AUDIT SCOTLAND

Transport Scotland

Edinburgh Trams Project

Position Statement as at September 2010

Background

Following a meeting between PAG, City of Edinburgh Council (CEC) auditors and Transport Scotland (TS) auditors, it was agreed that the local auditors should prepare a paper outlining the history of the trams project and the governance arrangements in place at TS and CEC.

The TS team met with the Chief Executive and agreed on an approach involving meeting with key TS staff and collection of relevant documentation.

It was agreed that at this stage Audit Scotland would not pursue political involvement, and that any position statement established after the meeting would be factual in content and not comment on the merits or otherwise of actions taken. However, TS recognise and accept that an Auditor General for Scotland report is almost inevitable in due course.

Chronology of the Trams Project

For the purposes of understanding TS involvement in the project we have used a timeline to document the key stages of the trams project and associated events.

<u>May 2002</u>

Transport Initiatives Edinburgh Ltd (tie ltd) was formed to deliver major capital projects for CEC.

<u>April / May 2006</u>

The Edinburgh Tram (Lines 1 and 2) Bills received royal assent in May and April 2006, respectively. This enabled the construction of a light rail, mass transit system in Edinburgh by the Scottish Executive's Labour / Lib Dem coalition. The Edinburgh Trams Act was ratified in November 2006.

<u>May 2007</u>

Scottish parliamentary elections which resulted in the minority SNP administration taking power.

<u>June 2007</u>

Following parliamentary transport debate, the SNP administration confirms their support for the trams project. At this stage a £500m cash cap was introduced, replacing the previous financial limit of £450m (subject to inflationary adjustments). Overall, the approved budget for the trams project is £545m. The cash cap of £500m is the proportion of funding required from TS, with the balance to be funded by CEC.

Ministers wished to make it absolutely clear that the project was being undertaken by CEC and tie ltd, and that TS involvement was only in providing the approved funding. TS therefore withdrew from the Trams Project Board (TPB) reducing their influence over the project to financial funding only. TS did not have an oversight role, although mechanisms were put in place to protect minister's interests. These mechanisms were:

- the financial agreement – this introduced the affordability and scope criteria which required the project, in its entirety, to be achieved within the £545m cap.
- withdrawal of TS from the TPB – following this decision representatives on the project board comprise officers from CEC and tie ltd.
- monthly progress reports from CEC in support of funding claims – contractor payment claims are submitted to tie ltd. These are reviewed and passed to CEC for further consideration and validation of costs incurred for work done. A report covering costs incurred and construction progress is prepared for submission to TS. Contractor payment claims are not submitted to TS. On the basis of these reports, TS make grant payments.
- additional commercial expertise is provided to TS by Cyril Sweett under contract to supplement TS staff engineering and construction skills mix. Cyril Sweett also review the reports provided by CEC providing commercial and programme observations to TS.

CEC are wholly responsible for tie ltd. TS role is to provide funding (to CEC) for the project, as TS do not have a direct relationship with tie ltd. CEC have complete financial and project management responsibility.

<u>June 07 – January 08</u>

Final business case for the project was prepared by CEC / tie ltd in December 2007. TS were not involved in the preparation of the final contract and financial close of the project. Financial close was finally achieved in May 2008. CEC / tie ltd opted for a fixed price contract arrangement, thereby transferring the risk of cost overruns to the successful bid company.

The Rail Delivery Directorate of TS generally use the section 70 (s70) grant model when funding major capital projects. This is based on the requirements of s70 of the Transport (Scotland) Act 2001. Although s70 is non-specific, sub-section 2 is the key driver for the model: *"grants under this section shall be of such amount and subject to such conditions (including conditions requiring their repayment in specified circumstances) as Scottish Ministers may determine."* For many projects TS act as the authorised undertaker and therefore have both oversight and interest. However, because of the nature of the trams project, TS developed a more robust s70 model which excludes project management oversight.

The offer of grant to CEC states that: *"the s70 grant to CEC shall be 91.7% of the eligible capital costs to a maximum of £500m which includes grant in respect of eligible capital costs already defrayed or incurred or to be defrayed or incurred up to 31 March 2008."*

Within the conditions, CEC were required to confirm that it had an approved final business case for the Edinburgh Trams Network (ETN) containing:

- an affordability assessment for phase 1a within a maximum capital cost of £545m
- a benefits cost ratio greater than 1
- no requirement for an ongoing subsidy for the ETN during the operational phase.

