KPMG notes from meeting with Transport Scotland ("TS") – Monday, 06 March 2006

Attendees: Damian Sharp (TS), John Ramsay (TS), Lorna Davis (TS), Julian Ware (KPMG), Uilleam Cameron (KPMG), Bruce Johnson (KPMG)

Damian Sharp introduced the meeting by outlining the key themes for the meeting the next day (07 March 2006) between Transport Scotland, City of Edinburgh Council ("CEC") and Transport Initiatives Edinburgh ("**tie**"). TS feel there is a need for all parties to keep a focus on the key objective and avoid becoming too involved in the detail. Lengthy discussions between separate public sector side advisers were wasteful.

Julian Ware reported on the main project developments since KPMG's last discussion with TS (14 February 2006). This covered KPMG's meeting with **tie** (22 February 2006) and the three overlapping issues currently facing the procurement process: Affordability, Value for Money and Headroom.

In KPMG's meeting with **tie** (22 February 2006), **tie** explained that their proposed financing structure for the Infraco involves 100% milestones, with performance bonds during and post construction of approximately 10% and 5% respectively. This amounts to 10% of the Infraco costs being made recoverable up to service commencement and 5% post service commencement. In terms of the risk profile this structure is referred to as 90:5:5.

Affordability

There was a short discussion of the affordability envelope. Transport Scotland saw this as a relatively simple issue; annual expenditure up to £150m in any one year would probably be manageable. The central issue was value for money.

Value for Money

There was a discussion of **tie**'s proposal of a 90:5:5 contract structure. Transport Scotland had concerns that this went too far towards milestone payments, and had insufficient retentions. A 10% performance bond was relatively low, compared to the scale of problems that could emerge during construction.

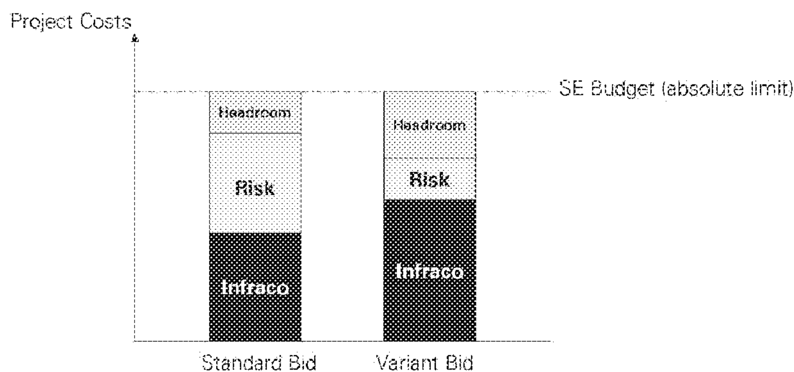
KPMG highlighted the "agent – principal" dilemma for Transport Scotland. Under enhanced conventional procurement, **tie** had an incentive not to give full information on costs and contingencies. Typically, overruns only emerged in the last stages of construction.

One option would be to ask for two bids: a Standard Bid (which was likely to be structured 90:5:5, as currently proposed by **tie**), and a Variant Bid which would transfer more than 10% risk. The market consultation had shown some appetite from contractors for longer maintenance periods and for DBFM structures. The Variant Bid would show the level of pricing differential.

Before agreeing this approach, TS wanted some joint advisory work to establish the best version of the variant, which would attract sensible pricing. There also needed to be an initial check of its marketability. Subject to these points, the variant could involve a higher percentage of retention and/or a longer term. The variant also needed to be kept simple.

Headroom

Transport Scotland outlined their current approach to consolidating the issues of risk transfer and headroom. This can be illustrated by the following graph (the Standard Bid is indicative of the 90:5:5 structure being proposed by **tie)**:



The graph shows that the Variant Bid might have a higher initial price, but might require a lower level of money to be retained against risk contingencies. This could mean that there would be more headroom against a fixed budget.

The amount of headroom required will depend not only on the structure chosen, but also on the progress of the project. More headroom would be required until there were committed contract prices for all three contracts (including the rolling stock).

This is particularly relevant to MUDFA. **tie** hope to let the MUDFA contract 12 months before contract close on the Infraco contract. The first six months will be design only; but substantial works will be done in the second six months. At the point of agreeing those works, the price of the Infraco contract will not be settled. There will be some information from the first round of bidding, but this will only be indicative. Bidders will be pricing to get into the next stage. Prices tend to rise between the first and final rounds. So there will have to be more headroom at the point of committing to MUDFA works to allow for this; the possibility, of course, remains that if the final bids exceed the total budget then the project will have to be cancelled after utility works have begun.

Gain/Pain

There will be no "Pain" mechanism. All costs over and above the SE's budget (including headroom) will have to be funded by CEC. TS accept that CEC have access to limited additional funding, and that the maximum budget for the scheme is likely to be in the £535 million range (£490 million from TS and £45 million from CEC). A "Gain" mechanism could be incorporated into the project costs so that any

gain would be shared on the same basis as contributions made to project budget – i.e., in the region of 90:10 (SE:CEC).

<u>Interface Issues</u>

Transport Scotland and KPMG agreed that management of the interface between Transport Scotland and **tie** was crucial. There was a need to safeguard the procurement process and bring out any problems, particularly in terms of delays and cost issues, as early as possible. However, Transport Scotland does not wish to be too invasive. An example was bid evaluation; TS wanted to be informed of what the bids were, but wanted to play no part in the bidder selection.

One method of ensuring an adequate level of transparency would be to have PUK take on a greater balancing role between Transport Scotland, **tie**, and the other advisors.

<u>Next Steps</u>

- Transport Scotland would be giving the same messages to **tie** and CEC the next day;
- Subject to this, they wanted KPMG, PwC and PUK to work up a Variant Bid structure;
- **tie** must provide a cost profile for the project scope from Leith to the Airport;
- **tie** must be made aware that there is a limit on the cost, without disclosing the limit to the market;
- KPMG should carry out further research on the contingency in the headroom calculations (10% is currently assumed);
- KPMG should to carry out further research to determine the marketability of a longer maintenance provision;
- KPMG should consult with Cyril Sweet, TS's programme managers. Cyril Sweet shared many of KPMG's concerns on optimism bias.

KPMG
14 May 2015