EDINBURGH TRAM PROJECT
FINANCIAL CLOSE DELIVERY PROGRAMME

Governance & Management
Expenditure & Funding
Final Business Case preparation
Programme & Approval process

- Report to TPB – 9 August 2007

Background

The procurement programme has been revised following the political hiatus in May and June. Financial close is now scheduled for January 2008. This note attempts to pull together the activities needed to deliver the funding for the tram project, the Final Business Case (FBC) and the related areas of project governance and the approvals process. The key dates on which it is based are those within the procurement programme.

Objectives

The objectives for the period to financial close are :

1. The project expenditure budget through to financial close is clearly stated, fully supported by the Tram Project Team and visible to all key stakeholders
2. Cash funding is received sufficiently in advance of expenditure such that cash resources to meet commitments are adequate
3. Approval points for new funding are visible and approval processes are planned and agreed in advance with key stakeholders
4. An effective and efficient governance model is deployed through to financial close in support of a sound decision-making process which will underpin success in the post-Close period

During this period we also need to prepare for the construction period and the objectives are :

5. Contracted payment terms for Infraco and Tramco, together with any guarantee or comfort letters, are fully supported by funding commitments from key stakeholders and documented in a legally binding form in the context of the procurement process
6. An effective and efficient governance model is developed and approved for the construction period in advance of financial close

The detailed sections below set out how these objectives will be met. A summary of the paper is set out next.

Summary

1. Project scope assumed to be Phase 1a with option to construct Phase 1b. Phase 1a to be contracted in January 2008, Phase 1b to be structured into the contract as an option at CEC discretion on fixed terms. Alternatives – simultaneous construction, omit Phase 1b – to be evaluated when bid output clearer.

2. TS to withdraw from regular monitoring, placing full responsibility on CEC.

3. Other than managing new approach by TS, no material changes proposed to existing governance model. Work needed on Council / TEL / tie formal documentation. New TS / CEC arrangements to be codified, especially 4-weekly meeting format.

4. Preparation of a near-final FBC to be accelerated to coincide with preferred bidder selection at end-September

5. Updated Project budget incorporating all advance expenditure to be finalised in immediate term and married up with timing of requests for new funding. Request for additional funding to be approved by TPB at end-September then Council and TS at end-October, to enable advance works and early mobilisation of Infraco / Tramco to proceed.

6. Funding arrangements now clarified by TS at £500m for Phase 1, with Phase 1a in full a mandatory condition.

7. Gateway review 3 in early October, to be driven by tie / TEL / CEC

8. Council meeting on 25 October to approve preferred bidder and FBC including funding arrangements. Final form all documents to be approved in December.

9. Funding for Phase 1a to be sustained in present assumed form – Government grant + CEC “£45m”. Action underway to develop incremental funding, but is unlikely to bear fruit until 2008 and should therefore be part of the Phase 1b consideration and not introduced as another risk factor to Phase 1a.

TPB Approvals requested

There are a number of issues to discuss but the approvals requested from TPB are as follows :

1. To approve the project scope planning assumption – Phase 1a + Option on 1b
2. To approve revised governance arrangements with Transport Scotland and the proposed Committee structure within project governance (a discussion on members / participants is recommended)
3. To note governance issues being addressed by CEC relating to tie and TEL
4. To approve the proposed terms of Government grant award
5. To approve approach to funding of Phase 1a and 1b
6. To consider approach to termination costs
7. To approve approach to additional funding for the pre-Close period, including advance works and early mobilisation (as set out in detail in accompanying TPB papers)
8. To approve the approach to preparing the FBC
9. To approve approach to OGC Gateway 3 review
10. To approve the summary Financial Close delivery Programme

Project Scope

The working assumption is that Phase 1a will be contractually committed and Phase 1b will be committed in the form of a time-limited option. Subsequent extensions will be described in the FBC but will not form part of the procurement process or funding dialogue at this stage. This may change if bidders submit final proposals which change the view of affordability, but at present this is the only reasonable basis to proceed with a firm procurement and funding programme. The emerging scenarios will be kept under close review.

