# Appendix A: Assessment of Counterparties and Risk

## 1 Purpose of Review

1.1.1 Waste Services for Herefordshire and Worcestershire were procured in 1998 by both Councils from a Special Purpose Vehicle (SPV) established for this Contract. There is a track record of delivery within this Contract over the last 15 years by the SPV. The SPV shareholders (Sponsors) are two well known and large environmental services companies:

- FCC Environment Limited (Fomento de Construcciones y Contratas) – formerly known as FOCSA in 1998, based in Northampton and now part of the worldwide FCC S.A Group; and
- Urbaser Ltd formerly known as Dragados Ltd in 1998, based in Cheltenham and now part of the worldwide ACS Group S.A headquartered in Spain.

1.1.2 The 1998 Deal was a pathfinder deal in the Waste Market. To ensure that the pathfinder Contract was attractive to the market, a number of Lender Friendly variants to what is now expected in a standard Waste PFI contract were negotiated.

1.1.3 The purpose of this review of Counterparties and Risk is to provide Full Council with information to consider and if thought fit approve a change in the Treasury Management and Capital Programme of the Council.

1.1.4 If approved, the Policy changes will be formalised in February 2014 will then provide a revised framework that creates the flexibility to allow the credit facility to be provided at Financial Close. The Credit Facility will be approximately £161 million and is subject to final negotiations and this encompasses:

- The Capital Expenditure Forecast of the Energy from Waste Plant including associated development costs;
- The buy-out of existing SPV shareholder subordinated debt; and
- Interest and transaction charges relevant to the variation.

1.1.5 The Credit Facility will be repaid by the SPV at the expiry of the PFI Contract in 2023 and the remaining unamortised debt of approximately £123 million will continue to be paid down by the Councils in line with their Treasury Management Strategy.

1.1.1 The Councils separate advisor team have supported negotiations with the SPV and the Council's review from a Funding perspective of the Contract Variation. The advisor team are set out below:

- Lenders Technical Advisor Fichtner
- Lenders Insurance Advisor Aon
- Lenders Financial Advisor Deloitte
- Lenders Legal Advisor Ashurst

1.1.6 All necessary consents including Extant Planning Permission have been achieved. The Council is familiar with the regulatory, legislative and industry background for the Facility given its role as Waste Disposal Authority.

# 2 The Council's specific Balance Sheet provision for Risk

2.1.1 The Council together with Herefordshire Council (the Councils) have developed an optimised solution for the provision of Prudential Borrowed Finance into SPV over the construction and operational period of the contract variation. The Council will hold a PFI Risk Reserve of approximately £16 million at Financial Close. An element of this reserve, approximately £6 million will be used to compensate the revenue budget over the period to 2023 for the reduced level of Waste Infrastructure Grant Credits referenced in the December report to Cabinet. The Council's remaining Reserve of approximately £10 million will be available to absorb any financial impact of risks set out in this risk review. This represents approximately 10% of the level of the Senior Term Loan Facility provided to the SPV and over 50% of the forecast surplus that will be generated for the Council from the provision of the Senior Term Loan Facility.

2.1.2 Should any of this Waste PFI Risk Reseve remain following Hot Commissioning of the Energy from Waste Facility then this will be used to further offset the increased cost to the Councils of the Energy from Waste Variation uplift on the Unitary Charge from 2017 in terms of either support for future Unitary Payments or a Capital Contribution to reduce down directly the unamortised debt within the SPV.

# 3 Analysis of the proposed project for the purpose of providing the loan facility

## 3.1 Project Summary

Asset being financed

3.1.2 The main asset to be financed by the provision of the Credit Facility is the Energy from Waste Plant with a cost of financing of £161 million for the Councils. This equates to approximately £120 million for the Council against a recommended approval of £125 million as contained in the December Cabinet Report that allows some headroom for unforeseen costs. The Credit Facility will be secured across all assets, including those were credit facilities are not amortised at the time of Financial Close. Work has therefore been undertaken n relation not just to the Energy from Waste Facility but also on the existing services provided as part of the Waste Management Services Contract that has been operating for over 15 years.

