

Internal Audit Project : Review of the Commercial Strategy – March 2010 to March 2011

June 2011

v1.2



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Review of the Commercial Strategy – March 2010 to March 2011

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This report is a draft and is expected to be superseded by our final report. We reserve the right to add, delete and/or amend the report as we consider appropriate. No party can rely on this draft report for any purpose.

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This report has been prepared on the basis of the limitations set out in Appendix 2 and our statement of responsibility at Appendix 4.

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Glossary of terms



- **BB** Bilfinger Berger UK Limited
- **BDDI** Base Date Design Information
- **BSC/Infraco** Bilfinger Berger UK Limited, Siemens plc and Construcciones y Auxiliar de Ferrocarriles SA "the Consortium"
- **CEC** City of Edinburgh Council
- **DLA** DLA Piper UK LLP
- **DRP** Dispute Resolution Procedure
- **FCL** Financial, Commercial and Legal Committee
- **GHP** Gordon Harris Partnership
- **HoT's** Heads of Terms
- **INTC** Infraco Notice of **tie** Change
- **MOU** Memorandum of Understanding
- **OFRS** Open for Revenue Service
- **OSSA** On Street Supplemental Agreement
- **PSSA** Princes Street Supplemental Agreement
- **RTN** Remediable Termination Notice
- **SDS** System Design Services
- **SQC** Senior Queen's Counsel
- **TPB** Tram Project Board
- **TEL** Transport Edinburgh Limited
- **TS** Transport Scotland
- **UWN** Underperformance Warning Notice

Review of the Commercial Strategy – March 2010 to March 2011

Executive summary



Background and Introduction

- As part of the 2010–2011 internal audit plan, Deloitte completed a high level review of the key events between Contract Signature on 14 May 2008 and the issue of the Project Pitchfork report in March 2010. This report was presented to the Audit Committee on 30 June 2010, with the final version issued on 16 August 2010.
- Following issue of our report, and at **tie**'s request, we met briefly with the Deputy Project Director on 22 September 2010 to discuss the high-level decision making processes adopted by **tie** from the date of the Project Pitchfork report to the date of the meeting. Following this meeting we issued a short summary meeting record.
- Subsequently, we were asked by the Audit Committee to extend our initial report to include a high level review of the processes applied by **tie** for the period from the issue of the Project Pitchfork report in March 2010 to the issue of the Project Resolution report during December 2010, and further, to include the key events leading up to the commencement of mediation in March 2011.
- Due to the confidentiality of the March 2011 mediation discussions, we have been provided with limited access to information produced and all documentation and discussions from the mediation is excluded from the scope of this report. We have however provided a chronology of events leading up to the mediation.
- The observations and commentary provided in this report are based on discussions with **tie** management as set out in Appendix 2, as well as selected documents detailed in Appendix 3. This review concentrates solely on the decision making process applied by **tie** and is not a forensic review of the commercial decisions taken during the period of the project under review. Our work specifically excludes analysis and commentary on the decisions taken by the contracting parties and internally within **tie**.

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Executive summary



Overall Conclusions

- A significant amount of work has been undertaken by **tie** since the issue of the Project Pitchfork report. We have summarised below our key observations together with managements responses:

	Observation	Page ref.	Management Response
1.	<p>The primary objectives of Project Pitchfork have not yet been achieved and the original programme to reach agreement with BSC by July 2010 through Project Carlisle has not been met.</p> <p>The primary objectives of Project Pitchfork , approved by the TPB in 10 March 2010, was the achievement of price and programme certainty. To achieve this, tie pursued a “twin track” approach, exploring the potential of a truncated Infraco Contract with BSC, whilst exercising a more assertive application of the existing Infraco Contract. At 07 March 2011, price and programme certainty had not been achieved and the dispute with BSC remains unresolved.</p>	12-14	
2.	<p>The amount claimed by BSC has been reduced by circa £12.7 million as a result of the DRPs.</p> <p>The continued use of the DRPs has reduced the estimates originally submitted by BSC from circa £23.9m to circa £11.2m for those DRPs that have been settled. A number of disputes remain unsettled, although we understand these are among the matters that have been mediated upon during March 2011. However, a clear interpretation on the relevant clauses of the contract has not been achieved, and BSC’s behaviour is reported as having “not improved” as a result of the DRPs.</p>	15-17	

Review of the Commercial Strategy – March 2010 to March 2011

Executive summary



Overall Conclusion (Contd.)

	Observation	Page ref.	Management Response
3.	<p>Legal advice obtained by tie highlights the risks of terminating the Infraco contract under the RTN approach adopted.</p> <p>Prior to the issue of Remediable Termination Notices and Underperformance Warning Notices to BSC, tie sought legal opinion from SQC (instructed on 22 June 2010), who advised that tie was in a strong position to issue Remedial Termination Notices (RTNs), which would potentially give tie the option to terminate if BSC did not implement the requisite remedial action. Senior Counsel (Richard Keen QC) was consulted on 08 July 2010, and advised tie that it would be able to issue a UWN under clause 56.7.1 of the Infraco Contract for "material breach". Subsequently, further legal advice obtained by tie suggested the possibility that the format of the notices <i>could</i> leave the validity of termination under these notices open to challenge. As a result of this, tie has expended significant resource and <i>may not</i> be in a position to terminate the Infraco Contract.</p>	23-30	
4.	<p>A significant amount of documentation exists for the period of the review.</p> <p>Documentation produced by tie records details of external advice, ad-hoc meetings, and decisions.</p> <p>tie also maintains an events log that records meetings and conference calls, attendees and key decisions made. A brief review of the events log found certain filenotes to be inconsistent and that not all TPB meetings which took place were recorded on the events log.</p>	35-37	

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Overall Conclusion (Contd.)

	Observation	Page ref.	Management Response
5.	<p>Potential governance risks have been identified.</p> <p>We noted that the final decision to submit the mediation papers prepared by tie and CEC in conjunction with their advisers, was taken by CEC and not the TPB. We recognise the TPB was regularly updated and that tie's CEO wrote to CEC on [24 February 2011 agreeing] to the submission of the papers. We have subsequently been informed by tie management that, prior to the commencement of the mediation, the TPB approved the representation of the TPB by tie and the CEC during the mediation process. Previous approvals to implement key actions have been obtained from the TPB prior to implementation and further analysis should be undertaken by tie to ensure that decisions taken by CEC as one of the project's stakeholders, which commits tie to a course of action, does not contravene the agreed and documented governance arrangements.</p> <p>We also note that the Audit Scotland report issued in February 2011 identified the need for CEC to consider reviewing the governance arrangements while the project is still in the construction phase.</p>	39-40	
6.	<p>On site progress remains limited.</p> <p>Infraco progress has been limited between March 2010 and March 2011, with 16.1% (against a a baseline plan of 79.4%) reported as complete in March 2010 and 28.2% reported as complete in March 2011 (against a baseline plan of 100%). The dispute with BSC has been ongoing during the period, with BSC formally ceasing work on a number of sites at the beginning of October 2010.</p>	N/A	

Supplemental information – Commentary on Key Workstreams

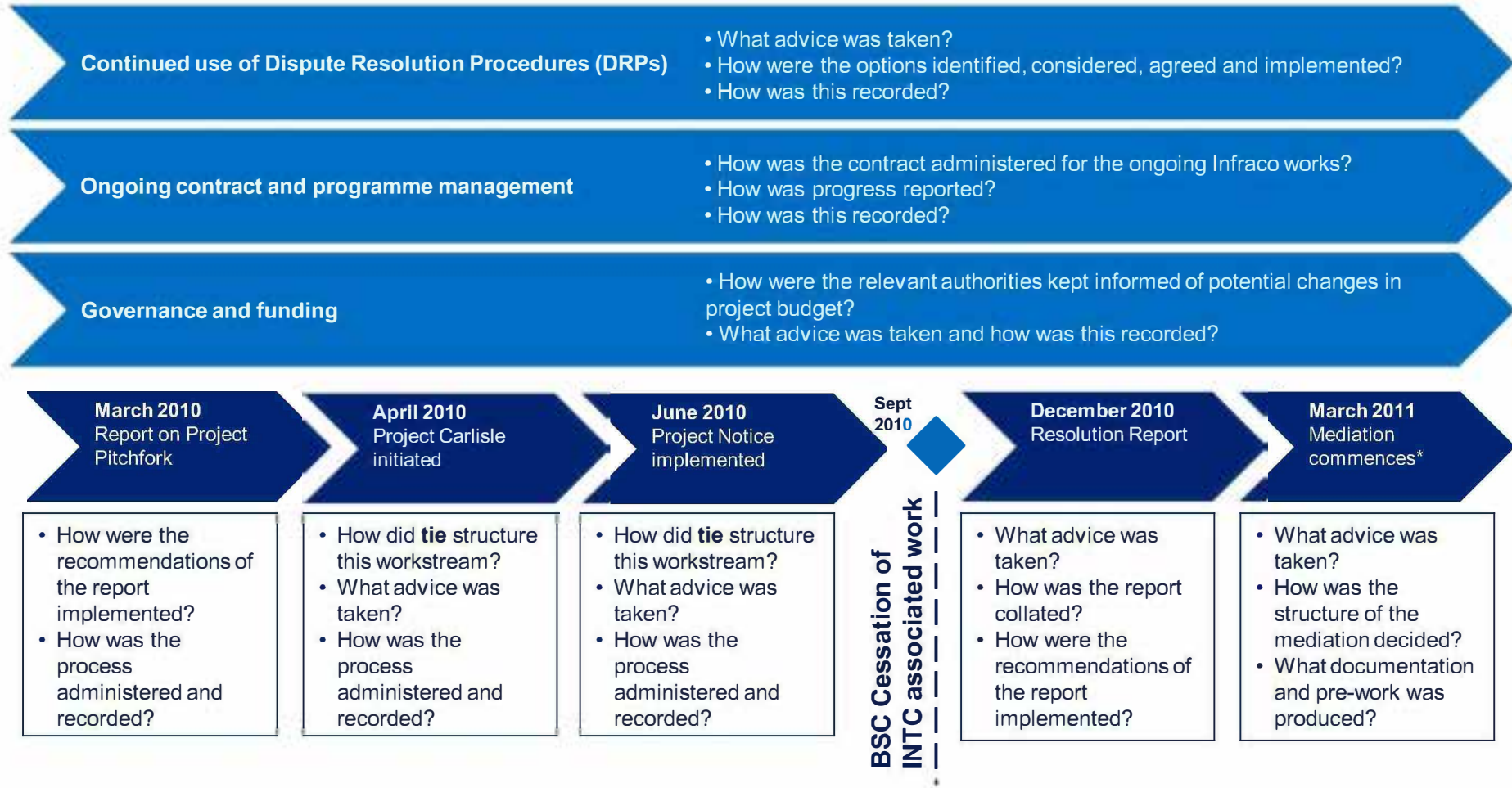


Review of the Commercial Strategy – March 2010 to March 2011

Introduction – Summary of key events



Due to the complexity of the project over the period under consideration, we have summarised the key events below following discussions with **tie** management. Overleaf, we have also summarised the key workstreams implemented following approval of the Project Pitchfork report recommendations. The schematic below outlines the key events that occurred from March 2010 to March 2011.



