

TRAM PROJECT

PROPOSED GOVERNANCE STRUCTURE – FEBRUARY 2006

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Current Delegated Authority Rules – see attachment

Background

The background is well known to recipients of this paper. Compared to the November 2005 proposal, this paper proposes a structure which fully incorporates TEL and streamlines meetings and the contractual structure.

There are three principal dimensions to be considered :

1. Design of an effective governance and decision-making structure, which reflects clear project roles and responsibilities
2. Legal compliance and effectiveness – competition law, procurement regulation and contractual structure
3. Tax efficiency

1 is the primary feature, providing our stakeholders and the construction market with confidence of delivery, but the other two dimensions must be handled carefully to avoid risk.

This paper summarises a proposed structure for discussion at the 20th February 2006 TEL Board. There is a critical need to codify the relationships quickly.

Proposal

The proposed structure has the following key features :

1. TEL is instructed by CEC to take responsibility for delivering a fully-integrated system, including arrangements with tie as the party responsible for delivery of the tram system. TEL's responsibilities include acting for CEC in wider transport planning matters to optimise the value of the integrated system. These arrangements are set out in a high-level "operating protocol" between CEC and TEL.
2. tie's formal contract (Operating Agreement) with CEC is amended to direct tie to provide its tram project services to TEL on behalf of CEC. The documentation of these services is embedded in the project programmes ; no additional tie / TEL operating agreement or protocol is needed. Tie is CEC's "in-house provider" of these services and continues to execute design, procurement, funding and delivery of the tram system (collectively "tram delivery"). The tie Board's responsibility is to ensure that tie delivers this service to TEL. tie will be the contractual counter-party for all contracts through to commencement of operations, at which time the Tramco and Infraco contracts will be novated to TEL.
3. The operations of the Tram Project Board are merged with the TEL Board. TEL Board meetings generally comprise the following principal strands :
 1. Development of the TEL Business Plan
 2. Tram Project Delivery
 3. Related Tram Project matters - external communications, safety, third party operators
 4. TEL transport strategy and related project activities
 5. TEL statutory matters

In addition to TEL Board members, to preserve the cohesion developed in the TPB structure, the following parties are invited to attend TEL Board meetings regularly for items 1 - 3 :

- Tram Project Director - Ian Kendall
- Other tie operational management and advisers as appropriate (McGarrity, Cross, Waugh, Bissett ; DLA, PwC)
- Other CEC representatives as appropriate
- Transdev representatives
- Scottish Executive - Bill Reeve or Damian Sharp
- PUK - James Papps

The full continuing commitment of all parties to the TEL decision-making process is needed, as was the case with the TPB. However, the formal decision-making involves only the directors of TEL ; other parties are technically in attendance only.

In defining the arrangements between CEC, TEL and tie the Delegated Authority Rules (DARs) need attention but should remain in very similar form to those currently in operation. The structural implications are :

- Delegated authority from CEC to TEL needs to be defined in the new CEC / TEL operating protocol
- The TEL Board inherits the tram authorities previously retained by the tie Board but also retains the authority which was previously delegated to the TPB.
- The TEL Board provides the Tram Project Director with similar authority to that presently vested in him.

The logic of this is that TEL has effectively stepped into tie's shoes for the tram project. When the TEL Board and the TPB are merged, there is no subsidiary level of authority between TEL and the Tram Project Director. These rules should continue to include all forms of change control, including those requiring input from CEC.

Composition of the Boards should be addressed against this background.

4. There is a need to coordinate the preparation of the TEL Business Plan with the production of the business case needed to support contractual commitment to tram construction and vehicles in mid-2007. The delivery of the TEL Business Plan (including JRC activity) remains the responsibility of the collaborative group under the leadership of Stewart McGarrity. Close liaison is required between these activities and those of tram delivery. To ensure this happens, it is proposed that both sets of documentation are prepared under the remit of the Tram Project Director. The TEL Board retains overall decision-making authority, on behalf of CEC, on all project issues except those specifically delegated to the Tram Project Director. The TEL Board will also have sight of the business case as it develops and will have final approval over the entire document. An informal steering group of NR / IK / GB (+ others as appropriate) provides guidance as the issues are developed.
5. Transdev continue to provide services to tie, under the DPOFA. This will include significant input to both tram delivery and to the TEL business planning process. Amendments to the DPOFA will require to be executed through tie. At (or just before) commencement of operations, the DPOFA would novate to TEL.

6. TEL does not initially employ a management team, except for its CEO. All management and other resource is provided by LB and tie (supported by Transdev). This will ensure best use of existing expertise, and will avoid duplication of people, process and cost. As TEL develops, additional people for specific roles will be required. The speed and nature of this development will be a matter for the TEL Board.
7. There needs to be clear definition of roles for all parties. To achieve this there is a need to define and debate certain key documents which together form the suite of Project Management documents :
 1. Project Baseline Design Definition Statement (as requested at 23.1.06 TEL Board)
 2. TEL Business Plan programme and budget
 3. Tram design, procurement, funding and delivery programme and budget

The design baseline will enable all parties to have a clear view of what is currently envisaged by CEC as Promoter, including work done and decisions taken to date.

The roles and persons responsible for each workstream within 2 and 3 should be explicit. The relationship of these three documents to each other must also be spelled out in detail.

Some lead (not necessarily exclusive) responsibilities are clear-cut :

- tie – executing tender procedures, tram system design, utility works
- TEL – directing the development of an integration plan, strategic marketing, related transport development such as new P&Rs.

Other responsibilities are not presently clear-cut, including :

- safety management strategy, which requires explicit systems, plans and audits ; there must also be personal identification of responsible senior management and directors.
- interchange design, especially Haymarket
- handling external communications (including FOISA)
- developing third party operator relationships
- operational dialogue with CEC officials.