Parties involved

3.1.3 The Shareholders and Sponsors of the SPV on a 50/50 basis are:

a) FCC Environment Limited; and

b) Urbaser Limited.

3.1.4 Whilst existing Shareholders in the established SPV, appropriate due diligence has been conducted on each Partner and is set out later in this report. The Shareholders agreed as part of the 1998 Deal to provide a Joint and Several Guarantee and Performance Bond on the Project that is being refreshed as part of this Contract Variation. This diligence will continue to Financial Close.

3.1.5 The Construction Contract (EPC) proposed Preferred Bidder is a Joint Venture between two significant construction companies. The SPV is in the final stages of negotiations with the EPC Joint Venture and therefore the names of these companies are unable to be made available in the public domain at the time of writing. However, provided below is a description of the work undertaken to satisfy the Councils on the strength, covenants and security package from the EPC Joint Venture. This supports in depth due diligence that has been undertaken by the SPV who will enter into the EPC contract with the that has been reviewed by the Councils alongside the Council's own assurance process. This includes for each Joint Venture Partner:

- Review of Business Undertakings;
- Financial Standing;
- Ownership Structures;
- Credit Ratings and reports from recognised Ratings Agencies;
- Short Term Cashflow reviews from Dunn and Bradstreet;
- Balance sheet Review; and
- Revenue review, EBITDA, and Profit after Tax.

3.1.6 The Joint Venture Partners are providing Joint and Several Guarantees from Parent Companies as part of the EPC Contract which provides additional strength to the protections available to the Council and the SPV in the event that one of the partners enters into any financial or operational difficulty.

3.1.7 The Operations and Maintenance Contract is being procured from Severn Waste Services Ltd (SWS), a wholly owned subsidiary of the SPV. SWS Ltd was incorporated at the same time as the PFI Contract was awarded in 1998 and absorbed the assets and liabilities of the Herefordshire and Worcestershire Council Local Authority Waste Disposal Corporation, Beacon Waste. This provider of services has a track record of over 15 years in the delivery of existing services.

<u>Gross surplus forecast in excess of cost of borrowing from PWLB</u>

3.1.8 The Councils are intending to provide the Credit Facility at a rate commensurate which may be offered by the commercial bank market to ensure that Mercia are not unduly benefitting from the provision of the Credit Facility by the Councils. Whilst the impact of any change in Credit Facility margins are borne not by the SPV but by the Councils in terms of changes to the Unitary Charge, the Councils feel that it is prudent to maintain this equivalence. The Councils will charge a rate equivalent to what a Commercial Bank may charge. The margins and applicable fees will be finalised at Financial Close by reference to the latest available information. The Margins, Arrangement and Commitment Fees have been tested against the Commercial Bank Market in the following ways:

- A soft market testing by Credit Agricole;
- Knowledge of recently closed Waste to Energy deals from the financial and legal advisors to the Council as Lender;
- Information contained in the Infrastructure Journal; and
- Recently closed and anonymised Waste to Energy Deals known to Defra.

3.1.9 The rates have been compared to primary research undertaken by the SPV's financial advisor and cross-checked to industry knowledge from the Lender's Financial Advisor.

Summary of risk assessed in providing the credit facility

3.1.10 Schedule 13 of the existing Waste Management Services Contract sets out the compensation on termination arrangements that will be enacted should termination occur during the Construction Phase. Termination could occur due to:

a) Council (as Purchaser) default;

b) No Fault; or

c) SPV default.

