APPENDIX

Council - 16 January 2014

Agenda item 7 (a)

REPORTS OF CABINET - MATTERS WHICH REQUIRE A DECISION BY COUNCIL - WASTE MANAGEMENT SERVICES CONTRACT

Supplementary Report by the Director of Resources

Context

1. The recommended decision to provide the funding for Mercia to deliver the Energy from Waste Contract Variation under the Waste Management Service Contract (WMSC) represents a significant decision for the Council. The Cabinet has recommended the Contract Variation on the basis of it offering Value for Money to the Council from a Waste Disposal Authority perspective. The Cabinet is responsible for Waste Disposal functions, but has made recommendations to Council with regard to budgetary and funding arrangements, having regard to any further report of the Director of Resources. This report provides some further background on those financial matters. Members are referred to the agenda report and minutes of the Cabinet meeting on 12 December for further detail.

2. The provision of Council funding obtained from the Public Works and Loans Board (PWLB) to Mercia would enable the Contract Variation to be delivered at a better Value for Money in Net Present Value terms than funding procured from the commercial market. This is based on a net surplus generated by the Council after setting aside some of this surplus for risks that Worcestershire County Council and Herefordshire Council ('the Councils') take on. If approved, the Councils would lend to Mercia at a commercial rate but source the funding from the PWLB at a lower rate. Value for Money is still equivalent with a Commercial Bank-financed variation because this net surplus is balanced by a reduced level of Waste Infrastructure Grant Credits (formerly known as PFI Grant), now agreed with Defra, as private finance is replaced by public finance.

3. Whilst it should be recognised in terms of the revenue budget the cost of financing the Contract Variation through public rather than private finance will result in a lower cost to taxpayers, at the same time, the Council is proposing to place at risk circa £125 million of funding that it itself (together with

Herefordshire Council lending £40 million) will obtain from the PWLB. This supplementary report sets out in some detail the information and work undertaken to confirm this risk is managed and mitigated where possible to enable the Council to consider the recommendation to approve the provision of lending to Mercia.

4. Council is reminded that the provision of funding is not meant to re-examine the value for money Waste Disposal decision but instead should consider approving the necessary funding arrangements and focus on the ability of the Council and controls it intends to put in place to safeguard the lending that is intended to be provided to Mercia. The Councils have received appropriate advice that they can act in the capacity of Lender to this Contract Variation and have determined the appropriate set aside of funds to manage Construction Phase Risk. Existing Compensation on Termination provisions within the WMSC ensure that the Lender is repaid the majority of any outstanding debt in any termination event during the operating period of the varied contract.

5. The decision as to whether the Councils should become the Lender requires that the Councils:

a) Make changes to their Treasury Policy Strategies and associated Treasury Management Statements to permit the provision of funding to Mercia including the increase in Authorised Borrowing Limits and Council credit ceilings;

b) Make changes to their Statement of Prudential Indicators, Minimum Revenue Provision Plans and Capital Programmes in advance of the years where funding will be advanced to Mercia to support the construction payments profile;

6. These powers are reserved to each Council's Full Council, and the details set out below are subject to Council approval to the recommendations set out in Recommendation 1 of the Cabinet report to Council, which this supplements.

Details of proposed loan arrangements

7. The particulars of each Council's lending arrangements, subject to the Council approval for lending, with Mercia will be set out in a standard Lender's Term Sheet and Credit Agreement. Both documents will be concluded and signed off at Financial Close later in the calendar year.

<u>Relationship with Herefordshire</u>

8. The Councils intend to provide funding on the same terms and conditions to Mercia, to be referred to as a Senior Term Loan Facility based on an approximate split of 75% and 25% respectively in accordance with the Joint Agreement between

the Councils.

<u>Why a Loan is required</u>

9. The Cabinet Report on the proposed Contract Variation to construct and finance an Energy from Waste Plant through the Council's existing WMSC was approved by the 2 Councils' Cabinets on 12 December 2013. The Option chosen to finance this is based on the Councils:

a) providing loan finance to Mercia in the period 2014 to 2023 that the Councils obtain through the PWLB; and

b) continuing to repay the outstanding debt finance at 2023 at the current conclusion of the WMSC until the debt finance is paid off in 2042.

10. The rates of interest offered by the Councils will be substantially equivalent to those that could be obtained by Mercia from Commercial Banks. The Councils, supported by appropriate legal, technical and financial advice, are also negotiating terms and conditions that would be expected by Commercial Banks in order to protect the repayment of the debt finance.