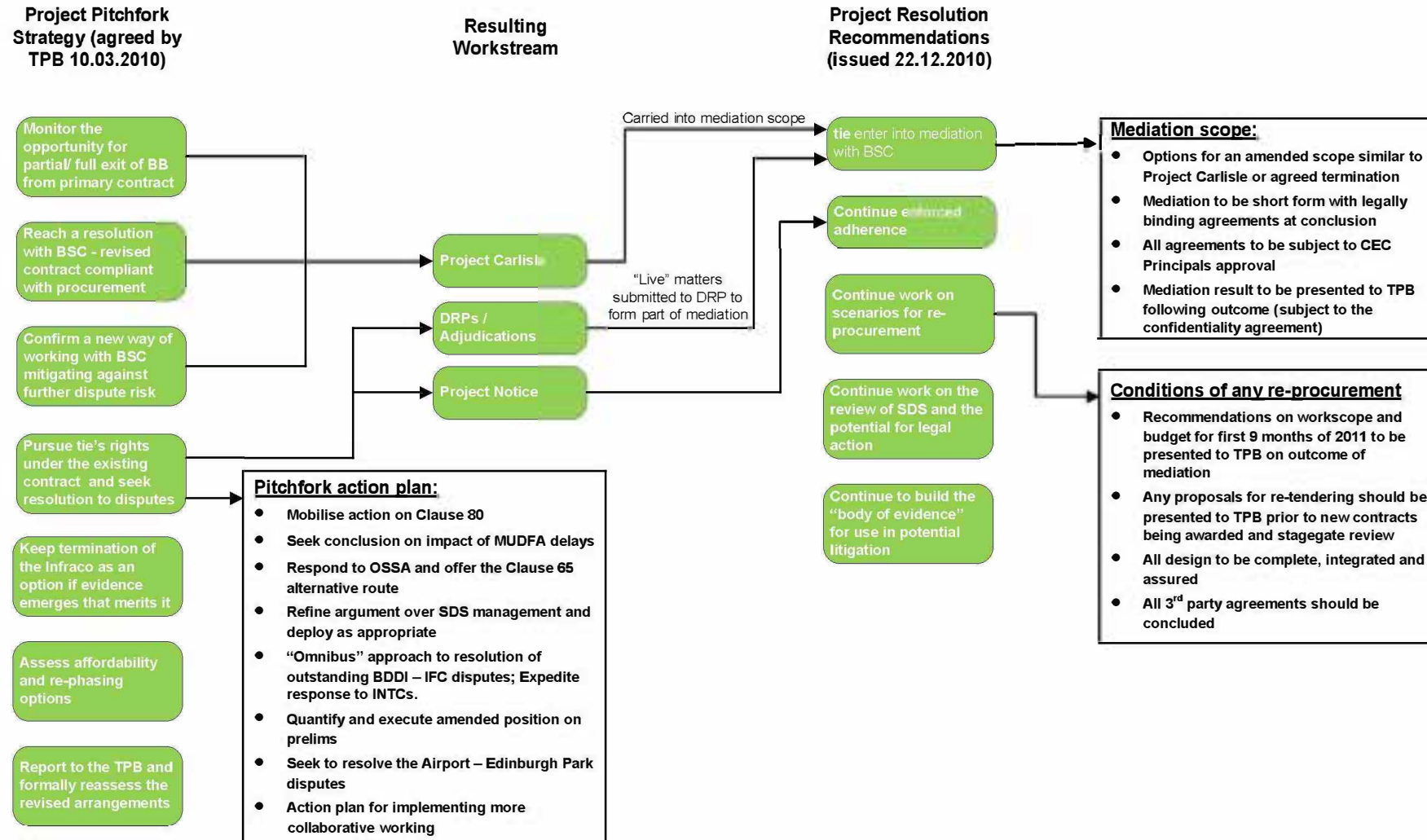
*Note: An assessment of the commercial strategy and activities during the mediation, and the results thereof, do not form part of this report.

Review of the Commercial Strategy – March 2010 to March 2011

Introduction - Summary of key workstreams



The schematic below details the various key recommendations and workstreams in the period and how they inter-relate.



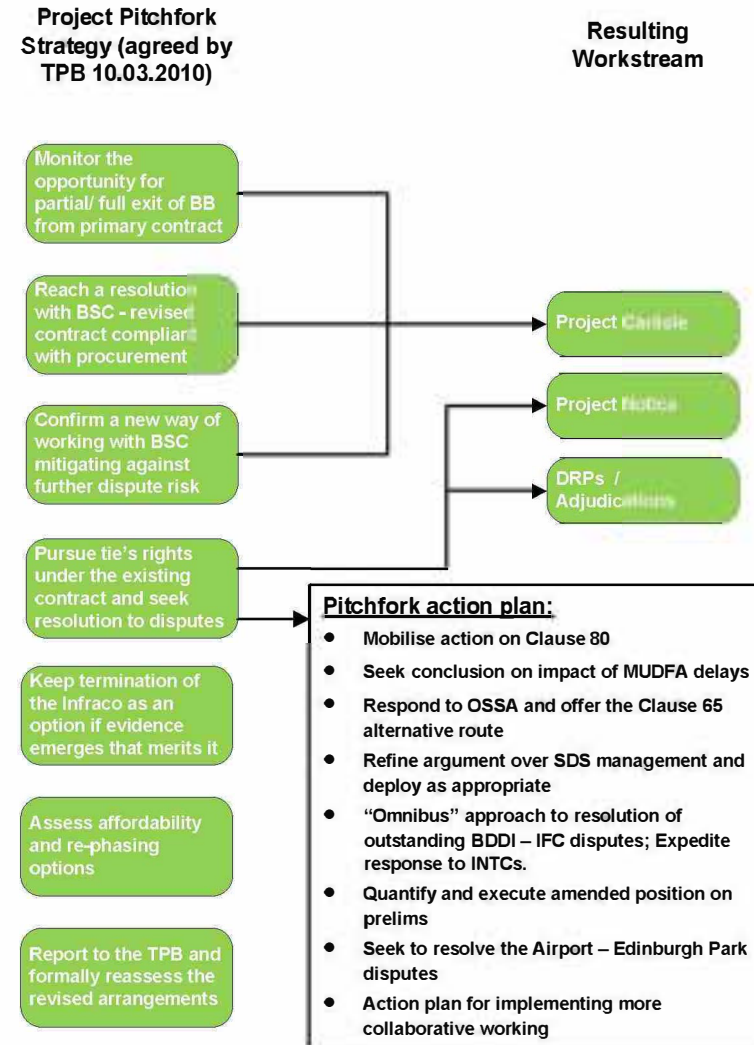
Review of the Commercial Strategy – March 2010 to March 2011

Project Pitchfork Summary



Background

- Project Pitchfork was initiated at the Joint Tram Project Board on 16 December 2009. Project Pitchfork is the working name for the project with the objective of setting out reasoned conclusions and recommendations on the future direction of the Edinburgh Tram Project. We have previously undertaken a review of the decision making processes leading to the Project Pitchfork recommendations¹. However, in order to provide context, we have summarised the recommended strategy agreed at the Tram Project Board on 10 March 2010.
- The Project Pitchfork Report was presented to the Tram Project Board (TPB) on 10 March 2010, detailing the four options identified by **tie** relating to the resolution of the various ongoing disputes with BSC. These options were:
 1. Termination of the Infraco Contract;
(unattractive at the time relative to finding a way forward)
 2. Partial or full exit of BB;
(attractive to **tie**, as it would provide the opportunity to continue with Siemens and CAF)
 3. Continue “As is”; and
(not acceptable to **tie** as issues around cost and programme certainty would not be resolved)
 4. Enforced adherence.
(it was anticipated the assertive application of the Infraco contract could lead to options one or two).
- Several recommendations were agreed at the TPB regarding these options and confirming the ongoing nature of the relationship between **tie** and BSC. The Project Pitchfork Report also outlined an action plan to target specific critical areas where the Infraco contract terms would be robustly applied, with the intention of achieving resolution on areas of the BSC dispute. This is illustrated in the adjacent schematic.



¹ “Internal Audit Project 2010-5: Review of the Commercial Strategy”–July 2010

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Project Pitchfork Recommendations



Approach

- We have assessed each of the recommendations agreed by the TPB on 10 March 2010, and the individual actions listed on the subsequent "Pitchfork action plan", utilising the following criteria:
 - Has **tie** applied a robust decision making process;
 - Does suitable evidence of the decision making process exist; and
 - Were there any opportunities to enhance the process currently in place.
- The key aspects of the recommendations of the Project Pitchfork Report are examined within this report. The table below provides an overview of how each recommendation was progressed by **tie**, and references the section in this report where the criteria specified above are applied.