3.1.11 In the case of SPV Default a formula set out in Schedule 13 applies that does potentially expose the Council as Lenders to some risk that it was not exposed to in its Waste Disposal Authority role. The Council as Lender has therefore negotiated with the SPV and members of the EPC Joint Venture to ensure the risks that Schedule 13 exposes the Council as Lender to be mitigated as far as possible. The following section sets out these risks and then summarises the Council as Lenders view on the Residual Risk the Councils as Lender is exposed to.

**3.2 Sponsors review**

3.2.1 Each Sponsor is supported by a Parent Company Guarantee (PCG) that has been in place since 1998 and will be refreshed as part of this Contract Variation. In addition to the Council's experience of the Sponsors, the Council has undertaken an overarching diligence exercise on the Sponsors' Parent Companies to confirm there is nothing that provides concerns to the Council from continuing their relationship with the Sponsors. This has included a high level review of balance sheets, operating performance and industry news and commentary as well as inquiries of representatives from the Sponsors.

FCC UK Limited

3.2.2 FCC SA provides a Parent Company Guarantee to FCC UK Limited. FCC SA is a leading Spanish construction company based in Barcelona. It is publicly traded and is part of the IBEX 35. Over 50% of the shares are owned by a company controlled by Esther Koplowitz, a billionaire businesswoman philanthropist. FCC SA is one of the leading diversified Spanish groups, employing around ninety thousand people. The business has the following divisions:

- Construction;
- Environmental services;
- Urban services (Versia);
- Cement;
- Real estate (Realia); and
- Energy.

3.2.3 Diligence in September 2012 identified a significant adjustment to earnings of approximately 0.7 billion Euro at FCC SA and significant restructuring plans. Assurance was sought from the FCC UK Limited Group Director to confirm that this did not affect FCC UK Limited. In response the following statement was received:

*'For FCC, the UK business is an important part of the FCC SA strategy and FCC Environment S. UK is seen as a key asset for the group per Strategic Plan 2013/2015 (Quote, extract of Strategic Plan " Boosting of the activity of waste treatment and management services in the UK " and " Services (Division) will*

*strengthen its leadership in its domestic markets and enhance waste management and treatment activities in the UK'*

3.2.4 The main reasons for the earnings adjustments were due to write downs in other parts of the group (Austria) and in the Group's Renewable Energy Division. Over the winter period FCC SA sold 51% of the company that owns its renewable energy assets. This transaction fulfilled two of the objectives set out in its Annual Strategic Plan: to focus Group activities on water, environmental services [including FCC UK] and infrastructure, and to reduce interest-bearing debt to below 5 billion euro. This sale came just after FCC completed refinancing of the debt of FCC Environment, its UK environmental services subsidiary, amounting to 381 million pounds sterling (456 million euro) for a period of four years.

3.2.5 This agreement is part of the very substantial progress made by FCC to refinance the entire group, which is expected to be completed in the short term and will provide it with "a sustainable financial structure adapted to the cash flow envisioned for the various businesses".

3.2.6 A review was undertaken of Dunn and Bradstreet Reports on FCC to gain an understanding of the short term cashflow position of the Sponsor and Group.

3.2.7 There were no issues that require reporting to members from this review.

Urbaser Ltd

3.2.8 Urbaser SA provides a Parent Company Urbaser Ltd. Urbaser Ltd is an environmental services company, who work internationally as one of the main operators in the environmental sector and a leader in waste management. Urbaser is part of Spain's largest builder, ACS (Actividades de Construcción y Servicios) Group. Urbaser specialise in providing local councils, boroughs, autonomous regions and industries all types of environmental services.

3.2.9 The group ACS, is a worldwide reference in infrastructures, industrial services, energy and environment. The ACS Group, through its environmental company Urbaser, is leader in waste management and treatment. It specialises in Street Cleaning, waste removal and transporting, urban waste treatment and recycling and comprehensive management of the water cycle and urban landscape and gardening.

3.2.10 Urbaser SA achieved a business turnover of 1.5 billion Euros in 2010 with a staff of more than 30.000 people and over 160 subsidiary companies forming the group. It provides services to more than 50 million people and is active in 4 continents.