Governance and management

Government and Transport Scotland

1. New funding arrangements require a revised governance approach.

2. The interests of the Government (shorthand for Cabinet, the Cabinet Secretary, the Executive and Transport Scotland) can be summarised as follows :
    a. Satisfaction that the Airport / Leith tramline will be delivered
    b. Confirmation that the BCR is greater than 1.0, now to reflect the world without EARL and any other substantial changes from the Draft FBC (December 2006) ; and
    c. Confirmation that there will be no Government subsidy requirement for the integrated bus and tram operations.

3. These are in line with the parameters used to assess the DFBC and are the measures which will be used to determine grant award. Other than general adherence to proper practices designed to protect the public pound, these are the only areas of Government focus. Documentation provided for Government assessment should be limited to material which is directly relevant to these parameters.

4. TS will withdraw from routine monitoring and from the TPB and sub-committees, in favour of a monitoring regime which will be a condition of a New Award Letter, in summary :

    - 4-weekly report as now
    - 4-weekly meeting between senior TS people (probably Bill Reeve and Jerry Morrison) and senior CEC people (probably Andrew Holmes and Donald McGougan), others at CEC's invitation including senior Project / tie / TEL people, scope to be limited to key issues relevant to TS / CEC with no additional reports unless agreed by exception.
    - Quarterly TS / CEC CEOs meeting, scope to be agreed but probably focussed on key tram project issues and wider Edinburgh transport matters, at discretion of the two CEOs.
    - Quarterly confirmation from CEC of compliance with New Award Letter terms

5. Satisfaction with governance arrangements planned for the construction period is CEC's responsibility, finalised by approval of the Final Business Case which will set out those proposed arrangements.

6. The new monitoring arrangements should commence in September 2007.

7. Certain aspects of 4-weekly reporting require further discussion : construction period programme requires to be cost-loaded at a sensible level of detail and will be basis of cash flows which support drawdown ; timing of submission to be re-addressed with objective of bringing forward by one week to align with other TS projects, again probably effective construction commencement.

City of Edinburgh Council

8. CEC require to clarify their internal governance arrangements, particularly delegated authority between the Council and tie / TEL and this must also interface with the TPB. It is imperative that the arrangements do not impede effectiveness of TPB and project operations.

9. Other CEC driven governance issues to address include :

    a. Communications with Councillors including a series of sounding board meetings
    b. Report to Council on 23rd August and need for careful coordination with Project Team and TEL
    c. Contractual relationship between CEC and project legal advisers DLA

Project level

The present governance model will prevail through to financial close with the following amendments :

1. The Legal Affairs Committee (LAC) has been introduced to monitor the overall coordination of legal advice

2. A Procurement Committee has been introduced to perform a top-down view of the procurement process and the emerging bids. This committee will also monitor the Financial Close Delivery Programme including funding, business case preparation and approvals processes.

The DPD will continue with a focus on the critical design and contractual issues and the MUDFA committee monitors progress on utilities.

All Committees are designed to expedite review and resolution of key issues, none have formal decision-making power which is reserved to TPB.

Construction period governance

The FBC will include the proposed governance model for the construction period.

Governance & Management - Points for discussion and action required

- TPB to approve proposed new governance arrangements set out above

- The remit, attendees and agenda for the 4-weekly CEC / TS meeting should be agreed in advance, GB to draft agenda / remit

- GB to organise session to resolve reporting issues. Suggestion is that any changes are aimed at post-Close period.

- CEC action on points 8 and 9, with support from tie as agreed at meeting on 7 August 2007.

Expenditure & Funding

Pre-close expenditure and additional funding required

1. The expenditure budget has been adjusted to accommodate refinement of MUDFA and insurance premium payments. Cumulative implementation spend to the end of Period 4 2007-08 (21.7.07) was £72.8m. Setting aside items which are dependent on Close or can be deferred, the spend to end-January 2008 is planned at £52.4m so that total pre-Close spend is £125.2m. Total funding to date including the current award of £60m is £114.8m. The shortfall of funding against current plan is therefore £10.4m.

