The City of Edinburgh Council

10.05am, Thursday, 27 June

Edinburgh Tram – Preparing for operations

Item number	8.2
Report number	
Wards	All

Links

Coalition pledges	P18
Council outcomes	CO7, CO8, CO22
Single Outcome Agreement	SO1

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Executive summary

Edinburgh Tram – Preparing for operations

Summary

Following reports to Council on 13 December 2012 (in relation to governance of Council companies) and 31 January 2013 (in relation to preparing for tram operations), this report updates Council on the current position and direction of travel, after detailed negotiations with Lothian Buses and Edinburgh Airport Limited (EAL) and in light of further work carried out on the financial model.

The report confirms the proposed corporate structure of the Council's transport group, and summarises the key terms of the tram operating agreement (in appendix 1) and of the shareholder agreements which will set out the governance arrangements for the group (appendix 2). The financial position is summarised in appendix 3 and a summary of the heads of terms with EAL is set out in appendix 4.

The report also highlights the critical need to ensure that appropriate governance and shareholder controls are in place to protect the Council's overall financial position and to ensure that the cumulative return of the integrated group is achieved as set out in the financial appendix.

Pending a further report to Council on 22 August 2013, further due diligence will be undertaken on the financial model (including a detailed cashflow analysis) and detailed legal opinions will be obtained in relation to procurement, state aid, competition and Transport Act matters. It is proposed to make this information together with an analysis of the key risks of the proposed arrangements available to elected members in a confidential data room (including a confidential briefing) in advance of the August meeting in order to inform the Council decision.

Recommendations

That Council:

1. notes the current position and direction of travel as set out in this report;

2. notes the critical need to ensure that appropriate governance, financial and shareholder controls are in place as set out in section 2.4 and instructs the Chief Executive to ensure they are exercised in order to protect the Council's overall financial position and to maximise the potential for achieving the cumulative return of the integrated group as set out in appendix 3;

3. ratifies and approves the exclusivity agreement entered into with Edinburgh Airport Limited and progress negotiations of the wider deal with Edinburgh Airport Ltd with the involvement of Lothian Buses;

4. delegates authority to the Chief Executive or the Director of Corporate Governance (in consultation with the Convener and Vice-Convener of the Transport and Environment Committee and transport spokespeople) to negotiate and enter into an interim services agreement among CEC, Tramco and Lothian Buses; and

5. approves the appointment of Atkins to undertake further financial due diligence and notes that legal opinions will be obtained as set out in this report and that a confidential data room (including a confidential briefing) will be made available for elected members prior to a further report to Council on 22 August 2013 .

Measures of success

Delivery of a safe, efficient and cost effective tram operation for the City.

Financial impact

Pending a further report to Council on 22 August 2013, further due diligence will be undertaken on the financial model and to allow the financial implications of the proposed arrangements to be reported to members.

Equalities impact

There is an ongoing full equalities impact assessment being undertaken in relation to the Edinburgh Tram project to ensure that as implementation progresses the equalities impact assessment is maintained.

Sustainability impact

As part of a broader sustainable transport strategy within the city it is anticipated that the tram will make a positive overall contribution to the environment by encouraging modal shift from private vehicles to public transport and mitigating the impacts of population growth and commuter and visitor generated traffic.

Consultation and engagement

There has been extensive engagement with the Chairman and Chief Executive of Lothian Buses plc. Initial conversations on the proposed corporate structure have also taken place with the other Lothian Councils.

Background reading / external references

Edinburgh Tram Project ,The City of Edinburgh Council 30 June 2011

Edinburgh Tram Project, The City of Edinburgh Council 2 September 2011

Edinburgh Tram Project, The City of Edinburgh Council 25 October 2012

Edinburgh Tram Project, The City of Edinburgh Council 31 January 2013

Report

Edinburgh trams – preparing for operations

1. Background

1.1 On 31 January 2013 an update was provided to Council on negotiations which had been taking place in relation to future passenger running operations for the Edinburgh trams. Details of the draft heads of terms and the commercial principles for the development of the long term agreement between the Council and the operator were provided, together with the key risks of the proposed arrangements.

1.2 In addition, the report of 31 January 2013 set out a proposed corporate structure for the group of transport companies, involving a new tram operating company ("Tramco"), separate from the existing bus company, Lothian Buses plc and a new wholly-owned holding company ("Topco") to hold the Council's 91% stake in Lothian Buses plc and 100% of the shares in Tramco.

1.3 It was also reported to Council that discussions had been taking place with Edinburgh Airport Ltd (EAL) regarding integration with airport operations to ensure that all three modes of transport work effectively together.

1.4 The decision of the Council at the 31 January 2013 meeting was;

1) To instruct the Chief Executive to continue to negotiate the detailed terms of the documentation with Lothian Buses and Edinburgh Airport Ltd.

2) To approve the proposed name of Topco as "Lothian Transport Limited".

3) To agree to the proposals in the report by the Chief Executive regarding Topco as an interim measure pending a report in June 2013 setting out a permanent future structure. This report should take legal and governance issues into account in considering Councillors' membership of Busco and Tramco.

