Meeting note - Clarification of DFBC issues

Held at **tie** offices, Citypoint, Haymarket, on 27 November 2006 at 14:00

Present	John Ramsay, Julian Ware, Ian Barlex, Nick Ruane, Stewart McGarrity, Alistair Sim, Miriam Thorne, Geoff Gilbert	TS, **tie**, KPMG
In attendance		
Apologies		
Distribution	All Participants	

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1 Matters arising from previous meeting

1.1 Aim

SM stated that he considered the aim of the meeting to be that all parties would leave with no outstanding questions that would prevent DFBC endorsement.

1.2 Themes

JW outlined what he considered to be the main themes of the meeting. These were familiar issues, which interlinked - risk / contingency, procurement, timescale and options. His views were provisional, and the KPMG report to Transport Scotland had not been finalised.

1.3 Optimism Bias / Risk

JW and NR asked for clarification of how the 12% optimism bias figures in the DFBC had been calculated. S McG stated that the figures (P90 level) were risk expressed on the pre-adjusted (for risk) cost figures – 57/455 for 1a (12.5%) and 7/75 for 1b (9%). The overall figure was 12%.

1.4 Previous experience of OB in England

JW repeated his current view, on the information available, that 12% was too low a figure. 20% was likely to be a more accurate figure for risk and optimism for a scheme of this type and magnitude. Of the 20%, 10% broadly covered the period until the Infraco contract was signed, and the other 10% the construction and commissioning period. There is no conclusive figure in the guidance or in the academic studies, the eventual number will be a matter of professional judgement. 20% was closer to out-turn risk levels experienced on previous schemes.

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GG and S McG stated that there was already some price "certainty" (op co, SDS and Mudfa), and that the trams tenders had already been received. However, JW suggested that initial tender prices may not necessarily be a useful predictor for the final price, particularly with only two infraco bidders. JW reiterated that he considered 20% a more reasonable figure for risk, and S McG confirmed understanding of this position.

1.5 Infraco bidding situation

JW expressed concern about the current bidding situation for Infraco (2 bidders), as well as requesting clarification on the Infraco payment mechanism. It was agreed to discuss this later in the meeting.

1.6 Decision on 1a / 1b

JW stated that, under current cost and funding estimates and with a 20% margin for risk/optimism, 1a seemed affordable against the expected affordability limit whilst 1b did not. S McG agreed with this assessment. JW stated that for 1b to go ahead with a level of comfort, it was likely that the full funding and risk/optimism allocation for the route would have to come from another source. JW also stated that, in his view, 1b should have a risk figure similar to 1a applied – so around 20% - (it is currently 9%).

1.7 Infraco procurement – risk to tie with only 2 bidders

JW expanded on his concerns for the Infraco procurement – with only 2 bidders, the prices received in spring 2007 would not be a useful predictor of final costs – it was likely that, at this point, bidders would tell **tie** "what they wanted to hear" to remain in the competition and secure a better negotiating position. The real price will only likely become known in July. The price submitted pre-decision will not necessarily be accurate. JW also outlined the risk of one bidder dropping out, and **tie** being left with only one remaining bidder. An alternative approach would be to start the procurement process again, but this would have cost and consequential timetable implications which were unlikely to be acceptable at this stage. There was also a risk that a bidder could threaten to pull out of the competition; **tie** might therefore have to offer inducements to the bidder to retain a competitive process, but this would mean **tie** lost commercial negotiating power and, ultimately, value for money.

In summary, a competition could proceed with two bidders, but it did represent a weak starting point and careful attention would be needed to risk and value for money issues.

1.8 Decision on 1b

S McG stated that he did not expect there to be a decision on 1b in the short-term. The DFBC covers 1a procurement, with an option available on 1b.

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1.9 Costs being moved from 1b to 1a

JW stated that moving costs from 1a to 1b would have a detrimental effect on 1a's BCR, which may cause problems for the scheme. GG confirmed that £9.3m of costs were being moved from 1b to 1a - £2m related to the completion of detailed design for 1b, the remaining £7.3m to diversion / utilities works costs being incurred concurrently for 1b.

1.10 Indexation assumptions

There was discussion over the difficulties of moving ahead with a variable affordability limit – depending on the indexation applied. This remained TS's position, and **tie** were currently recalculating the numbers. JW commented that it was important to get as much certainty on the index to be used as possible.

1.11 S McG stated that **tie** need to need to discuss the application of indices to market prices with Cyril Sweett. **Tie / SMcG**

1.12 GG stated that **tie** are using an inflation figure of 5% plus a small risk allowance uplift. JW reiterated that the assumptions used for indexation are crucial. He also noted that the comments on affordability were made on the assumption of a £500m contribution from TS; if the final number were lower, the affordability position for 1a would be more difficult.

