STRICTLY PRIVATE AND CONFIDENTIAL AND FOISA EXEMPT

DRAFT, UNFINISHED

Overview of the contract, the current disputes and the parties positions

This is a complex contract, but it is possible to distil some of the major issues.

Overview

Whilst the contract is a 'fixed price lump sum contract' there is a mechanism under the contract to vary the price where either the scope varies (which may be for a number of reasons, see below) or where genuinely unexpected conditions arise, for example unforeseen ground conditions. Disagreements have arisen between tie and BSC as to what is included in the original scope of works (and therefore the contract price) and what is an extra or a change and therefore not included in the contract price.

Changes- Reasons for the scope to change include where the client, or a third party (e.g. network rail) introduce a change. Such changes so far include changes to the design at Piccardy Place, or changes associated with the introduction of the Gogar interchange. Other examples of changes where the contractor is legitimately entitled to extra costs include...

Delays - The contract also provides that where the contractor is delayed through no fault of their own (such as the late running of the utility works), they are entitled to additional time, and in some cases the associated costs caused by those delays. However, the contract also includes an obligation on the contractor to mitigate all delays, however caused. We have recognised there is a legitimate delay caused by the utility works and have offered an extension of time to June 2012, which we believe, once mitigation is taken into account, is adequate compensation. It is important to note that, to date, the contractor has not submitted any credible substantiation of these delays, but we have on our own assessment awarded an extension of time nevertheless. The contractor is free to submit any further claims for extensions of time they believe they are entitled to, and we will assess these on their merits when they are submitted.

Design - At the time of letting the contract the design was not complete, this was known by all parties. The fact that the design was not complete is not uncommon for this type of contract as the system design, which is a bespoke Siemens system, still needed to be incorporated into the final design. The contractor conducted a due diligence on the design (during which they identified additional risks for which they received an increase in the contract price) and accepted the novation of the designer into the consortium, and the consortium is now responsible for the complete design, construction and maintenance of the system.

Because the design was not complete the contractor wanted qualify their price by excluding major or unforeseeable changes in the design, and this risk remains with the client. We believe that costs arising from 'normal design development' are the responsibility of the contractor, and we do not believe the contractor is disputing this principle. However the contractor believes that definition of normal design development, and specifically what is excluded from the definition of 'normal design development' allows the contractor to take an extreme view that, in effect, **all** design changes are the responsibility of the client. (They have recently amended their position to accept a small portion

of this design development risk, but not in our view to the point that reflects their obligations under the contract).

Disputes

The contract allows for a dispute resolution procedure (DRP) which allows issues where the parties are in dispute to be resolved within the contract without resorting to the courts. Following the procedure laid out in the contract does not prejudice either party's right to subsequently take an issue to court, but the parties must first exhaust the DRP set out in the contract.

The Dispute resolution process works as follows.

Where one party believes there is a dispute which has not been or cannot be resolved through normal discussion they can refer the issue to the formal process (DRP)

The DRP has different stages,

The party raising the dispute starts the clock ticking by issuing a 'Notification' to the other party.

- The parties must meet within 3 business days to resolve the issue.
- If unresolved, the parties then have a further 4 business days exchange 'position papers' on which the parties then negotiate.
- If still unresolved after 20 business days the CEO's of the two organisations must meet to resolve matters. (this period can be extended by mutual agreement)
- With 25 business days of the date of notification the issue must be referred to formal mediation or adjudication.
- If Adjudication, the party who raised the dispute must then arrange the adjudicator who can take up to 49 days from the date of appointment to reach a decision, this period can be extended but only by mutual agreement.
- If referred to mediation this can add 30 days, or longer by agreement.

It can be seen from the above that adjudication is only one part of the formal Dispute resolution Process (DRP), and that the DRP is itself only used when issues cannot be resolved in normal negotiations.

