

Senior Term Loan Facility Agreement

Actual Construction Period Cash Flow Test

For the period:
1 September 2015 to 31 December 2015



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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.

* Subject to the decision of the Councils regarding the January 2016 Unitary Payment (see page 5 and Appendix 1).

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 31 December 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 31 December 2015 of £3,939k*.

This shows that from 1 May 2014 to 31 December 2015, the operations have produced £3,939k* 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	Oct - Dec 15
Base case financial model						
<i>b/f cash attributable to Ops</i>	4,254	4,793	7,051	9,123	11,246	13,203
Gross revenue	18,603	10,448	10,847	11,813	12,374	10,627
Operating costs	(14,893)	(8,111)	(8,320)	(8,961)	(9,253)	(8,590)
Changes in working capital	(1,212)	320	(18)	(252)	(37)	451
Cell preparation assets	(612)	0	0	0	(632)	0
Corporation tax	(1,346)	(400)	(437)	(477)	(494)	(303)
Total change	539	2,258	2,072	2,122	1,957	2,185
Actuals						
<i>b/f cash attributable to Ops</i>	4,637	6,480	11,674	10,423	12,333	14,218
Gross revenue	19,688	13,341	10,578	11,929	12,091	10,523
Operating costs	(15,557)	(8,588)	(8,509)	(9,372)	(9,682)	(8,916)
Changes in working capital	(1,392)	1,363	(3,018)	(171)	(131)	3,331
Cell preparation assets	(333)	(286)	0	0	(189)	0
Corporation tax	(563)	(636)	(302)	(476)	(204)	171
Total change	1,843	5,194	(1,252)	1,910	1,885	5,109
Variance	1,304	2,936	(3,324)	(212)	(72)	2,924
Excess cash flow a/c b/f	383	1,687	4,624	1,299	1,087	1,015
Excess cash flow a/c c/f	1,687	4,624	1,299	1,087	1,015	3,939

Source: Mercia; Financial Model; Senior Term Loan Facility Agreement. * Subject to the decision of the Councils regarding the January 2016 Unitary Payment (see page 5 and Appendix 1).

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 £3,939k*.
- This means that in the period from 1 May 2014 to 31 December 2015, the operations have produced £3,939k* 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 £3,939k*, there have now been four consecutive periods of under-performance against the modelled forecast.
- From discussion with Mercia, the underperformance reflects tighter recyclable materials pricing in 2015 and reduced revenues and increased costs whilst new glassbreakers were being installed.
- Installation of the glassbreakers was forecast for Q3 2014 but had been delayed until Q4 2015 due to extended lead times on supply.
- Since the installation of the glassbreakers, costs have reduced and additionally, recyclable materials pricing has seen marginal increases in the current year (2016). As a result of these factors, Mercia are projecting an increase in the Excess Cash Flow for the next quarter.
- This situation¹ should continue to be monitored closely.

¹ As well as other the financial covenants; * Subject to the decision of the Councils regarding the January 2016 Unitary Payment (see page 5 and Appendix 1).

Revenue down and operating costs up against modelled forecast

- We note that for the period under consideration, revenue actuals were 1% below the modelled forecast, but operating costs were 5% above the modelled forecast.
- Quarter 4 2015 saw a drop in recycling revenue as there was a shutdown period at the Materials Reclamation Facility whilst glassbreaking equipment was installed.
- During the installation period of 3 to 4 weeks there was no recycling sales output, but also increased third party costs due to the fact that Mercia had to pay for processing during installation.

Early Unitary Payment

- As with the prior year, the January Unitary Charge was paid early to Mercia (£3,672k).
- Again, Mercia contend that *"this is not "extra" cash, but normal operating cash received a few days early. The Council payments usually arrive in the first few days of the month, but in December the payment arrived on 31 December. If the definitions are to be followed strictly, we would be denied access to this cash until such time as the next Cash Flow Test is due"*.
- This treatment would reduce the variance shown for 1 October 2015 to December 2015 by £3,672k so that the cumulative Excess Cash Flow c/f to 31 December 2015, would be £267k rather than £3,939k. This treatment is in line with that proposed for the 31 December 2014 period.