Project Pitchfork Recommendation	Comment	Section
Pursue tie's rights under the existing contract and seek resolution to disputes	Carried out through the "Pitchfork action plan", the continued use of DRPs, and Project Notice	"Workstreams - DRPs" and "Workstreams - Project Notice"
Monitor the opportunity for partial/ full exit of BB from primary contract	Became one of the key elements of Project Carlisle beyond April 2010	"Workstreams - Project Carlisle"
Reach a resolution with BSC - revised contract compliant with procurement	Became one of the key elements of Project Carlisle beyond April 2010	"Workstreams - Project Carlisle"
Confirm a new way of working with BSC mitigating against further dispute risk	Became one of the key elements of Project Carlisle beyond April 2010	"Workstreams - Project Carlisle"
Keep termination of the Infraco as an option if evidence emerges that merits it	Not an option pursued directly after Pitchfork, but given serious consideration as a result of other workstreams	"Governance and Funding"
Assess affordability and re-phasing options	Affordability assessed against ongoing commercial challenges. Option appraisal, and business case updated.	"Governance & Funding"
Report to the TPB and formally reassess the revised arrangements	Continued governance and reporting process	"Governance & Funding"

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Project Pitchfork Recommendations



Approach (Contd.)

- Similarly, the key aspects of the Project Pitchfork Report “Action Plan” are examined within this report, as identified in the table below.
- The Resolution Report issued during December 2010 records that the final action in the plan – “implementing a more collaborative working style” – has not been pursued due to “the lack of progress on Carlisle”. **tie** management have subsequently stated that if a breakthrough had been achieved, then a more partnering approach could have been adopted, but that any such approach would have had to have been a bilateral effort.

Pitchfork "Action Plan" Item	Comment	Section
Mobilise action on Clause 80	Addressed with DRPs	"Workstreams - DRPs"
Seek conclusion on impact of MUDFA delays	Addressed with DRPs	"Workstreams - DRPs"
Respond to OSSA and offer the Clause 65 alternative route	Addressed with Project Carlisle	"Workstreams - Project Carlisle"
Refine argument over SDS management and deploy as appropriate	Addressed with DRPs	"Workstreams - DRPs"
“Omnibus” approach to resolution of outstanding BDDI-IFC disputes; Expedite response to INTCs	Addressed with DRPs	"Workstreams - DRPs"
Quantify and execute amended position on prelims	Addressed with DRPs	"Workstreams - DRPs"
Seek to resolve the Airport – Edinburgh Park disputes	Addressed with DRPs	"Workstreams - DRPs"
Action plan for implementing more collaborative working	Not pursued	Not pursued

- The actions undertaken by **tie** to implement the above plan are reviewed in subsequent sections of this report.

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Workstreams – Continued use of Dispute Resolution Procedures (DRPs)



Background

- During July 2009, the TPB approved a **tie** recommendation to adopt a more formal contractual approach, involving the use of DRPs and other contractual mechanisms. Following this decision, a "Challenge Team" was introduced to challenge each DRP internally to test the strengths and weaknesses of the argument, anticipate the BSC strategy and assess readiness for the launch of the DRP.
- The role of the Challenge Team was reinforced by the appointment, through a competitive process, of McGrigors solicitors. Their initial appointment is recorded in a letter of appointment dated 20 August 2009 with an extension recorded on 25 February 2010.
- An analysis of the decision making process taken by **tie** and its advisors to initially progress the use of DRPs is contained within our Internal Audit Project 2010-05: Review of the Commercial Strategy report.
- The forward strategy for the use of DRPs from March 2010 was set out in the Project Pitchfork report as follows:
 1. Test a number of the contractual principles behind the change process;
 2. Reduce the values of the estimates being submitted by BSC;
 3. Progress works by application of clause 80.15 of the Infraco contract; and
 4. Encourage a change of behaviour in BSC as a whole.
- The Events Schedule indicates that two or three Challenge Sessions took place every month up until 31 May 2010.
- Following a suspension of DRPs to allow Project Carlisle the opportunity of success, the challenge process was amended in the Autumn of 2010 and **tie** advised that; "from Autumn 2010, McGrigors took over provision of legal representation for such matters from DLA and as such did not then provide any additional independent legal challenge. There was technical challenge and expert opinion sought and considered in a number of cases under DRP consideration. **tie** still reviewed DRP items with legal input from either DLA or McGrigors, specialist expert advice, and inviting CEC reps."

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Continued use of Dispute Resolution Procedures (DRPs)



Progress

- In **tie**'s monthly reports to Transport Scotland (TS) from March 2010, it is explained that "the contract with the BSC consortium prescribes a timetable for resolution of contractual disputes and it is expected that the budget and programme implications will become increasingly clear during 2010."
- **tie** took on significant additional expert resource to focus on areas of contract and dispute management as well as technical, commercial, forensic planning/delay analysis and litigation expertise, as recorded in the CEC Report, dated 24 June 2010.
- As at 15 December 2010, 25 matters had been placed in formal DRP, 16 by **tie** and 9 by BSC. Seven have been resolved by negotiation, two through external mediation, eleven have been referred to adjudication and five remain unresolved. Overall, the DRPs have led to BSC claims for additional payment being reduced from circa £23.9m to circa £11.2m for those DRPs that have reached financial settlement. This excludes the costs incurred by **tie** in progressing matters through DRP. Although the outcome of the DRPs in terms of legal principles is not clear and subject to further discussion, **tie** is satisfied that the overall balance of the DRP and adjudication outcomes has justified their usage.
- The Resolution Report states that the adjudication decisions have been "mixed" and have not provided the clear direction on the operation or interpretation of the contract that **tie** / CEC had hoped for at March 2010.
- The Resolution Report also states that the behaviour of BSC has "not improved" as a result of the DRPs.
- As at 16 March 2011, a total of 30 matters had been referred to DRP, 20 of which had been referred by **tie**. Seven had been resolved by negotiation, four through mediation and 12 through adjudication, with the remaining seven still "live".

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Continued use of Dispute Resolution Procedures (DRPs)



Summary

- **tie** has continued to utilise the DRPs to maintain commercial pressure on BSC, with a total of 20 matters referred to DRP by **tie** (out of 30 overall) as at 16 March 2011, which has led to significant financial savings over the original BSC estimates.
- Records of DRP initiations and decisions are stored on the **tie** intranet and summaries are minuted.
- A clear interpretation on the relevant clauses of the contract has not been achieved, and BSC's behaviour is reported as having "not improved" as a result of the DRPs.
- The Murrayfield Underpass adjudication decision set out that **tie** was unable to instruct works to progress using clause 80.15 (or clause 80.13) without there being an agreed estimate. The clarification of the interpretation of Clause 80 of the Infraco Contract was one of the key objectives identified in the Pitchfork Action Plan. Ultimately however, the adjudication referral was initiated by BSC, and not by **tie**.

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Workstreams - Project Carlisle and Project Notice- Key Events



The following schematic outlines the key events that occurred from March 2010 to March 2011 in relation to Projects Carlisle and Notice.

Event Schedule – Projects Carlisle and Notice													
Event/workstream	March '10	April '10	May '10	June '10	July '10	August '10	September '10	October '10	November '10	December '10	January '11	February '11	March '11
Project Carlisle		21.04.10 Meeting in Carlisle between tie and BSC	04.05.10 Carlisle MOU sent to BSC		29.07.10 BSC GMP offer: £443m +Euro 5.8m 05.07.10 BSC promised assured design by 16.07.10	24.08.10 tie counter offer: £267.3m	11.09.10 BSC GMP offer: £405m +Euro 5.8m 24.09.10 tie counter offer: £282.3m	14.10.10 BSC letter to tie - will not participate in further negotiations	03.11.10 tie ask for Confirmation of Carlisle termination				
Key Events	10.03.10 Project Pitchfork presentation to TPB	14.04.10 TPB	05.05.10 TPB	02.06.10 TPB 24.06.10 CEC update meeting	30.06.10 TPB 28.07.10 TPB 28.07.10 Meeting with Minister for Transport	25.08.10 TPB	22.09.10 TPB 29.09.10 Cessation of all BSC works subject to INTCS	21.10.10 TPB 14.10.10 CEC update meeting	17.11.10 TPB 06.12.10 CEC confirm mediation as preferred strategy	15.12.10 TPB 22.12.10 Resolution Report issued	12.01.11 TPB 10.02.11 Phoenix offer	09.02.11 TPB 24.02.11 Mediation statements complete	16.03.11 TPB 07.03.11 Mediation
Project Notice			05.05.10 TPB agrees 90.1.2 letters to be drafted	22.06.10 SQC instructed by tie	08.07.10 SQC consulted by tie 28.07.10 tie report an "in a position to issue an RTN"	04.08.10 Three draft RTNs sent for QC opinion	09.08.10 RTN1-3 15.08.10 RTN4 17.09.10 LWN1 01.09.10 RTN5 08.09.10 RTN6 21.09.10 RTN7 30.09.10 RTN8 29.09.10 RTN8 12.10.10 RTN10		22.11.10 SQC advise "material risk" should termination notice be given				

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Carlisle



Background

- One of the key recommendations of the strategy presented to the TPB on 10 March 2010 was to monitor the opportunity to achieve a partial or full exit for BB from the Infraco contract.
- Project Carlisle is the working name for the project with the objective of exploring an alternative way forward, the main proposal revolving around the truncation of the existing Infraco contract to complete around St. Andrews Square and the examination of the possibility of **tie** stepping in to complete the Civil Engineering works. **tie**'s desire, as identified in the Project Pitchfork Report, was to "agree a revised scope, price and programme, with the outcome of a tram operating to at least St. Andrew Square, with a very high degree of cost and programme certainty."
- Project Carlisle was initiated after a meeting on 21 April 2010 between **tie** and BSC (at the invitation of Michael Flynn – Siemens representative on the Infraco Board).

Workstream management

- The Resolution Report indicates that the following provisions were set up specifically for Project Carlisle:
 - A "clean team" using Anthony Rush and advisors from GHP and DLA. This team was authorised to discuss options, but had no power to agree or commit. All discussions were held on a without prejudice basis;
 - A draft Memorandum of Understanding (MOU) was sent to BSC on 04 May 2010 with a programme setting out an anticipated agreement being reached by early July 2010; and
 - A draft Heads of Terms (HoT) was shared with BSC on 09 June 2010 to reflect the MOU.
- At the TPB on 14 April 2010, the Board approved a recommendation that any future agreements reached would need to be binding on both parties.
- The Events Tracker indicates that a series of Project Carlisle meetings took place from the 21 April 2010 until the end of October, with a "Post Carlisle and Notice" meeting taking place between the Cabinet Secretary and **tie** on 21 June 2010.
- In addition to the overarching key governance arrangements (outlined in the "Governance and Funding" section of this report), further specific governance requirements are detailed in the Memorandum of Understanding between **tie** and BSC dated 04 May 2010. Requirements are also laid out in correspondence to BSC on 07 September 2010 – these include compliance with the Ethical Standards in Public Life (Scotland) Act 2000 – Model Code of Conduct and EU Procurement Law.

