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Transport Scotland
8 July 2011

Cabinet Secretary for Finance, Employment and Sustainable Growth
Cabinet Secretary for Infrastructure and Capital Investment

EDINBURGH TRAM REPORT

Purpose

1. As requested to provide Mr Swinney and Mr Neil with an assessment on the state of play on trams, including:

- A full financial assessment of the project as it stands now and the steps required to complete.
- Information on risks involved, risks removed, confidence in fixed price, remaining uncertainties over price.
- An assessment of the capability of CEC and TIE to complete in engineering, project management and financial areas.
- A full assessment of how CEC intend to close the financial gap and what is their ability to borrow, in terms of prudential borrowing.
- Advice on the contents of Sue Bruce's letter of 5 July to Mr Swinney.

Priority

2. Routine.

Financial Assessment

3. The total revised estimate to complete the tram from the Airport to St Andrew's Square now stands at between £725 million to £773 million. A breakdown of the key elements of that estimate is provided in the table below.

	High (£M)	Low(£M)
Airport to Haymarket	362.5 fixed price	362.5 fixed price
Haymarket to St Andrew's Square	22.5 target cost	22.5 target cost
Tram vehicles	62.4	62.4
Contingency & risk	77.5	30
Other costs to date	239	239
Project management	9	9
Total	**772.9**	**725.4**

4. The principal cost is the completion of the infrastructure works from the Airport to St Andrew's Square. That is split into 2 components based on the agreement reached at the mediation in March: a fixed price to complete all outstanding works between the Airport and Haymarket of £362.5 million; and the remaining works to complete to St Andrew's Square on the basis of a target cost estimate of £22.5 million. The tram supply has been split off from the main contract. All the trams have now been assembled and the final price is £62.4 million. The final estimated cost of the main contract is therefore £447.4 million. That compares to the original tender price for the Airport to Newhaven of £296 million.

5. The revised cost takes account of the £239 million already spent on land, advance works and other associated costs and an allowance of £9 million for CEC's project management costs to complete the works. The principal variable is a risk allowance of between £30 million to £77.5 million.

Confidence in revised estimate

6. Much of the uncertainty and scope for further contractual argument has been removed through the negotiation of a lump sum fixed price for the bulk of the works from the Airport to Haymarket. That was negotiated and agreed by both side during mediation and there is therefore a full understanding on both sides of the risks and costs now being accepted by each party. The level of confidence of delivering to budget ought to be high subject to the client not issuing variations or changes. Given that the design is now complete then the likelihood of that being necessary is low. The only exclusions to the fixed price are for artefacts, archaeology and munitions. These are standard exclusions and the risks are minor as most of the works are now out of the ground.

7. The remaining issue for the fixed price element is for CEC to ensure that the fixed price elements are properly reflected in the legal drafting of the revised terms and conditions. In the period since mediation, CEC has instructed Ashurst (a leading UK lawyer) to act on their behalf in the negotiations on revising the contract.

8. The on-street works between Haymarket and St Andrew's Square are being done on a target cost basis so the cost could be subject to variation depending on the extent of unforeseen ground conditions and service diversions encountered during excavation work. The estimated cost of £22.5m is based on full open book accounting so CEC will have full transparency of all the contractor's costs. That includes full tendering of sub-contract work and an agreed level of profit and overhead, with a so-called pain/gain mechanism if the works come in under or over the agreed target cost. It is a well tried and tested form of contract and subject to the amount of due diligence undertaken prior to agreeing the final target price has a good track record of delivery.

9. CEC have built in a fairly generous risk and contingency allowance ranging from £30 million to £77.5 million. Given the stage the project has reached the upper limit could be argued to be overly conservative but is undoubtedly coloured by the experience to date in the obstacles that have been encountered in excavating in city streets with little to nothing in the way of accurate records. CEC are attempting to mitigate that risk through further site investigation works, including radar scanning and bore holes in order to give greater certainty to the potential utilities conflict along Shandwick Place. This will

enable greater confidence to be established as to the quantum of the risk allowance for these works which could result in the risk allowance being reduced prior to report back to the Council in August. Overall CEC have employed the levels of due diligence we would expect to see for a project of this magnitude. What will be important, however, is the level of assurance they have received from their various specialist advisers.

