In February 2009 we were already considering our options to proceed with the construction of Phase 1a of the tram without Bilfinger Berger (BB). However the contract is with the consortium and it is therefore only BB's partners Siemens and CAF who could effect their removal, amicable or otherwise, from the project. This paper recaps on our previous deliberations updated to reflect the state of play in August 2009 following commencement of full scale contractual efforts by **tie** for force resolution and progress.

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This paper considers the principal commercial and procurement options which are available to progress the construction and completion of the first phase of the ETN in the context of the poor delivery by Infraco to now, the developing contractual disputes with the Infraco and the significant uncertainties we face with regard to the willingness and preparedness of the consortium (as currently constituted and managed) to progress delivery in accordance with the contract.

Option A - Terminate BSC and procure a replacement Infraco

Any decision to terminate the contract would require confident legal reasons to do so. The commercial behaviours of the Infraco to date do not accord with those of a willing contractor fulfilling their obligations but our lawyers are still completing the analysis of whether they constitute the persistent breaches which would allow us to terminate the contract and be confident of recovering our costs (and possibly damages) without being materially exposed to successful counterclaims by the Infraco.

A continued refusal by Infraco to carry out works when instructed to do so in respect of matters referred under the Dispute Resolution Procedure (DRP) would constitute a very signifcant breach of contract.

We have paid the BSC consortium £77m to date (BB £28.6m, S £26.5m and CAF £21.9m) compared to our estimate of the true value of work done of £40m - a difference of £37m. As security we have the performance and retention bonds in the amount of £25m, the CAF advance payment bond and the 20% liability cap under the contract which is joint and several to Bilfinger and Siemens and backed by Parent Company Guarantees from both. A very large proportion of the value of work done to date represents soft costs and mobilisation rather than physical infrastructure delivered. We have no contractual right to cease payment of sums certifiable while our dispute continues.

There are a number of compelling reasons to consider termination as the worst of outcomes:

- **Doubts about the deliverability of a new procurement on the same terms** - The market appetite for the Infraco work on our contractual terms was poor first time round (we only had two serious bids to consider) and it may not have changed. Large construction companies appear to have become more risk averse in this regard. There is no legal way to reengage with the under bidder or any obvious price advantage in doing so. However, a new procurement would be against the background of completed and consented design and completed utility diversions.

- **BB behaviours could reflect an under pricing or the original bid by them in relation to the subcontracts they have negotiated -** However subcontractor prices might be significantly softer in today's market and the proximity of the underbidder's price and other benchmarking carried out t at the time of contract make this unlikely.
  However, there is good evidence that civil construction costs have actually fallen in the past six months or so.

- **BB are now mobilised or appear to have their subcontractors ready to go and we have no big problems with Siemens/CAF performance –** Despite commercial stance there is an apparent eagerness apparent readiness now to progress on the ground and the subcontractors ready (albeit not yet under contract) to do the job. We still believe Siemens are best placed to deliver the non-civils infrastructure and are now delivering the specific engineering inputs to supplement SDS efforts and that CAF are performing as expected under their contract. <u>However</u> - Siemens were equally as aggressive as BB during contract negotiation and will not hesitate to take whatever opportunity comes their way. Simplistically in the case of BB and S we'd be losing many months of accumulated knowledge of the project and the challenges to deliver and would end up paying for mobilisation twice.

- **Political support** –The history of precarious political and public support for the project would weigh heavily on the minds of any new consortium considering a bid for the Infraco.

In summary termination is not an attractive option and should only be considered if:

It may be that the threat of an impending termination and our visible commitment to go through with it would be required to bring the other partners in the consortium to the table in respect of Options B below.

Option B - Facilitate the removal of BB and replacement with a new civils partner

In the event we are unable to reach an acceptable commercial outcome with BB and/or are unable to satisfy ourselves that BB were willing and able to deliver the project in accordance with the contract then this is an attractive option. There is still a conviction that Siemens and CAF are the right partners to deliver the technically specialist areas of the project.

