Herefordshire Council

	t and governance committee
Meeting date:	**22 September 2016**
Title of report:	**Energy from waste 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.

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

Alternative options

1 None, the loan arrangement was contractually agreed in May 2014, no breaches or areas of concern 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.

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. 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.

Financial advisor update

7 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.

8 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.”

9 The ACPCFT performed by Deloittes, attached at appendix a, reports a result of an excess cash flow amount of £0.4m as at 31 March 2016. This means that overall operations have produced £0.4m 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.

10 Mercia are 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 have achieved their 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

11 As set out in its terms of reference, the committee will be advised by external financial, technical and legal advisers on behalf of the council's section 151 officer. Fichtner consulting engineers have been appointed as technical advisor to the lender during the construction phase of the EfW. The company has produced a summary report up to 30 April 2016 for consideration by the committee and this is attached at appendix b.

12 The latest programme provided for review shows a target take over date of 29 December 2016, which is nine weeks ahead of the contractual take over date of 28 February 2017. Current progress however suggests this is optimistic but it is considered likely that take over will be achieved in advance of the contractual take over date. This was a positive development but has no impact on the loan arrangement or the risk register.

Waivers and consents

13 The committee are asked to note that since the previous update the following waivers and consents have been requested and approved:

a) In December 2015 the councils provided a waiver/consent under clause 18.4(b)(ii)(G) of the senior term loan facility agreement in relation to the appointment of Afcon for the building services contract following the HZI termination of Interserve.

b) In March 2016 the councils provided a consent permitting the surrender of a small part of the lease within the EnviRecover leasehold back to the councils, to enable the councils, as landlord, to underlet to Western Power Distribution, who are constructing an electricity sub-station on a small plot of land. There is no increase in risk to the councils resulting from provision of this consent, as a full indemnity covenant is included in the legal documentation, on the part of the adjacent leaseholder, mercia waste, to the landlord, the councils.

Deed of amendment

14 A deed of amendment was issued during the period to correct three errors contained in the variation agreement signed on 21 May 2014, being:

a) In respect of the annual discount of £0.3m which did not reflect the intention that the reduction would only be deducted from the planned take-over date and not from the date of financial close. The discount has been taken to date and the deed states the remedy payment to Mercia (May 2014 – May 2016) and the correct payments going forward;

b) The omission of a copy of contract variation 29, which had led to Mercia not being able to invoice aggregate levy costs to the council. Both the councils and mercia waste agree that this variation should have been included in annex 4 of the variation agreement (non-EfW contract variations). However this was omitted from the formal documentation at financial close. Therefore the deed of amendment rectifies this omission and includes it in annex 4 with effect from 21 May 2014 enabling Mercia to make the appropriate claims for any payment due under this variation; and

c) A couple of minor referencing errors in respect of the excess revenue sharing arrangements.

15 The lenders' legal adviser, Ashurst, have reviewed the deed of amendment and are content with the document.

16 Amendments 'a' and 'b' are in favour of mercia waste and therefore from a lenders' perspective only improve the position in terms of mercia waste meeting the quarterly cash flow test. The amendments also bring the contract into line with the financial model approved at financial close.

Community impact

17 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:

a) Managing our finances effectively to secure value for money and deliver a balanced budget

b) Making best use of the resources available to us in order to meet the council’s priorities (includes money, buildings, IT, information).

Equality duty

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

Financial implications

19 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 2016.

20 All costs incurred by advisors are recharged to mercia, including any in relation to the deed of amendment.

Legal implications

21 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

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

a) Counterparty risk

b) Security package

c) Key income generation assumptions in the financial model

d) Specific project risks

e) Interest and foreign exchange rate risk

23 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 2016.

24 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.

25 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.

26 Attached at appendix c is the risk register detailing the controls in place safeguarding the council's position in the lending arrangement. The risk register is shared with Worcester county council and is therefore in a jointly agreed format. 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.

Consultees

27 None.

Appendices

Appendix a Financial advisor update (ACPCFT)

Appendix b Technical advisor update

Appendix c	Risk register

Background papers

- None identified.