3.2.11 A review was undertaken of Dunn and Bradstreet Reports on FCC to gain an understanding of the short term cashflow position of the Sponsor and Group.

3.2.12 There were no issues that require reporting to members from this review.

**3.3 Industry and Project summary**

3.3.1 An analysis of the project, as normally considered by a Commercial Bank has been reviewed by the Section 151 Officer. A summary of details considered by the Section 151 Officer are referenced in summary below. Some specific information has not been provided below where it may compromise ongoing negotiations with the SPV or the potential preferred EPC Joint Venture.

3.3.2 The Energy from Waste PFI market has developed over the last 15 years since the Council first entered into the Waste Management Services Contract with Sponsors. The technology has been reviewed in detail by advisors and represents a standardised and reliable technology that has proven successful in a number of recent and similar projects. Detailed reports have been provided to the Council outlining the satisfaction of Technical Advisors.

3.3.3 Assurances have been received from the Lender's Technical Advisors that there are not any particular aspects of the industry and project that create additional risk over and above the standard risk profiles of a moving grate Energy from Waste Facility in the UK.

**3.4 Key Project risk assessment during the Construction Phase of the Contract Variation (2014 to 2017)**

Sponsor risk and Equity

3.4.2 The analysis of the risks inherent in the existing SPV Sponsors has been undertaken and is referenced in Section 3.2.

3.4.3 The Council has undertaken significant and detailed negotiations with the Sponsors to agree a Security Package with the Sponsors to ensure risk is appropriately placed with the Sponsors and managed across the Construction Phase. A Security Package from the Sponsors describes the way in which the Sponsors will support the SPV during the Construction Phase by way of Equity Investment that will take first loss should issues arise in the SPV.

3.4.4 Whilst the detail of the Security Package will be set out in the Contract Variation and the details are at this stage Commercially Sensitive the Councils have secured significant increases in the level of Equity and Equity Guarantees from Sponsors to ensure there is adequate protection for the Councils through the Sponsors Equity prior to any risk being borne by the Councils.

EPC Joint Venture Security Package

3.4.5 The Sponsors have worked with the Council as Lender to identify and secure an appropriate market standard Security Package from the proposed EPC Joint Venture Partnership. This has included ensuring the EPC Joint Venture have supplied evidence of appropriate products and protections that a Commercial Bank would demand. These have included:

- Insurances;
- Performance Bond Guarantees and replacement protocols from reputable providers rated with appropriate investment grade ratings; and
- Parent Company Guarantees.

3.4.6 The Lender's Advisors have confirmed that all requests made by the Councils are equivalent to those demanded by Commercial Banks. The Councils and Sponsors are now reaching final negotiations with the proposed EPC Construction Joint Venture. There are a small number of points that remain outstanding, however it is anticipated that in the round a Security Package will be agreed that would be acceptable to a Commercial Bank should it have been providing the Senior Term Loan Facility.

Failure to complete construction, construction delay and cost overrun

3.4.7 The Council will be taking on residual risk during the construction phase should any issues arise. It is important to note though that in terms of the risk hierarchy, the following stakeholders are required to mitigate any risks that arise before those risks are needed to be managed by the Councils.

- EPC Joint Venture Partnership and their Subcontractors; and
- Sponsors and their Parent Companies.

3.4.8 In particular, the Council's Advisors have confirmed that the Councils benefit from a much stronger covenant from these two sets of stakeholders as their exists a Joint and Several Liability agreement between both the EPC Joint Venture Partners and then also between the two established Sponsors.

3.4.9 Attached below is an extract of advice received from the Council's Legal Advisors to confirm the position this leaves the Council in.

