

**Paper to:** TPB **Meeting date:** 8<sup>th</sup> July 2009  
**Subject:** Value for Money Review of DPOFA  
**Preparer:** Alastair Richards

---

This paper sets out to re-examine the outsourcing of tram operation to Transdev and to evaluate possible ways forward based on 3 options:

- A) continue with Transdev under the DPOFA contract;
- B) take the Transdev DPOFA scope back in-house;
- C) As option (B), but with Transdev retaining an association with the project, as a retained advisor.

**Background**

Whether the most efficient and cost effective way forward is to remain with the current arrangement, or bring operations in-house, has been considered on a number of occasions over the past 3 years, however previously any decision has been deferred pending achievement of contract close. It was felt that pre contract close was not the right time to review the issue lest it brought instability into the procurement process, and unsettled the Infraco and Tramco bidders, funding bodies, politicians and stakeholders.

During the summer of 2008, following contract close, a preliminary review was undertaken which identified that a detailed review should be postponed until sufficient progress had been achieved with the detailed design of the infrastructure, systems and trams.

**Executive summary**

**1. DPOFA Contract Status**

The DPOFA, originally signed in 2004 with Transdev has now completed Phase A and B of the DPOFA scope. Since contract close was achieved with Infraco and Tramco, Phase C1 has been underway for approximately a year.

<u>Phase</u>	<u>Scope</u>	<u>Contract Duration</u>	<u>Latest Duration</u>
A & B	Preparation	Concluded Mid 2008	Concluded
C1	Mobilisation	Mid 2008 to Mid 2010	Ongoing to Late 2010
C2	Mobilisation	Mid 2010 to Mid 2011	Late 2010 to Q1 2012
D	Operational	Mid 2011 to Q1 2019	Q1 2012 to Q1 2019

The DPOFA was renegotiated extensively during 2007 in order to improve efficiency, to obtain synergies with TEL and to revise the scope to reflect the truncation of the scheme to Lines 1a and possibly 1b. It was re-executed in December 2007 for the then forthcoming 3 year mobilisation period (Phases C1 and C2) and the approximately 8 year operation period (Phase D).

**2. Financial**

Table 1 summarises the potential financial savings that would arise if the DPOFA scope was in sourced during the Mobilisation Period based upon the contracted rates.

Mobilisation Period Costs and Potential Savings	Phase C1 Consultancy 20% margin £ M (2007)	Phase C2 Workforce 6.7% margin £ M (2007)	Total Mobilisation Costs £ M (2007)
Mobilisation cost (2008 - 2011)	1.0	2.5	3.50
General Manager salary	0.29	0.28	0.57
mobilisation profit margin for Transdev	0.17	0.16	0.33
Therefore maximum mobilisation cost <b>saving</b>	<b>0.46</b>	<b>0.43</b>	<b>0.89</b>

Table 1

In sourcing would however import some financial risks for the mobilisation period, as shown in Table 2:

Mobilisation Period Risks	Total Mobilisation Cost Risk £ M
admin and control room staff understated by 2	0.07
non-operational salaries too low by 20%	0.14
non-labour costs understated by 20%	0.11
additional testing resource required	0.31
delay to Infracore testing by not providing drivers	0.25
Therefore mobilisation potential cost <b>risk</b>	<b>0.88</b>

Table 2

If the cost risks were all to crystallise during the mobilisation period they would net off against the potential savings, this however is a very pessimistic basis as it assumes no discounting of the cost risks due to probability of occurrence. When these are taken into account the cost risks reduce to and then worthwhile financial benefits accrue from in sourcing the activities during the Mobilisation period.

Table 3 summarises the potential financial savings that would arise if the DPOFA scope was in sourced during the Operations Period.

