EDINBURGH TRAM NETWORK
MAYDAY OPTIONS

COMMERCIALLY CONFIDENTIAL

Background as at 11.00am Monday 5th May 2008

On 30th April 2008, in a telephone call to Willie Gallagher, BB (Richard Walker) requested a last minute, substantial and unsupported price increase. This was at the final point before the pre-agreed timing of contract approval for signature. No such request has emerged from Siemens or from CAF or indeed SDS. The anticipation was that the contracts would be signed on 2nd May and a period of 36 hours was needed for completion preparation.

An emergency meeting of those members of the Tram Project Board who were available plus other parties was held on 30th April. Attending were :

Tie - Willie Gallagher, Steven Bell, Stewart McGarrity and Graeme Bissett
CEC – Donald McGougan, Dave Anderson, Marshall Poulton
TEL – David Mackay
DLA – Andrew Fitchie (latter part of meeting)

The options available were discussed and it was concluded that we should deploy tough tactics, but not stonewall the BB request completely as it was felt that the alternatives were likely to be worse notwithstanding the intense frustration at BB's tactics.

The agreed next steps were :

1. Tie would inform BB and S that tie will not accept last minute price gouging
2. A proposal from senior BB management that they would visit Edinburgh on Monday 5th May would be encouraged
3. We will cease legal engagement with the consortium, but work to freeze documents in a controlled manner
4. Means would be derived to communicate to Siemens that they had a responsibility to get BB into line and also to apply leverage against Siemen's reputation within the Scottish and UK public sector
5. CAF, SDS and TS would be informed
6. Council officials will consider how to disclose the matter properly to Councillors around the Council meeting on 1.05.08, bearing in mind the commercial sensitivity at this delicate point.

Actions 1-5 have been executed. BB management will visit Edinburgh on 5th May.

The purpose of this note is to analyse the alternative options to an agreement with BBS.

The financial effect is examined in more detail in Appendix 1.

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Gold Option

- BB withdraw the price gouge attempt, their lawyers engage properly to conclude contract details and the suite is signed later in w/b 5th May.

Issues :
- Tie willingness to entrust BB with the contract – we are ready to deal with them post-Close

Silver Option

- BB will not withdraw the price gouge but a negotiated number is agreed. Proceed as under Gold.

Issues :

- Justification for any compromise sum – almost certainly less expensive than other options except Gold. <u>Tie will seek to generate value for any sum conceded by means of buying out risk, providing incentivisation, removing uncertain elements of the contract</u>
- Relationship of final sum to the Council Report to be approved today – the sum agreed will dictate what additional approval is required
- Need to control any ambitions among Siemens and CAF for any similar last-minute hikes – <u>tactics to be defined</u>
- Tie willingness to entrust BB with the contract – we are ready to deal with them post-Close

Bronze option

As Silver, but BB go away for a period – say a week – before coming back to the table

Issues :
- As Silver, plus
- Communication of position externally – need a pre-pack announcement ready
- Assess cost of a short-term delay (say 2 weeks) compared to final proposed ransom payment to BB agreed on 5th May – <u>will be evaluated before 5th May, unlikely to be significant</u>

Iron options

- BB continue to demand substantial price gouge, tie will not relent and the position is supported by CEC and TS.
- Tie terminates procurement process with BBS consortium

Options

A. Siemens offered option to restructure consortium, incorporate a new civils contracter and confirm previous contract terms
B. Tramlines re-introduced
C. Full-scale re-procurement including PIN
D. Project termination

Basis for termination

Tie is entitled to terminate the BBS consortium's preferred bidder status because BBS have materially changed the price. Termination on this basis carries no risk of effective litigation by BB / S against tie. There is an additional responsibility on tie to respect Tramlines' interest in the transaction and a risk of challenge by Tramlines if tie does not.

The grounds on which BB seek to justify the price increase are important. In the conversation between Walker and WG, the grounds were stated as SDS risk, euro / sterling devaluation and supplier price pressure. There was also reference to BB making mistakes which had only recently been identified. These are not valid grounds for a price change at this stage and open BBS to litigation by tie.

- <u>At this point, it is critical that the conversation between Walker and WG is properly documented as this will be key evidence in any litigation</u>.

- <u>It is also important that a record of the meeting with the senior BB and S management on 24th April is created because that was the basis on which we believed the deal was done except for legal due diligence.</u>

BB may change their purported rationale on Monday 5th and we can deal with that if it happens.