*As the Councils are aware, the [proposed] EPC [Construction] Contractor is an unincorporated joint venture between two companies of reasonable size and financial strength. Each of these companies will procure a parent company guarantee in respect of its obligations under the EPC Contract.*

*These two contractors have accepted the concept of joint and several liability for all matters arising under the EPC Contract and therefore, if one of the JV partners becomes insolvent, Mercia [the SPV] will always have recourse to the other JV partner for the full amount of any liabilities arising under the EPC Contract.Therefore, in the event that one of the Contractors is unable to perform or becomes insolvent, there are a number of alternatives which would be available for Mercia:*

- *in the first instance, the remaining contractor will be keen to replace the defaulting/insolvent contractor as quickly as possible, so as to manage its own liability - therefore there will remain one part of the JV which is capable of performing its obligations and will have a very real incentive to remedy the situation <u>before</u> Mercia takes any action under the EPC Contract;*
- *one possible outcome is that the insolvent/defaulting Contractor may actually be sold to a new owner, in which case the situation will be remedied without Mercia having to take any further;*
- *if the financial position of the defaulting/insolvent Contractor is not rectified and the remaining JV partner does not replace its partner with a suitable replacement, Mercia will have the option of terminating the EPC Contract in the usual way and engaging a replacement contractor to build out the facility. If this occurs, Mercia will have a claim against the outgoing EPC Contractor for any losses it suffers (to the extent that these are not covered by the Performance Bond and Advance Payment Bond). However, as compared to many other such projects, even if one of the JV partners has become insolvent, Mercia will have a claim for the full amount outstanding against the solvent partner and, ultimately, against its parent under the applicable guarantee.*

*As the EPC Contractor is an unincorporated joint venture, this gives Mercia the opportunity to bring any claims against either one of the JV partners or both of them jointly and therefore the insolvency of one of these parties will not preclude a claim being made in full against, and recovered from, the other JV partner.*

***For this reason, the structure which has been adopted should be more robust than that typically found on other EfW projects, where there may only be one EPC Contractor.***

3.4.10 The Lender's Technical Advisors have undertaken a 'Fall Away' analysis that is typically provided to a Commercial Bank in order to assess quantitatively the costs that the SPV may be exposed to should their be a failure by, in this case, both EPC Joint Venture Partners at the same time – and therefore a much lower risk than where a Joint and Several Liability does not apply.

3.4.11 The Lender's Technical Advisors indicated the maximum financial exposure to the SPV occurs between months 15 and 17 of the construction period and that this maximum exposure is significantly less than the Equity injected by both Sponsors into the SPV. The Equity injected by the Sponsors absorbs any financial risk that cannot be mitigated by its subcontractors (like the Construction Joint Venture) before any risk is borne by the Councils.

3.4.12 Therefore, it can be concluded, that whilst a significant set aside has been retained by the Council within its Balance Sheet (the PFI Risk Reserve), £7.5 million, 75% of the total adjustment referenced in the Value for Money Analysis of £10 million, the scenarios modelled by the Council's advisors indicate that this is unlikely to be required in any scenario whereby the Construction Joint Venture defaults on its responsibilities to the SPV. The Fall Away analysis is modelled on a prudent basis, however, the Councils intend to retain this contingency in its balance sheet to mitigate any unforeseen risk.

3.4.13 The Councils and their Advisors shared this methodology in detail with Her Majesty's Treasury (HMT) as part of the Defra and HMT review. A range of potential worst case scenarios were worked through and the finding was that the Councils as Lender were not exposed to any loss event.

3.4.14 That said, in a scenario, that has not to date occurred on a similar project, could result in loss being borne by the Councils as Lender but those present at the meeting could not construct a scenario where this loss would result without moving into the scenarios that in reality have not occurred and would have only an extremely small possibility of occurring – to the point that the scenarios were not realistic.

3.4.15 Whilst risks is not eliminated, in summary, based on internal work within the Councils and on the advice of Financial, Technical and Legal experts, the Council as Lender has undertaken sufficient work to minimise the risks that they are exposed to in the Construction Period.