11. The Councils intend to make use of funding from the PWLB due to the historic low levels of interest associated with public sector borrowing. The public sector borrows money on the basis of long term gilt prices (Government Issued Debt Instruments) whilst the Commercial Banks costs of finance are based on the London Inter Bank Offer Rate (LIBOR). In rough terms the difference between the cost of public sector borrowing and that which could be obtained through Commercial Banks is a 3%.

12. The cost of debt finance incurred by Mercia to fund the EfW through the variation of the WMSC is a cost to the Councils through the Unitary Charge. Therefore Mercia as the Councils' contractor effectively passes through such debt costs that they incur in full to the Councils. This means that the Councils incur any risk of debt finance costs increasing or enjoy any benefit in full of reductions, whilst the effect on Mercia is neutral. It is therefore extremely beneficial for the Councils to work alongside Mercia to consider the lowest cost option for debt finance.

13. The provision of funding to Mercia is not risk free. In normal circumstances, the provider of a Senior Term Loan Facility bears the risk of financial loss should those losses not be mitigated within the SPV and the SPV fails.

14. The Councils have been advised that the risk of SPV failure is lower in this case as this WMSC was a pathfinder project alongside Defra (then DETR) in 1998 and therefore the financing agreements were lender-friendly in two key ways to ensure Commercial Banks would support the project in 1998:

a) During the operating phase, at least 90% of any outstanding debt finance would be repaid to the lender were the contract to be terminated for any reason – known as a 'hell or high water' clause; and

b) During the construction phase, the Councils the Waste Disposal Authority owns a number of risks that in financing deals being agreed in today's market would normally sit with the lender.

15. The Councils intend to take advantage of the comparatively lower rates of finance costs available to the public sector whilst at the same time making use of standards demanded by Commercial Banks to ensure the debt finance being provided to Mercia is repaid in the context of the Lender starting from a position of being exposed to less risk than normal.

<u>Description of loan facilities to be provided & linkage to the Capital Expenditure (given its size)</u>

16. The December Cabinet Report indicated a requirement to authorise capital expenditure of up to £125 million for the variation. This is based upon current estimates from the SPV and a small element of headroom to cater for any unexpected additional costs. The current structure of the Senior Term Loan Facilities provided to Mercia will mirror the structure that would be provided to Mercia by Commercial Banks and will comprise of two elements:

a) A interest only loan to the value of circa £92 million (£123 million when combined with Herefordshire Council) that will be taken on by the Councils in 2023 at a value equivalent to the forecast Net Book Value of Assets and then repaid to 2042; and

b) A loan that is repaid by Mercia to the Value of £28.5 million (£38 million when combined with Herefordshire Council) between 2017 and 2023 (when the WMSC concludes).

17. Both facilities will be drawn down by Mercia over the construction period for the EfW between 2014 and 2017. The profile of draw downs by Mercia will be subject to final negotiation with its Construction (EPC) Contractor and will mirror expenditure being incurred on the construction of the Energy from Waste Plant. The current profile is set out in Appendix C and will be matched by the Council's draw down from the PWLB.

18. The Council will borrow from the PWLB based on a repayment basis to maximise the efficiency and affordability of borrowing. The Councils have received QC confirmation (exempt) that the Councils can take on the lending role to Mercia under the WMSC in compliance with procurement and

local government law.

19. As the costs of financing are effectively being treated as a pass-through cost, the proposals would not alter the return on investment achieved by Mercia and are therefore neutral from Mercia's point of view – therefore there is no advantage conferred on Mercia by the proposals regarding financing. The Councils were able to act as Lender within their general powers of competence conferred by the Localism Act 2011.

20. The QC advice indicated a number of factors that the Councils needed to consider in agreeing to provide funding to Mercia. These have been incorporated into the negotiations with Mercia to date so that effectively the Councils agree financial and risk sharing positions with Mercia that in broad terms are reflective of the requirements that a Commercial Bank would make. The Councils have supported the discharge of this action through engaging technical, financial and legal advisors who advise Commercial Banks in normal circumstances.

Surplus forecast and its use

21. The forecast gross surplus that the Council will generate from the provision of funding is approximately £17 million. This represents approximately 75% of the total gross surplus estimated for the project that will be received by both Councils. This forecast surplus will be:

a) used to compensate the Council for the reduced level of WIG (previously known as PFI credits) and therefore ensure that the project remains affordable; and

b) Set aside to manage any potential risk during construction that is not absorbed by either Mercia or its sub-contractors.