In addition to the £500m cash cap, the s70 model introduced annual caps. These are:

- financial year to 31 March 2009 - £120m
- financial year to 31 March 2010 - £149m
- financial year to 31 March 2011 – so much of the grant as has not been defrayed or incurred in the prior financial years.

This funding split was assuming completion of the trams project and an open for revenue service date within 2011. As is normal with major capital construction contracts, expenditure is front loaded.

In both 2009 and 2010, expenditure has been within the annual caps.

<u>May 2008</u>

The contract for the trams project was awarded to the Bilfinger Siemens CAF consortium (BSC) on 14 May 2008. The contract comprises three main elements:

1. Infraco (Bilfinger / Siemens) – this plans to deliver the infrastructure for ETN, including the construction and installation of the track, tram stops and associated structures, electrical and mechanical works, commissioning and subsequent infrastructure maintenance. Completion of the works was to be monitored and certified upon completion of a series of milestones as defined in the contract. It was envisaged that tie ltd will pay the contract price to Infraco by cumulative certification of milestones achieved at the end of each 4 week period as applied for by Infraco under the contract.

2. Tramco (CAF) – this covers the manufacture of 27 tram vehicles and provides structural warranty for a period of up to 30 years. CAF have sound previous experience as they provided the trains for the Heathrow Express and vehicles for Seville's tram system. Payments are based on a system of milestone mechanisms for capital works with performance related payment mechanisms for maintenance.

3. Multi Utilities Diversion Framework Agreement (MUDFA) – the contract was originally awarded to Alfred McAlpine Infrastructure Services (AMIS) and work commenced in July 2007. Subsequently, AMIS was subject to takeover by Carillion plc who managed MUDFA works until the end of November 2009. The remaining utilities works are being undertaken by Clancy Docwra and Farrans.

Autumn 2008

Throughout the project TS met with CEC to discuss progress. Any meetings with tie ltd were arranged to include CEC and were used to discuss discrete issues, such as improved reporting. During the initial stages of the project, TS were reassured by tie ltd that their concerns and issues of work not progressing as planned, coupled with escalating costs, were merely opening difficulties.

TS are relying on monthly reports from CEC / tie ltd as relationship is arm's length. TS review these reports; however, there is limited evidence checking.

Throughout the project, Cyril Sweett have provided additional commercial and contract expertise to TS. At this time, there were anxieties about the robustness of the overall costs and programme associated with the final business case, particularly about the lack of 'float' in the project programme to accommodate risk and contingency. June 2010 reports are attached as appendices.

17 September 2008

On the back of mounting concerns, TS asked for a supplementary meeting with CEC / tie ltd to discuss improvements in reporting post financial close. The meeting also provided the first indication that things were going wrong within CEC / tie ltd regarding delays in contract mobilisation.

This was in addition to the monthly progress meetings held with CEC and the quarterly meetings with CEC directorship to which tie ltd are invited in order to discuss issues. Meetings with tie ltd are arranged as necessary to deal with specific project issues such as cost profiling.

February 2009

Bilfinger Berger (BB) stopped working on Princess Street construction. This served to confirm that both tie ltd and its contractors had differing attitudes to the Infraco contract: Siemens and Bilfinger Berger did not agree the Infraco contract was fixed price.

Since this point ministers are frustrated and essentially wanting resolution to be found, as it would be difficult to walk away from the project at this stage. Trams project was ratified by Ministers as they saw value in the project.

Update on contract June 2010

The original scope of utilities works covered 27,000m of pipes and cables. However, this had to be significantly extended once the physical conditions underground became clear. The complexity of utilities along the tram route, congestion of pipes and cables in key locations and unforeseen obstructions has proven to be much more difficult than originally anticipated. In addition, the records held by Scottish Utilities Companies and CEC were far from comprehensive. The final extent of diverted utilities is estimated at circa 50,000m. Currently 48,000m of the expected volume has been completed.