1.13 Property Developers' Contribution

JW asked whether there was any indication that the overall CEC contribution might exceed £45m, and S McG replied that this was a possibility,. Increased contributions were contingent on increased development; the pace of this development is not yet known. JW observed that there seemed to be no certainty over the composition of the £45m, and that the timetable for releasing the £45m was unknown. Were property development not to occur, CEC may have to contribute a greater level of cash. JW commented that previous information released on the composition of the £45m may already be out of date. S McG stated that he could envisage no circumstances under which the non-cash element of the £45m would be altered, and that any excess of CEC funding over £45m would most likely be applied to 1b only –any possible additional funding would only be relevant for 1b.

1.14 Possible leasing of trams

S McG raised the possibility that, if necessary, trams could be leased. JW expressed a concern that leasing might increase the risk to CEC, and that, were leasing to be seriously contemplated as an option, balance sheet and accounting treatment discussions of approximately one year ago would have to be revisited. MT, S McG and AS stated their belief that TEL

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borrowings are not consolidated into the CEC balance sheet. JW commented that, were CEC's borrowings to rise (as they would were they to enter into a finance leasing agreement), then the Scottish Executive grant from HM Treasury could be correspondingly reduced. In light of leasing legislative changes over the last few years that have resulted in erosion of tax benefits previously available, the only advantage to finance leasing may be marginal financial savings; an operating lease would likely be off balance sheet, but would be more expensive. These savings would however have to be considered in the overall context of increased risk..

1.15 JW repeated the observation that, there is only sufficient funding available for 1a within the current projected affordability envelope. Grouping of 1a and 1b could possibly be revisited after next May's elections.

1.16 Early truncation of 1a

JW asked what the level of savings from stopping 1a at Ocean Terminal rather than Newhaven could be - £18m had previously been suggested as a saving. S McG stated that the actual saving would be closer to £5m. Although truncation was operationally feasible, the loss of patronage and resultant impact on the BCR had not been modelled. Early truncation may result in a lack of commercial clout with developers in the Leith area.

1.17 Procurement and Payment mechanism

JW asked about the progress of the tramco evaluation. GG and S McG responded that the evaluation was well under way, but that the intention was not to complete the evaluation until the infraco evaluation is also underway; the results of the two processes will be announced together. Tram bidders have not been informed of the delay to the evaluation, but GG does not think they would be overly concerned. Procedures were in place to manage the joint procurement process.

GG stated that the tramco payment mechanism is lump sum and milestone-based. There was a discussion as to how tramco will be paid as Infraco's subcontractor. The two payment mechanisms need to match.

There have been weekly meetings with Infraco bidders during the first part of the bidding process. These are likely to stop as the bidders concentrate on finalising their bids. The bidding teams are not based in Edinburgh, but have been visiting regularly.

Infraco Pay Mech

There was a general discussion around the timing of payments to the Infraco contractor. Previously tie had proposed full payment during the construction period with a retention bond equal to 10% of the price. 5% of the retention bond would be released on opening, with the remaining 5% being released after a maintenance period.. New incorporation of milestones would entail payment according to the following schedule -

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85% - milestones during construction

5% on successful testing and commissioning

5% on successful trial-running

5% on completion of 98% system reliability test

GG observed that, in addition to milestones, tie are proposing to retain the bond. JRW said that, on the assumption the bond is cash collateralised, the 10% bond would effectively mean that 75% of the price is paid via milestones during construction. At the end of successful trial-running, there would be 10% payment (2 of the 3 milestones) and half of the bond would be repaid. There would hence only be 10% outstanding. During operations, it is anticipated that the remainder of the bond would be repaid, and the systems reliability payment would be made. This would bring the payments made up to 100% of the total value.

It was generally observed that the combination of milestones and a retention bond might entail a significant financing cost. JW commented that VfM would normally be secured by paying a significant amount of the contract price at the end of construction, and into operations. Were money to be saved by paying the Contractor earlier, then it might well be prudent to increase the risk contingency.

1.18 Novation

GG stated that the infraco bidders have accepted the general principles of novation, although current cap levels mean that there is a gap between what Infraco can absorb and what they can pass on to trams. Infraco could be penalised for more than it can pass on. GG stated that SDS is not in a strong negotiating position – there are no rights built into their contract to refuse novation, and they will be heavily penalised if they do.

1.19 Cancellation costs **Tie / S McG**

JW indicated that he had not seen any cancellation cost estimates in the DFBC, and asked whether they could be as high as £20m. S McG thought that cancellation costs would not be this high, but acknowledged that he did not know what the true level of cancellation costs may be. S McG agreed that **tie** would calculate them. He estimated that they would constitute 3 months of spend (£8m/£9m), plus demobilisation costs, pay-offs to bidders (£800k if pre-PB, £400k if after), run-down costs, SDS, Mudfa and associated legal costs.