2. This reflects the planned advance works and early mobilisation spend of £12m and contingency of £7.9m. These forecasts anticipate a continuing project and do not accommodate any termination costs. If Close is delayed there will be additional costs of £3m-£4m per month including utilities. The issue of pre-Close funding is therefore a priority for resolution.

Construction period

The post-Close budget is being updated to reflect new bidder submissions received on 7.8.07. The pre-Close costs noted above are consistent with the DFBC forecast of £592m.

Cash receipts

The timing of cash receipts will be addressed within the funding arrangements and the proposed approach is set out in the section on funding below. At present CEC provide the cash buffer but we must align the funding cash flows with the project requirements to ensure money is deployed efficiently. The underlying cash flow estimates will be refined as the preferred bidder payment profile becomes firmer.

Sources of funding

The revised funding arrangements set out by the Minister as a condition of continued Government support create an opportunity for CEC to develop a different approach to funding their commitments. This includes conclusion of developer contributions, prudential borrowing, leasing and utilisation of TEL cash flows. However, it is unlikely that these can be sufficiently developed to be a confident element of the FBC by January 2008.

It is therefore suggested that the funding structure for Phase 1a (Airport / Newhaven) is kept as simple as possible, with the arrangements for Phase 1b (Roseburn / Granton) being subjected to further analysis in 2008 (though starting now) in line with the planned duration of the period in which CEC has an option to construct.

The funding components for the construction phases will therefore comprise :

Phase 1a principal funding

- Executive grant - £500m award
- CEC cash and land contributions
- S75 land contributions (principally Forth Ports)
- Other S75 contributions which are substantially agreed and incorporated into CEC funding
- CEC asset sales and / or borrowing mechanism as required

These will need to be firmly agreed in line with the programme described below. The extent to which the other sources described below are affected by these arrangements must also be assessed and "future-proofed". An example would be the possibility of leasing arrangements which attach to equipment (eg tram vehicles) needed for Phase 1a as well as Phase 1b. This should be manageable.

Additional sources of funding (Phase1b and further extensions)

- CEC / TEL borrowing or leasing
- Developer contributions and related asset sales, especially Granton
- TEL resources, other than borrowing
- Third party grants (eg SESTRAN)
- Tax shelter mechanisms
- Other to be developed

The corporate and tax structuring in support of these sources needs further development. The work to do so has commenced but it is likely that finalisation will emerge in 2008.

<u>Terms of Government Funding</u>

1. Subject to overall agreement on funding terms, the anticipated aggregate grant award will be £500m and will be committed in the form of a New Award Letter, presently under preparation. There will be no further indexation (up or down). The grant will be available to fund Phases 1a and 1b but strictly on the basis that the whole of Phase 1a must be delivered. A decision to proceed with Phase 1b – whether coincident with financial close or at some future date – is solely that of CEC, but no additional grant award for Phase 1 will be made beyond £500m.

2. There is no Government requirement to future proof the EARL project (or any other project) in designing and constructing the Tram. In the event that the termination of the EARL project results in additional costs or savings to the Tram Project, these will be absorbed within the project budget and will not result in any change to the grant award of £500m.

3. The New Award Letter will reflect all previous grant awards for the implementation of the Tram Project, including the award of £60m approved in Spring 2007 and rollover from prior awards. The total pre-approved funding is <u>£114.8m</u>, of which £113.8m has been provided by Government and £1m by CEC.

The balance of grant award up to £500m of <u>£385.2m</u> will be subject to the terms of the New Award Letter.

4. The award of £385.2m will be on the basis that a proportionate funding mechanism is agreed. This will reflect the balance of commitment of £385.2m from the Government and the balance of commitment from CEC of £44m. This creates a ratio of 89.77% Government, 10.23% CEC to be applied to all future drawdowns until the aggregate Government funding reaches £500m. All further funding will be to the account of CEC.

   Any out of sync relationship to be adjusted in subsequent quarter's payment to avoid debate around the deadline for the immediate payment and possible delay.

   Variation to these terms will be permitted by agreement of both parties.