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Workstreams – Project Carlisle



Date	Correspondence	Activity
21-Apr-10	Meeting	Initial meeting in Carlisle
04-May-10	MOU	Early July targeted for agreement
02-Jun-10	TPB	Recommendation proposed to be ready for 30 June 2010
09-Jun-10	HoTs	Heads of Terms shared with BSC
11-Jun-10	Letter from BSC	BSC cannot meet tie 's desired completion dates
16-Jun-10	Meeting	BSC pricing exercise not yet commenced. Fully assured and integrated design promised by BSC for mid-July 2010. Confirmed intention to put Carlisle proposal to a main board meeting on 20 July 2010
20-Jun-10		Pricing exercise still yet to be commenced with sub-contractors.
29-Jun-10	Letter from BSC	"Ongoing commitment to Carlisle" letter - delivered a week late
05-Jul-10	Telephone call	BSC promise assured design by 16 July 2010
29-Jul-10	GMP	GMP delivered to tie
09-Aug-10	Design	Assured design sent to tie (rejected)
24-Aug-10	GMP	Counter offer from tie
13-Sep-10	GMP	Revised offer received from BSC
13-Sep-10	Meeting (tie and BSC)	Senior level meeting - agreement appears "some way off"
24-Sep-10	GMP	Counter offer from tie
14-Oct-10	Letter from BSC	"No point in meeting again"
29-Oct-10	Letter from BSC	BSC state it is tie that must compromise

Sources: (i) TPB minutes, 02 June 2010. (ii) Letter correspondence between **tie** and BSC between 11 June 2010 and 29 October 2010. (iii) Resolution Report (December 2010).

Programme and Timeline

- The adjacent table to the left provides an overview of the key dates associated with Project Carlisle.
- The minutes of the TPB held on 02 June 2010 record that two options (one of which was Project Carlisle) were being worked on and that a timetable to select an option had been set, with the team working towards providing the TPB with the information and detail required to facilitate a recommendation being made to both CEC and TS following the TPB on 30 June 2010. "Several" key meetings with senior Scottish Government and CEC representatives were to be arranged to take place "in the coming weeks".
- The draft MOU sent to BSC on 04 May 2010 set out a programme for agreement being reached by early July 2010.
- We have not been provided with any documentation referring to BSC's agreement to this timescale.
- One of the main areas of risk, as stated in the Resolution Report, was that the negotiating team felt that BSC would see Project Carlisle as an opportunity to re-price the contract. The Resolution Report notes that this risk was recorded and documented at the time.
- The TPB minutes of 20 June 2010 onwards reported that intensive negotiations were ongoing with BSC, and that BSC would "appear to becoming more engaged", following correspondence from BSC on 29 June 2010. In the TPB, it was noted that there were three "Critical Milestones" that were to be monitored in relation to Project Carlisle, being:
 - A conference call with BSC Board representatives on 05/07/2010 (this was completed);
 - The delivery of an assured integrated design by mid July (sent by BSC on 09 August 2010, and rejected by **tie**); and
 - The submission of the GMP and programme by BSC at the end of July (received by **tie** on 29 July, and subsequently rejected).

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Workstreams – Project Carlisle



Key correspondence

- These critical milestones indicate a slippage against the originally proposed delivery date of "early July 2010" laid out in the MOU delivered to BSC on 04 May 2010.
- Further dates were set out in the TPB on 30 June 2010 regarding the meeting of the Cabinet Secretary for Finance and Sustainable Growth and the Minister for Transport, Infrastructure and Climate Change on 28 July 2010, and that clarity "on the way forward" should be established before this meeting. The TPB agreed that the timeframe to either pursue or reject this workstream was limited, and recognised that the indications from the discussed critical milestones would determine the likelihood of a positive outcome.
- In their letter of 14 October 2010, **tie** states that the counter proposals made by BSC on 11 September and 01 October 2010 "do not address or recognise the purpose and essential requirements for compromise."
- In the October CEC update report dated 14 October 2010, Project Carlisle is described as part of a "twin track approach" (Notice being the other), seeking to "agree a revised scope, price and programme, with the outcome of a tram operating to at least St. Andrew Square, with a very high degree of cost and programme certainty." The report goes on to update the negotiations, and states: "an acceptable commercial settlement now unfortunately appears unlikely in the short term."
- In a letter dated 29 October 2010, BSC states that the "Infraco has not withdrawn from Project Carlisle", but that they "now believe the effort to achieve a Project Carlisle-type agreement has run its course", stating the lack of any acceptance of Infraco's proposed scope and programme, and being asked to "donate" £45m to the funding of the project, as reasons. BSC also responded to **tie** stating that they were taking "an opportunistic attitude towards the Contract terms", by claiming that **tie** had "unilaterally determined to withhold payment to which Infraco is entitled," and that **tie** "continues to campaign to draw Infraco to the negotiating table by way of threats and intimidation." Responding to points laid out in a letter from **tie** to BSC on 19 October 2010, BSC claim that **tie** has stated "Infraco must lower its price or termination is the only alternative."
- In reply to BSC's letter of 29 October 2010 on 03 November 2010, **tie** state that all of their representatives have been consistent in articulating the essential requirements for any compromise under the guise of Project Carlisle. The letter further states that, in reference to BSC's withdrawal from the Carlisle negotiations, that "in the absence of written denial by all Infraco Members by close of business on 05 November 2010, we will consider this to be their wish and proceed on the basis that the Infraco is no longer seeking to achieve a compromise with us."
- The draft presentation to the TPB on 15 December 2010 states that the latest position from BSC (regarding Carlisle) would result in the construction of the line from the Airport to Haymarket by the end of 2012, and reports that there is "no guarantee that a deal can be done." **tie** management have informed us that this was not reported within the final presentation to the TPB on 15 December 2010.

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Workstreams – Project Carlisle



Summary

- The table below summarises BSC and **tie**'s assessment of the lack of progress associated with Project Carlisle.
- The Resolution Report states that **tie**, in their opinion, consistently articulated the essential requirements of the Project throughout the period and, despite some optimism that a deal could be reached in June/July, **tie** was unable to secure the objectives set out within the Carlisle MOU, within the required parameters of cost and programme certainty. **tie** was of the view that BSC's price, programme and design were not capable of acceptance throughout the process.
- We note that key paper correspondence, key meetings and telephone calls have been recorded on the Events Schedule. Senior figures within TEL, TS and Scottish Government have been kept informed of the process throughout.
- We noted at our meeting with the Deputy Project Director on 22 September 2010 that, at that time, the Project Carlisle negotiations had not yet concluded. We expressed concern that with no definite milestone for the conclusion of Project Carlisle, the uncertain period experienced by the Project would continue for an undefined period of time. We recommended that **tie** consider setting a completion date for a final decision. Subsequent discussions with **tie** management have revealed that the process of offers and counter offers (two formally received from either party) extended the process, and that the aspiration to reach a conclusion existed throughout.
- Agreement was reached at the June 2010 TPB that the timeline to pursue or reject Carlisle was limited, and the three critical milestones to be monitored were set out, in particular the delivery of the assured design, GMP and programme by the end of July 2010. There is no indication that these timelines were reported against in the documentation we have reviewed. Carlisle eventually came to (an implied) close at the end of October 2010.

tie reasons for Carlisle Failure	BSC reasons for Carlisle failure
BSC displaying "an opportunistic attitude" to the contract terms	BSC not willing to reduce price by £45m
Cost certainty not achievable	BSC not willing to "donate" £45m to the project cost.
Infraco not providing a substantiated explanation of their offers	tie 's non-payment of Preliminaries
BSC unable to deliver an integrated design	tie 's non-payment of £3m for the "demonstrable costs" on Princes St
BSC's proposals do not settle all disputes	tie 's non-payment of other parts of agreed changes or cl.80.15 instructed works
Proposed deal contains "get-out" clauses for BSC, and not a GMP	tie 's "constant threat" to Infraco of termination
Lack of trust	tie 's general failure to act in a fair and reasonable manner

Source: (i) Letters of correspondence between **tie** and BSC, referring to Project Carlisle, between the dates of September 2010 and the end of October 2010; and (ii) Resolution Report, December 2010.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Background

- Following on from the TPB endorsement on 10 March 2010 of the recommendation that termination of the Infraco is retained as an option, an enhanced process of administering the provisions available under the Infraco contract was initiated in June 2010 to notify BSC of alleged breaches and underperformance and the requirement for remedial measures to be undertaken. The overall goal of Project Notice was to lead to three potential outcomes to the dispute, these being:
 - 1. Agreement on Project Carlisle;**
 - 2. Termination of the Infraco contract through Infraco default; or**
 - 3. A mediated settlement in respect of Termination of the Infraco contract.**
- The TPB minutes of 02 June 2010 record that BSC “continue to refuse to act on **tie**’s instructions to progress the works whilst changes are being evaluated/agreed”, and are progressing on the basis of “good will”.
- The report to CEC on 24 June 2010 records Project Notice as the second option being explored (the first being Project Carlisle) around termination of the Infraco contract, and that there was a “contractually defined process” that would enable this. Whilst the specific objectives are not set out in the documentation from that time, they are stated succinctly in the Resolution Report as set out in the table below.

Number	Summarised Project Notice Key Objectives
1	Obtain response from BSC to allegations of breach of contract
2	Make BSC aware of consequences of continued conduct and/or lack of progress on Project Carlisle
3	Bring matters to a head – in a way which the DRPs were not
4	Shift focus to the wider failures of BSC (away from design development and change mechanism)
5	Collate evidence of Infraco default and get legal opinion
6	Use DRP, RTN’s and UWN’s as negotiation tools to strengthen tie ’s position for one of the “three potential outcomes” (see above).