Operational Period Costs and Potential Savings (Note these are in 2004 costs and are indexed at RPIX)	Phase D Operations 6.7% margin Annually £M	Total Operations Costs 8 ½ years £ M
Annual operating cost	7.76	67.9
annual operational profit margin	0.56	4.9
additional cost synergies with TEL	0.07	0.61
Therefore annual maximum operation cost <b>saving</b>	<b>0.63</b>	<b>5.51</b>

Table 3

Once the tram is operational then the financial risks are primarily cost inflation and revenue which sit with TEL under the DPOFA anyway and so the in sourcing scenario is cost risk neutral, as can be seen above worthwhile financial benefits accrue from in sourcing the operational activities.



To summarise, table 4 shows the potential savings from in-sourcing the DPOFA activities from mid 2009.

<b>Total Potential Savings</b> (Note these are in 2004 costs and are indexed at RPIX)	<b>Total Mobilisation &amp; Operation 10 years £M</b>	<b>Total with Transdev Requested increases Mobilisation &amp; Operation 10 years £M</b>
Mobilisation & Operating costs	71.40	73.1
profit margin	5.23	5.43
additional cost synergies with TEL	1.18	1.18
Therefore mobilisation and operation cost <b>saving</b>	<b>6.40</b>	<b>6.61</b>

Table 4

### 3. Reputation

The tram is being branded as an integrated element within the integrated transport network including the Lothian Buses brand. This means that to the general public and most key stakeholders, the success or failure of the tram and buses will be synonymous. Whilst the DPOFA contract incorporates incentives and penalties respectively for good or deteriorating levels of performance, were the DPOFA to be in sourced then TEL would gain direct control over the focus of expenditure and effort in areas where it considered would yield the best performance service delivery. Also the effect of injecting additional resources would not be diluted by paying a profit margin to Transdev.

Transdev’s business strategy is based upon maintaining good relations with the public sector with the result that it is highly unlikely for them to take an adversarial approach to moves to take the work inhouse. It is most likely that in order to protect their reputation they would be mainly interested in agreeing a rational explanation to jointly explain their departure from the project to the transport community. This is felt to be achievable in a lower key manner at the end of the design phase, after:

- a significantly prolonged period up to Contract Close compared to that originally intended under the DPOFA, and
- the prospect of an extended period before operational service commencement;

rather than the inevitable high profile media attention and speculation that a termination would attract if it occurred post tram opening.

### 4. Competence

TEL have to employ sufficient tram management and safety competence to effectively manage the DPOFA and Infraco maintenance contracts and to discharge its duties arising out of the fact that it is the organisation that sells the tickets to the passengers and manages the strategic safety of the tram operation. Were the operations in sourced then the duplication of management effort can be streamlined. There is no evidence to suggest that Transdev can attract a higher

calibre of resource than that which can be recruited by TEL using the Edinburgh Tram brand directly.

To undertake the responsibilities required by in-sourcing the activities as well as managing the contracted out maintenance, 7 key functions must be filled. These are, Engineering, Safety and Quality, Maintenance and Commissioning, the Passenger Service Team, Finance, Documentation Control, Performance and Staff Development.

Some of these functions, for example finance, will draw upon shared resources from other areas within the one family organisation.