However the form is that our dispute is with the consortium as a whole and any decision to remove BB would be made by the other consortium partners not by us. This presents the challenge of exploring the position and objectives of Siemens as we engage in further discussions with the consortium. CAF seem genuinely perplexed by the current disputes and for the purpose of this analysis are held harmless whilst recognising they would be entitled to additional time and money flowing from the time consequences of what we agree with BB and Siemens insofar as they fall to our account.

The extent to which Siemens are fully complicit in the current contractual disputes is unclear. We know that Siemens were as commercially aggressive as BB during procurement and that they have continued to allow BB to lead the commercial engagement. Siemens senior management on site will be well aware of why we are experiencing delays to project delivery. Our engagement with Siemens commercial people on the financial valuation of the design programme v26 to v31 prolongation has been difficult as well. It is also significant that the

£50-80m additional costs notified by BB were not accompanied by an equivalent figure from Siemens (or CAF) and none has subsequently materialised.

A core part of our tactics to deliver Option B would be to

- Emphasise the delayed start to eg Princes St, the attendant risk to reputation and demonstrate our resolve (and, crucially, that of CEC and other stakeholders) and thereby bring about greater influence by Siemens in both the management of the project on the ground and in senior level engagement.
- Keep Siemens well briefed on the nature and extent of the principal contractual disputes we face and the detailed analysis of the issues and BB's delivery shortcomings rather than the high level generalised positions they have taken so far. This appears to be delivered through a targeted DRP campaign.

The financial stakes for Siemens are probably quite high – the delays to date if found to be substantially to our account would translate into significant prolongation entitlement to Siemens. If not then there is the possibility of a significant dispute within the consortium over costs as a result of BB delays. Again this points to a need to proceed to DRP to force Siemens hand.

We believe that Siemens material prices largely hold firm but that programme delay and disruption is a serious concern to them and the issue of design responsibility and responsibility for BDDI to IFC design evolution is still highly relevant to them given the reengineering of the SDS design of systems to match their proposals is not yet complete and as we do not have visibility of any incremental cost issues which may come out of that exercise.

Even if Siemens approached us prior to DRP with a view to engagement on a compromise settlement of affairs (with or without the removal of BB) it's likely we would be in much weak negotiating position, and therefore not achieving best value for money, without proving our points at DRP. That of course presupposes that our position on the matters we would refer to DRP is strong and we don't end up on the wrong side of a significant number and value of the determinations in any case.

It seems likely that should the replacement of the civils partner ultimately become desirable and necessary, the best result in terms of minimising time and cost impacts would be for Siemens themselves or the civils arm of their trackwork subcontractor BAM to undertake the role. Intuitively this would minimise the time to reassemble the complete consortium and we might expect the premium Siemens would try to negotiate to take on the civils work (and as general recompense for history) to be lower than that required by a new civils partner.

If BB was being replaced, the best outcome would be a preservation of the assembled BB supply chain as much as practicable and a continuation with programme critical activities whilst the new arrangements were being negotiated and put in effect. This probably dictates that we would like to see all the principal subcontractors committed (ie contracted and with collateral warranties to tie), fully mobilised and working first.

Option C – Facilitate the removal of BB and management of civils subcontracts directly by tie

The first reaction was that this would be an attractive option to examine as we could deliver the active project management we believe is missing from the BB input so far and make a significant saving by eliminating the BB "middleman" resource costs and mark-up. However

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this action would leave us managing risky contractual interfaces which are currently wrapped up in the Infraco consortium including:

- The engineering/design interface between the civils work and the following track and systems installation. We are aware of uncertainties regarding the final design (and approval) of system related elements is a concern to the consortium in relation to Princes St and other areas where they have yet to finish the reengineering of the SDS design to match the Infraco proposals. Presently that is a consortium risk and would present significant risks for us to manage stepping into the civils role.