Source: Resolution Report, 22 December 2010

- The TPB of 21 October 2010 records that the outcome of Project Notice would be included within the report schedules to be considered by CEC on 16 December 2010. This became the Resolution Report.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Observations (Contd.)

1. *Obtain response from BSC to allegations of breach of contract*

- The method by which **tie** formally represented allegations of potential breaches of the Infraco contract was via:
 1. A meeting held between the TEL / **tie** Chairman and senior members of the Infraco on 16 June 2010; and
 2. The issue of the first three RTNs on 09 August 2010.
- As far as we are aware, no response from BSC's representatives in attendance at the meeting of 16 June 2010 was recorded, and the meeting was not minuted.
- Formal allegations of breach were made by **tie** through the provisions of the Infraco Contract by issuing three RTNs on 09 August 2010. Under the contract, a response to each of these RTNs was required by 21 September 2010. Two responses, for RTNs 1 and 3 were received by **tie** within the required timeframe, and subsequently rejected by **tie**. A response to RTN 2 was not received. An review of the decision making process around the RTNs (and UWN) can be found at Part 6 of this section.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Observations (Contd.)

2. ***Make BSC aware of consequences of continued conduct and/or lack of progress on Project Carlisle***

- At a meeting held on 16 June 2010, **tie** senior representatives informed BSC that the alternative to Project Carlisle was for **tie** to issue Remediable Termination Notices (RTNs) under Clause 90.1.2 of the Infraco Contract.
- The CEC update report on 14 October 2010 records that the Council was informed that the mechanisms available under the Infraco contract were “already being utilised as part of **tie**’s continuous rigorous application of the contractual terms.” CEC was also asked to endorse the rigorous application of the contract by **tie**, and note that, given BSC’s behaviour and lack of remediation plans, “serious consideration would need to be given to termination of the contract and re-procurement”. It was also noted that where BSC had responded to issued notices, they had not “satisfactorily addressed the defaults identified”.
- In a letter addressed to BSC dated 19 October 2010, **tie** defend the issue of the RTNs and UWNs as being necessary, using the delivery of the IFC drawings for the retaining wall at the airport as an example.
- At the TPB of 21 October 2010, **tie** states that it “continues to administer the contract assertively”, with “formal correspondence” exchanges with BSC in regards to performance and contractual obligations.
- The continued issue of RTNs and UWNs in September and October was recorded by BSC in a Carlisle letter dated 14 October 2010. They found it “astonishing” that an RTN and UWN were issued within hours of an extension of an offer from **tie** to resolve differences between the Parties, effectively withdrawing their support for the Carlisle process in the same letter.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Observations (Contd.)

3. Bring matters to a head – in a way which the DRPs were not

- Whilst no direct reference is made within the Resolution Report as to how this objective was to be achieved, **tie** expected the increased diligence around the exercising of the contractual rights would lead to greater certainty of outcome for **tie**, as well as having the potential to bring the dispute to a close by achieving one of the "three outcomes" referred to in the Resolution Report (see slide 23).
- The TPB minutes of 02 June 2010 record that two options were being "worked on". This was discussed in "some detail" with the Board, with the key points recorded, including the requirement for certainty on cost and programme and the "absolute necessity" to have an agreed way of working.
- In the TS report of 25 June 2010, Transport Scotland were updated as to the contractual strategy currently adopted by **tie**. A "twin track" approach was now in action, with termination of the Infraco contract now being considered. The "continued contractually assertive approach" to contract management is also mentioned.
- The minutes of the TPB held on 22 September 2010 record that the Board recognised that resolution on Project Notice may still require "around two months" to conclude, and that it would be essential to obtain the "strongest possible" legal opinion on the key points to advise decision making.

4. Shift focus to the wider failures of BSC (away from design development and change mechanism)

- Again, no direct reference is made within the Resolution Report as to how this objective was to be achieved. However, the use of RTNs and UWNs to focus on non-design and variation based disputes appears to have shifted the focus in line with the stated objective.
- A letter from DLA Piper to Senior Counsel on 22 September 2010 records a request to review a further draft RTN in relation to Infraco's overall course of conduct in carrying out the Infraco Works. The letter also states that "if no acceptable rectification plan is delivered...(tie)...may seek to proceed to terminate the Infraco Contract." In his reply, Senior Counsel "appeared comfortable" with the approach taken within the RTN. This is recorded in an email dated 23 September 2010.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Observations (Contd.)

5. Collate evidence of Infraco default and get legal opinion

- **tie** sought legal opinion from SQC (instructed on 22 June 2010), who advised that **tie** was in a strong position to issue RTNs, which would potentially give **tie** the option to terminate if BSC did not implement the requisite remedial action. It is recorded in DLA Piper's Note of Consultation with Senior Counsel, dated 08 July 2010, that Counsel advised that a number of RTNs should be issued rather than one covering a number of breaches. This was noted as being because some of the breaches that were to be the subject of the RTNs were "not sufficient", making them "vulnerable" to challenge as an incompetent notice. By issuing them individually, one RTN failing would not prejudice the others.
- The minutes of the TPB held on 30 June 2010 record that the Board authorisation from the TPB on 02 June 2010 had been actioned and that the "necessary documentation" was in place to formally issue the RTN to BSC. The Board authorised the issue of the RTN.
- Counsel also confirmed that **tie** would need to provide evidence of adverse breach of contract to substantiate any termination claim. It is of note that **tie**, at the point of issuing the first RTNs, had not compiled this evidence. The Resolution Report states that a "conscious decision" was made to do this, as a result of time pressures from CEC to issue the RTNs.
- Since the first RTN was issued, **tie** instructed Acutus to prepare the required evidence to support the RTNs. A "virtual data room" was set up on **tie**'s extranet system for the storage of this evidence, whilst the draft narratives are kept at McGrigors' office (and were still under development at 12 April 2011).
- SQC opinion was also sought by **tie** on the issue of UWNs, as per Clause 56 of the Infraco Contract. The Resolution Report states that "some questions" were raised as to the validity of UWNs. Senior Counsel (Richard Keen QC) was consulted on 08 July 2010, and advised **tie** that it would be able to issue a UWN under clause 56.7.1 of the Infraco Contract for "material breach". If **tie** were to issue four UWNs in any 12 month period, this would trigger clause 90.1.1, which would enable termination of the Infraco Contract. Senior Counsel also confirmed that they would be happy to see any draft RTNs provided by **tie**.
- A DLA Piper letter and email correspondence records the submission of three draft RTNs to Counsel for opinion on 04 August 2010. These cover the topics of:
 1. Defects on Princes Street;
 2. Failure to comply with instructions in relation to the Infraco Works; and
 3. Breach of the Change Mechanism.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



5. Collate evidence of Infraco default and get legal opinion (Contd.)

- We noted that CEC update report from 14 October 2010 contains an update on the progress of Project Notice (though it is not referred to as such) and that **tie** "continue to administer the project in a robust manner; including compiling evidence of any breaches of contract by BSC; clarifying contractual changes; and completing the design."
- We also noted that it was recorded in the minutes of the TPB held on 17 November 2010 that **tie** were continuing the assertive contractual approach with BSC, and that several sessions with Senior Counsel had been undertaken. This is recorded elsewhere in email correspondence and letters exchanged between DLA Piper, Senior Counsel and **tie** in the foregoing months. The TPB minutes also record that CEC "are taking independent legal and Counsel advice on these matters." We have not seen details of this advice, and are therefore unable to verify its consistency with the advice received by **tie**.

6. Use DRP, RTN's and UWN's as negotiation tools to strengthen tie's position for one of the "three potential outcomes"

- It was reported to the TPB on 28 July 2010 that Senior Counsel was consulted on 08 July 2010, and that **tie** was now in a position to issue the first RTN. The timing and decision to issue the RTN was discussed at the TPB in detail. The Board endorsed the **tie** CEO's recommendation with regard to this, though it is not clear from the minutes as to the nature of the recommendation. The first RTN was issued on the 09 August 2010. We have examined the above objective in the context of the "3 potential outcomes", as noted in the Resolution Report, as follows:

(i) Agreement on Project Carlisle

- **tie** appears to have taken a partially cautionary approach to the exercising of contractual rights during August and September 2010, perhaps with regard to the ongoing Carlisle negotiations. This is evidenced by the following events in that period:
 - It was noted at the TPB on 25 August 2010 that, against the background of Workstreams "A" (Project Notice) and "B" (Project Carlisle), it was unlikely that **tie** would launch further matters into DRP (at that time).
 - Advice was received from Andrew Fitchie (DLA Piper) in an email dated 29 September 2010 stating that **tie**, following its formal rejection of BSC's rectification plan for the Princes Street RTN, needs to "have the courage of its convictions" by calling the Performance Bond at the full value (c. £9m). In reply, Anthony Rush was also in favour of calling the Performance Bond. However, in **tie's** view, calling on the Bond at that time would carry a "significant risk to Carlisle".
 - **tie** senior management confirmed to us that the option to call the Performance Bond in respect of the defective Princes Street works was still available, but that subsequent discussion with the Contractor at mediation (held in March 2011) has progressed matters in a manner that is acceptable to CEC.
 - In line with the twin track approach adopted by **tie**, the issuing of RTNs and UWNs continued in the same period in order to maintain contractual pressure on BSC, despite the continuing Carlisle negotiations.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Observations (Contd.)

(ii) Termination of the Infraco Contract through Infraco default

- At the date of this report, **tie** had issued 10 RTNs and 3 UWNs.
- Under the terms of the Infraco contract, **tie** is able to issue a termination notice should they not accept or receive a rectification plan to an RTN.
- BSC has contested the legitimacy of many of the RTNs. Senior Counsel opinion was sought by **tie** on 22 November 2010 and 01 December 2010. The Resolution Report states that BSC "do not agree" with **tie's** claim of an Infraco default and identifies the risk that BSC may challenge any termination notice.
- McGrigors has advised **tie** that a valid RTN must specify the nature of the Infraco default which has occurred and that there are "at least some respects in which the RTNs issued can be criticised for lack of specification". This has led McGrigors to advise that there is a "material risk" of BSC claiming wrongful repudiation of the Infraco Contract should RTNs be used as the basis of any purported termination.
- In order to mitigate against any potential challenge by BSC, **tie** are collating forensic evidence relating to all past potential breaches.

