
Edinburgh Tram Project

23 November 2010

In attendance:

Nicholas Dennys QC ("ND")
Alastair MacLean - CEC ("AM")
Nick Smith - CEC ("NS")
Carol Campbell – CEC ("CC")
David Anderson – Shepherd and Wedderburn ("DJA")
John Galloway – Shepherd and Wedderburn ("JG")

Update on Present Position and Introductory remarks

ND commenced the consultation by asking for an update on any recent developments in the matter.

AM explained tie had now received advice on the potential outcomes following termination and they had narrowed down the options open to them. AM stated that initially termination of the contract was tie's preferred outcome following the original consultations with Richard Keen ("RSK"). However, now RSK's advice was that there were strong contractual reasons why termination was significantly less attractive.

NS advised that there had been a further consultation yesterday between McGrigors and RSK. At that consultation more and more concerns were being expressed as to whether the factual basis for termination of the contract was strong enough to justify termination at this time.

AM said that McGrigors are considering the factual basis for termination. They had not yet reached a concluded view but it now seemed clear that in their opinion termination was not the "magic bullet" to remedy the present situation.

DJA explained the involvement of DLA Piper and McGrigors as legal advisers to tie. DLA had been instructed in relation to the Infraco contract and had been advising tie on strategy. McGrigors had been instructed by tie in relation to a number of individual disputes but were now being asked to review the position with regard to termination along with RSK.

The strategy which now seemed to be being considered was to select one of the termination notices and to seek to test the strength of the underlying grounds for termination through the DRP process. This would flush out whether the particular ground was likely to provide a sound basis for termination.

Further, in the past few days, AM explained, the Council's Chief Executive had been invited to meet with senior management from the German parent of Bilfinger Berger UK ("BB"). NS said that BB's reputation was suffering following contractual disputes in other locations around the world.

AM said that a meeting with BB may give CEC a better understanding of the facts and a new opportunity to move towards resolution. The Council had also decided to try to take matters forward

PRIVATE, CONFIDENTIAL AND PRIVILEGED

by way of mediation although it was not absolutely clear how, and on what basis, the mediation would be conducted.

ND asked for some further clarification. He said that before mediation is considered it should be established why the project is currently in trouble. Further, there was no point in considering termination unless the Council was clear what it would do if the contract were terminated.

It seemed to him that a key issue which was causing delay was design development.

1. The design is now being developed by the designer who has been novated to BB.
2. The position seemed to have been reached that design development issues were being dealt with by means of the DRP, including the adjudication decisions.

This was clearly a cumbersome way of proceeding.

ND explained his understanding was that the completion date has been pushed back on section A of the project by 154 days and that following the decision in the first adjudication, in order for tie to give an instruction to proceed with works which were not covered by the original design, it was necessary for Infraco to agree an estimate of the costs for that design with tie before work could proceed. This struck him as a somewhat startling conclusion but this appeared to be where matters stood.

ND stated the question arises as to who is responsible for the current delay. He said that, having read the Remediable Termination Notices ("RTN") he had a number of opening comments;

1. He highlighted the notice that related to Princes Street suggests that the design may not be adequate. However, Infraco have "punted that notice into the long grass" with their response in which they have very deliberately sought clarification from tie on a number of issues.
2. In his view as a consequence of the response received from the Infraco, the issues relating to Princes Street do not of themselves give firm grounds for termination under the contract, at this point in time.
3. The other RTNs were, in ND's opinion, not specific enough in their terms to form a sound basis for termination. The grounds set out were not sufficiently clear to demonstrate that there had been a breach.

Discussion of the options

The first step in any strategy must be to understand what CEC/tie would do if the Contract was actually terminated.

ND pointed out that regardless of whether the project was abandoned, or re-based or re-phased, there would be significant financial consequences, and there may be resulting political difficulties. For example, the project may become multi-phased with multiple contractors. The implications of that type of approach should be considered as well.

As part of determining the way forward it was important to consider what the project, in its current stage and in future stages, is worth. ND explained that it was his understanding that the civil contractor had been paid for all the works they have carried out under the contract and it would not be sensible to terminate the contract without consideration as to the next steps.

He asked whether CEC wished to replace the contractor or whether CEC wished to re-base and re-phase the project.

AM explained that the original thinking around termination had been to remove BB and to reduce the scope of the Works. Ideally, this would involve restructuring the project, at this point, so that the link to Edinburgh airport would be completed but the line to Leith would not be built.

NS asked whether, given that termination would, in all probability give rise to a claim for interdict, the focus should be on dispute resolution in terms of schedule 9 of the contract. It had been tie's

PRIVATE, CONFIDENTIAL AND PRIVILEGED

suggestion to use dispute resolution rather than full-blown litigation to resolve a number of issues and this was a tactic which was being actively considered as part of tie's latest thinking on termination.

