

Transport and Environment Committee

10.00am, Thursday, 6 December 2018

Edinburgh Trams Ltd – Changes to Operating Agreement

Item number	7.15
Report number	
Executive/routine	
Wards	
Council Commitments	

Executive Summary

This report seeks approval for changes to the current operating agreement with Edinburgh Trams Ltd. These changes are designed to:

- transfer the responsibility for the maintenance of the tram network to Edinburgh Trams Ltd so that maintenance delivery and cost is optimised and managed at an operational level;
- enable the company to operate an extended line, should the full business case for the tram line to Newhaven be approved;
- modify governance arrangements while allowing the Council to retain control of its tram assets; and
- modify the payment regime to better reflect the costs of operating the tram line.

The results of these changes would be that Edinburgh Trams would take full responsibility for all costs and income associated with the tram network, as well as paying an asset fee to the Council for the use of its assets. This would, in the short-term, mean that Edinburgh Trams would move from being a profitable company to a loss-making company, with these losses being partly funded through the issue of share capital to the Council. In the medium term it is anticipated that the company will return to profitability.

Edinburgh Trams Ltd – Changes to Operating Agreement

1. Recommendations

- 1.1 To note and approve the changes to the Operating Agreement with Edinburgh Trams as set out in this report.
- 1.2 To authorise the Executive Director of Place to conclude heads of terms with Edinburgh Trams Ltd by 31 December 2018.
- 1.3 To authorise the Executive Director of Place to negotiate and agree changes to the Operating Agreement in accordance with agreed heads of terms.
- 1.4 To note the financial and tax implications as set out in paragraphs 5.1 to 5.3.

2. Background

- 2.1 Edinburgh Trams Ltd was set up to operate the city's trams. It is 100% owned by Transport for Edinburgh, which is in turn 100% owned by the City of Edinburgh Council.

Current Operating Agreement

- 2.2 The current operating agreement was agreed by Council at its meeting of [22 August 2013](#). It sets out how responsibilities for the ownership, operation and maintenance of the trams are shared between the Council and Edinburgh Trams. It also includes a payment mechanism through which Edinburgh Trams pay the Council access fees to operate the tram system.
- 2.3 Under the current arrangements, the Council is responsible for the maintenance of the tram system and has separate contracts with CAF (vehicles), Bilfinger/Siemens (infrastructure) and Parkeon (ticket machines). While the Council undertakes management of these contracts, day to day issues are handled directly by Edinburgh Trams. These contracts were procured as part of the original tram construction project.
- 2.4 The operating agreement was developed when Edinburgh Trams was in its infancy and contained provisions within it to transfer maintenance responsibilities to the company at a later date. It is now considered that the company has developed sufficiently for the Council to consider transferring these responsibilities.

Taxation

- 2.5 The Council owns a number of arms-length companies, which are subject to corporation tax. At any point some of these companies may be profitable; others may be loss-making. Tax legislation allows for a company's profits to be offset by losses from other companies in the group for that year. For example, Parc Craigmillar Ltd made a tax loss of £1.4m in 2017 and surrendered this to Lothian Buses Limited. This reduced the tax bill payable by Lothian Buses to HMRC and the overall tax liability of the group for the year by £0.3m and also assisted the groups' cash flow position.
- 2.6 Noting this, the Council is working with its tax advisors, Scott Moncrieff, to ensure that any benefit to the Council's tax position resulting from these amendments is secured.

3. Main report

- 3.1 In view of the considerations outlined above, Council officers have been working with the management of Edinburgh Trams and Transport for Edinburgh to develop heads of terms for changes to the Operating Agreement. These heads of terms were approved in principle by the board of Edinburgh Trams on 16 November 2018 and considered by the board of Transport for Edinburgh on 30 November 2018.

- 3.2 The main considerations are set out below:

Maintenance

- 3.3 It is proposed that responsibility for planned, preventative and reactive maintenance be transferred from the Council to Edinburgh Trams. Responsibility for life cycle maintenance will remain with the Council, as asset owner, but this could be managed by Edinburgh Trams on the Council's behalf. Due to differing complexity of the individual contracts, the transfer of responsibilities is likely to be phased. The operating agreement with Edinburgh Trams will be amended to include provisions on maintenance standards and reporting requirements as and when responsibilities are transferred.

Advertising

- 3.4 It is proposed that Edinburgh Trams is fully responsible for all advertising and marketing licences relating to tram vehicles. The operating agreement and any other side agreements will be amended so that Edinburgh tram retains all costs and income from the sale of advertising on tram vehicles.