As of XX March 2010 To date XX issues have been put into DRP (aa by tie, bb by BSC), YY were settled before they reached adjudication, ZZ are still in the process (with CC expected to go to adjudication in due course), and 4 have been decided at adjudication, these being Hilton Car Park, Carricknowe bridge, Gogarburn bridge and Russell road retaining wall. Of these, the first three were adjudications on points of principle only, with no value attached, on the last one, the adjudicator was asked to decide on issues of principle and value.

To put this into context, there have so far been 565 notices of change. Not all of the these notices relate to design changes, they cover all the issues referred to above. Of these 565 notices, 91 have been withdrawn or superseded, of the remaining 474 we have received estimates for 241 and 250

are still outstanding (the totals do not add up because some INTCs have more than one estimate). Of the 241 submitted, 130 have been agreed (including XX that have been through the formal DRP, which in turn includes 1 of the 4 which went to adjudication, the other 3 adjudications were on points of principle, not value). Of the remaining 111, tie have asked for further information on 64, have rejected 26, and are currently assessing 25.

It should also be noted that the contract sets out a timetable for the timely submission of estimates, (18 days, which can be extended by mutual agreement) and to date, of the 241 estimates submitted only XX were submitted on time, with some being as late as YY weeks. Of the 250 not yet submitted, YY are now overdue, the worst case being WW

Considering the 130 that have been agreed, BSC's original estimates totalled £26.7m and after a combination of discussion, negotiation, mediation and adjudication these have been settled at £16.2m.

The major DRP's to date have involved a difference of opinion between tie and the consortium over the extent of some of the design changes, whether the cost associated with those falls to the client or the contractor, and what is fair value for those changes.

So turning to the 4 adjudications.

Hilton Car Park

This issue concerned works at the back of the Hilton car park at Edinburgh Airport. BSC's argument was that the works required were 'accommodation works' which are not included in the contract price, and they were entitled to an additional £180k and needed a specific instruction for these works. tie believe that these works were not accommodation works and were included in the contract price. The adjudicator (Mr Robert Howie QC) wholly agreed with **tie's** position, in that Infraco was obliged to carry out and complete the Hilton Hotel Car Park without instruction from **tie**.

Carrickknowe and Gogarburn bridges

Although technically two adjudications these two issues are very similar, were submitted at the same time and decided by the same adjudicator. The issue at stake was one of principle, the adjudicator was not asked to value the issues. The issue at stake was the extent to which changes to the design that had occurred since the 'Base date Design Information' (this is a contractual definition and it refers to various documents which existed on Xx November 2007) were or were not deemed to be included in the price, in short, were the changes normal design development or not. The adjudicator found almost entirely for the consortium on these specific examples. The adjudicator did not hear evidence from the parties, he only referred to written submissions, and in our view adopted a bizarre logic which does not stand any credible examination, he also left many questions unanswered. We did consider challenging this finding, but concluded, given the value and for tactical reasons that this would not be the best course of action. (It is interesting to note that the next adjudicator, Mr Wilson, asked both parties if they felt he was bound by Mr Hunter's adjudication, and both parties agreed that he would not be, and Mr Wilson then effectively overturned Mr Hunter's reasoning).

Mr Hunter was asked only to rule on points of principle, not value, and we have still not agreed the value for these two issues, BSC are at around £485k (having started originally at £660) and tie are at around £175k.

Russell Road Retaining Wall

This issue started life as a combination of 3 interlinked issues relating to access, design changes and contaminated ground. BSC's original estimate was £4.5m, which they then amended to £4.8m.

Through the normal channels, and then DRP, the issues of access and contaminated land were settled at around £1m, leaving only the design issue valued by BSC at £1.8m. Prior to entering into adjudication we had already offered a settlement of £1m. On entering adjudication we took the tactical decision to reduce our position to £0. On the specific issue in question the adjudicator (Mr Wilson) decided that most of the changes to the design were beyond normal design development (a decision that we largely agree with, hence our offer of £1m pre adjudication) and decided on a value of £1.46m.