The estimated final cost of £57.6m for this part of the project has increased by approximately £14.4m (25%) taking account of the extended project scope and time delays. Of this increase, £8.6m (15%) was anticipated and provided for in the original contingency risk allowance. The net costs of utilities have also been calculated after deducting a substantial credit from the utility companies for betterment of their assets.

Table 1 – analysis of total estimated project costs provided by CEC / tie ltd

Project element (relevant baseline date – 20/12/2007)	Original estimate for lines 1a and 1b - £m	Latest estimate for line 1a only - £m (as at June 2010)
General overall	28.233	29.857
Procurement consultant	68.173	89.167
Design	26.646	34.169
Financial issues / funding / procurement strategy	2.258	2.630
Parliamentary process / approvals	0.329	0.319
Construction works	276.302	314.453
Testing and commissioning	1.984	0.000
TRAMS, vehicles	51.370	58.493
Risk	48.974	4.221
Total	504.270	533.309

Table 2 – costs per contract element

Contract	Original estimate for lines 1a and 1b - £m	Latest estimate for line 1a only - £m (as at June 2010)
Infraco / MUDFA	276.302	314.453
Tramco	51.370	58.493
Other	176.598	160.363
Total	504.270	533.309

In summary, based on the payment scenarios described above, grant payments to CEC are made on the basis of cost of work done (COWD). Certificates of completion are submitted to tie ltd / CEC on a monthly basis. CEC subsequently prepare reports which are issued to TS. It is on the basis of these monthly reports that TS make payments.

We have obtained copies of the CEC submissions to TS for funding and the June 2010 report is attached. Also enclosed is a copy of the internal TS report prepared from the CEC report. Over the course of the project, these reports show a diverging opinion on the progress being made and the cost projections.

Progress and expenditure to date

Infraco – costs of work done accounts are approx 54% of the agreed contract sum. However, as at June 2010, total cumulative completion of the “civils” part of the Infraco contract is 19.2%, the target is 89.2%. Details and explanations for the slippage can be found in the attached TS and CEC reports.

In their 10 June report tie ltd noted that “given the commercial uncertainties with Infraco and continuing delays to the project it is now considered unlikely that the full scope of Phase 1a will be completed within the available funding of £545m.”

In the CEC report of the 24 June 2010 it is stated that “it is now considered prudent for the Council to plan for a further 10% over the currently approved funding of £545m on the understanding that further potential risks have been identified beyond this level.”

Latest projections by TS suggest that additional costs required to complete the project can be estimated as being up to £100m in excess of the £545m budget.

Tramco – this contract is well established with £41m of £58m already paid. Progress continues to be made in accordance with the delivery schedule. Work is progressing at various stages on the production line on 27 trams, with the first 12 trams now complete and undergoing testing. It is expected that the final tram will be delivered in January 2011.

MUDFA – cost of work done of £58.8m is in excess of approved budget of £57.5m for this element of the contract. The cost to completion of approximately £5m is the funding expected from utilities companies in recognition of the betterment of their assets. From information available, utilities works are approximately 96% complete.

There are two major criteria for the Trams project: affordability and scope. As at 10 June 2010, line 1A can no longer be delivered within the funding limit. At no point until 10 June 2010 were CEC in breach of the grant conditions.

TS have provided £355m in the period since project inception until June 2010. Following the breach, monthly payments to CEC continue at the rate of approx £3.5m per 4-weekly period. An analysis of TS expenditure on the trams project is included in an appendix to this report.

August 2010

TS have focused on ensuring that CEC do not breach the financial agreement, by influencing; where possible, that spend is going on the "hard" costs of the project rather than "soft" costs, for example dispute costs and legal fees to fund resolution of dispute with BB. However, TS has accepted the Council's argument for continued support for their dispute resolution strategy. Within the financial agreement, the default section covers the failure by CEC to meet the affordability and scope criteria of the project. Ministers have the ability to exercise powers which can reduce payments, claim back monies or stop payments by TS to CEC completely. At this point no decision has been taken.