Governance and project management

10. CEC are already in the process of significantly re-structuring the governance and contract management arrangements for the project going forward. Management responsibility will move from TIE to the Council with Dave Anderson, the Director of City Development, assuming the Senior Responsible Owner role with accountability to the Chief Executive for the delivery of the project. TIE will be down-sized and effectively become a resource to the CEC for lower level contract supervisory works.

11. The revised governance arrangements being proposed by CEC will include;

- **Joint Project Delivery Group** – All heads of discipline from the contractor/CEC/tie will meet on a fortnightly basis to ensure any issues are resolved around the table.

- **Joint Project Forum** – Essentially this will replace the tram project board and will be chaired by the Council Chief Executive. The forum will also comprise Dr's Keysberg and Schneppendahl who are the key decision makers from Bilfinger Berger and Siemens. Any issues that cannot be resolved at the Joint Delivery Group will be escalated to the Forum where a pragmatic decision will be made. CEC have indicated that they would welcome Scottish Government/Transport Scotland representation on this group.

- **Independent Certifier** – With the revised governance structure, there is a role for an independent certifier (who holds a duty of care to CEC) to assess commercial valuations where there is a difference over the amount of certificates and valuations. The Independent certifier will take a fair view of the valuations and payment will be made to the contractor on that basis.

12. The re-structuring addresses the failings identified in the recent Audit Scotland report but more importantly provides CEC with direct control of the contract and with oversight at the highest levels of management. On that basis it appears to offer a sound basis for effective management of the contract going forward.

Funding

Local authority capital expenditure financed by borrowing

13. Borrowing is one of the ways that local authorities finance their capital expenditure. Schedule 3 of the Local Government (Scotland) Act 1975 provides local authorities with the statutory authority to borrow money to fund capital expenditure. Section 35 of the Local Government in Scotland Act 2003 places local authorities under a

statutory duty to determine the amount they can afford to allocate to capital expenditure. In doing so, they must have regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. This requires local authorities to have regard to a series of indicators such as prudence, sustainability and affordability in determining their plans.

14. Local authorities are required by legislation to operate a Loans Fund. All monies borrowed externally from the market by the local authority are paid into the Loans Fund, which then makes advances to services accounts (General Fund and Housing Revenue Account (HRA)) to fund capital expenditure. The level of debt recorded by the Loans Fund is the value that must be charged to the local authority revenue account over a number of years. The annual repayment of the Loans Fund debt is known as the statutory repayment of debt.

City of Edinburgh Council – capital and borrowing information (non HRA housing)

15. The City of Edinburgh Council is required to make returns to the Scottish Government on capital and borrowing. These returns show that Edinburgh's loan fund debt has been rising over the last ten years. At March 2002 loan fund debt was £590.360 million and has risen to £850.108 million at 31 March 2010, an increase of £259.748 million or 44%. In 2009-10 debt costs (statutory repayment of debt) was £89.537 million (principal repayments £42.835 million and interest costs of £46.702 million). This rise in debt is evidenced in Edinburgh's debt per head of population which has also risen. At 31 March 2008 it was £1,410 rising to £1,626 by 31 March 2009 and at 31 March 2010 it was £1,780. We will not have values for 2010-11 until later this year, but provisional information provided indicates a borrowing requirement for 2010-11 of some £49.5 million.

16. In CEC's letter dated 5 July 2011 the Council identifies that the funding gap for the first phase of tram line 1a is estimated at around £100-£125 million, and indicates that borrowing would provide the lowest cost solution. Assuming the lower estimate of £100m this would increase the loan fund debt by 11.7% and represents a debt per head of population of about £209.

17. The current Public Works Loan Board rate quoted by the Council is 5.29% for a 30 year loan. Based on an Equal Instalment of Principal loan (EIP) over 30 years this indicates a total debt cost of £180.672 million which averages about £6 million a year over a 30 year period. The actual debt costs per year will vary depending on the type of loan.

18. In the same letter, the Council has proposed that it could fund the annual debt charges by retaining 100 per cent of any additional non domestic rates income generated through the proposed Business Rates Incentivisation Scheme. For the reasons set out below Local Government Finance colleagues do not consider this to be a feasible option.

