

**EDINBURGH TRAM PROJECT
GOVERNANCE AND CORPORATE MODEL RESTRUCTURING OPTIONS**

STRICTLY CONFIDENTIAL

Background and rationale for change

At the December TPB, a number of options for streamlining the current governance and corporate model were considered. The present structure is :

- CEC is client and principal stakeholder
- TEL is 100% sub responsible for overall delivery and future operational integration
- The TPB is a TEL sub-Committee established to oversee delivery (by tie) and planning for operations
- Tram Project Director reports formally to TPB on progress
- Tie Board is responsible for contractual fulfilment
- TS is principal funder

The governance model reflects inheritance but is working reasonably well. Roles and responsibilities are clear in practice. External parties (TS, Audit Scotland) have no major concerns and the model is operating in line with that approved in the 2007 Final Business Case. Attendance and engagement at regular meetings is generally good.

However, there are areas needing improvement :

- Tie Board meetings go beyond contractual focus and the demarcation between tie and TEL / TPB has grey areas. The calibre of the tie Board and quality of challenge is very good. This is a high quality resource which is somewhat out on a limb. The precise responsibilities of tie Limited are a cause for concern among tie Directors.
- There is considerable overlap in practice between tie Board and TPB interrogation
- Tie is seen as the player responsible for all aspects, not aligned to actual responsibilities (CEC in particular have key responsibilities around interface with public, roads and traffic which are attributed to tie)
- In general, CEC's leadership role is not well reflected in the execution of governance
- The TEL role and business model is not yet distinct. TEL is not established as an active company.

The structure could benefit from streamlining and there is an opportunity to create a future-proof structure. Essentially, there is one company too many. A better option would be the creation of a single legal entity, wholly-owned by CEC (but at arms length), responsible for delivery and operational integration planning and in due course operational management. This would clarify and streamline responsibilities, ensure a smooth transition from construction to operation and encourage end-to-end accountability (what is delivered now will be the responsibility of broadly the same group of senior people when it is operational).

If we can envisage the end-point, say roughly when trams commence revenue service, the single entity would have fulfilled its delivery responsibility and its responsibility for creating an integrated service model ; the same body carries forward the maintenance management responsibilities and takes up operational management for the integrated

system. LB would continue as the bus operating company, with its governance aligned with its new sub-group. The single entity could also pick up a strategic planning role in tandem with CEC.

There are questions about combining delivery and operations, but this should not be a barrier. The linkages between delivery and subsequent operation are extensive. Although the scale of delivery capacity is a variable, dependent on pipeline and workload, this can be managed. Similarly, if there is a wind-down in delivery capacity because the pipeline is dry, the challenge will require to be met whether there is a single-entity or the existing multiple entity model.

Options examined

If it is accepted that a single-entity model is the desired outcome, there are three main options :

- (A) TEL is the entity and tie is merged into TEL
- (B) Tie is the entity and TEL is merged into tie
- (C) A new entity (“Newco”) is created and both tie and TEL are merged into Newco

In all cases, the shares of Lothian buses plc will be transferred into ownership within this sub-group, as has been the anticipation for some time.

Option A creates the least overt change, but causes the maximum legal and contractual disruption. Option B minimises disruption but involves more sensitive communications issues. Option C does not obviously create a better structure, but would be the least disruptive.

There are numerous detailed issues around each option but the main pros and cons are as follows :

Option A – TEL

TEL’s public profile may not be strong at this stage, but does represent the anticipated future integrated transport company. Merging tie into TEL would reinforce the hierarchy of tie as project deliverer and TEL as ultimate oversight body. This structure would retain the TEL name and lose the tie name. There would be scope to adapt the TEL name if it was thought appropriate, perhaps in the context of a wider review of the integrated system branding. LB shares would be transferred to TEL in due course, as already made clear in the Final Business Case and in Council reports.

However, there are practical problems in moving tie’s activities into TEL – all of the major contracts would require to be assigned ; there are c90 employment contracts which would require to be moved ; there are also leases and various other third party contracts. In the other direction, TEL has minimal contractual liabilities and personnel. These challenges could be addressed but there would be complexities, legal costs and potential delay. Finally, critical health and safety responsibilities would require to be re-written.

Option (B) - tie

The flipside of the practical difficulty of the TEL model is the relative simplicity of the tie model. The downside of the tie model is that there would most likely need to be a change of company name from tie to TEL in order to preserve the profile of the

umbrella organisation, a change which will create presentational challenges to avoid accusations of smoke and mirrors. A new name in the context of a refreshed project branding exercise may help with this.

