

## **INITIAL MILESTONE PAYMENTS**

### **BACKGROUND**

The programmes for construction of the tram infrastructure and the supply of the tram vehicles are based on finely grained milestones which form the basis for payments to the contractors. Final details of this programme are still to be confirmed. However, it has been clearly understood for some time that a significant ramp-up in activities will be required by both, the Infraco and Tramco contractors, following Contract Award in order to:

- a) meet the overall construction completion date of Q1, 2011; and
- b) achieve affordable risk transfer for inflation risk consistent with the approved Procurement Strategy.

#### Initial milestones:

Both preferred bidders (Infraco and Tramco) have outlined the scope and programme of activities proposed to be undertaken immediately following Contract Award. The milestone payment for these activities will fall into period 12 and 13 2007. Although the amounts due at each milestone are to be finalised with the respective bidders, the proposals indicate activities and commitments to the value of £9m (Tramco) and £36m (Infraco) in those periods.

### **INFRACO**

The first milestones for Infraco cover 5 key areas:

- a) Contract Award Milestone
- b) Procurement of materials
- c) Procurement of large plant and equipment
- d) Mobilisation of staff, supply chain and planning and logistical activities

### **Initial Milestone Payment**

Following the initial proposals from Jan 07, BBS submitted a their bid in May 07. At the end of July following initial evaluation of prices, **tie** met with BBS to set further expectations for reduced prices in the bid update due for August 7<sup>th</sup>. One of the negotiation points related to BBS undertaking early mobilisation and early supply chain commitments to secure fixed prices for key price sensitive materials. Following this, BBS returned a bid on 7<sup>th</sup> August 07 with a reduction of £6.9m. One significant factor in obtaining this reduction was the introduction of first milestone payment in respect of early mobilisation and supply chain commitments, as outlined above.

### *FOISA Exempt – Qualified Exemption*

This was further developed in negotiation with BBS following return of their August 7<sup>th</sup> bid. This involved firming up their provisional allowance of £11.933m in respect of inflation. At the negotiation meeting on 24<sup>th</sup> August it was agreed that:-

- a) the commitments for price sensitive materials would be made under the mobilisation and advance works agreement and
- b) the associated payment would be made for price sensitive materials as part of the first milestone payment (circa 20% of the contract sum)

For this **tie** received a further reduction in the tender of 5.5m.

This combined reduction of £12.4m resulted in substantial part from the proposals for a milestone payment shortly after contract award of approximately 20% of the contract sum for early mobilisation and allowing for the forward purchase of materials to minimise inflation risks in key materials, including price sensitive metals. The scale of the price reductions obtained and transfer of risk in return for this initial milestone and forward purchase of materials represents good value for the public sector – a price reduction of £12.4m in return for an initial payment of circa £36m.

Since then further details of the proposed first milestone have been provided. These consist of:-

- a) *Contract Award Milestone*  
Deliverables under this milestone are the signed Infraco contract, the SDS, Tramco and Tram Maintenance novation agreements, placement of insurance, retention bonds and collateral warranties. Infraco costs associated with these and other activities to achieve Financial Close are £11m and will be due as part of the first milestone in Periods 11/12, 2007.
- b) *Procurement of materials*  
The procurement of items with long-lead times and / or high price volatility is essential to allow the Infraco to meet the overall construction programme and to meet the agreed risk transfer on inflation risks. These items include materials for surfacing, streetlighting and reinforcement for structures, tram shelters, structural steelwork for the depot, rail, switches and crossings, transformers, and copper cabling. The value of these items totals £16m and will fall due in the first milestone in Period 12, 2007.
- c) *Procurement of large plant and equipment*  
As for materials, early order of certain plant and equipment will be required to ensure their availability in compliance with the overall construction programme. Key items are equipment for the depot, traffic signalling, comms systems and tram controls, totalling £2.5m, falling due by Period 13, 2007.
- d) *Mobilisation of staff, supply chain and planning and logistical activities*  
The initial milestones will include setting up site offices, office running

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costs, staff costs, mobilisation of the supply chain resulting in the delivery of relevant contracts with contractors and sub-contractors, associated collateral warranties and bonds, provision of programmes, method statements, project quality plans and Health & Safety work. The costs have been estimated at £7m, arising in line with programme in Periods 12 and 13, 2007.