(A) Siemens led consortium

It would be legally competent for tie to engage with the preferred bidder consortium with a new civils contractor replacing BB. The drivers behind this would be Siemens desire to stay in the race and tie's desire to conclude as quickly as possible.

The process would involve :

- Siemens exiting BB from the consortium
- Identification and presentation by Siemens of a new consortium
- Re-qualification by tie of the new consortium
- Re-engagement on the contract suite

The implications are not straight-forward :

- The timescale is likely to be around 3 months if matters progressed reasonably well. Programme will move out by this extent.
- There will be important changes to the current Infraco contract terms to accomodate 1) passage of time (eg programme, design & consents, MUDFA interface) ; 2) requirements of new contractor (unknown).
- Likely that tie would be required by a new contractor to meet bid costs
- No guarantee that the revised consortium would adhere to previous deal and a strong likelihood that both consortium members would seek increments for inflation and other factors ; impossible to estimate at this stage whether there would be adequate compensating factors (such as reduced SDS risk)
- Limited likelihood of imposing effective sanctions on Siemens to adhere to existing terms – eg pay bid costs only if they stay within current contract terms especially price
- Probable need to re-assess SDS Novation Agreement (driven by SDS)
- Presumption that CAF will happily go along with this and not seek incremental costs

Although unpalatable, this is the best alternative to completion with BBS and we could reasonably expect both CEC and TS to be supportive given the level of investment already made.

(B) Reintroduce Tramlines

Retention of under-bidder interest in a deal is designed to accommodate the scenario we may now be in. Tramlines were an entirely credible partner and the preferred bidder decision was close. There were no knock-out defects in the Tramlines bid.

The process can be shaped by tie and would best involve :

- Tie terminating BBS
- Tie revising the original Tramlines contract to accommodate tie's preferred (and reasonable) position as reflected in the current Infraco contract, but with all undesirable concessions removed (decision needed on how to put price into play)
- Agree a one-month "hot review" by Tramlines to confirm all material contract terms or flag variations ; if we are in the same ballpark -
- Finalise all material terms
- Detailed re-engagement on the contract suite, Tramlines D/D on design etc through to close.

An alternative exists of freezing BBS's interest short of termination to sustain the perception of competition. This would almost certainly preclude successful litigation by tie and is not a particularly credible competitive backstop.

The implications are again not straight-forward :

- The timescale is likely to be around 6 months if matters progressed reasonably well. Programme will move out by this extent.
- There will be important changes to the current Infraco contract terms to accomodate 1) passage of time (eg programme, design & consents, MUDFA interface) ; 2) requirements of Tramlines (unknown)
- Introduction of entire Tramlines Proposal replacing BBS's version and need to align with design and ER's
- Uncertainty about Tramlines attitude to risk profile
- Loss of qualitative advantages perceived to be in BBS proposal which supported their selection as preferred bidder.
- Likely that tie would be required to meet bid costs
- No guarantee that Tramlines would adhere to previous deal and a strong likelihood that they will require increments for inflation and other factors ; impossible to estimate at this stage whether there would be adequate compensating factors (such as reduced SDS risk)
- Limited likelihood of imposing effective sanctions on Tramlines to adhere to existing terms – eg pay bid costs only if they stay within current contract terms especially price
- Probable need to re-assess SDS Novation Agreement (driven by SDS)
- Presumption that CAF will happily go along with this and not seek incremental costs

This option is more likely to lead to increased cost and programme delay than the Siemens-led approach. It is possible it could be deployed after an attempt were made to agree terms with a Siemens-led consortium. It is questionable whether CEC and TS would be supportive, although it is part of the existing procurement process and may be supported given the level of investment already made.

(C) Full re-procurement

This is the worst-case alternative short of termination. The procurement programme would extend out to around 1 year, adverse programme and cost ramifications are inevitable and it may be difficult to generate sufficient market interest from the limited number of possible players, including those rejected under the current procurement programme.

Notwithstanding the extent of public investment already made, it is highly questionable whether the public pound is best protected by embarking on an immediate full-scale re-procurement. CEC and TS's support for this approach is unlikely.

Recommendation

In addition to the primary considerations above, a range of secondary problems lurk, including :

- the sustainability of the design work
- the political threat arising from both loss of public confidence and the emergence of alternative uses of the funding
- implications of a delayed starting date on embargoed construction periods
- the continuing role and cost of Transdev
- need to revisit third party agreements
- ability to freeze work underway and avoid undue cost
- retention or re-shaping of tie resources

And many more.