Possible retention of additional non domestic rates income (NDRI)

19. The Scottish Government's funding to local authorities is allocated on the basis of need. The guaranteed funding provided is a combination of distributable non domestic rate income plus general revenue grant. Up to and including 2010-11 the distributable amount of non-domestic rate income was allocated to each local authority on the basis of

its share of total population with the guaranteed balance being made up by general revenue grant. Any additional non domestic rates income retained would have been compensated for by a reduction in general revenue grant and vice versa.

20. With effect from 1 April 2011-12 all local authorities will now retain all the non domestic rate income collected within their boundaries. As a result their general revenue grant has been adjusted accordingly. Edinburgh will receive £297.4 million in 2011-12 from non domestic rate income.

21. In addition the Scottish Government is committed to the introduction of a Business Rates Incentivisation scheme which will incentivise all local authorities to maximise their existing non domestic rates income and also to grow their potential non domestic rates tax base. This will be achieved by allowing them to retain a proportion of the non domestic rate income over and above an agreed target level. The current proposal is that any additional non domestic rate income should be shared 50:50 between the Scottish Government and the individual local authority for a 5 year period. Edinburgh's proposition is that they should be allowed to retain 100% of any additional income for a 30 year period to finance the cost of borrowing to meet their funding gap.

22. This proposal has a number of flaws, namely; there can be no guarantee that Edinburgh City Council will collect **any** additional non domestic rate income; any additional income retained by the Council over above the 50% allowed under the proposed scheme would be income lost to the Scottish Government; it could set a precedent and open the door to all other councils requesting the same concession for priority projects in their area which would be a loss of further income to the Scottish Government. It is also likely that COSLA would argue that if one council was allowed to retain 100% of additional business rates income then that option should be made available to all 32 local authorities. This again is unaffordable to the Scottish Government.

23. There is also the new Tax Incremental Financing (TIF) initiative that allows local authorities to capture locally generated, incremental non-domestic rate revenue from private sector development that has arisen as a direct result of local authority investment in "unlocking" infrastructure. The captured NDR revenue is then used to repay debt raised to finance the infrastructure investment. The first approved TIF scheme was the City of Edinburgh Council's Edinburgh Waterfront project, which was provisionally approved by the Cabinet Secretary for Finance and Sustainable Growth last September and given final approval in March. TIF is intended to be used to finance the development of a new cruise liner terminal, lock gates, esplanade and link road, costing £84m (unlocking £660m of private investment).

24. A more realistic funding option for the council maybe to use the additional funding it is likely to receive from the introduction of the new 85 per cent revenue funding floor. Local Government colleagues' submissions of 17 and 27 June refer. Sue Bruce's letter of 5 July does not make any specific mention of the funding floor but Councillor Mackenzie was reported in yesterday's Evening News as suggesting that it might offer a solution. I understand that you are meeting Local Government Finance colleagues on Tuesday 12 July to discuss the details of the proposed new funding floor.

Deferral of other CEC capital projects

25. Sue Bruce cited in her letter the impact on CEC's ability to progress other key capital projects in the short to medium term if funding had to be diverted from these to bridge the gap on the tram project. Given the difficult decisions that all parts of Government face in prioritising projects this does not appear to us to be a compelling reason for CEC not to consider this a possible way to fund the tram shortfall.

Lease or sale of surplus tram vehicles

26. Given that there is no realistic prospect of the tram being completed to Newhaven in the foreseeable future then CEC's proposal to either sell or lease the surplus tram fleet of up to 10 vehicles would appear to be a sensible option to explore. However, the purchase of these vehicles has already been subsidised by Scottish Government through the grant support. Technically, as they are 90% funded by Scottish Government any sale or lease receipt which was recycled back into the project could be seen as going above the £500 million funding limit set by Ministers.

Conclusion

27. **That Ministers note the above assessment of the current state of play of the tram project. Local Government Finance and Capital and Risk colleagues have contributed to and signed off the above advice.**

Ainslie McLaughlin
Director MTRIPS
Transport Scotland
8 July 2011

Ext [redacted]

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constit Interest	General Awareness
Minister for Housing and Transport			X		

DG Enterprise and Environment
DG Governance and Communities
Permanent Secretary
PS/Transport Scotland
David Middleton, Transport Scotland
Sharon Fairweather, Transport Scotland
Raymund Johnstone, Transport Scotland
John Ramsay, Transport Scotland
Kenny Hannaway, SGLD
Kirstin Baker, Capital and Risk
Graham Owenson, LGF
Bill Stitt, LGF