Financial Considerations

- 3.5 Currently Edinburgh Trams pays the Council tram and depot access fees of approximately £1.7m per annum for use of the tram infrastructure. It also reimburses the Council directly for costs incurred in respect of insurance and ticket machine maintenance and pays around £0.5m of advertising revenue generated. In addition, the operating agreement includes an infrastructure access fee of 18% of turnover, once cumulative turnover exceeds £60m and 27% of turnover once

cumulative turnover exceeds £117m. It is currently forecast that Edinburgh Tram will be required to start paying the infrastructure access fee at the lower rate from 2020.

- 3.6 It is proposed that this arrangement will be replaced, with effect from financial year 2018, by the following charges:
- Maintenance – Maintenance costs will be met directly by Edinburgh Trams. In the short-term, prior to contract novation/reprocurement Edinburgh Trams will reimburse the Council the full cost of tram, infrastructure, systems and ticket machine maintenance.
 - Insurance – Edinburgh Trams will continue to reimburse the Council for the costs of insuring the tram system.
 - Advertising – The Council will forgo any right to income received from advertising on the tram assets and the operating and advertising agreement will be redrafted to reflect this.
 - Asset Fee – The Council will charge Edinburgh Trams an asset fee of £8.5m per annum in consideration for its use of the tram assets.
- 3.7 In the short-term, the effect of these changes will change Edinburgh Trams from a profitable company to a loss-making one. It is recognised that Edinburgh Trams' cash flow will not be sufficient in the early years to pay the full extent of the charges and that the Council will purchase share capital in the form of ordinary B shares to supplement the available cash resources. It is anticipated that the company will return to profitability in the medium term.

Governance

- 3.8 Governance arrangements will be amended so that proposed business and operational plans are agreed with the Council in advance of being presented to the board of Edinburgh Trams.

Way Forward

- 3.9 On conclusion of heads of terms, the existing operating agreement will be altered to reflect the proposed changes to the payment mechanism with effect from financial year 2018.
- 3.10 It is anticipated that the remaining changes will be implemented on a phased basis with the aim of being concluded no later than 31 December 2019.

4. Measures of success

- 4.1 Operating agreement better aligned to efficient service delivery along the current tram line and the potential extended line to Newhaven.

5. Financial impact

- 5.1 The changes to the Operating Agreement will mean that Edinburgh Trams published accounts will show annual losses of around £10m for 2018, reducing over time as the business grows. In addition, changes to accounting requirements for leases will require the company to show the obligation to pay the asset fee as a liability on its balance sheet from 2019 onwards.
- 5.2 Based on existing arrangements, Edinburgh Trams is forecasting a profit before tax for 2018. The proposed changes to payment mechanisms are anticipated to result in Edinburgh Trams making a loss of around £10m in 2018. This is anticipated to remove Edinburgh Trams' corporation tax liability in 2018 and enable the company to reclaim the tax it incurred in 2017. Going forward under the new arrangements, Edinburgh Trams is not expected to have to pay corporation tax in the medium-term.
- 5.3 In addition, where profits are declared in other Council-owned companies, there may be potential to reduce tax liabilities across the Council group using group relief. The level of any reduction will depend on the extent of the losses incurred by Edinburgh Trams and level of profits generated by other companies.

6. Risk, policy, compliance and governance impact

- 6.1 In order to comply with company tax law, changes to the operating agreement have been put in place following the receipt of detailed tax advice from the Council's tax advisers, Scott Moncrieff. However, these arrangements will be subject to review by HMRC as part of their normal work.
- 6.2 In order to ensure the Council's tram assets are properly maintained, the heads of terms require the Council to agree the annual maintenance plan.
- 6.3 The boards of Edinburgh Trams and Transport for Edinburgh have approved these changes in principle.

7. Equalities impact

- 7.1 There are no direct equalities implications arising from this report.

8. Sustainability impact

- 8.1 There are no direct sustainability implications arising from this report.

9. Consultation and engagement

- 9.1 Proposed changes to the operating agreements have been developed in conjunction with the management of Edinburgh Trams and Transport for Edinburgh.
- 9.2 The boards of Edinburgh Trams and Transport for Edinburgh have approved these changes in principle.

10. Background reading/external references

10.1 Report to Council 22-08-13 - Edinburgh Tram - Preparing for Operations

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11. Appendices

None