(iii) A mediated settlement in respect of termination of the Infraco contract

- **tie's** desire with this objective was to make the potential contractual consequences of BSC's continued behaviour "so undesirable" and "potentially painful" that the situation may lead to a mediated settlement in respect of the Infraco Contract.
- This objective has been pursued by the application of the various contractual tools available to **tie**, including the use of RTNs and UWNs.
- In a letter dated 29 October 2010, BSC stated that several conversations arranged to discuss "mutually agreed termination" had taken place between **tie** and BSC prior to a meeting held on 11 October.
- In a letter to BSC dated 03 November 2010, **tie** points out that the "factual record" shows that it was in fact Infraco members who instigated the idea of a "divorce" and that "Mr Reid (of BB) articulated the options in his letter dated 05 March 2010."

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – Project Notice



Summary

- The objectives of Project Notice have been pursued by **tie** and a summary of each objective can be found in the table below.
- It is of note that, despite receiving extensive legal opinion prior to the issue of both the RTNs and UWNs, **tie** was informed that there existed a “material risk” of legal challenge should a termination notice be issued based on non-conformance of the requirements of the RTN due to the potential for a number of the RTNs to be criticised for lack of specification.
- **tie** appears to have made a concerted effort to “ease” the relationship with BSC during August and September 2010 by limiting the number of new matters referred to DRP, and by choosing not to call on the Performance Bond (as recommended by DLA) at the end of September 2010. However, this is contradicted by the issue of RTNs and UWNs during August and September, issued in response to the slow progress being made in the Carlisle negotiations.

Number	Summarised Project Notice Key Objective	Comment
1	Obtain response from BSC to allegations of breach of contract	Meeting held between BSC and tie on 16 June 2010, RTNs issued to BSC from August onwards.
2	Make BSC aware of consequences of continued conduct and/or lack of progress on Project Carlisle	Meeting held between BSC and tie on 16 June 2010, RTNs issued to BSC from August onwards.
3	Bring matters to a head – in a way which the DRPs were not	Application of UWNs and RTNs from August 2010. However, BSC become "more entrenched" and Carlisle negotiations fail. Mediated settlement discussed in its place.
4	Shift focus to the wider failures of BSC (away from design development and change mechanism)	Application of UWNs and RTNs from August 2010, focussing on programme, defects and design.
5	Collate evidence of InfraCo default and get legal opinion	Legal opinion sought on RTNs and UWNs and termination options, "virtual data room" maintained on tie 's extranet.
6	Use DRP, RTN's and UWN's as negotiation tools to strengthen tie 's position for one of the “3 potential outcomes” (see above).	Agreement on Carlisle was not reached and termination was ruled out. However, a mediated settlement is still possible.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – BSC Cessation, October 2010



Background

- The Resolution Report states that the “operation of Clause 80 has been one of the main areas of contention” in regards to (amongst other items):
 - Clause 80.15/80.13 and 34 instructions – progressing with the works with due expedition; and
 - Use of Clause 80 rather than Clause 65 (compensation events).
- As recorded in “Workstreams – Continued use of DRPs” elsewhere in our report, the Murrayfield Underpass adjudication decision, received in August 2010, set out that **tie** was unable to instruct works to progress using cl. 80.15 (or cl.80.13) without there being an agreed estimate.
- On 29 September 2010, BSC wrote to **tie** informing it that it would be ceasing works that were subject to an INTC where no **tie** change order or agreed estimate was in existence. A number of ITNCs (94) were specified in the letter.
- BSC stated that they were not under any obligation to proceed with these works and had done so (to date) on a “goodwill” basis. This is stated by BSC as being on the understanding that **tie** would agree estimates and issue change orders in respect to the relevant works.

Review of the Commercial Strategy – March 2010 to March 2011

Workstreams – BSC Cessation, October 2010



Management response

- **tie** responded to BSC's cessation letter on 04 October 2010, refuting BSC's reasoning for ceasing works to any section of the Infraco works and stating that any delay would be subject to the payment of liquidated damages.
- We have seen correspondence from **tie** to BSC addressing 34 ITNCs. The response from **tie** to BSC's claims that they could cease certain works without prejudice to the Infraco Contract generally falls into one of the five categories below:
 - The works associated with the ITNC in question are not a mandatory **tie** change and can/will be undertaken by others;
 - BSC have no "due cause" to suspend the relevant works, and are considered to be in breach of their obligations under the Infraco contract;
 - INTNCs relating to abortive costs in producing estimates are not considered relevant for BSC to state that the works associated with them have ceased;
 - Areas subject to what is, in **tie's** view, a compensation event (such as unforeseen ground conditions) do not constitute a change (under clause 80) and should therefore not be a cause for cessation of works; and
 - The relevant INTNC does not constitute a "Notified Departure" under the Infraco contract, and the failure of BSC to follow subsequent instructions from **tie** pursuant to Clause 34.1 place them in breach of contract.

Summary

- **tie** has applied a robust response to BSC's cessation of works, replying to a substantial number of ITNCs on an individual basis, and keeping correspondence with BSC regarding the cessation of certain works on the **tie** extranet.
- Whilst the detailed status around **tie's** position with BSC in regards to alleviating the cessation is not recorded in the TPB minutes and TS reports from October 2010 onwards, the lack of progress on site is reported to both. The TS reports from October 2010 onwards record BSC's demobilisation on certain sites, and that **tie** "continues to undertake monitoring on both active and inactive worksites" and have entered into "formal correspondence" with BSC.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Background

- As reported in our Audit Report, dated July 2010, the key governance documents include:
 - **tie**/CEC Operating Agreement;
 - Grant offer letter from Scottish Ministers to CEC with associated Terms and Conditions;
 - Delegated Authority Rules Rev 2.0 dated 05 February 2010;
 - the Governance section of Tram Project Board minutes; and
 - Operating Agreement compliance checklist.
- **tie** senior management have informed us that they are not aware of any updates or new governance documents since July 2010.
- The original governance and management model after financial close is set out in Appendix 2 of the Report On Terms Of Financial Close produced in May 2008. This was updated in the Operating Agreement between CEC and **tie** dated 18 December 2009. Governance requirements are also detailed in the Memorandum of Understanding between CEC, **tie** and Transport Edinburgh Ltd (TEL) and the Memorandum of Understanding between CEC, Edinburgh Trams Ltd and Transport Edinburgh Ltd both dated 18 December 2009.
- The TEL board has the authority to deliver the project up to a Baseline Cost of £545m and to a Baseline Date of October 2012. Where TEL becomes aware that it will be unable to deliver the project within the £545m Baseline Cost it must notify the Council.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Background (Contd.)

- As recorded in our previous Audit report, dated July 2010, **tie** issues a Checklist of Compliance with Conditions of Operating Agreements with CEC and Checklist of Compliance with Conditions of Grant of £500m from Scottish Ministers to CEC. This exercise was concluded during May 2010 and issued as a paper to the TEL Board on 2 June 2010. The paper states that:
 - *"The continuing uncertainty regarding outturn costs and programme require that the Board's attention be drawn to our compliance with the requirement that TEL determines and reports to the Council on circumstances where there is an "actual or reasonably expected" (i) delay of 3 months beyond the Baseline Date (currently Oct 2012); (ii) increase in capital cost which would mean that the Baseline Cost (currently £545m) is exceeded by greater than £1,000,000; or (iii) any substantial change to the design, scope or service pattern set out in the Final Business Case."*
- As a result of the above statement, two recommendations were made to the TEL Board on 2 June 2010:
 - *Note the assurance with respect to Operating Agreement and Grant Conditions compliance provided by the management review undertaken as documented on the attached checklists.*
 - *Approve the letter from the Chairman on behalf of the TEL Board to the Tram Monitoring Officer notifying a reasonable expectation the costs of delivering the whole Phase 1a scope will exceed £545m.*
- In the TPB of 12 January 2011, the hierarchical governance arrangements in regard to future decision making processes were discussed as follows:
 1. The **tie** CEO presents his recommendation to the TPB;
 2. The TPB considers the CEO's recommendation and makes a subsequent recommendation to the TEL Board;
 3. The TEL Board considers the TPB recommendation and makes a subsequent recommendation to CEC; and
 4. The full Council considers the TEL Board recommendation, and ratifies as necessary.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Stakeholder Communications

- The Resolution Report describes a number of key day-to-day governance arrangements in place from March 2010.
- **tie** has maintained an Events Log from March 2010. This records meetings and conference calls, attendees and key decisions made. The Log does not record any meeting records or filenotes issued after the event, but records any key decisions made during the relevant meeting / call. A brief review of the events log found certain filenotes to be inconsistent, with not all TPB meetings recorded.
- The table below shows the regular meetings instigated by **tie** in the period, as recorded on the **tie** Events Log.

Key meeting	Participants	Frequency / Dates	Meeting recorded/minuted?
Tram Project Board	tie	Every four weeks throughout period	✓
TEL Board	tie , TEL Board	10th March - no others recorded on Events Log	✓ (as part of TPB)
Strategic Options Group	tie , CEC	Varied from weekly to monthly up to 23 Nov 10	✗
Group Leaders	Group Leaders	One meeting recorded on Events Log on 05 Oct 10	✗
Transport Scotland	Transport Scotland, tie	Reports produced every four weeks throughout period. Quarterly reviews have taken place, and regular (weekly) meetings and telephone calls are recorded as having taken place.	✓
FCL	tie , CEC	Events log indicates FCL meetings taking place monthly from January 2011	✓
Scottish Government	tie , MSPs	Meetings and phones calls. Generally every two weeks, but more often at critical junctures.	✗

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Stakeholder Communications (Contd.)

