INFRASTRUCTURE AND GOVERNMENT

Edinburgh Trams Tender Issues

06 March 2006

CORPORATE FINANCE

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Three Issues

Value for Money

Is this the "best" contract in the long term?

Affordability

Will this fit within the budget/plans?

Headroom

What is the chance of a failed tender?

Strategic Choices for the SE

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March and April are key months for the project:
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Bill coming close to Assent;
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tie are finalising the tender documents;
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They need your consent.

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tie are working on an input based tender with detailed specifications in all three contracts.

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These will then be controlled and coordinated by tie.

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tie's latest proposal is for 100% of the payments to be made through "finely graded milestones". There would be a performance bond equivalent to a 5% turnkey payment and a 5% payment after the first 6/7 years – i.e., 90:5:5.

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There are two arguments for holding on to some medium term arrangements:
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They are likely to offer value for money; and
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They appear likely to help the SE with some of the affordability issues. It is

very hard for tie to argue against the affordability issues.

Strategic Choices for the SE

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KPMG have a view that conventional procurement for light rail can lead to overspends and delays – which will be brought to your attention only late in the construction process, and at a time when you have no realistic option other than to pay more money.

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tie feel that they have learnt the lessons of past procurements and can do better. This line has been used before; unfortunately there has been no shift in the results measured.

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The question here is how hard you want to push tie.

Strategic Choices for the SE

Clear Finance Arrangements with Gain and Pain Agreement

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These present a different set of questions; many of which are internal to the Executive.

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The concept is simple: before the tender starts, there should be a clear understanding between the 3 parties, including CEC, as to who is paying what and when, and what happens if the price moves from the current expected point. These arrangements will prevent a tender being launched which cannot succeed, and should also help incentivise tie and CEC to hold the costs down wherever possible.

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There is further work going on here; and any package will have to be negotiated with tie and CEC. But it is worth thinking what the end point might be:

– Agreement from CEC as to when and how £45m is being put in;
– Agreement from the SE as to the indexation arrangements;
– Agreement from the SE that there will be extra funding for financing costs, except for CEC's share;
– Agreement as to what happens if there is an underspend. KPMG have assumed that more railway is built; but this may not be practical for a small underspend;
– Agreement from CEC to absorb the first £[X]m of any overspend – e.g., £20m;
– Agreement from CEC and the SE to put in additional funding to cover any further overspend up to an agreed limit when the project would be cancelled. A 30:70 split might be the outturn.

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On present numbers, costs of £550 million are quite possible.

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A contingency must be factored into the total project cost – e.g., at least 5%, perhaps 10% for additional costs towards the end of the tender period.

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The concern here is how such a deal would look inside the Executive, and how it would sit against the public debate over the last month or so.

Possible Gain and Pain Mechanism
Gain
Likely answer – more railway
A, B, C: Tranches of cost saving on available budget
x, y, z: Percentages of tranches gained by the SE

GainSE= (A x [xSE]%) + (B x [ySE]%) + (C x [zSE]%)

Example:
SE Budget Contribution = £475m; CEC Budget Contribution = £45m; Total Project Cost = £500m
A = £15m; B = £5m; C = [remainder]
x = 75%; y = 50%; z = 0%

GainSE
= (£15m x 75%) + (£5m x 50%) + (£0m x 0%)
= £11.25m + £2.5m + £0m
= £13.75m

Therefore, SE's revised Budget Contribution is (£475m – £13.75m) or £461.25m

GainCEC = (A x [xCEC]%) + (B x [yCEC]%) + (C x [zCEC]%)

Using the same example, CEC's revised Budget Contribution is (£45m – £6.25m) or £38.75m

Possible Gain and Pain Mechanism
Pain
A, B, C: Tranches of cost overrun on available budget
x, y, z: Percentages of tranches incurred by the SE

PainSE= (A x [xSE]%) + (B x [ySE]%) + (C x [zSE]%)

Example:
SE Budget Contribution = £475m; CEC Budget Contribution = £45m; Total Project Cost = £570m
A = £20m; B = £20m; C = [remainder]
x = 25%; y = 50%; z = 75%

PainSE
= (£20m x 25%) + (£20m x 50%) + (£10m x 75%)
= £5m + £10m + £7.5m
= £22.5m

Therefore, SE's revised Budget Contribution is (£475m + £22.5m) or £497.5m

PainCEC = (A x [xCEC]%) + (B x [yCEC]%) + (C x [zCEC]%)

Using the same example, CEC's revised Budget Contribution is (£45m + £27.5m) or £72.5m

N.B. Much easier on a model/graph

Model Outputs
Capital and Resource Budget Impact
The following graphs illustrate the SE's Capital and Resource Budget cash outflows for the
following scenario:

- Total Project Cost – £484m + 5% contingency;
- SDS, MUDFA, Land Costs, and Other Costs funded through milestones;
- Infraco and Tramco funded through 50% milestones, 25% turnkey (financed by 6 year prudential borrowing by CEC) and 25% on-Balance Sheet PPP (6 years).

SE Capital Budget Impact

£000s

250,000
200,000
150,000
100,000
50,000
0

Jan-04
Jan-06
Jan-08
Jan-10
Jan-12
Jan-14
Jan-16
Jan-18
Jan-20
Jan-22
Jan-24
Jan-26
Jan-28
Jan-30
Jan-32
Jan-34
Jan-36
Jan-38
Jan-40
Jan-42

Model Outputs
Capital and Resource Budget Impact
SE Resource Budget Impact

£000s

250,000
200,000
150,000
100,000
50,000
0

Jan-04
Jan-06
Jan-08
Jan-10
Jan-12
Jan-14
Jan-16
Jan-18
Jan-20
Jan-22
Jan-24
Jan-26
Jan-28
Jan-30
Jan-32
Jan-34
Jan-36
Jan-38
Jan-40
Jan-42

The Resource Budget profile is based on the table below:

31 Mar-19 31 Mar-18 31 Mar-17 31 Mar-16 31 Mar-15 31 Mar-14 31 Mar-13 31 Mar-12
Period Ending
Total
Pru. Interest Repaid
Lease Interest Repaid
PPP Interest Repaid
-5,296 -5,867 -5,165 -4,371 -3,478 -2,475 -211 0
0 0 0 0 0 0 0 0
-5,086 -4,323 -3,674 -3,123 -2,655 -2,256 -1,918 0
-10,382 -10,190 -8,839 -7,494 -6,132 -4,732 -2,129 0

Model Outputs
Capital and Resource Budget Impact
The following graph illustrate the SE’s Capital Budget cash outflows for the previous scenario
but with all project costs funded through milestones.

N.B. There would be no impact on the SE’s Resource Budget.
SE Capital Budget Impact
£000s

250,000
200,000
150,000
100,000
50,000
0

Jan-04
Jan-06
Jan-08
Jan-10
Jan-12
Jan-14
Jan-16
Jan-18
Jan-20
Jan-22
Jan-24
Jan-26
Jan-28
Jan-30
Jan-32
Jan-34
Jan-36
Jan-38
Jan-40
Jan-42