1.5 In the period since the 31 January Council meeting, negotiations have continued with Lothian Buses on the operating agreement and the corporate documentation required to formalise the principles set out in the 13 December 2012 and 31 January 2013 reports.

1.6 This report updates the Council on the outcome of those discussions and provides the Council with the a summary of the key terms of the tram operating agreement and the corporate documentation required in order to operate the tram as part of the integrated transport vision for the city. The report also confirms that no changes are proposed to the interim group structure set out in the 31 January report.

1.7 Further work has been undertaken on the financial position of Lothian Buses, Tramco and Topco. An overview of the financial position is set out in the diagram at appendix 3. Further detailed financial information has been provided to members in the form of a confidential briefing in light of the commercial sensitivity of the information. Over the course of the coming weeks it is proposed that the scheduled due diligence will be undertaken on the business planning assumptions by Atkins in order to report back to Council in August 2013 with the final financial model and a detailed cashflow analysis.

1.8 The report also outlines the exclusivity arrangements entered into with EAL and the heads of terms which have been agreed following further discussions.

2. Main report

2.1 Corporate structure

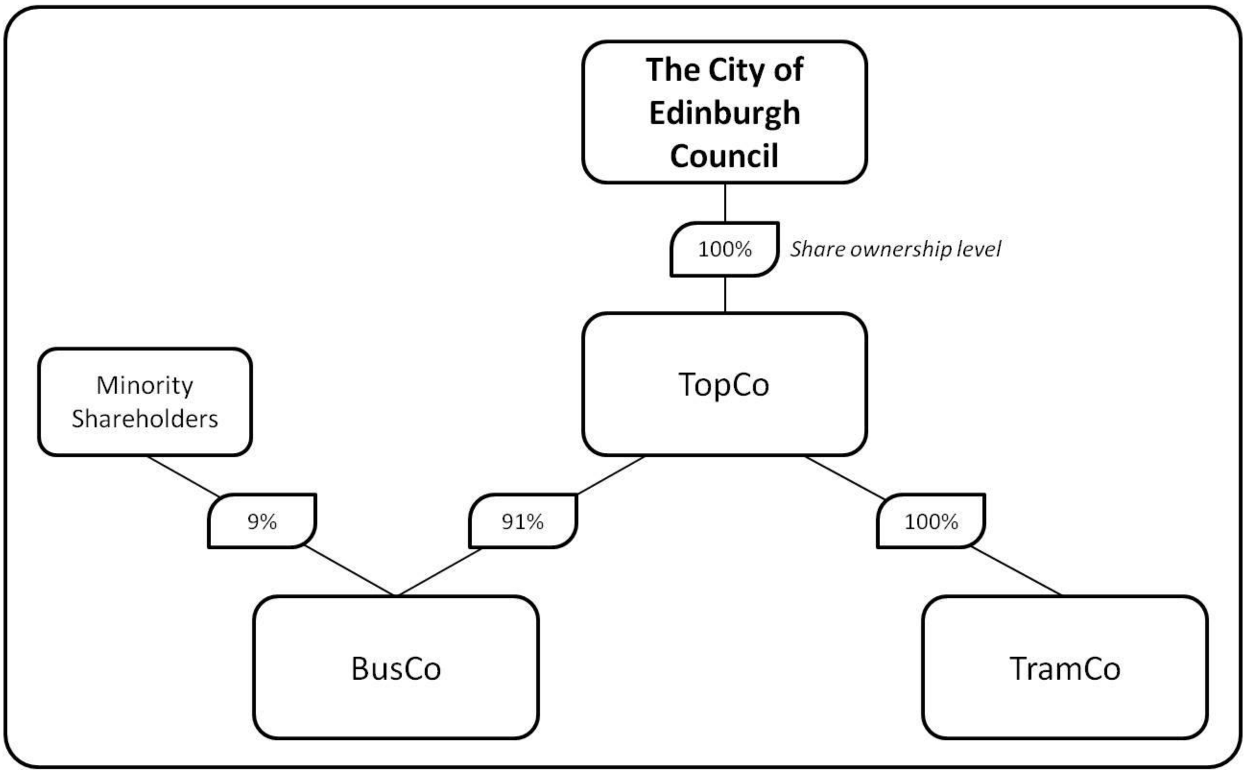
2.1.1 As described in the 31 January 2013 report to Council, a new governance structure is required for the group of companies charged with fulfilling the Council's wish for integrated transport in Edinburgh.

2.1.2 The proposed structure of the group involves putting in place a new holding company which controls both the existing bus operations (Lothian Buses plc) and the new tram operator. This structure ensures sole ownership by the City of Edinburgh Council of the tram company, given the minority interests of the other Lothians councils in the bus company.

2.1.3 In order to achieve this structure, two additional companies have been created. A new holding company ("Topco") has been put in place to hold the Council's 91% stake in Lothian Buses plc ("Busco") and a new tram company ("Tramco") has been created as a wholly owned subsidiary of Topco. Topco is wholly owned by the Council.

