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To: Cllr Mackenzie  
Subject: Tram Finance

## **1 Introduction**

This briefing is intended to detail the timetable for Final Business Case (FBC) approval, the main financial risks concerning the tram project and the approach being taken to identify, assess and mitigate these risks.

## **2 Background**

On 21st December 2006, the Council approved the Draft Final Business Case (DFBC) for Edinburgh Tram Network. This approval included the continuation of contract negotiations with tram vehicle providers (TRAMCO) and tram infrastructure providers (INFRACO) and the commencement of utilities diversions on receipt of funding from Transport Scotland. The report recommending this approval set out the financial risks associated with the project at that stage.

The procurement strategy for the tram is based on commissioning advanced designs to inform the procurement of the infrastructure contract and on advanced utility diversions to reduce risk of delay.

In moving from Draft Final Business Case to Final Business Case and signing of contracts, the following developments are being taken into account.

- The commencement of utilities diversions and any impact on cost and programme resulting from delays (the project's uncertainty prior to and following the Scottish Parliament Elections meant that work could not start until mid July)
- Additional design work defining the detailed scope of the project to inform the infrastructure bids
- Value engineering measures suggested by the designers and the infrastructure bidders to reduce the cost of construction
- Formal Best and Final Offers from INFRACO and TRAMCO bidders
- Further work on cost and risk assumptions over the past eight months
- Changes to funding assumptions as the Council is now carrying 100% of any over-run risk

It should be noted that the report in December estimated that the cost would be £592m (Phase 1a, £500m and Phase 1b £92m), compared with funding of only £545m. The FBC will therefore be for Phase 1a only, with an option to begin construction of 1b 12 months later.

### 3 Timetable to Financial Close

In order to meet project timetable (and budget), as well as to sustain bidder's interest, **tie** recommend financial close by January 2008.

In order to meet this deadline, the following programme must be adhered to:

Milestone	Date
Final Bids received from bidders, draft FBCv1 prepared for review by tie, TEL and CEC officers	End August 2007
Tram Project Board approval of FBCv1 and preferred bidder selection, with recommendation to CEC and TEL	26 <sup>th</sup> September 2007
OGC Gateway review 3	Early October 2007
Planning Committee approval of consultation for revision to Trams contribution policy, to allow for the continued collection of tram contributions when the tram is operational	4 <sup>th</sup> October 2007
Full Council meeting to approve FBC v1 and preferred bidder selection	25 <sup>th</sup> October 2007
Scottish Executive approval, including additional funding (Transport Scotland Officials plus Cabinet)	29 <sup>th</sup> October 2007
Completion of all contractual and funding documentation and completion of FBCv2, based on final deal	November/December 2007
Tram Project Board approval of FBCv2 and final deal, with recommendation to CEC and TEL	5 <sup>th</sup> December 2007
Planning Committee approval of revisions to tram contribution policy	6 <sup>th</sup> December 2007
Full Council approval of FBCv2 and final deal, which should include only minor changes from FBCv1, reported in October	19 <sup>th</sup> December 2007
Finalisation of documentation, signing of contracts and any guarantees required from CEC	11 <sup>th</sup> January 2008

**tie** ltd is close to completing FBCv1. Although Council officers have assisted in this work, more detailed work will be required before a recommendation to Council to approve the plan can be made. The work will include:

- Reviewing capital cost assumptions
- Assessing and quantifying the risks, including reviewing contract documentation
- Assessing the level of financial headroom required, compared to available funding
- Revaluating the Council's ability to raise its £45m contribution and any additional funding required for contingency purposes

### 4 Funding

Transport Scotland will continue to be the major funder of the project, with a grant of £500m. Council and **tie** employees are in the process of negotiating the terms and conditions of the grant award letter. The grant award letter will cap the contribution at £500m, with any cost overrun beyond £545m being met in full by the Council. The letter will also state that it is conditional upon the tram network not requiring on-going revenue support. The Council is therefore exposed to all capital and revenue

risk associated with the project. In order to reduce its exposure to some of the revenue risk, the Council is asking Transport Scotland to formally confirm that trams will be treated the same as buses in the National Concessionary Fares scheme, or any future scheme.

The Council is committed to contribute £45m to the project, as set out in the report to Council in December 2006. The table below summarises the actions officers are undertaking to ensure that this can be delivered.

	December 2006 Estimate £m	Progress to achieve the contributions
Council Cash	2.5	£1m provided in 2005/6, a further £1.5m is in the Council's capital budget for 2007/8
Council Land	6.2	Land is available and valuation has been provided by the District Valuer
Developers' Contributions – Cash	24.4	This is the largest and most uncertain element of the Council contribution, as it is dependent on the extent and speed of development along the tram line. Consultation on revisions to the tram planning guideline will be recommended to October Planning Committee, to enable the collection of contributions after the tram has started operating. In addition, development assumptions are being revisited and sensitivity analysis carried out to assess the robustness of assumptions.
Developers' Contributions – Land	2.2	Land is secured by S75 agreement and valuation has been provided by the District Valuer
Capital Receipts (Development Gains)	2.8	Sites are being revalued by Council surveyors to provide a greater certainty over land value
Capital Receipts	6.9	Sites are being revalued by Council surveyors to provide a greater certainty over land value
Total	45	

The majority of developers' contributions and capital receipts will not be available until after the project has been completed. However, the grant award from Transport Scotland is likely to require the Council to contribute at the same rate as it draws down grant. This may result in additional borrowing costs. An exercise to model the financing costs will be carried out with input from the Council's Treasury section.

