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Senior Term Loan Facility Agreement

Actual Construction Period Cash Flow Test

For the period:
1 July 2015 to 30 September 2015

worcestershire county council

Herefordshire Council

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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 a Waste to Energy (“WtE”) plant over the remainder of the WMSC, due to expire in 2023. Financial close was reached in May 2014.

In order to ensure the funding solution demonstrated VfM, the Councils used their prudential borrowing powers to debt fund Mercia’s WtE 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.”

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.

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;
- 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 to 30 September 2015.

Summary of results

The result of the ACPCFT performed by Mercia for the period under review is an Excess Cash Flow amount as at 30 September 2015 of £1,015k.

This shows that from 1 May 2014 to 30 September 2015, the operations have produced £1,015k more than was forecast for this period in the Base Case Financial Model.

Based on the above, the ACPCFT for the 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
Base case financial model					
b/f cash attributable to Ops	*4,254*	*4,793*	*7,051*	*9,123*	*11,246*
Gross revenue	18,603	10,448	10,847	11,813	12,374
Operating costs	(14,893)	(8,111)	(8,320)	(8,961)	(9,253)
Changes in working capital	(1,212)	320	(18)	(252)	(37)
Cell preparation assets	(612)	0	0	0	(632)
Corporation tax	(1,346)	(400)	(437)	(477)	(494)
Total change	**539**	**2,258**	**2,072**	**2,122**	**1,957**
Actuals					
b/f cash attributable to Ops	*4,637*	*6,480*	*11,674*	*10,423*	*12,333*
Gross revenue	19,688	13,341	10,578	11,929	12,091
Operating costs	(15,557)	(8,588)	(8,509)	(9,372)	(9,682)
Changes in working capital	(1,392)	1,363	(3,018)	(171)	(131)
Cell preparation assets	(333)	(286)	0	0	(189)
Corporation tax	(563)	(636)	(302)	(476)	(204)
Total change	**1,843**	**5,194**	**(1,252)**	**1,910**	**1,885**
Variance	**1,304**	**2,936**	**(3,324)**	**(212)**	**(72)**
Excess cash flow a/c b/f	383	1,687	4,624	1,299	1,087
Excess cash flow a/c c/f	**1,687**	**4,624**	**1,299**	**1,087**	**1,015**

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 period under review is an Excess Cash Flow amount of £1,015k.
- This means that in the period from 1 May 2014 to 30 September 2015, the operations have produced £1,015k more than was forecast for this period in the Base Case Financial Model.
- Based on the above, the ACPCFT for the period under review is satisfied. We have not identified any inconsistencies between Mercia's calculation and the underlying information.
- We note that despite the Excess Cash Flow amount at £1,015k, there have now been three consecutive periods of under-performance against the modelled forecast.
- We have questioned Mercia on this and provide the response in this report.

Revenue down and operating costs up against modelled forecast

- We note that for the period under consideration, revenue actuals were 2% below the modelled forecast, but operating costs were 5% above the modelled forecast.
- From discussion with Mercia, this is due to a fall in the sales value of recyclable materials, which accounts for a £0.5m shortfall in revenue compared to the Base Case Financial Model.
- The difference on costs relates to the delay in the installation of glass-breaking equipment, due to delivery lead times being longer than anticipated.
- The glass-breakers were assumed in the Base Case Financial Model to be installed during 2014, but are actually being installed during Q4 2015. This has resulted in additional sub-contract services being required in the meantime.

Cell preparation asset spend

- Cell preparation asset spend was 70% below the modelled forecast. From discussion with Mercia, this is a timing difference, as the cell preparation works have occurred later than usual in the current year.
- The work has now been completed (in November) and the balance of expenditure will therefore be included in Q4 2015 ACPCFT.

ACPCFT trend

- We note that whilst the Excess Cash Flow amount is still positive (at c.£1m), there have now been three consecutive periods of under-performance against the modelled forecast (i.e. an in period negative variance of actuals against the model).
- From discussion with Mercia, the key differences have been the drop in prices for recyclable materials and the additional costs relating to the delay to the installation of the glass-breaking equipment.
- Feedback from Mercia's recyclable material off-takers is that prices will remain at current lower levels "for the next few months, and then start to pick up".