ND stated that it was very unusual for an employer to be in the position of seeking to use the dispute resolution procedure to advance matters instead of a contractor. Even if the grounds for termination could be tested by dispute resolution as a short-term process, and the works could continue after a first decision, it would still result in CEC having to consider the process of re-procurement/re-phasing and the time and cost implications of that.

ND enquired as to the current situation regarding works on the project. AM explained that works were continuing at present but what was being done was minimal and "tactical". Infraco appeared to be undertaking just enough work to avoid the suggestion that they had abandoned the work.

ND said the general options open to CEC/tie were to:

1. terminate the current contract or;
2. re-negotiate the current contract, changing the work that the parties of the consortium do, but keeping them in place.

As part of assessing these options ND said that it was fundamental to understand whether the break down of the project was all a question of management. If the relationship between tie and Infraco had broken down it must then be considered whether to it was necessary to lose one or both, both in termination process and in terms of any subsequent re-procurement.

ND stated that Siemens, as one party of the consortium, have more of an incentive to complete the project because they have made an investment and will be keen to see that investment realised by providing their element of the works. BB on the other hand seem to have less of a driver to complete timeously because they are in a position to play the long game and presumably have a positive financial position.

Matters were even more complicated by the arms length approach of CEC, via tie, that means CEC is not in full ownership of the facts in respect of the running of the project. A fundamental problem was the degree of visibility that CEC had on day-to-day management of the project.

With regard to a potential negotiated resolution, NS explained that there had been extensive discussions around a re-basing of the project. This had been called Project Carlisle. The purpose of Project Carlisle was to see if it was possible to agree a fixed price for a fixed but revised scope.

NS explained that Project Carlisle negotiations had ended without resolution because of a gap of approximately £100 million between the parties. A factor which needed to be considered was that the cost of delivering the original scope may now be simply too expensive.

AM explained, that following Project Carlisle, tie and Infraco had effectively had an irretrievable breakdown of their relationship. AM stated that there was no likelihood that their relationship would revive with tie in its current position.

ND asked for a summary of the investment that CEC has made to date. NS explained that in respect of BB and Siemens, £120million has been paid to date for works with a value of somewhere between £50-£90million.

AM explained that in view of Project Carlisle it was clear that negotiation could not be achieved with the current parties to the project.

Contractual provisions with regard to termination

The provisions with respect of clauses 56(7)(1) and 56(7)(2) of the contract were discussed. ND agreed that it seemed obvious that those clauses were drafted, in effect, to apply after the project was complete and the trams were operational. He doubted, without expressing a firm view, that they could be used in the present circumstances.

PRIVATE, CONFIDENTIAL AND PRIVILEGED

NS explained that three Under Performance Warning Notices have been issued to date in the project under these provisions. NS also stated that the advice of RSK on this point had highlighted that the Under Performance Warning Notices could only be served in relation to "material breaches".

ND discussed what the outcome of being able to rely on clause 56(7)(1) would be. For example, ND suggested, it may be a trigger for a termination event under clause 90(1).

NS explained that in the opinion of RSK if four notices had been served (one more in addition to the current three), that would provide for a "termination event" in the contract.

ND explained that under 90(2) of the contract, the RTN relating to Princes Street was the strongest but the contractor had in fact dealt with the issues raised. ND discussed the application of the sub-clauses in those provisions. He queried which grounds for termination were being relied upon and whether those breaches were remediable or not.

NS said that it would be preferable to rely upon all of the issued notices in so far as termination could be achieved under grounds (a) or (g) of the definition of Infraco Default.

Tactically the decision had been taken, on the advice of RSK, to serve multiple notices to avoid the situation where a single notice with multiple grounds was held to ineffective. It also allowed tie to decide which notice gave it the best opportunity to successfully terminate the contract.

DJA explained that there was a question of credibility in CEC/tie issuing those notices if tie then does not follow through on all or any of them. ND confirmed that in his view you should only threaten to take a course of action if you are prepared to complete what it is that you were threatening to do.

ND said it was clear that given that the project has been put back by half a year (at this stage) and that only 10-15% of the work has been completed, CEC should have grounds for some form of contractual termination. However, he did not think that the existing notices gave a sound basis for proceeding to termination because they were two vague or (as was the case with the Princes Street notice) the contractor had put the onus of responding back onto tie.