5. There is agreement that the bidder terms should be based on cash flow neutrality in their accounts as a means of limiting capital cost bids. Accordingly, the funding from the Government should be scheduled alongside the CEC contribution such that payments can be made to contractors in a manner which achieves cash flow neutrality for the contractors.

6. There may be further advantage if advance sums can be offered to contractors. However, there are public sector accounting difficulties and risk management issues which will need to be addressed if this is to be pursued.

7. It is agreed that drawdown arrangements should be kept as administratively simple as possible, consistent with proper control by all parties. Government cannot advance very large sums – eg a full year's estimated requirement – but a quarterly structure should be workable. This will require sound forward estimates of spend and cash flows, reflecting in due course the contractual terms agreed with the successful bidders. The additional pre-Close funding (referred to as "Tranche A" of the new award) is covered below. For the period from Financial Close, using such estimates, cash drawdowns by CEC from Government should reflect an initial drawdown ("Tranche B") of the first two quarters' funding requirement with subsequent drawdowns to be made quarterly based on the succeeding quarter's requirement. This should provide adequate base funding avoiding a cash shortage. The operation of this mechanism will be monitored quarterly.

8. The drawdowns will require to reflect the proportionate funding arrangement, such that each new drawdown from Government (starting with Tranche A) will be restricted to 89.77% of the full amount required, with the balance to be contributed by CEC. It is recognised that the precise arrangements need further definition to accommodate the mix of cash and in-kind (land) contribution by CEC, but the broad principle should be adhered to by both parties. The operation of the proportionate mechanism will also be monitored quarterly.

9. It is recognised that there is likely to be a substantial additional funding requirement in the period prior to Financial Close beyond the funding currently in place. This reflects continuation of the current programme, including land acquisition and utility works. Although programme slippage arising from the post-election period has moved some cost forward, the sum involved remains substantial. TS have underlined a risk that Government may not be willing to provide further funding prior to financial close, which would have extremely damaging consequences for the project. The solution lies in the progress made through procurement, preparation of FBC and in the commitments given by CEC – see below under approvals.

10. The New Award Letter incorporating Tranche A (pre-Close) funding will need to be legally completed in advance of a cash shortfall. This should be approved by both the Council and TS in late October. The commitment by both parties to funding beyond financial close will be conditional upon Close being achieved.

11. CEC and tie are examining options for leasing and debt arrangements to support overall funding. These may prove to be financially efficient and carry other advantages. The scope of these arrangements is focussed on incremental funding for Phase 1b, but it may transpire that there is advantage in extending the facilities to encroach on Phase 1a. In the event that there is demonstrable advantage to all parties, CEC and Government will engage in good faith to conclude on appropriate action, most likely in 2008.

12. Dispute resolution process to be embedded in New Award Letter covering inter alia failure by either party to meet payment obligations. Needs to be capable of swift intervention to protect programme. Value of land needs to be agreed before Close to avoid any further debate.

13. Government is neutral to asset ownership, corporate structuring and related matters which are CEC's prerogative so long as within bounds of normal public sector good practice.

<u>Comfort letters on funding to bidders</u>

To reinforce bidder confidence and drive bids down, a comfort letter setting out the Government commitment to funding of the project should be deployed in mid / late August.

<u>Contingencies</u>

It is recognised that there is desire for a straight-forward arrangement between CEC and Government ; however, certain contingencies cannot be accepted unqualified by CEC in view of scale of financial risk relative to CEC resources. The issues ad results of dialogue to date are as follows :

a) Action taken by the Government which leads to a material extension of programme or increase in cost - incremental costs to be met by Government.

This is a major concern – stated to unacceptable to TS, too big a risk for CEC to take on unprotected.

b) Government determines not to support the project at some stage in the future resulting in termination costs – all termination costs and CEC sunk investment to be reimbursed.

   TS apparently accept need to be accountable for their failure to meet obligations.

c) Network Rail frustrate progress of project through immunisation (or other) arrangements

   Government will not underwrite this risk, but will enter into best endeavours agreement to support CEC in dialogue with NR.