Mr Wilson did have a hearing and in reaching his conclusion made some important conclusions that we find very encouraging, namely:

- He overturned the reasoning of Mr Hunter
- He also concluded that

"The fundamental provisions of the contract are that Infraco delivers the Infraco works comprised in the employer's requirements for the Contract Price including the Construction Works Price being expressly a fixed lump sum save for adjustment in accordance with the Contract. I do not agree that on a proper construction the Construction Works Price can be construed as being solely for the Works shown on the BDDI or any similar alternative construction"

- He also noted

*"It appears that something has gone wrong with the language of section 3.4.1.1 [*This is the wording which attempts to define 'normal design development'] *as, on the face of it, on a literal reading some part must be redundant to give it meaning. I consider that the formulation advanced by tie most nearly expresses the true intention of the parties as can be discerned."*

Progress and Programme

XXXXXXXXX

What is BSC's strategy/position?

There are three main planks to BSC's argument. Firstly that the price never included all the works for the whole tram system, secondly that they have no obligation to work in any areas where there is a dispute, and thirdly they have been delayed by the client, most especially in relation to the utilities, but also in relation to design changes.

"This was only ever a price for a three wheeled car"

In conversations with Richard Walker through 2009 it became clear that BSC's argument is that the price quoted was never intended to be a price for the whole of the tram system, (hence the quote above) and that tie (Willie Gallagher in particular) were fully aware of this. RW's view was that tie needed to get the contract signed at a price that was within the approved budget, and the only way to do this was to manipulate the scope so that the Construction Works Price (CWP) was in effect only for the details shown on BDDI, and that any change to this would be an extra. RW's view is that this was all subject to a gentleman's agreement which he cannot produce and which is vehemently denied by WG.

In addition, Dr Jochen Keysberg refers to the "Value engineering nonsense" saying that we all knew that there was never any expectation that the value engineering savings would be delivered and that this was a "scam" for getting the price below the approved budget. "This was taken out of the price pre contract so that it could be added back in afterwards"

In the Russell Road Retaining Wall adjudication hearing the adjudicator, Mr Wilson, asked the parties "If there are 21 tram stops shown in the employer's requirements, but only 14 shown on the drawings forming part of BDDI, who pays for the extra 7?" BSC's lawyer, Fraser McMillan stated that the client does because "we only priced BDDI".

A more sophisticated argument from BSC is that they priced the employers requirements (because that is what the contract says) but that price is so heavily qualified by the pricing assumptions and specified exclusions in Schedule part 4, that the effect is that they only priced BDDI.

Mr Wilson, in his adjudication finding opined on this very issue, as noted above.

Our response to this is:

We know from a member of the consortium that BB under-priced the job. "I have seen documents that you will never see and I know for a fact that we under-priced this job". The argument that this was never a price for the whole job is post rationalisation, (although it is clear from pre-contract communication that even during preferred bidder status BB were seeking to exclude many things from their price, and that on 4 separate occasions they approached tie for, and were given, more money)

If the price was only for BDDI, why did the price increase when the employer's requirements changed?

If the price was only for BDDI, why does the contract not say this?

If the effect of pricing assumption 1 is that they only priced BDDI, then there is no need for the other 42 pricing assumptions.

We have obtained legal advice and QC opinion that supports our view that BSC's interpretation of the contract is wrong. "BSC's position is superficially attractive, it is however wrong"

We find it difficult to imagine that a company the size of Bilfinger Berger, in consortium with Siemens, would enter into a contract which it had knowingly under-bid on the basis of getting that

money back through a 'gentleman's agreement'. We also find it incredible that tie and CEC, (with all the attendant scrutiny that went with the procurement process) or any individuals within those organisations would knowingly enter into such a contract. We consider this argument to be post rationalisation of the fact they under-bid the job. Our own calculations suggest they under-bid by approximately £NNm, and this is consistent with their public demands for money money which started in Feb 2009.