# 4 Key Project risk assessment during the Operational Phase of the Contract Variation (2017 to 2023)

4.1.1 From a lending perspective, at least 90% of any outstanding Senior Term Loan Facility is repayable in the event of any default within the contract period, whether that be due to default within the SPV, by the Councils or by both. The 10% difference to 100% will be due to any deductions the Councils may make in their role as the purchaser of services.

4.1.2 Therefore there are no further material risks during the Operating Phase that the Councils would take on in addition to those risks that the Councils have managed during the first 15 months of the Waste Management Services Contract.

4.1.3 A full review has been undertaken of the following areas though to ensure that the arrangements put into place by Sponsors would be acceptable to a Commercial Bank in the round including work on:

- Assumptions on Electricity Generation (Power Off-take) and the sale of Spare Capacity;
- The Key Subcontractors financial standing and operational performance; and
- Technical risks associated with the operation of the Facility.

4.1.4 There are no existing subsidies that present a risk to the facilities revenue generation. The Council's Advisors are now working with the SPV to confirm how the Operational and Maintenance Contract should be drafted as well as the performance regime for the availability and operation of the facility. The Councils will ensure that through appropriate advice, the requirements of the SPV are rigorous and appropriate manage and mitigate risk during the operational period.

# 5 Councils' further risk management

## 5.1 Interest rate risk

5.1.1 The Council's intention is to finance the provision of the Credit Facility through making draw-downs during the Construction Phase of the Contract (2014 to 2017 to match the SPV's requirements to pay the Construction Joint Venture.

5.1.2 The Council will incur some interest rate risk during the construction period in order to obtain these draw downs at various times. The expectation is that Gilt Rates should not move materially over the three year construction period. However, this will continue to remain under review and the Council may choose to draw down cash advances early from the PWLB to mitigate any interest rate risk in the short term..

## 5.2 Foreign Exchange Risk

5.2.1 The Councils incur risk in Foreign Exchange movements on the element of the costs to be financed that are in Euro. Approximately 60% of the costs to be financed are in Euro. The Councils take risk on the Euro movements up until Financial Close with the SPV and EPC entering into appropriate hedging arrangements post Financial Close to manage this risk.

5.2.2 As it stands the financial model takes a prudent assumption on the Sterling to Euro exchange rate and therefore there remains a limited amount of headroom in the amount to be financed before costs start to increase. Whilst even in the short term exchange rates can fluctuate, it is not anticipated that the Euro will appreciate against Sterling over the next three months to the extent to put the financial model assumptions at risk. This position will however, continue to be monitored. From a lending perspective, the only impact will be that additional funding may be required to be made available.

## 5.3 PWLB drawdown

5.3.1 PWLB draw down will be undertaken as part of the Council's usual Treasury Management activities and in accordance with an agreed schedule of advances to be made to the SPV alongside Herefordshire Council.

## 5.4 Bullet repayment financing

5.4.1 The Councils as Waste Disposal Authorities will need to refinance the Credit Facility in 2023 as they would do if Commercial Finance existed. The Council as part of its report on the Energy from Waste Contract Variation will confirm its intention to make this payment. Once this payment is made in 2023, there will be an immediate repayment to the Council as Lender to settle the Bullet Tranche.

5.4.2 Whilst the SPV will repay the bullet tranche on a maturity basis (one repayment at the end of the Contract), the Council will alongside Herefordshire Council on a several basis enter into either an annuity loan from the PWLB (repaying the Capital during the last 7 years of the Concession) or enter into a series of short dated maturity loans to manage its exposure to interest rate risks. Therefore the repayment by the SPV of the Bullet Tranche in 2023 will in turn just form part of the normal Treasury Management activities of the Council.

## 5.5 Joint Agreement with Herefordshire Council

5.5.1 The Joint Agreement between the County Council and Herefordshire Council will revised to incorporate the arrangements outlined in this paper.