22. Following the commissioning of the EfW asset, a review will be undertaken of any remaining gross surplus that has not been used for either a) or b) to consider any potential further use.

Funding Risk Management

23. The Councils have undertaken an assessment of risk of becoming the Lender. From a VFM perspective, the Councils have worked with their advisors on the lending side, in this case, Ashursts as legal advisors, Deloitte as financial advisors and Fitchner as technical advisors to understand the basis on which Commercial Banks reserve elements of the margin they make from providing debt finance against risks that may emerge. This has included a review of the following areas of risk:

a) Counterparty risk with Mercia's Shareholders and the major Construction and Operation subcontractors;

b) The Security package available from the Construction team and the Shareholders to cover the Construction period risk;

c) Key income generation assumptions in the Financial Model;

d) General Industry Risk;

e) Specific risks to this particular project; and

f) Interest Rate and Forex Risks.

24. The Councils have effectively negotiated a security package with Mercia and its EPC Contractor during the construction phase that has left only a minimal risk that costs are borne by the Councils should issues occur during construction. From a funding perspective, almost all of the debt finance is repayable during the operating period should termination on any basis occur.

25. The Councils have therefore worked to ensure risk is effectively retained where it resided in the 1998 contract or any new risk is transferred to Mercia and its supply chain.

26. The one area where the Councils are taking more risk when compared to the 1998 contract is during the Construction Phase. For this reason, the Councils are taking a prudent approach by not recognising in the Value for Money Assessment the full forecast surplus generated from providing funding from the PWLB. Instead, a reduction of 50% has been made to this surplus based on the need to recognise that the Councils may be exposed to residual risks that costs rise during the construction phase that may not be covered by either the EPC Security Package or Security Package provided by Mercia.

27. Whilst the Councils advisors have estimated that this residual risk is low, the already established Waste PFI Reserve will be maintained at a level of at least £10 million through the construction phase to provide a reserve should this risk materialise.

28. A full analysis of risks and how these have been mitigated or absorbed is contained in Appendix A.

Additional requirements to the Capital Programme

29. The Council is required to add the value equivalent to the funding being provided to support the Energy from Waste Contract Variation to its Capital Programme to comply with external financial reporting standards.

30. The Council sets its Capital Programme in February each year (updated as necessary through the year) as well as setting out its Prudential Indicators. The key objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. The February 2013 Capital Programme covered the period to the end of the 2015/16 financial year.

31. Subject to the approval of Council, an amount of up to £125 million will be added to the Council's Capital Programme in the financial years 2014/15 to 2017/18. The precise value and profile of these additions will be finalised by Financial Close, intended for around 31 March 2014.

Changes required to the Treasury Management Policies

32. This variation represents the largest single construction project that the Council has entered into. In addition, whilst there is uncertainty over the timing of a rise, the Bank of England and economic commentators are forecasting a rise in interest rates at some point in 2015 as well as gilt yield increases as the Bank of England programme of quantitative easing is tapered off.

33. The provision of funding for such a significant project will be aligned in this case directly to the asset that the lending is being used to create. This will ensure that risk is most appropriately managed as well as ensuring that the transaction can be seen in the round from a procurement perspective.

34. Therefore the Council will obtain its funding from the PWLB directly in line with the draw down requirements of Mercia to ensure that any interest rate risk and gilt yield increase risk are minimised to ensure the affordability of the project is controlled. Repayments by Mercia will be ring-fenced to directly repay the debt that specifically relates to this project. In accordance with Financial Regulations and the Council's Treasury Management Policy Statement, the Director of Resources is required to report annually on the activities of the Treasury Management operation. Subject to the approval of Council, a change set out in Appendix B will be made to the current Treasury Management Strategy to enable the Council to undertake its role as Lender to the SPV. This will create the framework within which the Council can provide the lending to the SPV.

35. The Council is required to set specific parameters, known as Prudential Indicators, each year to control the extent of its borrowing. The essential purpose of this requirement is to ensure that the Council always has the means to repay and doesn't borrow beyond its ability to service associated debts.

36. The Council incurs revenue costs in relation to Capital Expenditure through its Minimum Revenue Provision (MRP). These MRP costs flow through to be met by Central Government funding or local taxpayers. The Cabinet recommended the approval of the contract variation funded by public finance on the basis of it being the lowest forecast cost to the Council and therefore taxpayers, therefore the financing costs paid directly where the contract variation is supported by public finance are lower than the financing costs that would be paid through Mercia to a Commercial Bank for a contract variation supported by private finance.

