From: Ramsay J (John)
Sent: 24 January 2006 12:29
To: Rosie A (Sandy); King B (Ben); Caskie A (Andrew)
Cc: Reid DNG (David) (Finance); Sharp DP (Damian); Davis L (Lorna)
Subject: RE: MODELLING THE IMPACT OF

Sandy

Thanks for coming back to me on Julian's latest note. I was actually considering an early approach to everyone on this.

Current position: project scope & phasing.

As you know agreement on scope and phasing (and CEC contribution) is the subject of a CEC Tram report which is going to full Council, this Thursday. The scope outlined is for Leith to Edinburgh Airport.

Further phasing has been identified by CEC in terms of Haymarket to Granton (phase 2) and Granton to Leith (phase 3) with future interest being retained in the Airport to Newbridge phase. This represents the full scope of the 2 Bills which are nearing completion of the Consideration stages. All further phases will be wholly dependant on availability of CEC funding. Although CEC / tie think otherwise, it is very doubtful that there will be sufficient headroom after Phase 1 to consider Phase 2.

This note is a continuation of KPMG's thinking prior to and after the meeting we had with them on 8 December last. I invited KPMG to model the possible funding structure scenarios for uptake as soon as we have political clearance later this week.

John Ramsay

Project Manager - Edinburgh Trams

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-----Original Message-----
From: Rosie A (Sandy)
Sent: 24 January 2006 11:31
To: King B (Ben); Caskie A (Andrew)

Cc: Reid DNG (David) (Finance); Ramsay J (John)
Subject: RE: MODELLING THE IMPACT OF

Ben / John

I think we do need another discussion with Julian. The questions seem valid to me, but it is pointless to pursue and model hypothetical issues until we see a clear project proposal which clarifies not only scope but the desired / realistic method of funding.

I too find references to prudential borrowing confusing when to date no-one, so far as I am aware, has proposed prudential borrowing for this project. (Nor is prudential borrowing appropriate if the intention is to pay annual revenue charges to repay private sector project finance).

What would concern me is if someone has instructed modelling based on life-cycle payments for private finance of an on-balance sheet project. Without adequate risk transfer that becomes a finance lease and is unlikely to show good vfm. We have been through that issue already with housing colleagues!

So I think that there are probably only two scenarios - on-balance sheet project funded by CEC / SE cash provision (based on whatever 'deal' can be done by SE/Treasury to accumulate funds); or off-balance sheet project funded by private sector with higher public sector repayments justified by risk transfer (which can also accommodate some capital injections by public sector if desired to keep the private sector lending down).

Sandy

-----Original Message-----
From: King B (Ben)
Sent: 23 January 2006 17:46
To: Caskie A (Andrew); Rosie A (Sandy)
Subject: FW: MODELLING THE IMPACT OF

See below - a lot of it washes over me. I thought we had established our money is straight cash out grant and the Council has the asset and any related liability. the level of the liability could impact on overall "grant" from England, but then any borrowing (non prudential) can.

I didn't think we were doing an on balance sheet PP, rather we want private sector capital at risk

All this is academic if we don't know the scope. The key role of the Department should be halting things until the scope and procurement route and cost are clear.

Again, lets discuss

Cheers

-----Original Message-----
From: Ware, Julian [mailto:Julian.Ware@KPMG.co.uk]
Sent: 23 January 2006 16:36
To: Ramsay J (John)
Cc: King B (Ben); Atter, Lewis; Johnson, Bruce; Malcolm, Craig
Subject: MODELLING THE IMPACT OF

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John,

I am afraid that this is a complex note, which asks questions rather than providing answers. I suspect that it is one you will want to pass to your finance division – and that we may need a discussion. Depending on developments in the next few weeks on the wider issues, these quite esoteric points may have a serious effect on the Executive.

We are currently trying to build a model for you which will show the impact on the Executive's public expenditure budget of the tram scheme. Bruce has made good progress and we will soon have a model that covers milestone payments, turnkey payments and an on balance sheet PPP. Simple changes to the model will cover changes in the total cost of the project, changes in the balance of funding between the Executive and the City and changes in the balance of the three different types of payments in the payment mechanism.

One of the advantages of building models is that they require clear formulae, and consequently highlight areas where the rules or mechanisms are in doubt.

We have been starting to consider differences of capital and resource expenditure in our model – because we think that you have separate capital and resource budgets and would find this useful. And this has raised some questions. As far as we know, no Scottish local authority has tried before to use an on balance sheet PPP on this scale – nor to combine on balance sheet PPP with prudential borrowing.

If we start with the assumption that the PPP is treated as supported borrowing, not prudential borrowing, then we are clear from the December meeting that an increase in Scottish local authority borrowing produces a reduction in grant to the Executive. We are also clear how an on balance sheet PPP supported by an English Department, say DfT, would be handled. But we are not clear how the two sets of rules fit together. The English mechanism would split the PPP into a capital and a non capital element; with the capital element paid once up front, and the remainder

treated as resource. Our reading of the July 2004 policy document is that Scottish supported borrowing is aggregated and deducted from the block grant – but it does not say whether the deduction is capital or resource. And it is also unclear whether net reductions in debt outstanding would lead to increases in grant to Scotland.

If we look at prudential borrowing instead, then the first question is whether this is compatible with an on balance sheet PPP. The logic of UK policy suggests that it should be, but we do not think there has been an example yet. There will be issues marrying the normal PPP repayment profile with the minimum repayment provision for prudential borrowing, but these should be manageable – especially where the life is as short as 7 or 8 years. Grant payments in support of prudential borrowing interest and repayments will be treated as resource; the treatment of the borrowing itself will be a UK matter and not of direct interest. If the prudential borrowing route is used, then it may well be sensible to "reserve" prudential borrowing capacity with Treasury in advance. We know that TfL have already done this; it protects against the danger that there is a squeeze on this UK budget in 2010/2011. The Executive would have to make a value for money case.

To sum up:

- We think the capital/resource split matters to the Executive, but have no detailed information
- We know that the supported/prudential difference matters; we do not know how supported would convert into capital and resource

- We think that it might be possible to treat an on balance sheet PPP as prudential. This would smooth the impact on the Executive, but would make switch expenditure from capital to resource. Again it would be worth clarifying the precise mechanisms

- We would recommend early discussions with your internal finance experts. We have built this note up from public sources, and may have missed something important.

Julian Ware

KPMG Corporate Finance

00 44 [redacted] or 00 44 [redacted]

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