- In addition to the above meetings, **tie** management have facilitated/attended:
 - Regular Chairman's meetings/updates;
 - Funders' Oversight Group meetings;
 - Final Cost meetings;
 - Mediation meetings;
 - Pitchfork workshops;
 - CEC and CEC legal meetings;
 - Resolution meetings;
 - Scope, valuation and programme meetings.
- **tie's** CEO regularly meets senior CEC officials to provide detailed updates on the project on an ad-hoc basis.
- The governance process applied for the Project Pitchfork team governance process has continued to be utilised up to the date of the production of the Project Resolution Report in December 2010. In particular, Level 1 and Level 2 meetings are recorded in the **tie** Event Log. These were defined in the Project Pitchfork team governance provisions as follows:
 - **Level 1** **Progress Updates - attended by the project team and DLA;**
 - **Level 2** **Challenge Session - attended by the project team and others invited as required;**
- **tie** has previously advised that agendas are issued and minutes taken for the level 1 and level 2 meetings.
- The level 1-5 meetings are all recorded in the Event Log supplied to us by **tie** (though only Level 1 and Level 2 are recorded as such). With regards to challenge meetings, **tie** has advised that McGrigors took over the provision of legal representation from DLA from Autumn 2010.
- The report to CEC of 24 June 2010 records that "the development of the dispute (from the start) with BSC has been reported regularly to the Council, with reports prepared for the April and August 2009 Council meetings."
- **tie's** regular reports to Transport Scotland are sent by **tie** to CEC for onward transmission to Transport Scotland.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Key correspondence / minutes

- On 02 June 2010 the TPB approved a paper relating to compliance with the **tie** and TEL operating Agreements and TS Grant Conditions. The members of the TEL Board present at the TPB authorised the Chairman of TEL to formally notify the Tram Monitoring Officer confirming a reasonable expectation that the costs of delivering the whole Phase 1a scope would exceed £545m. This was carried out on 08 June 2010 and recorded in CEC report dated 24 June 2010.
- The Events Schedule notes that the Funders' Oversight Group met on 18 June 2010 to review the funding requirement from TS over the next 2 years to help with TS cash flow planning. The schedule also show "Final cost estimate meetings" took place on 22 June 2010 and 29 June 2010.
- A further update (forecast) meeting between **tie**/CEC & TS took place on 19 October 2010.
- Commentary on governance requirements has continued in the TPB minutes provided as part of this review. For example:
 - At the TPB of 21 October 2010, it was recorded that discussions were ongoing with TS on the funding implications for a range of scenarios to be provided in advance of the Scottish Government Budget Review, scheduled for 18 November 2010.
 - At the TPB of 15 December 2010, the Board approved the request to increase the tram project budget. It was further agreed that the TPB request that the TEL Board formally write to inform CEC Chief Executive that the funding envelope of £545m has been reached and required extending. It was also recorded that extension of this budget beyond £545m would require full CEC approval.
 - At the FCL Sub-committee meeting held on 08 February 2011, the current funding allowance of £545m was discussed in advance of the discussion at the TPB.
 - It was noted in the TPB on 09 February that it was **tie**'s intention to "recast the budgets and forecasts on conclusion of the mediation process".
 - The notes from the Scottish Parliament Public Audit Committee held on 23 February 2011 record Donald McGougan (on Funding): "We have been charged with doing contingency planning in relation to a figure of up to £600m...as we consider the business case for this tram going forward we also anticipate that the surpluses that would be generated would support further borrowing."
 - At the FCL Sub-committee meeting on 22 March 2011, it was reported that the costs associated with DRP would be significantly higher in the period due to Mediation costs. The actual costs were not disclosed. We have subsequently been informed by **tie** senior management that a costed change order was raised and approved at the TPB on 11 April 2011.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Audit Scotland report

- Audit Scotland performed a review on behalf of the Auditor General for Scotland of the overall Edinburgh Tram project, and the report was issued in February 2011. The summarised key issues and recommendations for the project were as follows:
 - It is vitally important that a cost effective resolution of the current dispute is resolved. It is important that CEC and **tie** maintain a clear view of the benefits of a negotiated solution when compared against any additional costs which might be incurred.
 - If no satisfactory solution can be found, then CEC and **tie** will need to consider fully the consequences of alternatives including termination of the contract with BSC.
 - Given the concern over what the project may finally cost, CEC and **tie** should develop options for the project and clearly set out costs and timetables for delivery.
 - Given that Phase 1a is unlikely to be delivered for £545 million, **tie** needs to define its strategy for the project to ensure that its commitments and available funding are aligned.
 - Project Governance arrangements are complex. CEC needs to consider a wider review of governance arrangements while the project is still in the construction phase. CEC needs to satisfy itself that the membership and remit of each element of the governance framework contains sufficient scrutiny of the project's progress and risk management arrangements.
 - Although TS already monitors project spend, their future involvement needs to be considered with regards to providing advice and monitoring the project's progress. The Scottish Government should also consider whether TS should use its expertise in managing major transport projects to be more actively involved and assist the project in avoiding further delays and cost overruns.
- The Report also records that the TPB continues to be the project's main governance body and consists of the **tie** chief executive, two CEC officials, the TEL director responsible for bus and tram integration, and four non-executive directors with expertise in transport issues.
- Further to the Audit Scotland findings, we were advised by **tie** senior management that TS's Director of Major Projects (Ainslie McLaughlin) played a significant role both in the preparation of the mediation and in the mediation itself.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



CEC's role

- Senior management at **tie** observed a "change in dynamic" from November 2010 whereby CEC became more engaged and took up a greater role in the management of the relationship with BSC.
- This is evidenced in the Emergency Motion put forward by the Council Leader on 18 November 2010, which includes (amongst other items):
 1. The Council Leader will take all appropriate steps to facilitate mediation and asked the Chief Executive to take forward a mediation proposal;
 2. The Chief Executive subsequently discussed with the Chief Executive of **tie** the potential for using mediation or any other form of dispute resolution; and
 3. The TPB on 17 November agreed to support an independent mediation process. This pre-dated the Council motion of 18 November 2010.
- In addition, CEC's head of legal and administrative services gave the final approval for the mediation statement to be released. However, we were informed that three members of **tie** were heavily involved in the decision making and option development process. We were also advised that substantial resource from **tie**, CEC, as well as external advisors, were allocated to the development of the mediation strategy.
- Notes from the Scottish Parliament Public Audit Committee 23 February 2011 record the Director of Finance for CEC confirming the Council is the project owner and co-funder, and **tie** is the delivery agent.

Review of the Commercial Strategy – March 2010 to March 2011

Governance and Funding



Summary observations

- As identified in our previous Internal Audit Report, **tie** has continued to be guarded on the reporting of uncertain Anticipated Final Cost out-turn positions to both CEC and Transport Scotland until certainty has been achieved on the matters in dispute with BSC. Whilst **tie** has now informed CEC and TS that there is a "reasonable expectation" that the £545m for Phase 1a will be exceeded, it has also stated that "until the key issues are resolved through the contractual and legal process, it will not be possible to accurately forecast a revised budget outturn (TS Report 25 October 2010)." It is of note that obtaining cost certainty has been one of the key objectives of the Pitchfork recommendations. At March 2011, no agreement has been reached between BSC and **tie** on programme or time. Should certainty be reached as a result of the March 2011 mediation, **tie** will report the agreed date to the key stakeholders in line with their governance requirements.
- The Audit Scotland report of February 2011 identified the need for CEC to consider reviewing the governance arrangements while the project was still in the construction phase.
- The notes from the Scottish Parliament Public Audit Committee held on 23 February 2011 record CEC's director of development stating:
"I believe that the governance structure is complex, but that all of the adequate checks and measures are in relation to reporting progress on the project are in place. Where the project currently stands is a symptom not of the governance arrangements, but of the contractual dispute with the consortium."

Review of the Commercial Strategy – March 2010 to March 2011

Mediation



Introduction

- As noted in our limitations (Appendix 2), this report specifically excludes a review of the mediation process or the decision making process therein. However, we have assembled a summarised chronology of events, and have noted comments made during our discussions with **tie**.

Background

- Prior to October 2010, there is limited documented evidence that a mediated settlement of the Infraco Contract was being seriously considered as an option for **tie**.
- In a Carlisle letter dated 29 October 2010, BSC state that the meeting of 11 October 2010 was "preceded by several conversations ...between Messrs Jeffrey and Walker...solely arranged to discuss mutually agreed termination."
- In **tie**'s response to BSC's letter on 03 November 2010, it is pointed out that the "factual record" shows that it was in fact Infraco members who instigated the idea of a "divorce" and that "Mr Reid articulated the options...in his letter dated 05 March 2010."
- On 17 November 2010, McGrigors were instructed to contact Pinsent Masons to set in motion the agreement of the mediation process. This eventually resulted in the agreement of both the mediator and the mediation dates as follows:
 - 10 February 2011: BSC to deliver the Phoenix offer;
 - 17 February 2011: **tie** to respond to BSC's offer; and
 - 24 February 2011: Mediation statements.
- The dates set for the mediation were 08-11 March 2011.

Review of the Commercial Strategy – March 2010 to March 2011

Mediation



Chronology of events

November 2010

- On 16 November 2010, the CEO of CEC wrote to the Managing Director of BB offering a meeting with CEC officers.
- In response to a letter sent by **tie** on 22 November 2010, CEC sent a letter to **tie** dated 6 December 2010 confirming that CEC's preferred strategy (for "commercial reasons") was to move to mediation on a short-term basis, ideally with a view to both sides "walking away" from the Infraco contract. The letter set an initial goal for short-form mediation to happen in January 2011, involving a representative of **tie**, a representative of CEC, and two representatives from BB – one from the UK Company and one from the German Company.
- The "Narrative on process leading up to Mediation" provided by **tie**, dated 13 April 2011, states that CEC "decided that they would present the Tram Opening Statement" and "lead the mediation from CEC's perspective."
- The Board authorised **tie**'s CEO to approach BSC with an offer to enter into a process to seek a mediated settlement at the TPB of 17 November 2010. The opportunity for mediation was debated in detail by the Board, and it was unanimously agreed that all avenues to resolve matters with BSC must be explored and exhausted. Subsequently, **tie** wrote to BSC suggesting that mediation be considered. This was responded to positively by BSC on 19 November 2010.
- A Liberal Democrat Emergency Motion dated 18 November 2010 records the following:
 - The Chief Executive wrote to BB on 16 November to offer a meeting with CEC;
 - The Council Leader and Chief Executive met with the Cabinet Secretary for Finance and Sustainable Growth at which they discussed the possibility of mediation; and
 - The Council Leader was to take "all appropriate steps" to facilitate mediation, and asked the Chief Executive to take forward a mediation proposal.
 - The CEO of CEC subsequently discussed with the CEO of **tie** the potential for using mediation,
- **tie** then wrote to CEC on 22 November to seek agreement on outcomes and the desired process for the mediation.
- Two letters were sent on 24 November and 02 December 2010 by BSC to **tie** to propose an agenda for the mediation.

