Tram Project
Summary of funding position as of 6 May 2005

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The purpose of this paper is to explain the current funding position in the context of the decisions that now need to be taken to ensure progress is maintained.

Background

The chronology in brief has been as follows :

September 2002 – Preliminary Business Case ("PBC") submitted, incorporating three tram lines and a congestion charging scheme

April 2003 – Public announcement of Executive £375m grant award for project, "sufficient to ensure the construction of at least [Line1]".

June 2003 – tie informed that grant will not be index-linked, contrary to the PBC assumption

December 2003 – Bills submitted ; updated costings for Lines 1 and 2, show a £100m increase in capital cost measured in 2003 prices

September 2004 – Draft Outline Business Case ("OBC") submitted to SE in support of further development and implementation funding. This demonstrated that there was a clear risk to funding of the whole of the network and that further work was required to support a funding case for the network excluding the Newbridge shuttle. Additional £5.0m implementation funding approved by SE.

September-December 2004 – Parliamentary review of individual line Preliminary Financial Cases ; both Committees approved Bills in principle, but both caveated that further examination of funding adequacy would be sought at Consideration stage.

March 2005 – Interim OBC ("IOBC") submitted to CEC and SE, demonstrating that the September 2004 cost and revenue projections remained the best estimate, with only minor variation. Detailed funding models presented comprehensively for the first time with PwC's input.

April / May 2005 – dialogue with Council and SE on 1) their commitment to the necessary funding ; 2) the implications of a funding shortfall ; and 3) the implementation funding required to maintain momentum.

Funding position

The funding models in the IOBC assume the following principal components :

- Grant of £375m available from SE
- CEC take full risk on operating surplus contribution, including 70% of revenue risk under DPOFA and the need to generate additional commercial revenues and developer contributions

Tie also proposed risk-sharing mechanisms which would provide CEC with SE underpinning to their financial risks.

The modelling identified a substantial funding gap against construction of the Full Network including the Newbridge Shuttle. A conventional funding (non-PFI) model would result in a capital funding gap of £140m in inflated cash terms ; this also incorporated prudential borrowing by CEC of £44m, without which the gap would increase. If the Shuttle were deferred (the Airport Network model), a conventional funding model would result in a capital funding gap of £60m in inflated cash terms ; this also incorporates a level of borrowing by CEC, this time optimised at £63m.

A paper was presented to the April Tram Project Steering Group setting out the detailed options. The paper also made the case for an improvement on the level of SE grant support, on numerous grounds. The argument is set out in Appendix 1.

Officials at the Executive have informed tie that they will not support a business case in the foreseeable future which requires more than £375m. Accordingly, tie require to apply this limitation in defining the scope of a deliverable Phase 1 of the project.

In addition, officials at the Council have indicated to tie that they have a serious concern about the extent of financial risk implicit in the full network model and in the Airport Network model. It is unlikely that the Council will feel able to take on any debt to support the project funding and a reasonable cushion will be needed to take account of risk in the projected revenues, operating costs and impact on Lothian Buses. The financial measure is that the Council must be confident they will continue to receive from the integrated system at least the £2m pa contribution presently produced by Lothian Buses.

The implications are that Phase 1 of the tram project will require to be substantially curtailed compared to the Council's ambitions for a full Line 1 plus Line 2 Network.

Possible ways forward and recommendation

Each of Lines 1 and Line 2 have now been thoroughly assessed in economic and financial terms.

Line 1 would be fundable within the limitations set out above, but falls far short of CEC's desired strategy. Alternative transport strategies for the corridor to the Airport will need to be established in addition to the concept of a delayed construction to Line 2. The implications for key areas such as Edinburgh Park, Gogarburn (RBS) and the Airport will need careful consideration.

Line 2 is also fundable within the limitations but the introduction of the EARL project has created a new and material uncertainty in relation to the previous Line 2 assessment. This is being evaluated in the light of the detail which now supports the draft EARL Bill. There would be major economic development implications in adopting Line 2 in preference to Line 1 for the first phase, particularly for the Waterfront development area.

It is possible that an alternative network configuration may make better economic and financial sense than either of the two individual lines. The best alternative configuration may involve a portion of Line 3.

There are therefore options, but it is necessary that a decision is taken at an early stage on network scope in the light of the funding limitation. Approval on funding for the next stages of implementation is now overdue and the lack of this funding will cause programme delay and a loss of market credibility if not in place by end-June. It has been agreed that tie will produce an update to the March IOBC by May 31st to facilitate this approval.

It should also be noted that :

- Tie's procurement strategy has been designed to be scalable and additional phases will be accommodated in a cost-effective and risk-controlled manner.

- Early implementation work – design, service integration planning etc – can be applied to the segments of the route which would almost certainly feature in the optimised Phase 1. Accordingly, the risk of wasted expenditure in the short term (2005-06) can be eliminated.

Recommendation

1. tie will prepare the May IOBC on the basis that Phase 1 will be Line 1. Since this will demonstrate a sound financial and economic case, it is anticipated that this should support full release of the funding required to move the project forward.

2. tie will continue to work on a) the impact of EARL on Line 2 ; and b) alternative configurations including a potential segment of Line 3.