A meeting of the Tram Project Board is scheduled for 13 September 2010 to discuss options on the future of the project (Infraco contract). Consideration of these options by a CEC full council meeting had been expected on 16 September 2010, however it was announced on 27 August 2010 that the full council meeting would be postponed by one month. At these meetings we expect the following options to be considered:

- continuing with the current contract – this would require resolution to the numerous payment disputes currently within the resolution process and agreement of a revised contract between CEC / tie ltd and Bilfinger. This would likely require further reduction to the scope of the project to ensure it satisfies the affordability criteria.
- terminating the contract with Bilfinger – commence legal termination of the contract, however this would likely result in extensive legal proceeding at a significant cost to CEC / tie ltd, with potential for compensation payment to Bilfinger. It is unlikely any new contract could be tendered and subsequently awarded until legal procedures finished. The timescales for this process are unknown, but could be very lengthy.

- "immature divorce" – requires agreement by both parties to terminate the contract. Similar to above, this may result in extensive legal proceeding.
- "mature divorce" – again, this requires agreement by both parties to terminate the contract. Although legal proceedings would be required, it is estimated that resolution of all issues, re-tendering and awarding of new contracts could be completed in approximately one year. This is the preferred option of CEC and tie ltd.

The decision on the future direction of the Trams project lies between CEC, tie ltd and ministers. Discussions on the future of the project have been ongoing since March 2009.

Evaluation of contract

From financial close, BB did not accept the terms of the fixed price contract. The contract is described as 'the essence of the agreement was that it provided a lump sum, fixed price for an agreed delivery specification and programme, with appropriate mechanisms to attribute the financial and time impact of any subsequent changes'. Bilfinger would have been fully aware that the type of contract being used was not an industry standard, and seem to have identified loopholes which they could exploit.

On the face of it, the contract appears to be achieving value for money and ensuring the public sector is only subject to minimal risk levels for the delivery of a major capital project. Yet the contract was inherently flawed, as a fixed price contract was unexpected given the nature, scale and complexities of the trams project. The use of the fixed price contract reduced interest from other contractors and the number of tenders received in the final bidding process was low.

Bilfinger are a global organisation with a degree of past experience in delivering major public sector capital projects.

Future of the project

CEC have 4 main strategic options open to them, of which the preferred option is the "mature divorce". The issue is to re-tender the project at its current stage of completion with regards to the current circumstances (15 dispute resolution processes underway as at June 2010) would involve further uncertain delay, with no work being undertaken in the interim.

Also, there remain no certainties on cost. Tie ltd has to renegotiate the contract for those elements of work outstanding to achieve certainty on cost. Essentially BB are quoting £Xm to complete A to B; however tie ltd will not accept this. The next stage is formal notice of termination, which will in turn provoke a legal response from BB.

A meeting with ministers in imminent to discuss the project.

Legal Ruling

On the 31 August 2010, Lord Dervaird "ruled that attempts to force construction firm Bilfinger Berger to commence work where there is no agreement on costs have no basis in law". Tie ltd has disputed this ruling insisting that "it still has the right to force the construction firm to start work while negotiations over costs continue in parallel".

This adjudication relates to one case under one clause of the trams contract. However, prior to the ruling, tie ltd had the power to instruct contractors to continue working even if an estimate had not been provided for how much the job would cost. This ruling could potentially set precedence for those unresolved issues within the dispute resolution process. There have so far been 15 issues escalated into formal contractual disputes, and rulings have been issued on seven. While the outcomes to date have been mixed, there have overall been a substantial saving of approximately £14m to the public purse.

Summary

The legal contract for the project should have been robust. However, there appear to be flaws in the contract with regard to its fixed price, and the substantial transference of risk to the private sector.

Following financial close, amendments to governance arrangements reduced TS responsibility to that of funding payment claims, as project responsibility lay solely with CEC. Restructuring TS involvement and the introduction of the £500m cash cap were introduced to help protect Ministers interests.

The commercial confidentiality of the contract between CEC / tie ltd and BSC and the subsequent disputes have also had a detrimental affect on the progress on of the project and potential resolution.

TS in conjunction with Cyril Sweett have concerns around affordability and scope issues. At present, CEC / tie ltd do not appear to be fully transparent in the information they are presenting.

From the first cost submission by Bilfinger, they did not accept the fixed price, and therefore payment disputes were inevitable.

The latest legal ruling in the dispute resolution process, ruled in favour of Bilfinger. By confirming that tie ltd can no longer force Bilfinger to continue working until costs are agreed, this may further escalate the project costs and timescales.

Bill Convery / Mari-Anne Williamson