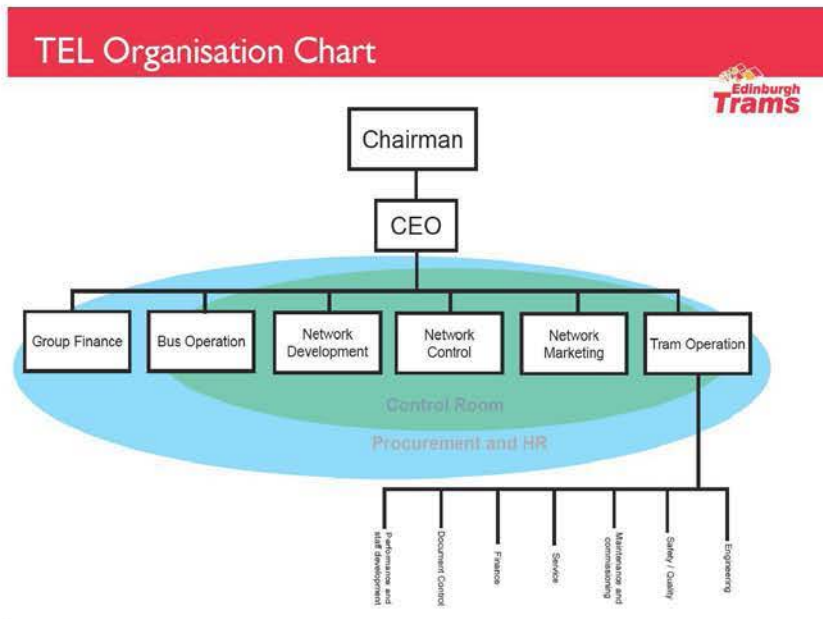


Figure 1.

Other resources, for example commissioning support, will be drawn from contracted staff rather than full-time employees due to the transitory nature of this role. Discussions have been held with a number of organisations that could assist in this, Interfleet, Mott Macdonald and North Star have strong capabilities in these areas, should we require their support.

**5. Strategic**

Transdev plc has a mandate from their parent company to expand their business in the UK primarily through acquisitions. Most activity to date has been in the bus sector where they are successfully targeting local authority and privately owned bus companies having purchased, amongst others, Bournemouth Buses from the council owners and the City Sightseeing operation in York. Their bidding performance on light rail franchises in the past, e.g. Docklands Light Railway and Manchester Metrolink, where in both cases they failed to make the shortlist, has shown them to be non-competitive on price and averse to commercial risk.



Early in the project, (during 2003/04), Transdev lobbied CEC and other parties for the sale to them of a significant shareholding in Lothian Buses, the proceeds of which they suggested CEC could use as (part of) its contribution to the capital cost of the tram project. In recent months this proposal has been (informally) aired again by Transdev along with other suggestions as to how they could 'buy in' to the Edinburgh public transport/bus market.

Transdev's other light rail operation in the UK, Nottingham, is in the process of being re-tendered as part of the competition for extension of the system which is likely to be decided on the construction element, rather than the capability of the operating partner. Transdev acquired 20% shareholding in NCT, the council owned bus operator, as part of their involvement in the Nottingham tram operation, and envisage a sizeable increase in their shareholding if the planned extensions proceed and they are successful in the re-tendering exercise.

## **6. Administrative**

The contracting out of the tram operations imposes an administrative burden upon tie/TEL and does, despite the flexibility provided for under the DPOFA terms, place restrictions on tie/TEL's freedom of action as the project progresses. An example of this would be the flexibility to react to changes of the Project Programme, and take advantage of phased opening and or shortened periods of trial running of the trams. There is also a commercial tension, in that for Transdev during Phase C1 they may be motivated to create a higher workload, which requires more resources, which can then be charged to the project. This would maximise their profit.

Taking the DPOFA scope in house would help to streamline the existing mix of contractors working on the project, Bilfinger Berger, Siemens, CAF and Carrillion, reducing the number of parties involved, streamlining procedures, speeding up decision making and maximising time spent on delivering the project, rather than on contract administration and compliance. This was one of the main driving forces behind bringing together Bilfinger Berger and Siemens into one consortium, BBS, and the novation of Parsons Brinkerhoff (SDS) into Infracore, along with CAF joining the Infracore consortium, resulting in 4 contractors being reduced to 1 for contractual/administrative purposes.

## **7. Outcomes**

Assumptions inevitably have to be made in order to predict the quality of tram service outcomes likely to be achieved with and without the DPOFA in place, however what cannot be argued is that TEL has an overriding commercial requirement and the commitment from top down that the tram service will be at least as good, and ideally better than, the high standard of the existing TEL bus operations. TEL is responsible only to 1 body - CEC its shareholder, whereas Transdev's primary responsibility is to its own parent company, then to its contract counterparty, Tie.