2.1.4 In line with Lothian Buses' articles of association, the other Lothian Councils will be requested to provide waiver letters to allow the proposed transfer of the Council's shareholding in Lothian Buses to the new Topco. Initial discussions have taken place with the other Lothian councils regarding the proposed arrangements. As Lothian Buses is a public limited company, Takeover Panel requirements will also need to be met.

2.1.5 The proposed new corporate structure is set out below.



2.2 Operating agreement

2.2.1 The terms set out in the heads of terms proposal to Council on 31 January 2013 remain the basis for the operating agreement.

2.2.2 The key principles that form the operating agreement between Tramco and CEC are as follows:

(i) Tramco will earn revenues derived from tram operations;

(ii) Tramco will pay from these revenues, operational running costs, certain tram maintenance costs that are properly and reasonably incurred, and depot maintenance costs;

(iii) Tramco will be paid a management fee of 10% of operational surpluses up to a capped amount of £250,000 per annum;

(iv) Tramco will contribute the balance of any operational surpluses to a sinking fund which the Council will use to contribute towards the balance of tram maintenance costs, infrastructure maintenance and refurbishment costs;

(v) The costs of tram and infrastructure refurbishment will be borne by the Council;

(vi) The costs of infrastructure maintenance, with the exception of the depot and certain tram maintenance costs, will be borne by the Council;

(vii) In order to meet the initial start up costs in the early years of operations CEC will provide capital in the form of a loan up to a maximum of £3m to Topco to cover the start-up costs;

(viii)Topco/Tramco will determine tram fare levels CEC will have full visibility of and be consulted on these; and

(ix) the duration of the agreement is 15 years.

2.2.3 A summary of the key terms of the operating agreement is set out in appendix 1.

2.2.4 It is important to note that although headline terms have been agreed, much of the detail in relation to operations will be contained in the operating and maintenance protocols. These documents will require significant work over the coming weeks.

2.3 Interim services agreement

2.3.1 As reported to Council on 31 January 2013, Lothian Buses have been preparing for operations under an interim operating agreement. As we move towards the final structure for tram operations, it is proposed that tram operating services will be provided to CEC from Tramco, while certain management services will continue to be provided by Lothian Buses.

2.3.2 In order to reflect the revised interim arrangements, it is proposed to terminate the existing interim operating agreement with Lothian Buses and replace it with a new interim services agreement among CEC, Tramco and Lothian Buses.

2.4 Integrated transport model

2.4.1 In the report to Council on 30 June 2011, a number of assumptions were made, based on the prevailing economic forecasts at that time, with regard to the patronage and revenues that could be generated by completing the tram to St Andrew Square.

2.4.2 These forecasts indicated that an operating profit could be made by the combined tram and bus business of £2m per annum following an initial ramp up period in patronage.

2.4.3 In the report to Council on 25 August 2011, assumptions were made with regard to the funding of the capital costs of tram in relation to the ability for CEC to lease trams to the operating company (£2.7m per annum) and draw down of further operating surpluses from the operating company of £2m per annum.

2.4.4 These assumptions were prior to meaningful engagement with Lothian Buses as potential operator and before heads of terms were agreed on the key commercial principles.

2.4.5 In the summer of 2012 a draft financial model was constructed by Lothian Buses and the Council. This revised model took into account updated patronage, revenue and cost assumptions. The financial model provided a baseline on which to model the revenues and costs of tram operations within the context of the integrated transport model proposed for Edinburgh.

2.4.6 It should be noted that the financial model remains in draft form, with a number of key elements such as insurance and maintenance costs that require to be validated. The current forecasts are subject to due diligence, suggest that tram returns an operating surplus in the third year of operations and exceeds the forecast operating surplus, reported in 2011 of £2m, in the sixth year of operations.

2.4.7 In the course of the coming weeks due diligence work will be undertaken to examine and validate the inputs to the financial model and the cashflow requirements. It is proposed to instruct Atkins to carry out this exercise given their previous involvement in verification of the business case in 2011. The result of this exercise will be reported back to the Council in August 2013 as part of the report finalising the operating arrangements for tram.

2.4.8 Reference is made to appendix 3 of the report, which provides a high level summary of the forecast financial position, modelled over the fifteen year term of the tram operating agreement.

2.4.9 It should be noted that, this shows a positive forecast position for CEC of £5m over the 15 year term of the operating agreement when considering the finances of CEC, Topco, Tramco and Busco as a whole. This position assumes the payment of dividends from both Busco and Tramco as shown. In order to achieve this position, the boards of the companies will require to work together to seek integrated transport, promoting revenue and carefully managing expenditure.

2.4.10 The positive position shown also assumes that additional opportunities to derive income from integrated transport operations are realised as set out in appendix 3.

2.4.11 As reported to Council on 31 January 2013 and reinforced in this report, the financial risk of tram operations remains with the Council. It is clearly critical that CEC carefully monitors the financial position over the term of the agreement. Failure to exercise shareholder controls, to monitor the financial position and to realise opportunities to derive additional income could result in a deficit forecast position for CEC over the term of the agreement.

