# Senior Term Loan Facility Agreement

Actual Construction Period Cash Flow Test

For the period:
1 January 2017 to 31 March 2017

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# Actual Construction Period Cash Flow Test

## Background

Mercia has a Waste Management Services Contract ("WMSC") with the Councils. Mercia secured planning consent for a new facility and re-negotiated the WMSC for the design, construction and operation of an Energy from Waste ("EfW") plant over the remainder of the WMSC, due to expire in 2023. Financial close was reached in May 2014 and takeover in March 2017, in line with the contract.

In order to ensure the funding solution demonstrated Value for Money ("VfM"), the Councils used their Prudential borrowing powers to debt fund Mercia's EfW Plant.

Based on a capital structure of 85% debt and 15% equity, the Councils issued a senior loan facility.

Within the Senior Term Loan Facility Agreement ("STLFA"), the Councils included an Actual Construction Period Cash Flow Test ("ACPCFT"). This test is carried out on a quarterly basis following financial close (the first quarter ending 30 September 2014) and is used to determine whether:

"*Actual Operating Cash generated during that period plus the brought forward cash balance attributable to operations is equal to, or exceeds… the amount of Operating Cash projected to be generated during that period plus the brought forward cash balance attributable to operations as shown in the Base Case Financial Model*."

The cash flow that is assessed in this report relates to Mercia's complete business, which includes not only the EfW plant mentioned above but two other plants that are more recycling focussed.

Should a shortfall occur, Mercia will be required to remedy this shortfall by means of an equity injection equal to the amount of the shortfall in accordance with the contractual documentation.

The plant completed its takeover in March 2017 as expected and has since been undergoing performance tests. These are so far going to plan, with no issues discovered, and are scheduled to last until the end of June in line with the EPC contract.

Source: Mercia; Financial Model; Senior Term Loan Facility Agreement.

## Scope of review

Deloitte has reviewed the calculation provided by Mercia for the ACPCFT. In doing so Deloitte has:

- Agreed the terms of the calculation to the STLFA;
- Agreed the "model" Operating Cash generated during the period to the Base Case Financial Model;
- Agreed the actual Operating Cash generated during the period to management information;
- Re-performed the calculation of the ACPCFT; and
- Compared the senior term loan facility draw downs against those forecast in the Base Case Financial Model.

We have not received any technical reports for the period 1 January 2017 to 31 March 2017.

## Summary of results

The result of the ACPCFT performed by Mercia for the period under review is an Excess Cash Flow amount as at 31 March 2017 of £2,223k, which has decreased by £963k from the Cash Flow flow test in the previous period. This drop is due to timing differences between Q4 2016 and Q1 2017, and marginally lower recyclable volumes and prices.

The revenue and cost figures differ quite significantly from the forecasted numbers due to a change in recognition of the loan bullet payment, which was previously excluded (see subsequent pages for more detail). This is a non-cash item, however, and has been reversed in the cash flow calculation. It does therefore not affect the test that this report is assessing.

Based on the above, the ACPCFT for the quarterly period under review would be satisfied. In completing our work set out above, we have not identified any inconsistencies between Mercia's calculation and the underlying information.