   CEC / tie / TEL to consider whether risk is acceptable and process manageable, allowing also for ORR potential intervention.

d) Other third party involvement – BAA plc, HMRI, HSE, other

   CEC foresee potentially unacceptable risk balance and need to address further. TS unwilling to underwrite.

e) Mechanism required to protect CEC / TEL from Government action which affects materially the operational performance of the integrated bus and tram system, for example substantial financial support for Son of EARL (Tram disruption and revenue attrition).

   TS unwilling to do this, also raises the issue of legality of a compensation payment in a competitive environment.

Expenditure & Funding - Points for discussion and action required

The key issues to resolve are :

- Additional Tranche A (pre-Close) funding and process to formally approve New Award Letter by end-October at the latest. The variables are 1) overall re-assessment of spend pattern including actual to date ; 2) advance works and early mobilisation investment compared to costs of delay ; 3) effect of emerging bid proposals.

- Means of handling termination cost exposure.

- Approach to contingencies

Main action points are :

- The most important next step is the submission of a draft of the New Award Letter due from TS by 14 August. This should capture all of the important matters described above. Work is underway to provide the data needed to finalise the structural terms.

- Rolling assessment of bidder submissions and effect on overall affordability, cash flow requirements and project phasing

Final Business Case

1. Agreed that FBC should be DFBC amended only as necessary. Specific points to update are embedding of the no-EARL scenario as base case, reflected also in BCR calculation (work already substantially executed in support of DFBC) ; and revised capital costs based on preferred bids as necessary.

2. TS comments / tie responses on DFBC to be embedded in FBC, understood not to be fundamental, no further iterations or reporting & debate with TS needed on these matters.

3. The programme outlined below accommodates the procurement programme but the key new dimension is the suggestion that we seek to have the FBC effectively completed, based around the preferred bid, in time for the TPB meeting on 27 September. This document will be referred to as FBC Version 1, with final form FBC Version 2 as the basis for financial close. It is anticipated that there will be minimal difference between these two documents.

4. FBC to reflect same assumptions about concessionary fare support as in DFBC. Government position is that parties should be "no better and no worse off". CEC position is that there must be a commitment, otherwise tram scheme cannot be approved. However, needs secondary legislation and this needs further thought. Words to be framed around no distinction between tram and bus and consistent with regime at the time.

Final Business Case – Points for discussion and action required

- A detailed programme to update the DFBC is in preparation with the objective of having a decent draft of FBC v1 in front of the TPB on 5 September.

Programme & Approval process

The suggested outline Financial Close Delivery Programme ("the Close Programme") is set out below. The procurement programme requires that the TPB meeting approves the Conditional Contract Award Recommendation on 27 September with financial close in January 2008.

The reasoning behind the Close Programme below is that :

- The preferred bid numbers should be robust, otherwise we would not be in a position to recommend a preferred bidder – if this is the case we should be able to prepare the FBC confidently around these numbers

- Approval on 27 September of the preferred bidder and of FBC Version 1 by the TPB would facilitate approval of the same proposition by the full Council on 25 October. This would enable the project team to inform the preferred bidder in formal terms, which will streamline the subsequent process and limit the scope for uncertainty and risk of leaks. The team are confident they can sustain adequate competitive tension over the period to finalise the contractual terms.

- This acceleration avoids a disjointed two-stage process for all stakeholders and in particular the need to have key documents approved over the Christmas period

- Pressure of time will eliminate unnecessary work – the work to update the FBC is underway and an assessment is being made of the means to minimise changes from last year's DFBC, which was the product of extensive (and costly) work. The necessary changes are largely contained in the sections on procurement process, risk transfer and affordability. These revolve around the final contractual arrangements with the bidders. All other aspects are largely as stated a year ago. Issues like EARL and any changes to TEL operational assumptions can be captured in new sensitivity sections. TS's previous comments on the DFBC were largely benign and easily incorporated.

- Approval of the FBC Version 1 and the preferred bidder in September will support approval of the New Award Letter at end-October including the application for the new pre-Close funding required. This should help TS considerably in their assessment of the grant of that additional funding, even if CEC make a contribution.