Option (C) – Newco

This option would incur the practical difficulties noted above, offers no obvious advantages and therefore holds little attraction.

Detailed evaluation

At the December TPB, it was agreed that the following areas required examination, initially to identify fatal flaws in the options proposed.

1. Contractual obligations of the existing entities, TUPE and Council guarantees
2. Decision-making clarity, Board composition and responsibilities in all entities
3. Tram monitoring Officer role
4. Communications implications
5. Impact on current tax planning
6. Competition Law and State Aid considerations
7. Transport Act 1985 considerations
8. Terms of the Grant Award Letter
9. LB share transfer and position of LB minority shareholders
10. Health & Safety obligations
11. HR, employment and people issues
12. Constitutional documents – Memorandum and Articles of Association for each entity, Operating Agreements

Since December, a preliminary review has been performed with legal and tax advice on a number of these areas. The work was focussed on Options A and B. A summary of findings is set out below, but the conclusion is that both options are deliverable, though there are important challenges under each route.

Contractual obligations, TUPE, Council guarantees

Option A (TEL) will require assignation or other legal transfer of the main Infraco suite, collateral warranties, DPOFA, a range of third party agreements and operational contracts such as property leases. Although machinery is in place to assign Infraco, experience of the consortium's behaviour to date highlights the risk that this process could become problematic at a sensitive time in the commercial negotiations. The Council would remain as guarantor under the new structure. The issue with all other agreements is the time and cost involved in execution, rather than a more fundamental concern. All employees of tie would require to transfer under TUPE to TEL, a well-rehearsed process but again involving time, cost and important communications with tie's people.

Option B (tie) would require no such changes.

Tax planning

PwC have reviewed the proposals and concluded that Options A and B should both be capable of implementation without jeopardising the project corporation tax planning.

The override remains that the law is under review by HMRC and new provisions could be introduced which would create a problem. This is true under all options.

A practical issue was surfaced in relation to the current tax status of tie / TEL as “not-for-profit”. This status will need to change to make the planning effective but no problems are anticipated in doing so.

PwC have also confirmed that VAT neutrality should be achievable under both options.

There are concerns about certain more complex tax areas including CGT and Stamp Duty which will require more detailed examination.

Once the direction is agreed, we will require to negotiate a fee arrangement to execute the tax planning, including the legal work required to implement the long-funding lease which is key to the planning.

Competition law and State Aid

The “single economic entity” is preserved under each option. No new problems are anticipated.

TA85

The design of a new structure which is intended to prevail well into the future must take full account of the pivotal and dominant role of Lothian Buses which will represent 80% of passenger operations for the foreseeable future beyond tram revenue service commencement.

The restructuring proposals do not appear to create any additional problems in relation to TA85. There are important management and operational issues to address under all options and a structural option which complies with TA85 and which could facilitate the right balance between strategic control and management independence is discussed below.

Grant Award letter

If Option A (TEL) is adopted, the funding flow would require to be redirected to TEL once TEL had absorbed the Infraco contractual obligations and the terms of the Award Letter revised. Option B (tie) should result in minimal impact on the Award Letter. TS would require to confirm that the new governance arrangements were acceptable under either Option, but particularly under Option A which redirects funding. At this stage, it is reasonable to assume that new arrangements which were acceptable to CEC and the members of the new Board structures should be acceptable to TS. A detailed assessment can be performed in due course including the risk that any opening up of the Award Letter could inspire amendment unrelated to the governance restructuring.

LB share transfer and minority shareholders

The LB shares would be transferred either to TEL (as has previously been envisaged) or to tie. The mechanics of transfer are being investigated by CEC and at this stage the assumption is that there should be power on the part of CEC to transfer the shares to a member of its group. Since tie and TEL are 100% subsidiaries, the name of the transferee should make no difference.

There may be sensitivity at transferring the LB shares into the ownership of a “project delivery company” if Option B is pursued, but this is a sub-set of the communication challenge offered by Option B and commented on below.

H&S obligations

It is not anticipated that there are any barriers to either route arising from H&S considerations. It will be essential that rigorous and fully compliant arrangements are established under any new model. Option B (tie) would cause less disruption because of the alignment with contract but this would not be a material factor in favour of that option.

