Herefordshire Council

Meeting:	Audit and governance committee
Meeting date:	24 November 2015
Title of report:	Energy from waste (EfW) loan update
Report by:	Head of corporate finance

Classification

Open

Key Decision

This is not an executive decision.

Wards Affected

Countywide

Purpose

To provide assurance to the audit and governance committee on the status of the energy from waste (EfW) loan arrangement.

Recommendation(s)

THAT:

a) **the risks to the council, as lender, are confirmed as being reasonable and appropriate having regard to the risks typically assumed by long term senior funders to waste projects in the United Kingdom and best banking practice; and**

b) **arrangements for the administration of the loan are reviewed and, having regard to the advice of external advisors, confirmed as satisfactory.**

Alternative options

1 None; the loan arrangement was contractually agreed in May 2014, no breaches have taken place during this reporting period.

Reasons for recommendations

2 To fulfil the functions delegated to the committee in relation to governance of the waste loan arrangement.

Further information on the subject of this report is available from
Josie Rushgrove, head of corporate finance on Tel (01432) 261867

Key considerations

Background

3 Following the approval to provide financing of the construction of an energy from waste (EfW) plant, council delegated to the audit and governance committee the responsibility to review the loan arrangements (including waiver terms) and risks to the council as lender and make recommendations as necessary.

4 No decisions or courses of action have been identified for recommendation to the committee.

Key loan features and update

5 Herefordshire and Worcestershire councils are funding the EfW plant through the use of prudential borrowing. Drawdowns of funding from Mercia will continue over a 33 month construction period, between 2014 and 2017, before loan repayments fall due. Repayments will commence in February 2017.

6 The total loan facility is for £163.5m, with Herefordshire providing 24.2% of the loan value, £40m. The loan facility is split between two tranches being an interest only loan facility and a repayable loan:

- £9m repayment loan and
- £31m interest only (bullet) loan

7 Total loan interest and fees chargeable to Mercia are fixed and are representative of commercial bank charges. These total £69m (£17m for Herefordshire) during the loan period. These charges are repayable before the PFI contract ends in 2023 and are recharged to the councils by Mercia through the unitary charge for waste disposal.

8 Herefordshire will obtain loan finance in line with its treasury management strategy. This will include short term borrowings and longer term finance from the public works loan board where interest rates are aligned to long term gilt prices. Commercial banks rates are based on the London interbank offer rate (LIBOR). The differential between the long term gilt price and LIBOR rates are typically 3% therefore the cost of debt incurred will be less than the cost charged to Mercia resulting in an estimated surplus of approximately £5m for Herefordshire. This surplus has been reflected in council budgets approved by Council in February 2015.

9 The outstanding loan balance in 2023 reflects the expected net book value of the plant at that date. There are strict handover and regular testing arrangements in place that escalate when nearing the end of the contract protecting the return condition of the plant.

10 The remaining loan balance of £31m will be repaid after the end of the PFI contract period (2023) until the end of the plant’s useful life (2042).

General progress update

11 The council's contractual relationship is with Mercia. Mercia has sub-contracted the work to HZI (Hitachi Zosen Inova). HZI had then sub-contracted the civil engineering aspects of the work to a company called Interserve Construction Limited (Interserve). A decision has been made by HZI to terminate their contract with Interserve. HZI

have now taken direct control of the civil engineering contract.

12 HZI had expressed concern about the time taken on the civil engineering works and to ensure that the contract remained on time and to budget decided to replace Interserve. The termination was a matter for HZI and Interserve and the risk rested with HZI, not with the councils.

13 Mercia have assured that, because the majority of the civil engineering work is complete, there would be no cost impact and there would be no impact on the critical path of the project as a result of the change of sub-contractor.

14 Confirmation has been received from the sponsors that they did not consider that there were any financial risks associated with the project at this stage that impacted on them as sponsors. The council, in its role as funder, would only be exposed to risk after the sponsors.

15 If the project were to extend beyond the takeover date, then HZI would pay liquidated damages to Mercia who would then reimburse the Council as lender. There is no impact on the take-over date and loan repayments at this stage.

17 This committee is tasked with reviewing the risks as a result of the funding provided by the council to Mercia. This includes ensuring the risks are considered reasonable and appropriate. Attached is a risk register (at appendix d) detailing the unmitigated and mitigated risks arising as a result of the council being lender to Mercia. All risks are typical of a long term senior funder to waste projects and are aligned to best banking practice.

Financial advisor update

18 The latest progress update from the financial advisors show that Mercia have met all senior term loan facility agreement (STLFA) requirements during this reporting period. Cover ratios and cash flow test requirements that ensure Mercia have equity and cash balances sufficient to cover loan repayments have been complied with.

19 Part of the loan conditions is the actual construction period cash flow test (ACPCFT) which confirms Mercia have sufficient cash flows in relation to Mercia's equity contribution to the EfW. The ACPCFT is prepared by Mercia on a quarterly basis and reviewed by Deloittes acting in the capacity as financial advisors to the councils in relation to the STLFA 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 amounts 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."

20 The ACPCFT performed by Deloittes it attached at appendix a and reports a result of an excess cash flow amount £1m. This means that overall operations have produced £1m more than forecast in the base case financial model. This reflects the impact of additional waste going to Mercia as the economy improves and means the mandatory test was satisfied.

21 Mercia is able to use existing business as equity for cash flow purposes. The cashflow Mercia sets aside during the construction phase qualifies as Mercia's contribution of equity capital. Mercia has achieved its required contribution of equity capital to the project that takes risk ahead of the councils STLFA. A higher cash flow

offsets the need for Mercia to draw down funds and the council has the ability to lock up Mercia's equity if Mercia fails to achieve an adequate level of excess cash. At present Mercia has the right level of equity to satisfy the tests required under the loan agreement. The ACPCFT test is satisfied.