37. It is important to recognise that the Council is able to

undertake significant investments due to its size and balance sheet strength, but there is always a limit to which its balance sheet can support investment, based on a judgement on the requirement to set aside revenue to repay the costs of debt finance increase against revenue budget to support in-year revenue expenditure.Having created the framework for lending, the budget report in February 2014 will include the full set of Prudential Indicators taking account of the above adjustments as well as reflecting the latest capital programme and borrowing rates. The Council will need to consider carefully future commitments to Capital beyond 2017 as the percentage of costs allocated towards paying for debt increase.

38. The Director of Resources confirms that the Council will be able to change its Prudential Indicators including the Authorised and Operational Borrowing Limits to accommodate this lending without compromising the requirements of its Prudential Code.

Impact on Medium Term Financial Plan

39. The Medium Term Financial Plan (MTFP) approved by Council in February 2013 included provision in 2016/17 for the uplift in Unitary Charge indicated at that time by the negotiations with Mercia. Since that time the timescales have slipped for construction to 2017/18 and the forecast uplift has reduced for the Council from £6 million to £4.5 million (75% of the £6 million affordability envelope referenced in the December 2013 Cabinet Report). This included the forecast cost of debt financing.

40. The February 2014 Budget Report will therefore reflect a movement of the future budget growth previously included in 2016/17 to 2017/18. As a result of the reduction in forecast Unitary Charge from the value indicated at February 2013 there is a slight reduction in the MTFP requirement due to the proposed contract variation.

Proposed Governance Arrangements to safeguard the provision of funding

41. In order to ensure that there is sufficient separation of roles and responsibilities between the Council as a lender and the Council as a waste disposal authority and address any conflicts of interest, the Director of Resources recommends the establishment of a special Waste Contract Credit Committee post Financial Close that will operate over the life of the WMSC to 2023.

42. The proposed terms of reference are set out in full within Appendix E. It is suggested that Council considers creating such a committee following financial close of the variation.

43. In order to benefit from a clearer separation of roles, the Committee may be advised by an external financial expert who will report to the Committee, attend its meetings and provide expert advice to it. As necessary, the Committee may also

receive legal advice from an external firm of solicitors with expertise in banking law. The Council's s151 officer and Monitoring Officer will retain their overarching statutory roles in respect of the Committee.

44. The Cabinet will continue to be responsible for exercising the role of the Council's executive, acting as a waste disposal authority within the overall Budget and Policy framework set by the Council. The Cabinet will have no supervisory or other responsibility for the Waste Contract Credit Committee.

Defra and Her Majesty's Treasury

45. The Councils have been working with HM Treasury and Defra to confirm the basis on which the Councils have the powers to provide funding to Mercia, the required safeguards that need to be put into place as well as how to arrive at a robust valuation of risk that it will take on. HM Treasury has not raised any concerns with the negotiated position reached with Mercia and the actual transfer of risk, but HM Treasury have fed back through Defra that an issue exists with how risk is assessed in Central Government Accounting.

46. Since the 12 December 2013 Cabinet Report recommending the Contract Variation supported by Public Finance, the Councils have concluded negotiations with Defra on the level of retained Waste Infrastructure Grant credits. The Councils agreed a reduction in line with that reported in the 12 December 2013 Cabinet Report. The confirmation letter from Defra is appended as Appendix D. Defra has since confirmed through email on 23 December 2013 that that HM Treasury (including their ministers) have given their approval.

Supporting Information

- ***Appendix A***: Assessment of Counterparties and Risk
- ***Appendix B***: Treasury Management Strategy 2013/14
- ***Appendix C*** Current forecast drawdown profile
- ***Appendix D*** Defra Letter
- ***Appendix E*** *Draft Waste Credit Control Committee Terms of Reference*

Contact Points

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Background Papers

In the opinion of the proper officer (in this case the Director of Business, Environment and Communities) the following are the background papers relating to the subject matter of this report:-

Waste Management Services Contract Report approved by Cabinet on 12 December 2013

Joint Municipal Waste Management Strategy including Annex D – Residual Waste Options Appraisal

Agenda papers and background documents accessible to the public for the meetings of the Cabinet held on: 17 September 2009, 17 December 2009, 9 February 2012, 13 December 2012

Planning Decision by Secretary of State on Hartlebury EfW