2.4.12 There are a variety of opportunities that could enhance revenue and manage down costs. These opportunities are in relation to:

(a) engagement with the maintenance provider to revise maintenance agreements in order to make savings;

(b) the setting of fare levels – whilst Topco/Tramco and Busco will have responsibility for setting tram and bus fare levels respectively, CEC will have a keen interest in the revenue generated both as shareholder and client under the operating agreement;

(c) ensuring complementary and integrated timetabling for tram and bus;

(d) promotion of key transport interchanges such as Haymarket station, Waverley station, Edinburgh Park and Gogar Interchange This is considered critical, in order to enhance integrated public transport in the city, and should provide positive trip generation for the tram as part of an enhanced public transport offering;

(e) complementary arrangements with Edinburgh airport and other public transport interchanges;

(f) effective marketing and branding strategies to examine advertising and naming rights potential and generally to increase patronage;

(g) development of a long term strategy for expansion of park and ride sites; and

(h) Initiatives with large employers along the tram route.

2.4.13 For the reasons outlined above, a number of key shareholder controls are recommended. To ensure the performance of the group and to safeguard the Council's investment in integrated transport it is critical that;

(a) an effective and well run board is in place each for group company with board composition being the prerogative of CEC;

(b) shareholder controls are in place not only in relation to the business plan but also in relation to other areas such as the ability to make changes to the business , the appointment of directors and any material changes to the remuneration of the Executive Directors(s).

(c) CEC has full observer rights and the right to receive comprehensive information at Topco, Tramco and Busco level; and

(d) Busco and Topco dividend policy, (which will be set out in the annual business plan) requires excess cash in the business to be returned to the shareholders.

2.5 Governance

2.5.1 Whilst there are good reasons for the separation of the bus and tram companies, it is clear for the reasons outlined above that effective shareholder engagement and strong direction from the Topco board will be critical if the Council's stated aim of an integrated transport service is to be achieved.

2.5.2 A summary of the key terms of the shareholders agreements is set out in appendix 2.

2.6 Edinburgh Airport

2.6.1 Following the Council decision on 31 January 2013, officers have continued to negotiate with Edinburgh Airport on the delivery of an integrated transport model to enhance transport links to and within Edinburgh and engender collaborative operational benefits for the parties. A key component of the future viability of buses and trams and integration with airport operations is that all three modes of transport work in harmony together.

2.6.2 In order to agree a period of exclusivity for discussions, CEC required to enter into an agreement with EAL, terms of which are included in (confidential) appendix 4These negotiations have now reached agreed heads of terms which are summarised in the confidential appendix. Negotiations will continue over the coming weeks with the final agreement being reported to the Council meeting on 22 August 2013 as part of the final financial package for tram operations.

2.7 Further diligence

2.7.1 The financial model for tram operations is based on the business model verified by Atkins in 2011 and developed in 2012 using updated patronage and cost forecasts from Steer Davies Gleave and Lothian Buses. Some of the assumptions have been updated in the 2013 model and will be the subject of the due diligence exercise from Atkins. It should be noted that, if running costs are higher or patronage/revenues are lower than set out in that business case, the Council will bear the financial risk.

2.7.2 As part of Atkins' due diligence, there will be sensitivity testing undertaken on the financial model. This sensitivity testing will also be analysed against the Council's long term financial plan and previous reports to Council on tram finances. In addition, there will be a thorough cashflow analysis undertaken to examine the short term cash requirements.

2.7.3 It is proposed to obtain detailed legal advice in relation to procurement, state aid, competition and Transport Act matters and to make this information, together with an analysis of the key risks of the proposed arrangements, available to elected members in a confidential data room (including a confidential briefing) in advance of the 22 August meeting.

3. Recommendations

That Council:

3.1 notes the current position and direction of travel as set out in this report;

3.2 notes the critical need to ensure that appropriate governance, financial and shareholder controls are in place as set out in section 2.4 and instructs the Chief Executive to ensure they are exercised in order to protect the Council's overall financial position and to maximise the potential for achieving the cumulative return of the integrated group as set out in appendix 3;

3.3 ratifies and approves the exclusivity agreement entered into with Edinburgh Airport Limited and progress negotiations of the wider deal with Edinburgh Airport Ltd with the involvement of Lothian Buses;

3.4 delegates authority to the Chief Executive or the Director of Corporate Governance (in consultation with the Convener and Vice-Convener of the Transport and Environment Committee and transport spokespeople) to negotiate and enter into an interim services agreement among CEC, Tramco and Lothian Buses; and

3.5 approves the appointment of Atkins to undertake further financial due diligence and notes that legal opinions will be obtained as set out in this report and that a confidential data room (including a confidential briefing) will be made available for elected members prior to a further report to Council on 22 August 2013.

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Chief Executive

Links

Coalition pledges	P18
Council outcomes	CO7, CO8, CO22
Single Outcome Agreement	SO1
Appendices	Appendix 1 – Tram operating agreement summary Appendix 2 – Shareholder agreements summary Appendix 3 – Financial position Appendix 4 – EAL Heads of Terms (confidential)

1. **INTRODUCTION**

1.1 This document contains a high-level summary of the Operating Agreement draft dated 10 May 2013 (the **"OA"**) to be entered into between CEC and TramCo. Please note that this document is not intended to be a comprehensive summary of the OA and the detailed drafting should be consulted to obtain a full understanding of the contractual provisions.