# Calculation

## Actual Construction Period Cash Flow Test

| Metric (£000) | May – Sep 14 | Oct – Dec 14 | Jan - Mar 15 | Apr - Jun 15 | Jul - Sep 15 | Oct - Dec 15 | Jan - Mar 16 | Apr - Jun 16 | Jul - Sep 16 | Sep - Dec 16 | Jan-Mar 17 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Base case financial model** | | | | | | | | | | | |
| *b/f cash attributable to Ops* | 4,254 | 4,793 | 7,051 | 9,123 | 11,246 | 13,203 | 15,388 | 17,482 | 19,801 | 22,115 | 24,242 |
| Gross revenue | 18,603 | 10,448 | 10,847 | 11,813 | 12,374 | 10,627 | 11,140 | 12,046 | 12,640 | 10,861 | 14,496 |
| Operating costs | (14,893) | (8,111) | (8,320) | (8,961) | (9,253) | (8,590) | (8,821) | (9,439) | (9,671) | (8,775) | (7,823) |
| Changes in working capital | (1,212) | 320 | (18) | (252) | (37) | 451 | 138 | 134 | (216) | 359 | (4,234) |
| Cell preparation assets | (612) | 0 | 0 | 0 | (632) | 0 | 0 | 0 | 0 | 0 | 0 |
| Corporation tax | (1,346) | (400) | (437) | (477) | (494) | (303) | (363) | (423) | (439) | (318) | (426) |
| **Total change** | **539** | **2,258** | **2,072** | **2,122** | **1,957** | **2,185** | **2,094** | **2,319** | **2,314** | **2,127** | **2,013** |
| *c/f cash attributable to Ops* | **4,793** | **7,051** | **9,123** | **11,246** | **13,203** | **15,388** | **17,482** | **19,801** | **22,115** | **24,242** | **26,255** |
| **Actuals** | | | | | | | | | | | |
| b/f cash attributable to Ops | 4,637 | 6,480 | 11,674 | 10,423 | 12,333 | 14,218 | 15,655 | 17,860 | 20,197 | 23,165 | 27,428 |
| *Gross revenue* | 19,688 | 13,341 | 10,578 | 11,929 | 12,091 | 10,523 | 11,091 | 13,078 | 12,487 | 8,991 | 12,231 |
| Operating costs | (15,557) | (8,588) | (8,509) | (9,372) | (9,682) | (8,916) | (9,245) | (9,812) | (9,847) | (6,409) | (6,875) |
| Changes in working capital | (1,392) | 1,363 | (3,018) | (171) | (131) | (341) | 358 | (928) | 332 | 1,683 | (4,307) |
| Cell preparation assets | (333) | (286) | 0 | 0 | (189) | 0 | 0 | 0 | 0 | 0 | 0 |
| Corporation tax | (563) | (636) | (302) | (476) | (204) | 171 | 0 | 0 | (4) | (3) | 0 |
| **Total change** | **1,843** | **5,194** | **(1,252)** | **1,910** | **1,885** | **1,437** | **2,204** | **2,338** | **2,968** | **4,262** | **1,050** |
| **Variance** | **1,304** | **2,936** | **(3,324)** | **(212)** | **(72)** | **(748)** | **110** | **20** | **654** | **2,135** | **(963)** |
| Excess cash flow a/c b/f | 383 | 1,687 | 4,623 | 1,299 | 1,087 | 1,015 | 267 | 377 | 396 | 1,050 | 3,186 |
| **Excess cash flow a/c c/f** | **1,687** | **4,623** | **1,299** | **1,087** | **1,015** | **267** | **377** | **397** | **1,050** | **3,186** | **2,222** |

Source: Mercia; Financial Model; Senior Term Loan Facility Agreement.

# Commentary

**Summary**

- The calculation is the result of a methodology agreed between parties (the Councils and Mercia) as per the STLFA signed on 21 May 2014.
- The outcome of the ACPCFT performed by Mercia for the quarter under review is an Excess Cash Flow amount of £2,223k.
- That means in the period from 1 May 2014 to 31 March 2017, the operations have produced £2,223k more Excess Cash Flow than was forecast in the Base Case Financial Model.
- We note that in this quarter there has been an under-performance against the Base Case Financial Model of £963k.
- Based on the above, the ACPCFT for the period under review is satisfied, given the cumulative balance remains in excess of the modelled amount. We have not identified any inconsistencies between Mercia's calculation and the underlying information.
- The main driver behind the worse than modelled performance is the revenue, which fell short of expectation by £2,265k (£12,231k vs. £14,496k). This was partially mitigated by the positive performance in operating costs (£948k lower than expectations). Additionally, there was again no corporation tax charge, despite £426k being budgeted.

**Revenue and operating costs down against modelled forecast**

- We note that for the quarter under consideration, revenue actuals were 16% below the modelled forecast, and operating costs 12% below the modelled forecast.
- The majority of the variance of revenue compared to the forecasts is driven by the change in recognition of the bullet payment as described above. However, as stated on p.3, this does not affect the cash flow position.
- The remainder of the variance (that not explained by the amortisation) is due to lower landfill volumes (for which Mercia is charged and then recharges) and recycling prices.
- The EfW site began commissioning activities in Q3 2016, with minimal volumes diverted from landfill. This continued at a greater level through Q4 and Q1 until the plant reached take-over in March 2017.