Review of the Commercial Strategy – March 2010 to March 2011

Mediation



Chronology of events (Cont'd.)

December 2010

- Concerns were also raised within the TPB of 15 December 2010 as to the level of commercial resource being deployed by BSC. In response, **tie**'s CEO stated his intention to "further enhance **tie**'s commercial capability in the New Year."
- The TPB of 15 December 2010 approved **tie**'s CEO's recommendation that the mediation should:
 - Commence as soon as possible;
 - Cover the completion of the route from the Airport to St. Andrew Square;
 - Follow a fast track/commercial process; and
 - That performance criteria should be bound into delivery of the mediated outcome to encourage adherence to any agreed terms.
- An additional recommendation is noted in the TPB minutes of 12 January 2011: "**tie** to develop the mediation strategy with CEC Legal and Finance Directors". A key requirement of any mediated settlement discussed by the TPB in this meeting was around price and delivery certainty.

January 2011

- We are advised that, from January to March 2011, **tie** and CEC jointly prepared the documentation for mediation and CEC were involved at CEO level. During this period, CEC appointed an independent advisor, Colin Smith, who was to advise CEC CEO on mediation strategy.
- It was also recorded that CEC had taken independent legal advice and that it had met with **tie** legal advisors several times over the preceding weeks. The parties had reportedly agreed a mediator to facilitate the process, and this mediator was available during mid January/February 2011. On a governance point, the Board agreed that the mediation strategy was to be developed by the **tie** CEO in conjunction with CEC Chief Executive and CEC Directors of Legal Services and Finance.
- We were informed by **tie** that it was agreed between **tie** and BSC that BSC would provide "Project Phoenix (Carlisle V2)" proposals as a precursor to the mediation discussions on 21 January 2011. This was extended to 28 January 2011 and ultimately BSC opted to produce the Project Phoenix proposals as part of the mediation documentation.

Review of the Commercial Strategy – March 2010 to March 2011

Mediation



Chronology of events (Cont'd.)

February 2011

- A number of "possible outcomes" were discussed in the TPB of 09 February 2011 as follows:
 1. Agreement is reached with BSC to continue with the works to a defined scope under revised contractual conditions;
 2. Mutually agreed termination of the Infraco Contract; and
 3. Continue on under the existing contractual terms, which may lead to either party adopting unilateral action leading to termination of the contract.
 - It was noted that option 3 above was "not a realistic option", and that the outcome of the mediation must be legally binding on both parties.
- In the TPB of 09 February 2011, it was noted that CEC would be requested to ratify the outcome of the mediation process on the recommendation of the mediation team and the TPB.
- The notes from the Scottish Parliament Public Audit Committee held on 23 February 2011 record that, when challenged on why the mediation had taken three months to commence, the CEO of CEC stated that a "huge amount of preparation" had gone into the process.
- On 24 February 2011, BSC submitted proposals around a reduced scope based on the Infraco Contract, for discussion in the upcoming mediation. The name of these proposals, as agreed by the parties, was Project Phoenix. The reduced scope comprises works between Edinburgh Airport and Haymarket Viaduct, enabling works in Phase 1A, and work already executed in sections 1B, 1C and 1D.

March 2011 onwards

- At the TPB on 16 March 2011, it was noted that the contractual timeframe to complete a number of the outstanding "live" matters submitted to DRP would overlap the mediation process, and that these matters would therefore form part of the mediation discussions.
- The "Narrative on process leading up to Mediation" provided by **tie**, dated 13 April 2011, states that CEC CEO "decided that they would present the Tram Opening Statement" and "lead the mediation from CEC's perspective."
- During our discussions with **tie** senior management on 28 April 2011, concern was expressed over the unrecorded nature of the mediation process and how the decision making process during the mediation could be reviewed, should it be required in future.

Supplemental Information – Review of the Commercial Strategy

Appendices



Review of the Commercial Strategy

Appendix 1 - Detailed Scope and Objectives



Background and Overall Objective:

- The scope of this work agreed with **tie** management at the outset of this internal audit is provided below for information.
- The commercial strategy implemented by **tie** to resolve the escalating dispute with BSC is an important aspect of the overall governance framework adopted by **tie**. We completed a review of the key events between contract signature on 14 May 2008 and the issue of the Project Pitchfork report in March 2010. This report was presented to the Audit Committee on 30 June 2010, with the final version issued on 16 August 2010.
- We have been asked to extend this report to include the period from the issue of the Project Pitchfork report in March 2010 to the issue of the Project Resolution report during December 2010, and further to include the key events leading up to the commencement of mediation in March 2011.
- The review will assess the following elements:
 - Has **tie** applied a robust decision making process;
 - Does suitable evidence of the decision making process exist; and
 - Were there any opportunities to enhance the process currently in place.

Review of the Commercial Strategy

Appendix 1 - Detailed Scope and Objectives ((Contd.))



Project coverage and testing:

- The review considered, for the period March 2010 to March 2011, in relation to key workstreams and events:
 - What issue(s) initiated the workstream
 - What were the key inputs;
 - What advice did **tie** take;
 - What information was available to **tie**;
 - What decision making process was adopted;
 - How was the decision making process recorded;
 - How was the decision implemented; and
 - Was there a change to the decision made during implementation.

- The additional meeting held with **tie** in September 2010 (meeting record issued October 2010) has also been incorporated into the review.

Review of the Commercial Strategy

Appendix 2 - Approach and Limitations



Approach

- We adopted the following approach for this review:
 - Reviewed documentation supplied by **tie** surrounding the key workstreams and events;
 - Met with **tie** senior management to discuss the context of the key events:
 - Steven Bell
 - Susan Clark
 - Richard Jeffrey
 - Preparation of a draft report, including recommendations for improvements in the process together with supporting documentation.

Limitations

- The review concentrates solely on the decision making process applied by **tie** and is not a forensic review of the commercial decisions taken during the period of the project under review and our work specifically excludes analysis and commentary on the decisions taken by the contracting parties and internally within **tie**.
- **It should be noted that this report specifically excludes a review of the mediation process or the decision making process therein.**

Review of the Commercial Strategy

Appendix 3 – List of Documentation



As part of our work we have undertaken a high level review of the following documents:

- Tram Project Board minutes dated 10 March 2010, 14 April 2010, 05 May 2010, 02 June 2010, 30 June 2010, 28 July 2010, 25 August 2010, 22 September 2010, 21 October 2010, 17 November 2010, 15 December 2010,
- Adjudication Decisions:
 - Hilton Car Park 13 October 2009
 - Depot Access Bridge 22 September 2010
 - Payment of Preliminaries 02 March 2011
 - Section 7 drainage 24 May 2010
 - Carrick Knowe Bridge 16 November 2009
 - Gogarburn Bridge 16 November 2009
 - Murrayfield Underpass 07 August 2010, including explanation decision – 09 August 2010
 - Subcontractors 13 December 2010
 - Landfill Tax (date not disclosed, but approximately December/January 2010/2011)
 - MUDFA Rev 8 16 July 2010
 - Russell Road Retaining Wall Two 04 January 2010
 - Tower Bridge 18 May 2010
- **tie** Event Log (March 2010 to March 2011)
- Project Resolution Report, December 2010

Review of the Commercial Strategy

Appendix 3 – List of Documentation (Contd.)



- Transport Scotland 4 Week Reporting Packs, dated 01 April 2010, 30 April 2010, 28 May 2010, 25 June 2010, 22 July 2010, 20 August 2010, 17 September 2010, 15 October 2010, 12 November 2010, 10 December 2010, 07 January 2011
- Notes from the Scottish Parliament Public Audit Committee 23 February 2011 – Edinburgh Trams Interim Report
- Audit Scotland, Edinburgh Trams Interim Report, February 2011
- Report to the Council, Edinburgh Tram Project: Update, 18 December 2010
- CEC/TEL Operating Agreement
- **tie**/TEL/CEC MOU 18 December 2010
- **tie**/CEC Operating agreement 15 April 2008
- Full Council Report, June 24 2010 and October 14 2010
- BSC correspondence 25.1.201/KDR.6860 29 September 2010
- MUDFA DRP decision reasoning 26 July 2010
- BSC correspondence – replacement of deputy project director 24 November 2010
- Notes of **tie**/BSC meeting 12 October 2010
- BSC correspondence – end of Carlisle project 14 October 2010
- CEC emergency motion 18 November 2010
- **tie** correspondence to CEC outlining mediation scope
- BSC and **tie** "Cessation of Works" correspondence, dated 05 November 2010, 7 December 2010, 28 January 2011, 16 February 2011, 22 February 2011, 24 February 2011, 04 March 2011, 18 March 2011, 25 March 2011
- Project Phoenix Proposal, 24 February 2011

Review of the Commercial Strategy

Appendix 4 – Statement of Responsibility



We take responsibility for this report which is prepared on the limitations set out below.

The matters raised in this report are only those which came to our attention during the course of our work and are not necessarily a comprehensive statement of all the weaknesses that exist or all improvements that might be made. Recommendations for improvements should be assessed by you for their full impact before they are implemented. The performance of internal controls work should not be taken as a substitute for management's responsibilities for the application of sound commercial practices. We emphasise that the responsibility for a sound system of internal controls rests with management and work performed by Deloitte should not be relied upon to identify all strengths and weaknesses in internal controls, nor relied upon to identify all circumstances of fraud or irregularity. Auditors in conducting their work are required to have regards to the possibility of fraud or irregularities. Even sound systems of internal control can only provide reasonable assurance and not absolute assurance and may not be proof against collusive fraud. Our procedures are designed to focus on areas as identified by management as being of greatest risk and significance and as such we rely on management to provide us full access to their accounting records and transactions for the purpose of our audit work and to ensure the authenticity of these documents. Effective and timely implementation of our recommendations by management is important for the maintenance of a reliable internal control system.

Deloitte LLP, Edinburgh, May 2011

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