Strategy

ND explained, in his opinion, the best strategy to provide a route to terminate was to establish a number of clear grounds for termination. In his view the best way of doing this was to focus on the deliverables in the project as a route to establishing that Infraco was in breach of contract. As a matter of fact the project was clearly in delay and although the Contractor might seek to blame tie for the majority of this delay, Infraco must be concerned about the amount of progress which had actually been achieved.

ND recommended that tie/CEC proceed as follows;

1. To ask the contractor for an updated programme of the deliverables including
 - (i) the status of design; and
 - (ii) current progress.

On (i) a simple update as to where they are at present and confirmation of the design that the Contractor was relying on to build the project.

On (ii) asking for a fully explained programme of when they are going to complete each phase and the project. In summary the contractor should be asked when the first tram will be running.

2. CEC can then reply to that programme to state that the contractors are not proceeding regularly and diligently with the works and request that the Contractor provide a "realistic programme".
3. Upon the contractors reply, CEC are then in a position to say that the project is not proceeding diligently and therefore contractual termination could be based on this alone.

PRIVATE, CONFIDENTIAL AND PRIVILEGED

ND advised strongly that CEC should not base termination of the contract on the existing RTNs.

ND then turned to consider the suggestion that tie test the grounds for termination through the DRP process.

He stated that putting the underlying issues upon which the existing notices were based through a dispute resolution process as a way of testing the strength of the case on termination would likely have significant time implications and an uncertain outcome.

DJA said that testing the termination process at dispute resolution could also result in significant publicity if a negative outcome is leaked to the press, especially if the decision is that CEC cannot terminate the contract. AM raised his concern that entering into a termination battle was uncertain as to who would come out best and right now. Further, it was not clear what CEC/tie would achieve in a mediation process.

ND explained that mediation will take time and is potentially futile in light of Project Carlisle, which suggested neither party wants to resolve matters amicably, although the fact the BB's parent in Germany was interested in meeting with the Council at least suggested they were interested in the contract. DJA explained that structuring of a mediation to maximise its success would be challenging given the range of disputes and the efforts which had been made to date to achieve a negotiated settlement.

NS explained that there now seemed to be some confusion with the recent developments on mediation and the potential meetings between CEC leadership and BB Germany. AM pointed out that tie had decided to pursue 4 or 5 different strategies over the last few months and had not maintained a coherent position on the route to achieving a resolution.

ND agreed that mediation would probably not be a time efficient step.

NS said that even in terms of negotiation it seems that when BB UK come to an agreement on performance with tie, BB Germany steps in and says no. ND and NS agreed that on this point it was important to talk with the correct individuals who are in control of decision making at BB. ND said a meeting with BB at this time was possibly a good idea however entering into the process of mediation was, in his opinion, certainly not.

AM explained the present situation within the suspicions of potential; i) fixed pricing on the contract; and ii) contractual bonuses and/or misrepresentations involving tie and DLA Piper.

ND explained that although it was not necessarily related to his current instructions, it was of certain relevance as to the fundamental voidability of the contract and, if suspicions turn out to be true, could have a significant and useful impact from CEC's perspective. AM agreed that this could provide another route to the outcome that CEC seeks.

Conclusions

AM asked in summary for the best route to break the current deadlock.

ND advised that tie needs to ask for an update on design process and the design to which Infracore is working. As part of this tie must be prepared to make as little changes to the project as possible and only where those changes are "absolutely necessary". Pressure should be brought on Infracore to perform whilst seeking to establish breaches of contract which could, if the Council wished, form strong grounds for termination.

ND confirmed that it was his view that the existing notices did not give the best prospect of successfully terminating the contract. For example, with regard to the substantial errors raised with regards to the design at Princes Street, the consortium has come back with a proposal that the existing design is now inadequate. In his view you could not terminate on the ground set out in an RTN where queries had been raised by the contractor that had not been addressed.

PRIVATE, CONFIDENTIAL AND PRIVILEGED

ND advised that in consideration of this, CEC should put maximum pressure on Infraco and press for a response to a request for a programme of deliverables. It was essential to exert short-term pressure on Infraco holding them to the agreement on both design and programme points.

ND went on to explain that termination by agreement or relying upon the termination provisions within the current contract would result in both delay and financial costs each with their own political implications.

ND stated that CEC should consider the dissolution of tie in favour of a better project management team (however he accepted that this was out with his present instructions).

ND summarised as follows:

1. Pressure should be brought upon BB and Infraco and specifically in terms of them providing an updated notice of project progress to date.
2. tie should investigate those factors presently involved in the dispute
3. tie should investigate the base line contract for the routes to termination, and how this can be achieved.

AM said that it was wise now to pressure the contractor to perform and to be consistent in terms of demanding performance under the contract.

Conference: 1.5 hours