**Change in recognition of bullet payment**

- From a discussion with Mercia on 25 May 2017 and 15 June 2016, the under performance of revenue and lower operating costs is as a result of the change in recognition of the bullet payment.
- Facility B of the loan is to be repaid in full (£128m) at the contract expiry date (2023) and is therefore unwound as income on a straight line basis over this period.
- This matches the depreciation of the asset, which also had an initial value of £128m and has a useful life until 2023.
- Previously, this depreciation and unwinding of the deferred income were not included in the numbers assessed in this report as they cancelled each other out.
- Now, however, that the plant has passed takeover date, they have been included due to different methods being used. Mercia's actual figures unwind the deferred income between takeover date and contract expiry whilst the plant continues to be depreciated since financial close. The model forecasts these two treatments remaining the same. This accounts for £1.7m of the £2.3m revenue variance in this quarter.
- NB: this does not affect the cash flow variance due to being a non-cash item.

Source: Mercia; Financial Model; Senior Term Loan Facility Agreement.

# Commentary (continued)

**Changes in working capital and corporation tax**

- The decrease in the Excess Cash Flow amount has been principally driven by unfavourable movements in the Revenue as highlighted above (excluding the bullet payment treatment as this is a non-cash item). This was partially offset by lower than forecasted Operating Costs and corporation tax, reflective of favourable positions on deductions and allowances compared to the modelled forecast.

- Working capital performed broadly in line with expectations, with a £4,307k downwards movement in the quarter, compared with a modelled £4,234k downwards movement.

- At the time of writing, Mercia is working with its advisors to project the corporation tax calculations going forward.

**ACPCFT trend**

- It has been noted that despite a decrease in the Excess Cash Flow of £964k from the previous period, the cumulative total is still positive at £2,223k and therefore the requirements are satisfied.

- Prior to Q1 2016 there were four consecutive periods of under-performance against the modelled forecast (i.e. a negative variance of actuals against the model). However, in 2016 there were four consecutive quarters of over-performance, leading to the substantial positive cumulative balance now.

- Mercia stated that there was a slight downwards shift in the pricing of recyclable materials during the period, though Deloitte has not validated this.

- Similarly, the recyclable volumes have fallen marginally; a trend that is not expected to continue. Deloitte has not validated this.

- Mercia is projecting a stable or increased Excess Cash Flow Account for the next quarter.

- In any case, should the ACPCFT be failed in subsequent quarters, the process to resolve this has been extracted and included in Appendix 2.

# Senior Term Facility Loan draw downs

## Actuals vs Forecast in the Financial Model

The table below shows the actual Senior Term Facility Loan draw downs against those forecast in the financial model.

| Model | May – Sep 14 | Oct – Dec 14 | Jan - Mar 15 | Apr - Jun 15 | Jul - Sep 15 | Oct - Dec 15 | Jan - Mar 16 | Apr - Jun 16 | Jul - Sept 16 | Oct - Dec 16 | Jan - Mar 17 | Cumulative |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Model** | | | | | | | | | | | | |
| Facility A | 5,332 | 2,419 | 1,836 | 5,797 | 3,433 | 4,530 | 2,683 | 2,821 | 1,262 | 970 | 4,362 | **35,445** |
| Facility B | 19,262 | 8,738 | 6,633 | 20,941 | 12,403 | 16,364 | 9,694 | 10,191 | 4,559 | 3,505 | 15,759 | **128,049** |
| **Total** | **24,594** | **11,157** | **8,469** | **26,738** | **15,837** | **20,893** | **12,377** | **13,012** | **5,821** | **4,475** | **20,121** | **163,495** |
| **Actual** | | | | | | | | | | | | |
| Facility A | 4,576 | - | 1,713 | 2,375 | 3,289 | 4,746 | 5,180 | 5,626 | - | 2,021 | 5,919 | **35,445** |
| Facility B | 16,532 | - | 6,187 | 8,581 | 11,883 | 17,145 | 18,715 | 20,324 | - | 7,300 | 21,383 | **128,049** |
| **Total** | **21,108** | **-** | **7,900** | **10,957** | **15,172** | **21,891** | **23,895** | **25,950** | **-** | **9,321** | **27,302** | **163,495** |
| **Difference** | **(3,486)** | **(11,157)** | **(569)** | **(15,781)** | **(665)** | **997** | **11,518** | **12,938** | **(5,821)** | **4,846** | **7,181** | **0** |

Facility A is the amortising loan. Capital repayments begin in the next quarter, i.e. ending 30 June 2017 following the end of the construction period. Facility B is the bullet loan which is forecast to be repaid in the quarter ending 31 December 2023, and is unwound over the period until that date (see explanation on page 5 of Mercia's different recognition vs. the financial model).