- Delay and disruption to Siemens due to delayed completion by sub-contractors managed by us, very probably due to the very risks associated with obstructions and unforeseen ground conditions which BB is concerned about.

We do not have visibility of the extent to which BB has passed these risks through to its subcontractors and at what price. We could engaging with Siemens on a way to limit or cap exposure to such risks – but at a price which is unlikely to represent value for money. Alterations or supplements to the Infraco contract would also be likely to be significant and therefore time consuming and expensive to negotiate and get approval for.

A step into the civils role by tie would very likely meet stiff stakeholder resistance for the reasons above but also because it does not meet the minimum risk transfer criteria which were applied to the procurement strategy for the project in the Final Business Case. The extent of the allowance for these risks in our cost estimate could be very prohibitive.

Lastly – we would require to do due diligence on the contractual arrangements with the subcontractors negotiated by BB. We would need sound legal advice as to our competence under procurement rules to engage the subcontractors directly in the absence of concluded contracts and collateral warranties to tie which would provide our step in rights. In the absence of these arrangements there would be nothing to stop the subcontractors attempting to renegotiate more favourable terms.

For the foregoing reasons – the option for direct management of the civils by tie would appear to have very significant obstacles to delivery.

Option D – Negotiate a major variation to the Infraco contract to settle all outstanding contractual disputes

Engagement with Infraco (principally BB) to date has clarified their overarching position with regard to:

- BDDI to IFC issue - all marginal costs to the clients account
- There are pervasive obstacles (including incomplete design and utility diversions, unknown ground conditions, lack of access) which render them unable to work efficiently anywhere on the route - all delays and disruption to the client's account
- The best outcome for the client is to stop work for 6 months to complete design and remove aforementioned obstacles during which time they will present a new programme and cost to complete the project.
- They would require payment for any significant work in the meantime on a cost plus basis

It is unclear how this approach would relate back to the £50-80m BB loss which was tabled although that figure certainly did not include delay and disruption to Siemens and CAF. We could also expect that the delay to programmed opening would be 12 months or more (broadly the 6 mths stoppage plus a further 6 mths for the extent of delay already experienced which could not be recovered).

This approach would be completely unacceptable to us on many levels:

- It does not respect the contractual obligations we believe they have with respect to design management and evolution
- A 6 mth stop and the resulting inflation and prolongation costs alone would make the project wholly unaffordable
- Any re-pricing would without respect to the fixed price we negotiated up to financial close and pass all historic pricing experience by BB back to us. Such an approach would likely be open to challenge under procurement rules in any case.
- A cost plus basis does not incentivise the contractor to deliver to time and budget and is not in accordance with the risk transfers objectives of our procurement strategy
- The stakeholders would not get renewed comfort with regard to programme and costs until several months from now.

For these reasons we have rejected outright their general proposals and have consistently stated our position that the project needs to be broken down into geographical sections and to consider the particular issues with each - broadly:

We dispute that BDDI to IFC is all to our account – but recognise explicitly that we will pay for changes which are outwith "normal design development" and which are due to risk that we are responsible for such as approvals and ground conditions. We recognise for instance that piled retaining wall construction instead of earth banking on parts of the railway corridor is outwith the definition of normal design development (albeit we have an issue with the original SDS design not taking account of ground conditions necessitating the change). There are similar issues on the railway corridor structures, the Murrayfield tram stop and at St Andrew Sq which we need to consider.

Our latest outturn estimate presented to the Board in January 09 included a high side £6m provision for design and other direct cost changes found to our account. BB verbally estimate their additional direct costs at £20m+ (part of the low end of the £50-80m additional costs range with no visibility of detail) and we are as yet unaware of additional costs which might come out of the Siemens re-engineering of SDS systems design.

