CONFIDENTIAL

DRAFT REPORT

to

tie BOARD

DPOFA PROCUREMENT

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Date of Original: 8 August 2003Date of Version: 20 June 2015Draft No: 1
Ref: AF/EDIDP/310299/1/2670831

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1. INTRODUCTION

This report has been prepared by DLA with input from **tie**, **tie's** Edinburgh Tram financial and technical advisors and from Partnerships UK.

2. EXECUTIVE SUMMARY

The DPOF procurement Group is asked to report to the tie Board on three matters which arose at the Board meeting held on July [•] 2003

- Operating Franchise Period

  Recommendation:

  tie invites bids on the basis of a 15 year term for the DPOF Agreement with an option for **tie** to extend the term for 5 years on the same or better terms.

- Lost Revenue for Lothian Buses (LB)

  Recommendation:

  No proposal or contractual arrangement is inserted into the DPOF Agreement designed to allow compensation for LB for revenue lost to the Edinburgh Tram Network.

- Memorandum of Understanding with LB

  In order to safeguard the DPOFA procurement process and to discharge **tie**'s duties under procurement law, a formal agreement on LB's support and participation in the procurement and delivery of Edinburgh Tram Network is critical.

  A proposed draft confidential MoU is attached at Appendix A to this report for the Board's consideration although the Board may consider further preparatory action necessary.

3. OPERATING FRANCHISE PERIOD

3.1 The length of the operating franchise which **tie** grants to an operator for the Edinburgh Tram Network is essentially a commercial and policy decision. There are however two procurement law issues which influence the contractual structure being developed:

- in order to minimise the risk of challenge to the procurement that an award of an operating contract was made prematurely (because of lack of technical definition and commercial certainty regarding the Edinburgh Tram Network), the DPOF Agreement needs to represent a continuum from development phase, through infrastructure procurement to service operation. Technically, therefore, the exclusive right to operate the tram network commences on award of the DPOFA, likely to be four to five years prior to planned actual service commencement in 2009.

- there is the possibility of new EU procurement regulations being introduced in 2004/5 which could limit transport services franchises to 15 years. Any contract awarded prior to their introduction would however be exempt. Under the expected procurement timetable for DPOFA, these EU regulations (in whatever form may be ultimately sanctioned by the European Commission) are unlikely to be promulgated before the appointment of the Edinburgh Tram Network Operator.

3.2 After discussion and consensus within the DPOF working group (and feedback from the May 2003 PIN interviews with a number of prospective operator candidates), it was decided that a medium term operating period might suit **tie**'s objectives best. Many tram operating franchises on the Continent are five to seven years; this has been further confirmed by the July PQ submissions which cite examples.

In order to give **tie** flexibility on its ultimate decision, the June 11 2003 OJEC Notice advertising the proposed competitive tender indicated that **tie** was considering an operating franchise period of up to 10 years for Line One, with lesser periods for Lines Two and Three. This would represent an overall DPOFA contractual engagement of approximately 15 years from early 2004 to 2019. (The OJEC Notice also reserved **tie**'s position by stating that the contract could be for a term of up to twenty years.)

3.3 **tie** Board has expressed the view that an operating term of five years was short, given current intention to provide for a contractual recalibration of Target Costs and Target

Revenues at three year intervals during operations. The factors which most influence the choice of term are presently:

- a balance between the continuity to build a long term business and flexibility for **tie**
- the ramp-up period of two to three years for each Line and reset/benchmarking during operating period
- CEC policy view (emphasis on achieving model shift and full integration)
- efficient interface with Infrastructure and Equipment Provider(s) and the implications of a change of network operator
- network expansion timetable
- senior debt supporting infrastructure delivery requiring stability.

All these points, speak to the possible benefit of **tie** letting an operating franchise which permits the development of a longer term business by the Operator.

3.4 Under the current programme, the DPOF Agreement with an initial term of 15 years with an option for **tie** to renew for 5 years (on the same or better terms) would represent:

- a 12 year operating period for Lines One and Two: 2009-2019
- an 6 year operating period for Line Three: 2013-2019

This length of franchise would give Lines One and Two 3 reset exercises each and Line Three two. The resets would relate to the network as a whole after service commencement of each new line.

3.5 The operating periods in paragraph 4 above appear longer than the European franchises being quoted by Transdev and Keolis, for example. To offset any operator perception of increased risk assumption, it is proposed that sustained satisfactory service delivery and achievement of revenue and cost targets would secure entitlement to long term incentive payment, potentially sizeable relative to the annual operating fee, depending on what level of incentive **tie** sets.

3.6 Given the termination rights proposed in the draft DPOF Agreement, **tie** faces very little downside in offering the possibility of a longer term operating mandate. A stable operating environment should foster opportunity for both bus-tram integration and robust operator - infrastructure provider relations, coupled with the facility to explore how the Tramco can evolve as a network operator.

4. LOST REVENUE ACCOUNTING

4.1 The issue put to the Procurement Working Group is whether the revenue collection and gain sharing arrangements agreed between **tie** and the tram operator ought to include an accounting for revenue earned by the tram network at the expense of Lothian Bus. For the reasons set out in this note, the Procurement Working Group regards this proposition as inconsistent with and potentially damaging to the objectives of DPOFA procurement and transport integration generally.

4.2 The Development Partnering and Operating Franchise Agreement is structured to encourage the following:

- a realistic acceptance of revenue risk by the Operator in exchange for an upside share against an agreed Target Revenue
- commercial arrangements with incumbent bus and public transport operators which aim at integration, stability and service coordination which are fully compliant with competition law
- use of a reset mechanism during the tram operating franchise period to address developments in the transport market and performance of the system against objective, measurable financial targets.
- incentive to achieve sustained superior performance to position the tram business as a prime competitor to the use of private cars for commuter and leisure journeys into and within Edinburgh.