From discussions with Mercia management, the lack of a draw down in the quarters 1 October 2014 to 31 December 2014 and 1 July 2016 to 30 September 2016 reflects both a delay in the EfW build (meaning less cash was required for the EfW build) and the lower-than-expected capital expenditure in non-EfW build (meaning that more of the cash can be used on the EfW build). Overall the actual loan drawdowns are still expected to match those forecast in the model.

At the end of Q1 2017 i.e. by the takeover date, the drawdown actuals match the modelled forecast. The difference in timing of the drawdowns is as a result of the above factors; predominantly differences between the programme and the milestones assumed in the model.

Source: Mercia; Financial Model

# Appendix 1

## Mercia's calculation (£000)

**Cash Flow Test Calculation**

| | 1 Jan 17 to 31 Mar 17 ACTUAL | 1 Jan 17 to 31 Mar 17 MODEL |
|---|---|---|
| **Profit Before Depreciation and Tax** | **5,356** | **6,673** |
| **Working Capital Movement (Operating)** | **-4,307** | **-4,234** |
| Corporation Tax (Cash) | - | -426 |
| **Operating Cash Flow** | **1,050** | **2,013** |

| Excess Cash Flow | 1 Jan 17 to 31 Mar 17 ACTUAL | | |
|---|---|---|---|
| | Actual | Model | Var |
| Operating Cash Opening Balance | 27,428 | 24,242 | 3,186 |
| Operating Cash Flow (as above) | 1,050 | 2,013 | (963) |
| **Operating Cash Closing Balance** | **28,478** | **26,255** | **2,223** |

## Mercia's cash flow notice

| | |
|---|---|
| *Excess Cash – Opening Balance (Dec 2016)* | *3,186* |
| *Gross Revenue* | *-2,264* |
| *Operating Costs* | *+948* |
| *Changes in Working Capital* | *-73* |
| *Corporation Tax* | *+426* |
| *Total* | *-963* |
| *Excess Cash – Closing Balance (Mar 2017)* | *2,223* |

Source: Mercia; Mercia also provided the workings behind this calculation so that the calculation could be reconciled to the company's trial balance and so it could be presented in a manner mirroring the description in the Senior Term Loan Facilities Agreement (see page 4).

# Appendix 2

**Extracts from Senior Term Loan Facility Agreement**

"**Actual Construction Period Cash Flow Test**" means the quarterly test to be carried out on each Actual Construction Period Cash Flow Testing Date, in relation to the preceding quarter to determine whether: actual Operating Cash generated during that period plus the brought forward cash balance attributable to operations is equal to, or exceeds the amount of Operating Cash projected to be generated during that period plus the brought forward cash balance attributable to operations as shown in the Base Case Financial Model;

"**Actual Construction Period Cash Flow Testing Date**" means each Quarter Date following Financial Close, up to and including Completion;

"**Actual Construction Period Cash Flow Shortfall**" has the meaning given to it in clause 15.9 (Actual Construction Cash Flow Test);

"**Actual Construction Period Cash Flow Remedy Amount**" means the minimum amount necessary following a failure by the Borrower of the Actual Construction Period Cash Flow Test, to pass such test;

"**Actual Construction Period Excess Cash Flow Amount**" means the amount of Operating Cash generated in any quarter during the Construction Period which is greater than the amount required to satisfy the Actual Construction Period Cash Flow Test; and

"**Base Cash Financial Model**" means the computer model, agreed between the Lenders and the Borrower at Financial Close, as amended from time to time by agreement between the Lenders and the Borrower and delivered pursuant to paragraph 11.1 (Part I – Initial Conditions Precedent) of Schedule 3;

"**Current Assets**" means:

a) cash held by the Borrower;
b) any balance on the Debt Service Reserve Account;
c) any balance on the Maintenance Reserve Account;
d) any prepayments received;
e) amounts owed to the Borrower and/or the amounts of any accounts receivable (in each case from trade debtors or HMRC in respect of VAT);
f) amounts in respect of deferred taxes;
g) inventory; and
h) any cell preparation assets.