HR, employment and people issues

In addition to TUPE, the legal employer will change from tie to TEL under Option A, requiring re-presentation of HR procedural documents and processes under TEL’s name.

The following aspects have not been investigated in detail at this stage but are not anticipated to contain show-stoppers under either option.

Board composition, responsibilities and decision-making hierarchy – it is essential that complete clarity of responsibility and accountability emerges from this process. The individuals involved will require this in relation to their own roles. The underlying process should be straight-forward but the key issue is to have the right people around the right Board with a clear role. This aspect needs to feature as part of the next stage of structural discussion.

Communications - the internal and external perception of the restructuring will need careful assessment. There are many moving parts and it is recommended that CEC lead a group to address this aspect as a priority. External perceptions are vital, but we should not under-estimate the importance of offering the project team a clear view of the way forward, especially if their own legal arrangements are to be changed.

TMO role – will need to be clear and properly documented but in principle should be effective under either option.

Constitutional documents – these are documents to be agreed within the family and should be addressed once the principle structural and people decisions have been progressed.

Conclusions and compromise proposal

The preliminary assessment described above highlights two main challenges :

- Option A (TEL) – managing the contractual dislocation necessary to install all of tie’s contracts within TEL.
- Option B (tie) – the communication challenge of appearing to remove the overarching transport company (TEL), replacing TEL with the “project delivery company” which has not hitherto been positioned for an operational role and the risk of accusations of “smoke and mirrors” inherent in name changes.

If a single-entity model is to be delivered, one of these challenges needs to be taken on and dialogue is now needed to gather a consensus on the right approach.

An alternative which could achieve most of the single-entity benefits and which would avoid the main challenges in delivering Options A and B has also now been examined. The main features of “Option D” would be :

- TEL acquires the shares of tie
- Transdev contract assigned to TEL
- LB shares transferred to TEL, such that TEL is now 100% owner of tie, 91% owner of LB (if the minorities stay in) and the contractual counterparty to Transdev
- Tie and TEL agree a simple framework within which tie operates to deliver the infrastructure (tie’s current role)
- The Board of TEL to be reshaped but the tie Directors to be appointed to Board of TEL (all to be discussed and agreed with individuals). The Board of tie is reduced to Chairman and CEO and possibly one non-executive director.

This would avoid contractual dislocation but enable an external presentation of alignment under TEL. It will be critical that the relationship between the two companies is documented clearly so that the responsibilities of the two Boards are clear. However, the essence is that the re-constituted TEL Board has responsibility for all aspects of project delivery including those executed by its new subsidiary, tie Limited.

The downside is that this does not create a streamlined single-entity structure but this can be mitigated by effective codification of responsibilities between tie and TEL. In theory this could also be achieved under the current arrangements. However, the “top company” is the Council at present which makes the codification and the practical application of responsibilities more difficult. A clearly delineated “top company” beneath the Council (TEL) provides the focus which would otherwise be lacking.

Compliance with Transport Act 1985

The TA85 codifies the relationship between the Council and its bus company. The essence is a requirement to sustain separation between CEC and the bus operations. Since the system will in future be integrated tram and bus, this effectively means that tram and bus operations need to respect the requirements of TA85. The precise applicability of the Act to the new system requires further work, but a mechanism which could achieve the right balance is described below.

- Options A, B or D are executed under a top company (eg TEL under Options A or D)
- A new 100% subsidiary of the top company (call it Transport Operations Limited or “TOL”) is established 1) to acquire the shares of LB ; and 2) to inherit the Transdev contract.

- TOL has an executive management Board, possibly with independent Chair but no CEC members.
- TOL operates within a framework approved by the top company but otherwise has autonomy to manage operations (in line with LB's current model), responding to competition and day to day operational events without formal recourse to the top company.

The downside is the creation of another new entity, although this could be operated efficiently if responsibilities are properly codified. A detailed examination of the requirements of the Act, together with tax implications and any wider legal considerations, should be performed before this new structure is executed.

Recommended action

This preliminary view indicates that Options A, B and D are deliverable. The TPB, tie Board and TEL Board are invited to comment on the main challenges under A and B and the possible hybrid Option D. It is recommended that the Council should then take the thinking forward with the family companies. The next stage of assessment should incorporate the design of detailed Board structures and composition to achieve clarity of decision-making, responsibility and accountability. Communications strategy and the internal constitutional documents can then be addressed.

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