We dispute that that all delays on the programme to date are to our account and have a conviction that the project needs to be considered section by section. We believe in particular that delays on the railway corridor and from the depot going west could have been significantly mitigated by good project management by Infraco and they have been obstructive in refusing to start work before changes have been agreed, by not providing the estimates and good project management service required by the contract to allow these works to proceed and by hitherto not having their supply chain mobilised to start work as scheduled. For our part we have acknowledged specific delays (such as access to the depot and other delays due to late completion of utility diversions) will need consideration by us and that there is a complex analysis of the delays to date which needs to be completed and which will be shared equitably by us and the contractor.

Our latest outturn estimate presented to the Board in January included a high side £10m provision for our share of prolongation and delay/disruption costs over the life of the project. BB verbally estimate their bill so far at £20m for prolongation and £10m for delay/disruption (no visibility of detail). Crucially the BB figures do not appear to take any account of the acceleration and programme integration opportunities we know exist and which would mitigate these costs as they have failed to provide the programme management service they are required to do under the contract. We are as yet unaware of the consequential prolongation and delay/disruption costs for Siemens.

We have also explicitly recognised that there are engineering and construction issues associated with the on-street sections which might need special treatment – the approach to dealing with the alternative road construction challenges on Princes St being a worked example of how a justifiable evolution of the contract principles can work in practice. BB have similar concerns regarding future disruption to works on Leith Walk due to unidentified obstructions and utilities as a result of experience with the limited work they carried out on Leith Walk prior to the Xmas 08 embargo.

The inescapable conclusion is that we are in no position to negotiate any significant variation to the Infraco contract even if we thought that was a wise way forward as:

- The Infraco has so far refused to engage or is unable to engage in a detailed analysis of the way forward area by area and an integrated programme reflecting a way forward overall. The notable exception to this is the constructive engagement on Princes St up until the point where it became a victim of the broader commercial disputes but nonetheless provides evidence that where there is a will there is a way.
- The Infraco wants agreement to disputed contractual principles before engagement on the detail and want all changes agreed before commencing work. It's important to remember that the latter positions have emerged over the past 6-8 weeks and have not been a stated and clearly communicated position since contract inception.
- There is no sense as yet that the Infraco would be willing to compromise or trade at an acceptable level – again assuming we could convince ourselves that was a value for money way forward in the circumstances.

Option E – Pursue the settlement of all significant contractual disputes through the DRP process under the contract

In the analysis of all options above it seems clear that if there is to be no significant u-turn by the BSC consortium on the significant contractual points in dispute then the best outcome in any case will be served by a prompt and uncompromising progression of the disputed matters through the DRP process.

The time imperative is critical – the DRP process is governed by strict timetables and whilst we cannot in any way compromise upon the quality of submission we make in each case we will require the indulgence of our stakeholders with regard to continuing uncertainty and continued expenditure on the project whilst we go through DRP until we reach resolution on all significant matters, hopefully by constructive engagement rather than a prolonged DRP "war" which would be in no parties best interests.

As previously stated the objective is to confidently present a revised programme and outturn cost estimate for the project and to be confident about having a constructive relationship with the consortium going forward. We anticipate that this will probably require intervention by the other consortium members and may even require the replacement of BB as in Option B.

We face two broad but possibly challenges priorities in the conduct of the DRP process in that we want to refer issues in a way which will best facilitate the progression of the most urgent works to mitigate further delay to the programme and therefore delay related costs, but at the same time we want to establish our position on the broader points of dispute as quickly as possible to provide stakeholder comfort on costs and programme. The latter would involve the broader brush approach which BSC are seeking and we believe our interests would be best served by tackling the issues on a selective basis to flush out the technical and practical detail behind individual circumstances and sections of the route and thereby avoid getting picked-off on broad legal interpretation of the contract.

The mapping out of the DRP process is the subject of a separate paper and will encompass a series of "Stage-gate" reviews to take stock of our position, engage with independent legal and technical experts and report back to CEC and Transport Scotland.