1.2 The OA is made pursuant to the Tram Acts and is an appointment by CEC for TramCo to operate the "authorised tramway" (as defined in the Tram Acts). (clause 6)

1.3 Capitalised terms used in this document have the meaning given to them in the OA.

2. **SERVICES**

2.1 TramCo will be required to provide public passenger transport services on the Edinburgh Tram Network (**"ETN"**) from the Services Commencement Date, which is intended to be the date that revenue earning passenger services on the ETN commence. (clause 4)

2.2 TramCo will be required to comply with all applicable laws (including relevant safety laws) and good industry practice when carrying out its obligations under the OA. (clause 5.4)

2.3 TramCo will be required to measure and record its compliance with certain key performance indicators and performance measures which will be specified in the OA. (clause 8.2) The key performance indicators and measures are to be developed and will be set out in Part 2 of Schedule 1 to the OA. Please note, it is not intended that TramCo's compliance or non-compliance with the key performance indicators and measures will impact on payment under the OA (ie no performance deduction regime).

3. **DURATION OF CONTRACT**

3.1 TramCo will provide the Services under the OA for 15 years. (clause 2)

4. **PAYMENT**

4.1 TramCo will directly sell tickets to passengers to use the ETN and all ticket revenue will initially be collected by or on behalf of TramCo. TramCo must comply with CEC's Tickets and Fares Policy and also the provisions of the Local Concessionary Scheme. (clauses 13 and 16)

4.2 TramCo may also receive revenue from certain specified advertising rights. Generally, this includes advertising in or on the Trams, on the tickets and within a specified area on the Tramstops. (clause 15.2)

4.3 From the revenue collected on the ETN, TramCo may retain amounts for its properly and reasonably incurred costs (eg operating costs and amounts payable to Lothain Buses (**"LB"**) under the Services Agreement (see item 7 below)). (schedule 3)

4.4 TramCo will pay CEC a monthly fee for the maintenance of the depots and the Trams. Where, having deducted TramCo's properly and reasonably incurred costs, the revenue from the ETN in any month is insufficient for TramCo to pay CEC the entire maintenance fee, TramCo shall pay CEC the remaining revenue from that month. The amount of any unpaid maintenance fee shall be carried forward and paid by TramCo to CEC from revenue in the next or later months. (schedule 3)

4.5 In respect of each operating year, where there is a surplus (ie any year where the revenue from the ETN exceeds TramCo's costs and the maintenance fees payable to CEC), TramCo shall be entitled to retain 10% of that surplus up to a maximum amount of £250,000 per year. The remaining surplus will be paid to CEC. Please note, where TramCo has a deficit from a previous operating year (ie any year where the revenue from the ETN is less than TramCo's costs and the maintenance fees payable to CEC), any surplus in a subsequent operating year will first be applied to pay the deficit. (schedule 3)

5. MARKETING

5.1 TramCo will be responsible for undertaking the marketing of the ETN with the aim of increasing patronage. (clause 15.1)

6. MAINTENANCE

6.1 CEC will be responsible for ensuring that the Trams, the ETN and the depot are maintained in accordance with an agreed protocol. As described above, TramCo will pay CEC a monthly fee for maintenance. (clauses 10, 11 and 12)

6.2 From 3 years after the Services Commencement Date, CEC may on 12 months' notice transfer to TramCo the responsibility for undertaking the maintenance of the Trams and the depot. If applicable, the parties will agree the terms and scope of such arrangements at that time. (clauses 11 and 12)

7. LOTHIAN BUSES / SERVICES AGREEMENT

7.1 TramCo will be entitled to sub-contract to LB under the Services Agreement (in a form which will be agreed by CEC) the provision of certain services. We understand that LB will provide back-room services for TramCo and will be responsible for the collection/processing of fares from the ETN.

7.2 It is intended that TramCo will not be entitled to amend the Services Agreement without the consent of CEC. (clause 38.1)

8. LICENCES

8.1 On or prior to the Services Commencement Date, CEC and TramCo will enter into a Depot Licence, a Track Licence and a Tram Licence, giving TramCo access to and requiring TramCo to fulfil certain obligations in relation to, the depot at Gogar, the track on which the Trams operate and the Trams themselves. The forms of the licences will be scheduled to the OA.

9. INTELLECTUAL PROPERTY

9.1 The terms of the OA relating to intellectual property remain under discussion. However, it is intended that CEC will own all intellectual property rights developed, created or acquired by TramCo in performing its obligations under the OA (excluding (if any) the intellectual property rights of LB). (clause 37)

10. PROTOCOLS

10.1 It is envisaged that certain protocols will set out the procedures for the day-to-day running of the ETN and the passenger services. Likewise, a protocol will apply with respect to the arrangements between TramCo and each of Infraco (maintaining the depot and infrastructure) and CAF (maintaining the Trams).

10.2 We understand that the protocols for the OA will be based on the relevant terms of existing DPOFA, although may not be a full pass down.