"**Current Liabilities**" means:

a) amounts owed by the Borrower and/or the amounts of any accounts payable (in each case to trade creditors or HMRC in respect of National Insurance and VAT);
b) the amount of any accruals or provisions made;
c) the amount of any deferred tax liability;
d) any cell restoration liabilities;
e) any aftercare liabilities; and
f) liabilities in respect of Corporation Tax

Source: Senior Term Loan Facility Agreement

# Appendix 2 (continued)

## Extracts from Senior Term Loan Facility Agreement

"**Gross Revenue**" means, at any Ratio Testing Date and without double counting, the sum of:

a) operating revenue including the Unitary Payment, any interim service payments (if applicable) and any actual or guaranteed third party income, but excluding, for the avoidance of doubt, the Bullet Payment;
b) interest earned on all cash accounts (other than the Distribution Account);
c) damages;
d) insurance Proceeds to the extent received as compensation for loss of revenue;
e) income earned on Authorised Investments (other than any Authorised Investments in respect of the Distribution Account, if any);
f) rebates of Tax actually received or projected to be received in the latest Approved Budget; and
g) all other income or proceeds of a revenue nature from whatever source;

Assumed in the Approved Financial Model to be receivable by the Borrower in the period commencing with such Ratio Testing Date and terminating on the Final Repayment Date or, in respect of any Ratio Testing Period ended on that Ratio Testing Date, all such revenues actually received during such Ratio Testing Period;

"**Operating Cash**" means:

a) gross Revenue; less
b) operating costs; plus or minus
c) changes in Working Capital; less
d) corporation Tax.

In each case, in respect of the Financial Year, as reflected in the operating cash flow calculation in the Approved Financial Model;

"**Working Capital**" means Current Assets minus Current Liabilities

Source: Senior Term Loan Facility Agreement

"Operating Costs" means, without double counting any of those costs, and including any VAT thereon, costs identified as, or as the case may be, falling within the category of:

a) costs and expenses of administering, maintaining and operating the Borrower, SWSL and BWL and the Project including, without limitation, all operating costs accrued prior to, or arising after Financial Close relating to the Borrower's, SWSL's and BWL's existing operations under, or related to, the Waste Management Services Contract all costs relating to Environmental Matters and the costs of complying with the requirements of Environmental Laws and the terms and conditions of Environmental Authorisations (together in all cases with any applicable VAT thereon which is irrecoverable VAT);

b) the costs of insurance premia (other than in relation to insurances covering the construction and commissioning of the Plant) and all property and occupation charges and rates to which the Project may be subject (together in each case with any applicable VAT thereon which is irrecoverable VAT);

c) sums payable by the Borrower under the terms of the Project Documents to which it is a party, other than in relation to construction and commissioning of the Plant (together with any applicable VAT thereon which is irrecoverable VAT);

d) taxes payable (excluding VAT other than "output tax" within the meaning of Section 24(2) of the Value Added Tax Act 1994) other than in relation to the construction and commissioning of the Plant;

e) development costs; and

f) in all cases, the equivalent lines thereafter in each Approved Budget and each Approved Financial Model.

The Borrower may only withdraw sums from the Excess Cash Flow Account:

i. to meet Project Costs at any time on or after the Take-Over Date, but prior to Completion; or

ii. to transfer any amount standing to the credit of Excess Cash Flow Account on Completion to the Distribution Account, provided that no Event of Default is continuing.

# Appendix 2 (continued)

## Extracts from Senior Term Loan Facility Agreement

**Actual Construction Period Cash Flow Test**

a) On each Actual Construction Period Cash Flow Testing Date, the Borrower will provide evidence satisfactory to the Lenders (acting reasonably) that the Actual Construction Period Cash Flow Test has been satisfied.

b) Where there is a failure by the Borrower to satisfy the Actual Construction Period Cash Flow Test on any Actual Construction Period Cash Flow Testing Date (an "**Actual Construction Period Cash Flow Shortfall**"):

   i. The Borrower shall serve a Standby Equity Funding Notice on each Shareholder pursuant to clause 4.2 (Standby Equity Funding Notice) of the Equity Agreement and through such notice request that each Shareholder contribute Equity in an amount equal to its Standby Contribution in accordance with clause 4.1 (Provision of Standby Equity) of the Equity Agreement; and

   ii. in the event that [*Shareholder A*] fails to contribute Equity in accordance with clause 15.10(b)(i) above, the Borrower or the Security Agent shall be entitled to make a claim under the Equity Guarantee ([*Shareholder A*]) for an amount equal to [*Shareholder A's*] Standby Contribution of the Actual Construction Period Cash Flow Remedy Amount within the relevant period that such Equity is required to be paid pursuant to clause 8.1(b) ([*Shareholder A's parent*] Guarantee) of the Equity Agreement.

Source: Senior Term Loan Facility Agreement