"This contract allows us to hold you to ransom"

Throughout this project BSC (especially BB) have used lack of progress (and the public and political pressure on tie to deliver progress) as a lever to force us to accept their interpretation of the contract. Their tactic has been to raise a very large number of change notices and then refuse to start work anywhere where they believe there is a change. This, combined with the late delivery of estimates, or estimates that lack sufficient detail (thus making it make it impossible for tie to properly assess the estimates) effectively allows them to stop the job at their whim, holding the client to ransom, hence the quote from Dr Keysberg above.

BSC deployed this tactic in the run up to starting work on Princes Street, claiming they could not/would not start work unless tie signed a supplemental agreement which changed part of the job onto a cost plus basis.

This tactic has meant that they have significantly under-delivered against planned progress (actual to date versus elapsed time to date...). Whilst it is true that the utility works have delayed their access to the city centre sections, this does not explain the slow progress, or lack of progress on other sections of the project.

It is also interesting to note that they have not signed any sub-contracts for the project yet, as this protects them against claims form their sub-contractors for delay.

During conversations with Dr Keysberg in 2009 he used the above quote, and this was repeated at a board meeting in Germany, where David Darcy was present.

Whilst their commercial rationale for adopting this approach is clear, their contractual basis for this approach is somewhat less clear. They argue that Clause 80 forbids them from starting work anywhere where a change is not agreed. Taken to its extreme, this would allow them to submit a notice of change, however valid or supported, and then stop work until the issue is resolved, thus frustrating the contract.

Our response to this is

We have very strong legal advice (including QC opinion) that suggests their approach to this element of the contract is fundamentally wrong. We also know that this approach is causing much tension between BB and Siemens, and Siemens view is that BB's approach to clause 80 is "suicidal"

"This contract will never get a tram built"

In all our discussions with BB, they have consistently sought to undermine the credibility of the contract using phrases such as the one above, and "if you want to get to America, you don't buy a bicycle". They have argued the only way to get the tram built is to switch to a cost plus contract,

which is a tactic they have used elsewhere in the world. At every opportunity they have sought to demonstrate the current contract does not work, arguing that it is in the client's best interest to change the form of contract.

Our response to this is

The contract is bespoke and that does introduce some uncertainty and opportunity for challenge by virtue of the fact that the contract has not been tested in court. However the contract does include some very employer friendly clauses, and is perfectly capable of building a tram if it is used properly, rather than abused, in particular the issue of whether or not the contractor is obliged to proceed where there is an alleged change. We also note that BB were claiming the contract does not work within a few days of signing it.

What is tie's position?

We believe that BSC (in particular BB) have under-estimated both the cost and programme for the job. We also believe that they have failed to manage the design (the design is currently very late with only XX IFC packages out of YY currently complete, and we have information from sub-contractors that they are being told they cannot start because no IFC drawings are available), failed to manage the supply chain (they still do not have any signed sub-contracts), and failed to manage and mitigate the programme.

The result of all this is that progress is way behind programme, and way below the planned progress rates. BSC's approach, as detailed above, is to use the utility delays, and their interpretation of clause 80, to disguise their own shortcomings, and to use the lack of progress as a lever to pressure tie into agreeing their view on additional costs.

Our view is that BSC are entitled to some additional costs under the contract, and an extension of time to allow for MUDFA delays.

We have tried in the past to adopt a compromising position, but to date that has not been reciprocated by BSC. We have therefore now adopted a much more contractually assertive approach in an effort to bring the key matters to a head.

We have developed a strategy to do this, which is confidential, but we expect this to bring matters to a head in the next few months.

What is BSC's response to this?

So far BSC have advanced no new arguments or evidence in defence of their position, they have however embarked on a concerted (and largely transparent) campaign to undermine the credibility of tie, both at an organisational level and a personal level.