- Publication to the bidders of these additional dimensions to the programme should help rebuild confidence and help our team turn the screw on their pricing deliberations.

The summary of the proposed top-down programme is set out below. This now anticipates substantially complete FBC (Version 1) to accompany Preferred Bidder recommendation and draft New Award Letter (which includes Tranche A pre-Close funding) going before TPB on Sept 26th and full Council on Oct 25th. Careful project management should allow TS IDM to approve same on Oct 10th, followed by full council approval on Oct 25th and Cabinet approval in week beginning Oct 29th.

It is implicit in the references to FBC v1 that full agreement has been reached on all key terms of the Infraco / Tramco contracts and on the funding agreement between CEC and TS.

The critical dates are set out in summary below :

End-July	Issue of a more detailed version of the outline programme linked to the existing procurement programme and agreement of all key tie / TEL / CEC and TS people to deliver [Done, currently under refinement]
End August	Draft of FBC v1 available for tie / TEL / CEC review, including best estimate of preferred bid based on end-August returns from bidders (draft revised sections will be circulated during August, Procurement Group meetings will be convened to address issues and to help manage progress and the TPB will be updated on 5 September).
Mid-Sept	Finalisation and informal approval by tie / TEL / CEC of "September Documents" : 1) FBC v1 2) preferred bidder recommendation 3) draft New Award Letter including Tranche A funding Possible additional TPB meeting to review final form of September Documents for submission to Council
Sept 19th	September Documents submitted to TPB
Sept 26th	TPB approval (and recommendation to TEL Board / CEC) of same [preferably alongside draft report to Council]. Submission of September Documents to CEC Officials and extracts submitted to Government (prior review preferable and to be planned)
Oct 1	Contracts for additional advance works and early mobilisation entered into, conditional inter alia on termination without adverse cost in event that CEC / Government do not approve FBC v1, Preferred bidder recommendation and / or Tranche A funding within New Award Letter.
Early Oct	Gateway 3 review, confirmation to TS on critical issues
Oct 10th	TS IDM reviews / approves September Document extracts, plus update on Gateway 3
Oct 18th	Report and supporting documents circulated in advance of full Council meeting on .....
Oct 25th	Full council meeting to approve FBC v1, Preferred bidder recommendation and draft New Award Letter. [Conceivable the decision incorporates a need for further assessment of risk, headroom or related matters.]
Oct 29th	Cabinet approval of September documents including New Award Letter / Tranche A funding. [May depend on strength of Council decision.]
Nov / Dec	Completion of all contractual and funding documentation, update to produce FBC v2, official level approval by all parties

Dec *19th	TPB approval, recommendation to TEL Board / CEC (*date may need revised)
Dec 20th	Report to full Council, which should reflect only marginal changes to form agreed in October ; full Council approval
Dec 21st	Government sign-off conditional on all other aspects of financial close (mechanics of sign-off to be addressed). [Will depend on terms, conditionality and previous decisions.]
To 11th Jan	Finalisation of documentation, final negotiation etc

The scope of Gateway 3 to be in line with standard OGC guidelines and to be agreed in advance with TS. Report to go to IDM Board Oct 10th, all subsequent approvals dependent on all "red, hold" issues being resolved.

The key dependencies are :

- Design progress
- Procurement programme and continued bidder support in the competition
- That the Project Team and CEC officials can work effectively together to ensure CEC approvals to all aspects are executed timeously, especially planning and legal
- Council acceptance of risk transfer within Infraco / Tramco contracts and funding arrangements
- That the Gateway Review can be organised in this timeframe
- TS process
- Network Rail immunisation
- That no show-stoppers emerge anywhere

Programme & Approval process – Points for discussion and action required

- The programme has been agreed in principle by the project team and by the main stakeholders, although there are a number of specific elements which require further refinement. This dialogue is underway.

- The project will not necessarily run into insurmountable difficulty if the schedule slips. However, there will be a direct cost implication and a threat to completion in the target period of Q1 2011.

- The TPB is invited to approve the programme.

GB
8.08.07