10.3 The protocols are currently in preparation and have yet to be discussed by the parties in any detail.

11. NETWORK EXPANSION

11.1 CEC will be responsible for making any decisions (in its absolute discretion) regarding any expansion of the ETN. If CEC is considering expanding the ETN it may either terminate the OA or negotiate with TramCo to amend the OA to provide for TramCo to operate the expanded network. (clause 22)

12. INDEMNITIES

12.1 TramCo indemnifies CEC for any losses in connection with death/personal injury, third party loss (including property damage), third party claims and breach of statutory duty which is caused or contributed to by TramCo. (clause 28.1(b))

12.2 CEC indemnifies TramCo for any losses in connection with death/personal injury, third party loss (including property damage), third party claims and breach of statutory duty which is caused or contributed to by CEC. Further, it is intended that the OA will include a pass down (for TramCo's benefit) of the indemnity to CEC from (i) Infraco under the Infraco Contract and (ii) CAF under the Tram Maintenance Agreement. (clause 28.1(c))

13. EARLY TERMINATION

13.1 CEC may terminate the OA prior to its designated expiry date if an "Operator Default" has occurred, which includes events of insolvency, material breach of TramCo's obligations, change of control, wilful misconduct, certain levels of poor performance and non-payment of sums due. (clause 31)

13.2 TramCo is entitled to terminate the OA prior to its designated expiry date if CEC fails to pay any sum over a specified threshold amount or if CEC breaches the OA in a way that frustrates or renders it impossible for TramCo to perform its obligations for longer than a month. (clause 32.1(b))

13.3 Where a force majeure event occurs and continues for 180 days or more, either party may terminate the OA.

14. VOLUNTARY TERMINATION

14.1 Five years after signature of the OA, CEC may voluntarily terminate the OA for any reason by giving TramCo 12 months' notice. (clause 33.2)

15. HANDBACK ON EXPIRY

15.1 On expiry (or early termination) of the OA, TramCo must return the Trams, depot and related equipment to CEC. If CEC has transferred responsibility for undertaking the maintenance of the Trams and the depot to TramCo as described above, then TramCo must return the relevant items to CEC in condition which meets the requirements specified in the OA. (schedule 6)

16. GOVERNING LAW AND JURISDICTION

16.1 The OA will be governed by the laws of Scotland and the Court of Session will have exclusive jurisdiction to hear any disputes.

Appendix 2A – Topco shareholder agreement summary

1. INTRODUCTION

This paper summarises the key provisions of the draft shareholder agreement for **Topco**.

This report is, of course, no substitute for reading the shareholder agreement.

2. SUMMARY

2.1 Parties

The parties to the agreement are Topco and the Council.

2.2 Business of Topco

The business of the Topco is:

- to act as a holding company and to hold the Council's shareholding in Lothian Buses and Tramco;
- to develop and provide an integrated network of public transport in Edinburgh and the Lothians.

2.3 Topco board

Board composition is the prerogative of CEC and is to be discussed and agreed

2.4 Tramco board

Board composition is the prerogative of CEC and is to be discussed and agreed.

2.5 Topco and Tramco board meetings

- All material decisions are to be taken at board meetings.
- Board meetings of Topco and Tramco are to be held at least quarterly.
- Five business days' advance notice of board meetings are to be given unless board meetings are required to be held on short notice.
- In addition to the directors, the Observer is entitled to receive notice of meetings and access to the board papers.

2.6 Observer

The Council has the right to appoint one council official as an observer at both Topco and Tramco board meetings and board committee meetings. The Observer is entitled to attend and speak but not vote at meetings.

Observer to have access to all papers but not necessarily paper copies.

Data room conditions may need to apply. A workable data room process will need to be agreed.

2.7 Remuneration Committee

The remuneration committee will determine the emoluments of the directors and senior employees of Topco and the Tramco. The remuneration committee must take into account the Council's views and be cognisant of public policy. Benchmarking and performance management are required. The representatives of the Topco remuneration committee will be up to CEC. In the event of a material change of the remuneration of the CEO, approval of the shareholders in general meeting will be required.

2.8 **Annual Budget and Business Plan**

An annual budget of Topco for each financial year has to be prepared and approved by the board.

In relation to the business plan, the board is to consult the shareholder initially. In the event that after consultation the shareholder is not satisfied with the business plan (acting reasonably in light of its commercial interests), the shareholder (within 90 days) can exercise a veto and the existing business plan will continue until agreement is reached.

2.9 **Accounts**

Quarterly management accounts of Topco and Tramco have to be delivered to the Council within 30 days of the end of the relevant quarter.

Audited accounts of Topco have to be sent to the Council within four months of the end of the relevant period.

2.10 **Access to books and records**

The Council has the right to access the books and records but data room conditions may be put in place for commercially sensitive material.

2.11 **Dividends**

There will be a statement as to the dividend policy in the shareholders agreements the intent of which will be that if there is excess cash in the businesses it can be pulled up to the shareholder. The directors will declare dividends.