In addition to this £45m, the Council is looking at further ways either to fund phase 1b and/or provide additional financial headroom for the project to cover normal increases in expenditure. Options under consideration include:

- Leasing of tram vehicles or similar arrangement to utilise capital allowances

- Potential contribution from Lothian Buses through TEL
- Review of TEL business plan assumptions to generate more profits from bus/tram operations
- Seeking additional contributions from third parties such as BAA
- Further capital asset sales

## 5 Costing assumptions

### Capital

Costs in the draft business case were based on an initial pricing of the outline design, benchmarked against other tram schemes. Where prices were known (eg Utilities Diversions), contract prices were used. For each element of cost, a risk premium was added, based on the impact and likelihood of the risk. The average risk contingency at the time of the Draft Final Business case was 12%.

The Final Business Case will be based on more detailed designs and firm prices from the preferred bidder. This should give greater certainty over cost. In addition, there will be a similar contingency for any risk or uncertainty over costs. Over the next few weeks the prices, proposed contracts and risk assumptions will be reviewed to determine how much risk has been transferred to the private sector and how much contingency or headroom is required to meet unforeseen costs. To support this process, the project will be subject to an OGC Gateway review at the beginning of September and external legal and financial advice will be sought jointly with **tie**, where necessary.

In order to reduce costs, **tie** are investigating a number of opportunities for “value engineering” suggested by bidders and designers. These need to be properly assessed from a technical standpoint to ensure that they do not add to project costs at a later date either through delaying the planning approvals process, or by increasing tram maintenance costs.

### Revenue

The revenue assumptions for the combined bus and tram network (TEL Business Plan) in the Draft Final Business Case were based on current and historical Lothian buses performance as well as the modelling of growth in passenger demand as the result of new development.

**tie** do not intend to revisit the operational case in much detail as the assumptions have not changed materially. The main changes affecting revenue are:

- The abandonment of Edinburgh Airport Rail Link will result in **increased** patronage for tram
- Lothian Buses results for 2006 and the first half of 2007 have shown that the base assumptions were overly conservative and patronage is higher than forecast

Costs for maintenance of the tram will be evaluated with the infrastructure contract. If prices increase materially, the TEL business plan may have to be reassessed.

A high proportion of bus/tram users are entitled to concessionary travel. The Council is negotiating with the Scottish Executive to ensure that tram will be treated in the same way as bus for travel concessions. If this is not the case, it will have a material impact on current assumptions.

## 6 Risks

tie have a detailed risk register which attempts to identify all risks associated with the project so that they can be effectively managed. The main financial risks are summarised in the table below:

Risk Category	Risks
Capital Expenditure	<ul style="list-style-type: none"> <li>• Unforeseen utilities result in additional costs and delays, possibly causing delays to infrastructure works and corresponding costs</li> <li>• Continued delays from designers result in delays to infrastructure works or to gaining planning/TRO approvals, with corresponding impact on costs (claims)</li> <li>• Infrastructure/Tramco contracts transfer insufficient risk to the private sector</li> <li>• Wide-area impact of the tram is greater than predicted necessitating further works that are not currently in the budget</li> <li>• Failure to get agreement with Network Rail over immunisation results in delays and/or additional costs</li> <li>• Over ambitious programme has insufficient slack to avoid delay and additional cost</li> </ul>
Revenue Income and Expenditure	<ul style="list-style-type: none"> <li>• Failure to get agreement with Transport Scotland on concessionary travel and/or significant changes to national scheme resulting in reduced income</li> <li>• Modelling error in passenger growth assumptions</li> <li>• Error in operational expenditure assumptions</li> <li>• Increased maintenance costs in order to achieve capital savings</li> <li>• Fall in bus patronage compared with BP assumptions</li> </ul>
Funding	<ul style="list-style-type: none"> <li>• Developers contributions are less/later than planned</li> <li>• Change to planning legislation or legal challenge prevents the Council from collecting tram contributions after the tram is operational</li> <li>• Capital Receipts are less/later than planned</li> </ul>

## **7 Mitigation Measures**

As stated above, between now and the recommendation to Council on 25<sup>th</sup> October, Council and **tie** staff will be assessing and quantifying risk in order to determine an appropriate level of financial headroom and, if necessary, identify further funding to provide this headroom. This will allow cost overruns to be accommodated within available funding.

In addition to providing contingency or headroom, it is important that cost is kept under tight control and risks are carefully managed. To this end, the Tram Project Board reviews costs and risks on a monthly basis and has a rigorous change control system in place. The recent Audit Scotland report provided a positive assessment of tram project governance and this is being strengthened further following the report to Council on 23<sup>rd</sup> August 2007. In addition, an OGC3 Gateway review will be carried out in October to ensure that the project is ready to proceed to the next stage.

The project is about to enter its next stage and the work of **tie** will change from procurement to contract management. It will be necessary to change/strengthen the team at **tie** to reflect this so that contractor claims can be minimised.

Finally, the project is being implemented on a phased basis, to limit the exposure to cost overrun. Phase 1b will not begin until there is greater certainty of costs and funding. Similarly, consideration will be given to phasing the construction of phase 1a so that the section between Ocean Terminal and Newhaven is only built if sufficient funds are available.