Further details of the above are provided in Appendix A.

### **TRAMCO**

Similarly, the Project negotiated a reduction in price of £500,000 with CAF the vehicle manufacturer in return for an initial milestone payment, representing early mobilisation including design and supply chain commitments. This represents a discount of 1% on the price. Similar to Infraco procurement commitments will be made under the Mobilisation and Advance Works Contract, thus securing the programme. Additionally the project receives the following deliverables at this milestone:-

- a) Mobilisation of staff and planning & logistical activities  
The initial milestone includes development and delivery of agreements between Tramco and Infraco, Programmes, Resourcing commitments, Quality and Management Plans. The costs associated with these activities are £200k and will fall due in Periods 12 and 13, 2007.
- b) Design works  
This element of the initial milestones relates to the Tram mock-up, progression of the Tram preliminary design and industrial design works valued at £400k due in Period 12, 2007.
- c) Hedging of the exchange rate to fix the tram vehicle contract for delivery in sterling avoiding further adverse changes in the sterling euro exchange rate.
- d) Mobilisation of the supply chain includes placing procurement commitments for traction packages, braking systems and other key items totalling £8.7m.

The discount of £500,000 and the deliverables obtained represent good value to the Public Sector given that it also enables risks to programme to be reduced.

### **KEY RISKS**

There are two key risks to be mitigated in the approach outlined above:-

- a) Supplier insolvency resulting in loss of advance payments. Two aspects are to be considered insolvency of the Infraco Contractor and insolvency of the primary supplier
- b) CEC exposure in the event that a contract is not awarded

**PROTECTIONS AGAINST IMPACT OF SUPPLIER INSOLVENCY**

Protections against such failure are to be included within the Infraco contract terms. This is particularly important in respect of materials and equipment committed and paid for but not yet delivered. Dealing first with Infraco insolvency: The Infraco, BBS, consists of two major international contractors, Siemens and Bilfinger Berger. Both currently have strong investment grade credit ratings reflecting the strength of their balance sheets.

In the circumstances of the insolvency of one of the Infraco consortium members (both UK registered companies, wholly owned by their German parents) the contract terms will provide for:-

- a) The remaining Infraco consortium member proposes a plan to deliver the contract using an alternative consortium partner/supplier.
- b) The remaining Infraco will be liable for providing the deliverables for which any payments have already been made.
- c) The requirement that sub-contracts require automatic vesting of title in CEC in any materials and supplies for which advance payments have been made by **tie**
- d) Recourse to the parent companies under parent company guarantees
- e) Recovery of any resulting losses by calling in a performance bond

In the circumstances of the insolvency of both Infraco consortium members, the contract terms will provide for:-

- a) The automatic assignment of the key supply contracts for advance materials and supplies to **tie**
- b) Sub contracts vesting title in any materials and supplies to CEC for which advance payments have been made by **tie**
- c) Recourse to the parent companies under parent company guarantees
- d) Recovery of any resulting losses by calling in a performance bond

To ensure these protections are included in sub contracts for advance materials purchases, such suppliers will be designated key subcontractors. **tie** has the right of review and approval of the terms of all key sub-contracts. This will enable **tie** to check that key provisions are in place and to review the creditworthiness of the supply chain..

In the circumstances where Infraco's supplier becomes insolvent before the delivery of advance purchase materials, Infraco remains responsible for delivery of these items, if necessary from alternative suppliers approved by **tie**.

Similar provisions are being included within the Tramco contract terms.

**CONSEQUENCES IF AN INFRACO CONTRACT IS NOT AWARDED**

As noted above advance materials commitments are scheduled to be made under Mobilisation and Advance Works Contracts. Such commitments will only be made with **tie's** approval, such approval being conditional on being advised of and agreeing cancellation costs and key contract terms. However, no payments are made until after Infraco contract award. Should Infraco not proceed then Infraco will be entitled to recover any cancellation costs in respect of approved commitments. These are currently estimated at 10% of the value of the estimated value of advance purchase commitments, which equates to approximately £2m.

The same arrangements apply within the Tramco contract. Cancellation costs for the advance commitments are estimated at £0.9m.