The optimum answer is not likely to be simply “TEL” or “tie”, more likely a collaborative group ; but this needs to be positively considered up front, with clear reporting lines.

These roles and responsibilities may well change over time, especially as TEL develops its role. We do however have an immediate need for a clear structure to execute matters over the critical next few months.

8. The composition and structure of the tie Board and its governance processes will continue broadly as it is now. In relation to the tram project, the tie Board has a responsibility to ensure that tie Limited, through the Tram Project Director, delivers the services required by TEL and CEC as tie's clients.
9. LB continues as bus operator. Bearing in mind transport and competition legislation, consideration needs to be given to the means by which objectives are aligned so that it is in LB's commercial interest to support an integrated system. There may be merit from TEL's perspective in having a written instruction from CEC to LB along these lines, as further protection.

Legal compliance and effectiveness – competition law, procurement regulation and contractual structure

A) Competition Law

Under the structure above, there is no change to shareholdings. An alternative structure could incorporate :

- TEL acquiring from CEC its shares in tie Limited, so that tie becomes a 100% subsidiary of TEL rather than CEC
- TEL acquiring from CEC its shares in Lothian Buses plc, so that LB becomes a 91% subsidiary of TEL.

This would create a single economic entity which would support compliance with competition legislation. However, changes to shareholding are not necessary for compliance and DLA have confirmed that the structure proposed in this paper is fully defensible in competition law terms.

A change to tie's shareholding may not sit well with tie's other clients and will invite an additional level of Council process. There is also a question as to where tie's shareholding should sit when the project is complete. TEL's Board may have a concern about inheriting corporate responsibility for tram project delivery (as opposed to acting as client to tie) ; and would also inherit similar responsibility for all of tie's projects. Since the primary tie / TEL relationship relates to tram there seems little advantage in bringing all other projects within TEL Board responsibility.

Transferring the shareholding of LB at this time would also run into the tax problem identified in November and would raise immediate questions about the treatment of minority shareholdings in LB.

B) Procurement regulation

At present, tie enjoys the privilege of “in-house provider” status which permits CEC to use tie’s services without competitive tender. The proposed structure will require to sustain this status.

A key to this is to avoid hardening the arteries in the structure by imposing arms-length type agreements between members of the CEC family. Advice from DLA is that such agreements can create a false impression that the entities are operating independently of each other, which could require TEL to operate a full competitive procurement process for tram delivery services. Since we are effectively re-organising within the group, and tie’s role is largely unchanged as CEC’s in-house delivery provider, this is inappropriate. DLA have confirmed that a structure similar to that set out above will minimise risk of successful challenge.

A further important feature is funding. At present, the Executive fund CEC which funds tie on the basis of proper financial reporting. It is recommended that the tram project funding continues to follow this path and is not redirected through TEL. This avoids any apparent dilution to tie’s procurement status. It will also avoid unnecessary accounting and cash flow activity within TEL. The TEL Board’s control will be through its delegations and regular reporting by the Tram Project Director. The DARS will need to address funding and payment explicitly.

C) Contractual structure

Retaining tie’s relationship with all key contractual parties – MUDFA, Tramco, Infracore, DPOFA – will significantly simplify the tender process and future legal relationships compared to a scenario where TEL inherits all such relationships at financial close.

Taxation

The tax effect of the proposed structure is under review by PwC.

Board responsibilities

The Boards of tie, LB and TEL have fiduciary duties to their shareholders and to creditors. The fiduciary duties extend to proper stewardship of each company. In view of the integrated nature of the activities of the three companies, it seems that the actions described above can fit with the concept of proper stewardship, because each entity has clearly defined responsibilities, which will be approved by its shareholder.

The most fundamental responsibility is financial stability. At present, tie is properly funded and has specific budget allocation to handle anticipated TEL spend in the current 2005–6 year. Costs already picked up by LB can be reallocated. If the activities of TEL are focussed on service integration as outlined above, subsequent funding awards for 2006–07 from SE (and partly from CEC) will cover the costs. Once we are agreed on the governance structure, it will be possible to set up accounting mechanisms to match spend / funding with the legally responsible entities.

Recommendation and issues to be addressed

The TEL Board, tie Board and project stakeholders are invited to support the proposed structure.

The clock is now ticking on the system design and contract procurement process. It is vital that we are able to present a coherent governance picture to the market. The following matters require follow up with the objective of having a complete suite of governance documentation available for approval at the TEL Board on 20 March 2006. A tie Board meeting may need to be convened in March for the same purpose.

To achieve this, in-principle agreement to the proposal is required at the 20 February TEL Board and 27 February tie Board. If this proposal is not accepted, alternative suggestions need to be developed urgently.

Preliminary matters outstanding :

1. Conclusion to tax advice

Issues to be addressed by 20 March 2006 :

1. Project Baseline Design Definition Statement (as requested at 23.1.06 TEL Board)
2. Terms of Operating protocol between CEC and TEL
3. Amendments to CEC / tie Operating Agreement
4. Amended Delegated Authority Rules between CEC, tie and TEL
5. TEL Operating Business Plan for 2006–7 – people, resources, costs, sources of funding. This will need to respect the financial year end of 31.3.07, but would be most usefully taken forward to Financial Close. This plan needs to be dovetailed with that of tie for the same period and be directly related to the funding request to SE / CEC which will follow.
6. Project Programme – key dates and decision points for tram delivery and TEL Business Plan, including interface between these processes
7. Amendments to tie and TEL Memo / Arts
8. Composition of tie and TEL Boards
9. Legal / financial advisory relationships
10. Office accommodation