2.12 **Consent matters**

Topco undertakes to make sure that a number of matters are not undertaken without the Council's consent. Consent matters for Topco and Tramco include:

- appointing or removing any director;
- making any material change to the business outside the normal course (material meaning a part or parts of the business representing 10% or more of the turnover of Topco for the previous financial year);
- making any strategic acquisitions outside the normal course of business;
- incurring liabilities other than on an arms-length basis in the ordinary course of business; and
- entering into any guarantees or indemnities other than in relation to any wholly owned subsidiary or in the ordinary course of business;

Appendix 2B – Busco shareholder agreement

1. INTRODUCTION

This paper summarises the key provisions of the draft majority shareholder agreement for Lothian Buses plc ("**LB**").

This report is, of course, no substitute for reading the shareholder agreement.

2. SUMMARY

2.1 Parties

The parties to the agreement are Topco, the Council and LB.

2.2 Business of LB

The business of LB will include operating bus networks in Edinburgh and the Lothians as part of an integrated network of public transport service in harmony with other modes of transport owned or operated by an Affiliate of the Company.

In addition LB will continue to operate tram business as at present and (subject to the consent matters below) may integrate new elements to the business.

2.3 LB board

Board composition is the prerogative of CEC and is to be discussed and agreed.

2.4 LB board meetings

- All material decisions are to be taken at board meetings.
- Board meetings of LB are to be held at least quarterly.
- Five business days' advance notice of board meetings are to be given unless board meetings are required to be held on short notice.
- In addition to the directors, the Observer is entitled to receive notice of meetings and access to the board papers.

2.5 Observer

The Council has the right to appoint one council official as an observer at LB board meetings and board committee meetings. The Observer is entitled to attend and speak but not vote at meetings.

Observer to have access to all papers but not necessarily to paper copies.

Data room conditions may need to apply. A workable data room process will need to be agreed.

2.6 Remuneration Committee

The remuneration committee will determine the emoluments of the directors and senior employees of Busco. The remuneration committee must take into account the Council's views and be cognisant of public policy. Benchmarking and performance management are required. The representatives of the Busco remuneration committee will be up to the Busco Board. In the event of a material change of the remuneration of the Executive Director(s), approval of the shareholders in general meeting will be required.

2.7 Annual Budget and Business Plan

An annual budget of LB for each financial year has to be prepared and approved by the board.

In relation to the business plan, the board is to consult the shareholder initially. In the event that after consultation the shareholder is not satisfied with the business plan (acting reasonably in light of its commercial interests) rather, the shareholder (within 90 days) can exercise a veto and the existing business plan will continue until agreement is reached.

2.8 Accounts

Quarterly management accounts of LB have to be delivered to the Council within 30 days of the end of the relevant quarter.

Audited accounts of LB have to be sent to the Council within four months of the end of the relevant period.

2.9 Access to books and records

The Council has the right to access the books and records but data room conditions may be put in place for commercially sensitive material.

2.10 Dividends

There will be a statement as to the dividend policy in the shareholders agreements the intent of which will be that if there are distributable reserves in the business (after taking into account future requirements and expected liabilities) they can be pulled up to the shareholder.

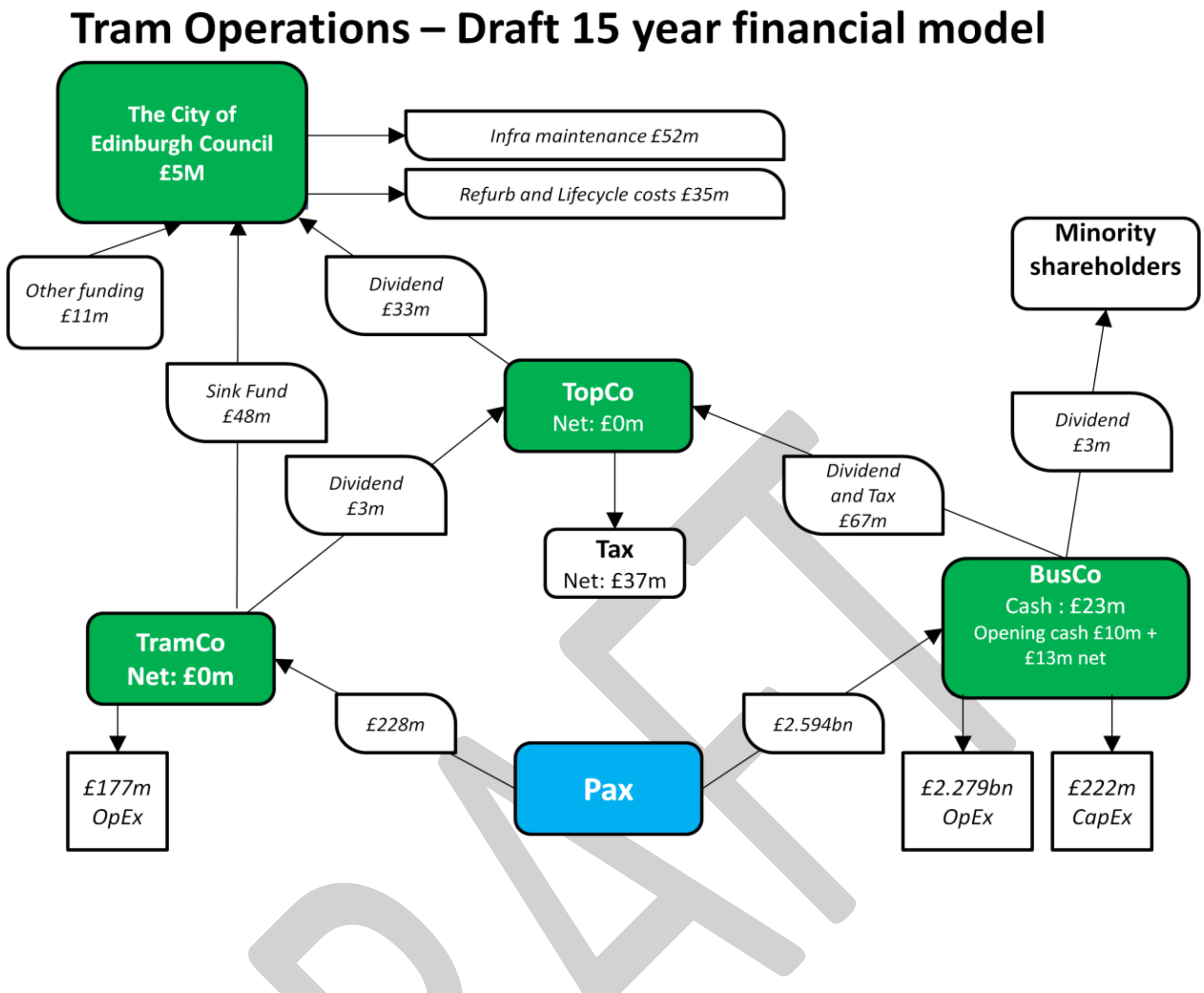
The directors will declare dividends.