Technical advisor update

22 The lenders' technical advisor has confirmed that the expected takeover date is now the planned takeover date plus one month, March 2017. There is still a possibility that this date could be brought forward, in any case the takeover date does not impact on the loan arrangement, loan repayments will commence in February 2017. Funding of the loan repayments will come from liquidated damages if required.

23 Fichtner Consulting Engineers are technical advisors to the lenders during the construction phase of the plant. A copy of the latest progress summary report is attached at appendix b. No significant issues have arisen during the period and the construction completion date is not deemed to be at risk.

24 The main elements of the civil engineering works are complete with the evacuation of the bunker largely delivered on budget, although slightly behind forecast timescales. There has been some re-ordering of the remaining civil engineering programme to allow the mechanical and engineering programme to commence to keep the construction timetable on track.

25 The construction focus is now on building the superstructure of the plant, including the concrete based bunker and tipping hall and the steel superstructure that houses the boiler hall and administrative buildings.

26 Fichtner had indicated that HZI had a good health and safety record on site and had concluded that it was a well-run site with good control processes.

27 At takeover the council will be in receipt of a fully operational facility that had passed all relevant tests. Operating tests would be undertaken for an approximate six month period in advance of the takeover date to ensure that it was in full working order. Waste would be treated during this period without any cost to the councils.

28 Attached at appendix c is a letter from Fichtner confirming that there are no concerns about the quality of the work as a result of the termination of the Interserve contract.

Waivers and consents

29 The committee are asked to note that since the previous update the following waivers and consents have been requested and approved under clause 18.4(b)(ii)(G) of the loan agreement:

- The appointment of ARUP and Royal Haskoning as major subcontractors for the fire design prevention.
- The appointment of either Compco or Agus as major subcontractors to replace a number of subcontracts that require re-procurement.
- The appointment of Orona Elevators for the lift contract.

30 All of these follow the HZI termination of Interserve and the completion of due

diligence checks by officers and advisors.

31 Sponsors confirmed that the remaining civil packages to be let by HZI following the termination of Interserve total £14m of which 70% relates to building services. HZI are permitted to let the remainder of the contracts (£5m) without consent from the lenders.

Community impact

32 There is no additional community impact as a result of this progress update report. The loan arrangement will contribute to the following council corporate objectives:

- Managing our finances effectively to secure value for money and deliver a balanced budget
- Making best use of the resources available to us in order to meet the council's priorities (includes money, buildings, IT, information).

Equality duty

33 This update and its recommendations do not have an impact on equality or human rights.

Financial implications

34 The loan arrangement is progressing to plan with the financial implications being reflected in the medium term financial strategy and treasury management strategy approved by Council in February 2015.

35 Actual loan drawdowns are approximately two months behind the base case financial model which is consistent with the delay on civil engineering works. Accelerated drawdowns are expected. The impact on budgets are immaterial at this stage, the delay will not affect the loan repayment date, 28 February 2017. If delays continue the financial impact will be reflected in the updated treasury management strategy presented to cabinet in January 2016.

36 All costs incurred by advisors are recharged to Mercia.

Legal implications

37 The terms and arrangements for this loan agreement are set out in the Senior Term Loan Facilities Agreement. There are no specific legal comments arising from this report.

Risk management

38 The councils have undertaken an assessment of risk in its role as lender working with legal advisors (Ashurst), finance advisors (Deloitte) and technical advisors (Fichtner) to understand the basis on which commercial banks reserve elements of their margin against risks. The review considered:

- Counterparty risk

- Security package
- Key income generation assumptions in the financial model
- Specific project risks
- Interest and foreign exchange rate risk

39 The councils negotiated a security package that has left minimal risk that costs would be borne by the councils should issues occur during the construction phase. The loan arrangement security package mirrors that expected in a commercial bank arrangement. Advisors completed a risk fall away analysis and in recognition of this during the construction phase Herefordshire will retain 50% of its loan surplus in its waste disposal reserve should any construction period risk materialise. This reserve balance is included in the council's medium term financial strategy approved by Council in February 2015.

40 Risks are retained where they resided in the original 1998 waste disposal contract and any new risks have been transferred to Mercia and its supply chain. There are actions that can be taken if a default situation were to arise, for example taking shares or assets in Mercia in lieu of loan repayment. No indications of default are currently present.

41 Existing compensation on termination contract clauses ensure that the lender is repaid the majority (90%) of any outstanding debt balance if any termination event should occur during the PFI contract period.

42 Attached at appendix d is the risk register detailing the controls in place safeguarding the council's position in the lending arrangement. The committee is asked to note and consider the risks which are considered to be reasonable and appropriate having regard to the risks typically assumed by long term senior funders to waste projects in the UK and best banking practice.

43 Although the expected takeover date had been deferred until 31 March 2017, the repayment of the loan from 28 February 2017 is not at risk. Due diligence tests have been undertaken to establish the financial strength of HZI to continue with the contract. These highlighted no concerns therefore there are no changes to the residual risk. The council is not facing any more risks as a result of the waivers and consents issued. The security packages in place are therefore working effectively.

Consultees

44 None.

Appendices

Appendix a Financial advisor update (ACPCFT)
Appendix b General technical advisor update
Appendix c Specific technical advisor update (installation quality)
Appendix d Risk register

Background papers

None identified.

Further information on the subject of this report is available from
Josie Rushgrove, head of corporate finance on Tel (01432) 261867