Painful as it is, there seems little question that the route which will lead to the best value for money is to agree and complete the BBS deal as close to the current terms as possible. Although judgemental, the financial analysis in Appendix 1 supports this. None of this prices in the loss of revenues from delayed service commencement or the delayed flow of economic benefit.

GB
5.05.08

APPENDIX 1
OUTLINE FINANCIAL ANALYSIS OF IRON OPTIONS

The total Tram Project cost is £508m. Spend by end 2007-08 was £130m of which the majority is of continuing value – SDS designs, Land acquisition, MUDFA works and Preliminary Infraco / Tramco works. These account for £88m and in this analysis are assumed to be capable of being frozen or continue to be executed (and funded) to reach a conclusion. A balance of £42m covers the full range of tie's project management activities plus legals, Transdev, CEC. A proportion of this is "embedded value" but this is re-addressed below in the analysis of incremental costs.

The spend to go amounts to £378m, and the effect of inflation arising from delay is estimated as follows reflecting three possible scenarios :

- 3-month delay - a Siemens-led consortium excluding BB can be constructed and delivered competently under procurement law and regulation
- 6-month delay - Tramlines are re-introduced
- 12-month delay - Full-scale re-procurement of Infraco

In all three scenarios, CAF are assumed to be retained as Tramco provider. The other assumptions are as follows :

Inflation impact :

- MUDFA, SDS and land acquisition will be executed as planned at current prices
- Infraco is delayed and all spend to go attracts an inflationary increment
- Tramco is frozen, then closed along with the revised Infraco consortium – unlikely CAF will freeze prices to accommodate the delay
- Transdev, comms, project management and insurance costs are mostly people / consultancy costs which are inflating at less than materials, but not by much

Incremental costs :

- Security and safety around executed works
- Limited rework of SDS designs due to changed streetscape, traffic management or other matters affecting design
- Extended Transdev and Comms costs for longer period, allowing for back-end loading
- Extended tie project management costs
- Additional period of pre-operational insurance
- Legals to support procurement options

For the Siemens-led option, it is possible they could be negotiated into holding the existing price base, at least partly to avoid any procurement challenge. However, we have no guarantee of this and past behaviour implies that any opportunity to increase their price will be pursued. In addition to inflation, Siemens may seek to extract additional price improvements. Tramlines would also see themselves in a favourable position and could be expected to exploit that strength. In the other direction, the SDS / consents risk would be mitigated, arguably also MUDFA though this is less sensitive.

These elements are very difficult to measure but sighting shots are offered below. Theoretically a new competition would remove this risk but that also assumes a strong degree of market interest. The risk of entering a contest which has already failed would be likely to add to bidder risk premia.

It could be argued that the above-RPI sector inflation may not continue, especially in steel and raw materials, but this would be a brave assumption. In addition, pressure on UK rail and infrastructure sector resources is intense through to 2012. Accordingly recent inflation rates would appear to be a good base for rates over the next few years.

The estimates are set out below :

Description of expenditure	Spend after 2007-8 £'m	Cost inflation factor	Siemens 3 month delay £'m	Tramlines 6 month delay £'m	Re-bid 12 month delay £'m
MUDFA	30	0.0%	0.0	0.0	0.0
SDS	3	0.0%	0.0	0.0	0.0
Land	4	0.0%	0.0	0.0	0.0
Infraco	216	6.0%	3.2	6.5	13.0
Tramco	56	6.0%	0.8	1.7	3.4
Transdev	6	6.0%	0.1	0.2	0.4
Comms	3	6.0%	0.0	0.1	0.2
Project management	24	5.0%	0.3	0.6	1.2
Insurance	4	5.0%	0.1	0.1	0.2
Risk	32	6.0%	0.5	1.0	1.9
	378		5.0	10.1	20.2
Incremental costs :					
Security and safety			0.3	0.6	1.2
Design re-work			0	0.1	0.3
Transdev			0.1	0.2	0.4
Comms for extended period			0	0.1	0.3
Project management			1.5	3	6
Insurance			0.3	0.7	1.3
Legal costs for procurement			0.2	0.4	1.5
			2.4	5.1	11
Measurable costs increases			7.4	15.2	31.2
Potential Siemens / CAF ransom		???????	5.0		
Potential Tramlines ransom		???????		10.0	
Reduced SDS / consents risk		QRA	(3)	(3)	(3)
Total estimated cost risk			9.4	22.2	28.2