With the DPOFA in place TEL gains the benefit of input from Transdev's wider experience, without the DPOFA TEL would be freer to craft the tram service it requires without having to do this through an 'Agent'. TEL would certainly maintain and improve its links with other tram systems and experience sharing forums that exist which are based on the natural instinct of people working in the common industry. This would mitigate the loss of direct access to the experience under contract with Transdev. For example, TEL is a full member of CPT's Fixed Track Section, the trade association for UK light rail operators. Tie is a member of UKtram, the body working with Department for Transport to progress tram standards throughout the UK.

## **8. Risks/Opportunities**

There is an opportunity to obtain resource synergies by taking the DPOFA in house by eliminating staff duplication and removing the profit and risk margin between TEL and Transdev necessitated by having a contract structure in place. The counter balancing risk imported by taking the contract back remains significant whilst the design is finalised for construction, but then dramatically reduces in mid to late 2009 before increasing again from early 2010 as the start of service commencement approaches. After opening the risk then again reduces dramatically.

## **9. Contractual Implications**

During Phase C1 the notice period under DPOFA is 30 days with an entitlement for the Contractor to be reimbursed for demobilisation costs of those staff and resources that do not TUPE over to tie/TEL, assuming TUPE applies in this situation.

During Phases C2 and D the notice period under DPOFA is 3 months with an entitlement for the Contractor to be reimbursed for both demobilisation costs for those staff and resources that do not TUPE over to tie/TEL, as well as for loss of profit for the original contract duration.

There is no explicit anti-competitive clause in DPOFA, so Transdev would not be in breach of contract, for example, by acquiring another bus operator in the Edinburgh area and thus becoming themselves a competitor to TEL services whilst remaining under contract to TEL to operate the tram. Breach of contract would only occur if they neglected to perform their contractual obligations under DPOFA for any reason, something that Transdev will be shreud enough to avoid.

The appendix contains a legal opinion from DLA detailing the contractual situation.

## **10. Conclusion**

If the strategic decision is taken to terminate the DPOFA, which is the course of action that this paper recommends, there are two logical windows of opportunity for making a change to in source the tram operations, mid 2009 to late 2009 and then

three years post-opening in 2015 in association with the contractual reset mechanism.

In between these two periods the risk profiles are changing and critical outcomes have to be realised, e.g. finalisation of construction, preparation for the start of passenger service, or service increases and bedding down periods, which do not make for good opportunities to effect a change of this nature.

Clear benefits arise from seizing the earliest window of opportunity as it would attract far lower demobilisation compensation entitlement, would provide TEL with the best opportunity to prepare the high quality operation that is critical for it to have in place and would also realise the greatest cost savings.

TEL already has many of the skills and abilities needed to successfully undertake the responsibilities of Transdev under DPOFA, and will relatively easily be able to acquire those it does not currently have. There seems no good reason not to streamline the number of parties involved in the project, and taking the savings and benefits that would accrue, from taking operations in house. Not least also in light of Transdev's recent request to increase certain of the DPOFA fixed costs in order to protect or possibly increase their margin.

### **Recommended Strategy**

1. TPB authorise the Executive Team to engage with Transdev and inform them that it is the intention to terminate the present DPOFA contract during the current Phase C1.
2. As a result of the ongoing competitions in which Transdev are involved, it is believed to be highly likely that they will not wish any public announcement at a critical time for them and that they will seek to be able continue to claim an association with the Edinburgh Project, whilst reluctantly relinquishing the operational scope.
3. Negotiate a 'son of DPOFA' agreement with Transdev to provide technical support.
4. If this is not achievable then reach an agreed timing and approach to press announcement.
5. Take the appropriate steps to transfer key staff.

### **Impact on budget**

Summary of impact on tram budget (£512M) (if any) and where additional funding will come from. No impact is anticipated as there is an existing budget included within the £512M for DPOFA and the savings will off-set the increased costs arising from the currently anticipated, but as yet unapproved, extended duration of the Project to February 2012.







**Appendix 1:**

Legal Opinion on Termination Options