3. The implementation work will focus on Line 1 and initially on the segment from Haymarket to Ocean Terminal.

4. An updated summary of the funding position and the phasing proposal will be prepared for parliamentary scrutiny in the Autumn of this year.

This approach should enable both Bills to proceed on the argument that CEC needs the powers to construct the full network in order that it can make an informed selection of the second and subsequent phases. It is unlikely that a fully evaluated alternative configuration will be available by the time of Royal Assent.

The final scope and phasing will require to be agreed by Spring 2006 when the final form of the OBC will be submitted to the Executive in support of the system and vehicles tender process.

APPENDIX 1

<u>Rationale for improved Executive Grant</u>

1. In deferring the Newbridge Shuttle, there is acceptance that the economic and strategic benefits of the line to Newbridge will be deferred until additional funding sources are developed. This represents an important contribution by CEC to achieving a coherent and affordable first phase of the tram network.

2. The deferral of Newbridge is also a substantial truncation in comparison to the 2002 Preliminary Business Case ("the 2002 PBC") which was the basis on which approval in principle was given by the Executive to CEC and which formed the basis of the £375m grant award. In addition to deferring Newbridge, the proposed Line 3 to the network has now been shelved in the light of the termination of the Congestion Charging scheme.

3. There are a number of additional new dimensions to the design of the Edinburgh tram network compared to the case put forward in the 2002 PBC. These include :

- The capital costs of the network were extensively re-evaluated in 2003, reflecting the agreed routing following extensive public consultation in mid-2003 and more detailed cost analysis than was available to support the 2002 PBC. This produced a robust basis for the submission of the Bills in December 2003. Benchmarking against existing and planned schemes in England coupled with further review of capital costs by tie's own professionals, its advisers and by messrs Arup on behalf of the Parliamentary committees have re-confirmed the capital cost estimates as sound.

- The identified capital cost increase from the 2002 PBC was due to both inflation and to underlying design and cost factors. The overall cost increase was c£100m. In Spring 2003, the Treasury implemented new guidelines for capital cost estimation including the concept of Optimism Bias as a means of ensuring early stage cost estimates were sound. Had this been applied to the 2002 PBC estimates, the capital cost presented to the Executive would have been some £150m higher. The best estimates of capital costs in the IOBC are comfortably within this prudent estimate. It is not possible to be definitive about what effect the application of Optimism Bias in the 2002 PBC may have had on anticipated grant support. It does however seem reasonable to assume that it would been taken into account.

- In a similar vein, the 2002 PBC anticipated grant indexation to take account of inflation. Since inflation is a major component of the funding gap, the impact of indexation – at some £76m – does require further consideration, while respectfully acknowledging previous comment from the Executive.

- The critical importance of developing a fully integrated transport network is now much better understood. Successive reports have highlighted this as a key driver of light rail scheme benefits and financial stability. Edinburgh's approach has been well-documented, but it is important to recognise that the work involved in designing such a system is substantial and has only recently (mid 2004) commenced at a detailed level. The Council's ownership of Lothian Buses requires that the financial effect of the tram on Lothian Buses be carefully evaluated. This requires a 5-10 year view of bus service patterns, capital funding requirements and fare levels. These features were not well-developed when the 2002 PBC financial model was compiled, but are now receiving detailed attention. In addition, we can only work within present legislation, which requires that we achieve a very delicate balance between integration activity and compliance with competition legislation. The design of an integrated service pattern, with all the benefits it will bring, will undoubtedly result in a different (and possibly materially different) pattern of tram revenues and operating costs. The outcome will however be considerably more reliable as a basis for financial projections.

- The procurement structure now proposed (and already partly implemented) has most (if not all) of the features of current best practice, providing further assurance to the robustness of the plans. In particular, the early involvement of Transdev, the phased approach to design, the separation of revenue risk from capital cost tenders, the separation of utility work and the dual procurement approach to system construction and vehicle acquisition will all contribute to risk mitigation, competitive tendering and control of cost. This approach had been developed to only an outline level in late 2002.

- Tie has had the benefit of input from the prospective operator, Transdev, in addressing these complex matters since mid-2004.

- In 2003, the Executive committed to the construction of EARL, which has important implications for Line 2 and a network including Line 2.

- Finally, the Tram Bills have both received parliamentary stage 1 approval, but in both cases the adequacy of funding has been flagged as requiring further examination.

The progress since the 2002 PBC was prepared is considerable. However, major new dimensions have been identified and the financial structure supporting the tram project must accommodate these factors.

In addition to the system specific issues referred to above, it has become increasingly clear that English schemes have suffered from a lack of financial cohesion between the funding department (now DfT) and the scheme promoters. One consequence has been the enforced central government underwriting of some schemes which have hit financial difficulty soon after operational commencement.

The informal partnership approach to developing the Edinburgh system adopted by the Council (with support from tie) and the Executive appears to have worked well in getting the scheme to its current stage of development. It is therefore worthwhile addressing how this partnering approach can be taken forward to ensure financial stability. The financial risk-sharing proposals described in the IOBC are examples of how this can be developed to all parties' advantage. Tie appreciates that this introduces a new model for the financial support to the scheme but believes it is worthy of consideration.