Commentary (continued)

Early Unitary Payment (continued)

- Note that the full early payment was £4,115k, but £443k was relating to capital expenditure rather than operating and therefore was excluded as appropriate.
- This effect of this adjustment will be reversed in the next quarter. Deloitte will ensure that this is completed as appropriate.

ACPCFT trend

- We note that whilst the Excess Cash Flow amount is still positive (at £3,939k or £267k*), there have now been four 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 pricing for recyclable materials, and the reduced revenue and additional costs relating to the during the installation of the glassbreaking equipment.
 - Installation of the glassbreakers was forecast for Q3 2014 but had been delayed until Q4 2015 due to extended lead times on supply.
 - This also partly explains the positive performance in the early quarters of the test and subsequent underperformance since the revenue reduction during the 4 week installation period materialised in Q4 2015 rather than Q3 2014.
- It is understood that the installation has now been completed and the plant is now working as expected. We also understand that the anticipated drop in sub-contractor costs is materialising in Quarter 1 2016.
 - Furthermore, Mercia contend that recyclable materials pricing has seen some marginal increases in the current year (2016), though Deloitte have not validated this.
 - As a result of these factors, Mercia are projecting an increase in the Excess Cash Flow Account for the next quarter.
 - We also understand that there are no similar delayed projects that could have a comparable impact on revenues and costs/
 - As a result, Mercia believe that there is no cause for concern with regard to the ACPCFT trend over 2015.
 - In any case, should the ACPCFT be failed in subsequent quarters, the process to resolve this has been extracted and included in Appendix 2.

* Subject to the decision of the Councils regarding the January 2016 Unitary Payment (see page 5 and Appendix 1).

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	Cumulative
Model							
Facility A	5,241	2,341	1,725	5,633	3,205	4,249	22,394
Facility B	18,898	8,426	6,190	20,288	11,490	15,241	80,535
Total	24,139	10,767	7,916	25,921	14,695	19,490	102,928
Actual							
Facility A	4,576		1,713	2,375	3,289	4,746	16,700
Facility B	16,532		6,187	8,581	11,883	17,145	60,328
Total	21,108	0	7,900	10,957	15,172	21,891	77,028
Difference	(3,031)	(10,767)	(16)	(14,965)	477	2,401	(25,901)

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. This has partly been the case in Q3 and Q4 of 2015.

Source: Mercia; Financial Model

Appendix 1

Mercia's calculation (£000)

Cash Flow Test Calculation

	1 Oct 15 to 31 Dec 15 ACTUAL	1 Oct 15 to 10 Dec 15 MODEL
Profit Before Depreciation and Tax	1,607	2,037
Working Capital Movement (Operating)	3,331	451
Cell Preparation Assets	-	-
Corporation Tax (Cash)	171	-303
Operating Cash Flow	5,109	2,185

Excess Cash Flow

	1 Oct to 31 Dec 2015		
	Actual	Model	Var
Operating Cash Opening Balance	14,218	13,203	1,015
Operating Cash Flow (as above)	5,109	2,185	2,924
Operating Cash Closing Balance	19,327	15,388	3,940

Early Payment received from Council (31.12.15)	4,115
Element of payment that relates to Capex, not Operating cash	443
Element of payment that relates to Operating cash	3,672

Excess Cash Flow, after adjusting for Early Receipt **267**

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).

Mercia's cash flow notice

<i>Excess Cash – Opening Balance (Sep 2015)</i>	1,015
<i>Gross Revenue</i>	-115
<i>Operating Costs</i>	-710
<i>Changes in Working Capital</i>	-397
<i>Corporation Tax</i>	+474
<i>Total</i>	-748
<i>Excess Cash – Closing Balance (Dec 2015)</i>	267

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;

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.

Appendix 2 (continued)

Extracts from Senior Term Loan Facility Agreement

Actual Construction Period Cashflow Test

- (a) On each Actual Construction Period Cashflow Testing Date, the Borrower will provide evidence satisfactory to the Lenders (acting reasonably) that the Actual Construction Period Cashflow Test has been satisfied.
- (b) Where there is a failure by the Borrower to satisfy the Actual Construction Period Cashflow Test on any Actual Construction Period Cashflow Testing Date (an "**Actual Construction Period Cashflow 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 Cashflow 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.



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