2.11 Consent matters

LB undertakes to make sure that a number of matters are not undertaken without the Council's consent. Consent matters for LB and its subsidiaries include:

- In relation to the non executive directors of Busco appointing or removing any director;
- In relation to the appointment of the executive directors of Busco: it is for the board to approve and consult with CEC. If the shareholder does not agree with the proposed appointment, then other than in the case of the employee representative the shareholder can exercise a veto right.
- making any material change to the business outside the normal course (material meaning a part or parts of the business representing 10% or more of the turnover of LB for the previous financial year);
- making any strategic acquisitions outside the normal course of business;
- incurring liabilities other than on an arms-length basis in the ordinary course of business; and
- entering into any guarantees or indemnities other than in relation to any wholly owned subsidiary or in the ordinary course of business.

Appendix 3 – Financial position



Note on financial model

The 15 year term has been modelled to be consistent with the term of the tram operating agreement.

Revenues are derived from passenger fares (“Pax”). These revenues are distributed from tram passengers to Tramco and from bus passengers to Busco.

Over the 15 year model it is forecast that Busco derives revenues of £2.594bn, Tramco derives £228m.

From these revenues Busco are forecast to pay operating expenditure (“opex”) of £2.279bn and capital expenditure (“capex”) (primarily new buses) of £222m.

Over the term of the agreement, Busco have forecast to pay Topco, a dividend of £33m.

This would leave Busco with a net positive cashflow of £23m over the 15 year term.

From Tramco revenues, Tramco is forecast to pay opex of £177m. These costs relate to operational running costs, certain tram maintenance costs that are properly and reasonably incurred, and depot maintenance costs.

Appendix 3 – Financial position

Tramco will pay the remaining forecast surplus of £48m to CEC to contribute to a sinking fund to pay for infrastructure maintenance, the balance of tram maintenance and refurbishment costs, for which CEC are liable.

Tramco will also take a management fee of £3m forecast over the 15 year term, which it will pass to Topco.

Through a combination of the Tramco surplus and the Busco dividend, CEC will receive £36m in dividend payments that can be attributed to infrastructure maintenance, certain tram maintenance and refurbishment costs.

CEC are obliged to maintain the infrastructure, certain tram maintenance (with the exception of the depot; this is a Tramco obligation) and pay for refurbishment costs. Currently, the maintenance agreements are in place with CAF and Siemens. These are historic agreements previously negotiated by tie Ltd. It may be possible to enter into maintenance arrangements on more advantageous terms. Once tram operations have commenced, a full review will be carried out. If more advantageous terms are available CEC may wish to exercise its right to terminate either/both of the maintenance agreements at the first opportunity (3 years).

Other Funding

In order for the position set out in the diagram to be achieved, it is critical that CEC have in place and exercises the appropriate shareholder controls, takes proactive measures to realise income and tax savings from the opportunities set out below and actively monitors the financial position over the term.

Funding Opportunities	
Tax Planning	**Income**
Tax saving of £11m may be possible within the group if the sinking fund payments are allowable as deductions from income for Corporation tax purposes.	The Airport arrangements have the potential to increase patronage and jointly generate additional income Fare optimisation Advertising rights income Increased patronage through optimal integration