See over page

Commentary (continued)

- Although this means Mercia expects “to stay below the modelled revenues for recyclable materials” for the next quarter, Mercia expects a “reduction in operating costs following the installation of the glass-breakers that will reduce its third-party processing costs”.
- Overall, in the context of the £72k underperformance in the latest quarter, the Excess Cash Flow amount of £1,015k remains relatively large.

Next ACPCFT

- Furthermore, the installation of the glass-breakers during Q4 2015 will adversely affect the next ACPCFT (for the period to 31 December 2015) as there will be a 4 weeks shut-down for installation, and therefore no third party recycling revenue during this period. However, once installed, Mercia anticipate a significant reduction in sub-contracted costs compared to the previous quarters.

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
Model					
Facility A	5,241	2,341	1,725	5,633	3,205
Facility B	18,898	8,426	6,190	20,288	11,490
Total	**24,139**	**10,767**	**7,916**	**25,921**	**14,695**
Actual					
Facility A	4,576	0	1,713	2,375	3,289
Facility B	16,532	0	6,187	8,581	11,883
Total	**21,108**	**0**	**7,900**	**10,957**	**15,172**
Difference	**(3,031)**	**(10,767)**	**(16)**	**(14,965)**	**477**

Facility A is the amortising loan. Capital repayment begins in the quarter ended 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 ended 31 December 2023.

From discussion with Mercia management, the lack of draw down in October 2014 to December 2014 period reflects both a delay in the WtE build (meaning less cash was required for the WtE build) and the lower than expected capital expenditure in non-WtE build (meaning that more cash can be used on the WtE build).

In the quarter to 30 June 2015, the draw down was also significantly below the modelled expectation. From discussion with Mercia management, the lower than forecast draw downs are due to the fact that, in general, there have been delays in the timing of some of the EPC milestone payments and the asset replacement programme has been a little behind due to the lead times for delivery / installation. These are delays in the timing of capital expenditure payments, and Mercia anticipate catching up with the model drawdowns later this year. The draw downs in the quarter ending 30 September 2015 were in line with the model forecast.

Source: Mercia; Financial Model

Appendix 1

Mercia's calculation (£000)

Cash Flow Test Calculation

	1 Jul 15 to 30 Sep 15 ACTUAL	1 Jul 15 to 30 Sep 15 MODEL
Profit Before Depreciation and Tax	**2,409**	**3,120**
Working Capital Movement (Operating)	-131	-37
Cell Preparation Assets	-189	-632
Corporation Tax (Cash)	-204	-494
Operating Cash Flow	**1,885**	**1,957**

Excess Cash Flow	1 Jul to 30 Sep 2015		
	Actual	Model	Var
Operating Cash Opening Balance	12,333	11,246	1,087
Operating Cash Flow (as above)	1,885	1,957	(72)
Operating Cash Closing Balance	**14,218**	**13,203**	**1,015**

Mercia's cash flow notice

Excess Cash – Opening Balance (Jun 2015)	*1,087*
Gross Revenue	*-283*
Operating Costs	*-428*
Changes in Working Capital	*+349*
Corporation Tax	*+290*
Total	*-72*
Excess Cash – Closing Balance (Sept 2015)	*1,015*

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 mapping to the description in the Senior Term Loan Facilities Agreement (see page 4).

Appendix 2

Extracts from Senior Term Loan Facility Agreement

"Actual Construction Period Cashflow Test" means the quarterly test to be carried out on each Actual Construction Period Cashflow Testing Date, in relation to the preceding quarter period to determine whether:

(a) actual Operating Cash generated during that period plus the brought forward cash balance attributable to operations is equal to, or exceeds:

(b) 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 Cashflow Testing Date" means each Quarter Date following Financial Close, up to and including Completion;

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

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

"Actual Construction Period Excess Cashflow 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 Cashflow Test;

"Base Case 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; plus

(b) interest earned on all cash accounts (other than the Distribution Account); plus

(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 that Financial Year, as reflected in the operating cashflow 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 cost 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; and

(e) development costs,

and in all cases, the equivalent lines thereafter in each Approved Budget and each Approved Financial Model;

(b) 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.

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