4.3 Successful operation and marketing of the tram network (and its expansion) and incremental growth in ridership will result in transfer of ridership from bus to tram on specific corridors. Permanent switch of passenger allegiance will depend upon a number of factors including fares, reliability, quality and convenience. A strong tram business will impact bus transport revenues and CEC System Aspirational Objectives for the tram recognise that bus routes will require modification in order to support the tram corridors and to reshape public transport usage.

4.4 Declining bus patronage may occur for a variety of reasons unconnected to the introduction of tram lines: employment demographics, population age, poor bus service, bus-bus competition and other modal shifts away from bus. This may be more or less marked during the commencement of tram operations and meaningful, objective measurement of Lothian Bus income lost directly to trams over any period would be contentious, if not impossible. It is not axiomatic that the tram's overall impact on bus ridership will be negative since bus network changes may produce benefits for the bus operators by opening new catchment areas.

4.5 Patronage growth on the tram network is an important shared objective for the Operator and for **tie.** Introducing a mechanic to protect Lothian Buses against the tram undermines that alignment. It would also be likely to significantly curb the Operator's appetite for revenue risk, since the more bus passengers travelled by tram, the more compensation would flow to Lothian Bus, thus removing reasons for achieving higher tram ridership numbers. The tram system will itself be competing with other transport modes, (including EARL). It is not realistic to assume a tram operator would be prepared to accept anything other than nominal farebox risk if part of his revenue upside is committed to reimbursing a direct competitor.

4.6 In the event that Lothian Bus received compensation for income lost to the tram network, First and other potentially affected Edinburgh bus operators' position would require careful consideration, as Lothian Bus would effectively be receiving a subsidy by reason of CEC's intervention.

4.7 In order for CEC to achieve integration of public transport as envisaged under ITI and the System Aspirational objectives for the Edinburgh Tram, Lothian Buses must be incentivised to engage commercially with the tram operations. Rewarding Lothian Buses for lost income does not create either impetus or incentive to look for opportunity during bus network and service replanning.

4.8 Finally, providing in the contractual structure for tram operations that the tram will directly compensate a bus operator for lost revenue would require analysis to see how this could escape being an anti-competitive practice. This would almost certainly be a potentially counterproductive during discussions on regulatory clearance of bus-tram integration arrangements. Furthermore, it may well constitute a breach of CEC's statutory duty under Section 63 (7) the Transport Act 1985 not to inhibit competition in the Edinburgh public transport market.

5. MEMORANDUM OF UNDERSTANDING

The evidence indicates a significant risk that Lothian Bus plc management's reaction to the Edinburgh Tram Network procurement may represent a difficulty. It is extremely important that **tie** is able to demonstrate to the market clear ability to manage an efficient, predictable and open process. **tie**'s objective to achieve bus-tram integration requires commitment from LB to treat the introduction of the Edinburgh Tram Network as an opportunity, not as a repeat of CERT. Control of LB's operations strategy would require a change in current LB Board practice and therefore a direct arrangement between **tie** and LB is appropriate. The proposed Memorandum of Understanding has one key objective: to place **tie** in control of LB's approach towards its involvement in the tram operation. The draft document is short and this report does not rehearse all of its content.

The MoU has been prepared with input from Grant Thornton, Partnerships UK and, importantly, **tie.** It is, however, presented to the **tie** Board on the basis that none of **tie**'s advisors have seen or reviewed the LB shareholders/operating agreement nor is there precise knowledge of CEC or the other council shareholders position. As LB's principal shareholder, CEC has the right to test the appropriateness of LB's management decisions in relation to bus-tram integration, the more so given (a) CEC's statutory duty to oversee a Local Transport Strategy which does not inhibit competition in the market being introduced by new public transport service providers and (b) a stated key CEC System Aspirational Objectives for Edinburgh Tram Network is the modification of bus services and network to support the tram. It is a strategic question for **tie** whether the shareholders' views on the MoU should be canvassed.

Paragraph 6 of the MoU requires comment. Ultimately, the modality and extent of any LB participation in the operation of Edinburgh Tram is a matter for CEC. Any arrangements between the tram operator and LB regarding bus-tram integration will need analysis to ensure that no issues arise in relation to competition law. There is inherent conflict between the effective integration of public transportation and the statutory restraint of technically anti-competitive practices (such as agreements on fare setting or routing made between service providers). **tie's** focus at present is on an efficient procurement and primary responsibility for regulatory clearance on integration will be placed with the bidders during the DPOFA procurement but it is important that LB follows the same discipline.

tie is under a duty to ensure that the DPOFA procurement is fair, transparent and non-discriminatory. That duty coincides with **tie**'s interest in protecting the procurement from pre-emptive action. The MoU therefore aims at securing approval right over any LB initiatives which could distort or damage the DPOFA procurement but also extends to the operating phase. Allowing LB freedom to disrupt the procurement process would expose **tie** (and CEC) to the risk of challenge. This is because, through CEC as shareholder, the means exists to safeguard the fairness and efficiency of the procurement. It is foreseeable that LB will resist signing up to the MoU but for CEC to permit its subsidiary to destabilise the DPOFA procurement and conduct operations to negate efforts to introduce a new provider into the transport market would be inconsistent with CEC's statutory duty mentioned above.

This possible arrangement with LB should not of course obscure the need for **tie** to endeavour to secure suitable undertakings from the other major bus operators regarding their expected involvement in the procurement.

The draft MoU is attached as Appendix A to this report.

DLA

08 August 2003

APPENDIX A