Coventry City Council

Public Report

Cabinet Report

A separate report is submitted in the private part of the agenda in respect of this item, as it contains details of financial information required to be kept private in accordance with Schedule 12A of the Local Government Act 1972. The grounds for privacy are that it contains information relating to the financial and business affairs of any particular person (including the authority holding that information) and information in respect of which a claim to legal professional privilege could be maintained in legal proceedings. The public interest in maintaining the exemption under Schedule 12A outweighs the public interest in disclosing the information.

Cabinet 27th August 2019

Name of Cabinet Member:
Cabinet Member for Strategic Finance and Resources – Councillor J Mutton

Director Approving Submission of the report:
Chief Executive

Ward(s) affected:
None

Title:
Coventry Street Lighting PFI Debt Re-Financing

Is this a key decision?
No

Executive Summary:

This report seeks Cabinet approval for refinancing the Council's Street Lighting PFI Contract to deliver lower costs than under the existing contract. Due to the need to achieve financial close before the end of September, Cabinet is being requested to approve delegation to the Director of Finance and Corporate Services following consultation with the Cabinet Member for Strategic Finance and Resources to agree the final legal and financial details with an intention to achieve the most favourably beneficial outcome for the Council. The financial parameters within which agreement is anticipated to be made are set out in the private version of the report.

Recommendations:

The Cabinet is requested to:

(1) Approve in principle the proposals for re-financing the City Council's Street Lighting Private Finance Initiative debt in line with the financial proposals set out in the private version of the report.

(2) Delegate authority to the Director of Finance and Corporate Services, following consultation with the Cabinet Member for Strategic Finance and Resources, to:

a. Agree the final proposal for re-financing on the basis that a financial benefit is provided to the Council over the term of the PFI contract and subject to the Director of Finance and Corporate Services seeking such legal and financial advice as he deems necessary.

b. Negotiate, agree and enter into any and all documents; issue any notices or certificates; and/or take any decisions; that the Director of Finance and Corporate Services deems necessary to document and implement the agreed proposal for re-financing.

List of Appendices included:

None

Background papers:

None

Other useful documents

Report to Cabinet 23rd February 2010: Coventry Street Lighting Private Finance Initiative – Preferred Bidder Appointment and Award of Contract

Has it been or will it be considered by Scrutiny?

No

Has it been or will it be considered by any other Council Committee, Advisory Panel or other body?

No

Will this report go to Council?

No

Report title: Coventry Street Lighting PFI Debt Re-financing

1. Context (or background)

1.1 The City Council entered a PFI contract with Connect Roads Coventry (CRC) in 2010 to upgrade and maintain street lighting in the city over a 25-year period. The contract has 16 years to run. The Council pays a unitary charge to CRC to cover all the costs of the PFI scheme, including the costs of servicing the debt, as well as ongoing services and maintenance of the Street Lighting in the city. This amounted to £7.9m in 2018/19. The contract is one that the Council considers works effectively and there are good working relationships between the Council and CRC.

1.2 Originally, Balfour Beatty Investments Ltd owned 100% of CRC, but has sold an 80% stake to Equitix Infrastructure 4 Ltd, one of the funds set by the specialist infrastructure investor, Equitix. Equitix have been active in both acquiring PFI schemes and looking to re-finance PFI debt in recent years. The shareholders invested around £6m in the project at Financial Close, predominantly through shareholder loans but also some ordinary share capital.

1.3 Around £50m of the c.£56m capital investment costs under the contract were funded by CRC borrowing from 2 lenders: Barclays and Nord LB. As things stand there is around £45m outstanding. Loans from the 2 lenders (Barclays and Nord LB) are charged at an interest rate of c6.9%. Those floating rate loans were hedged at the start of the contract through complimentary interest rate swap agreements with the same funders, to turn them into fixed rate loans for the full funding term which runs to 6 months from the contract expiry date. Since the original arrangement, the Barclay swap was subsequently novated to Aviva.

1.4 There is a contractual obligation for PFI agreements to be analysed on a regular basis to identify any potential benefits from debt re-financing. However, all parties need to be in agreement for a re-financing to occur. The opportunity to refinance the PFI at this point reflects current lower interest rates (this project reached financial close when the funding market was still being negatively impacted by the banking crash and as such affected funding terms), changes in the financial markets in recent years and the position of lenders and their preference for continuing to participate in the PFI market or redirect their attention into other financial instruments. These circumstances have coincided at this point, providing an opportunity to reduce the cost to the PFI scheme, thereby providing savings to both the PFI provider and the City Council under the contract. Several other local authorities have undertaken debt restructuring of this nature in recent years.

1.5 The PFI scheme is part funded by government grant. As a consequence, the Department for Transport (DfT) is a key stakeholder and must agree to any refinancing arrangement as must HM Treasury who provide pan Government oversight of all PFI projects.

2. Options considered and recommended proposal

2.1 There are a number of potential options to reduce costs, ranging from the renegotiation of the existing terms to the replacement of existing lenders through a full debt re-financing.

Option 1: Do Nothing

2.2 Under this option the existing arrangement could continue with an interest cost of 6.9% pa. Whilst this fixed cost would provide certainty it is be higher than could be achieved in the current climate. Although doing nothing would not necessarily prevent a restructure or negotiation in the future, there is no guarantee that this would be the case. Doing nothing would also delay any savings that could be achieved.

Option 2: Full Open Market Funding Competition

2.3 Under this option new funders would be sought within the banking market, with both the existing funding agreements being cancelled, and new agreements put in place. There would be significant one-off transaction and breakage costs to buy out the current funders, in particular the existing swap contracts, which are set out in the private report. These major one-off costs would in turn need to be met from new debt within the scheme, the funding costs of which would largely offset any savings through a lower interest rate, giving a small estimated one-off gain which is set out in the private report.

2.4 However, as the scheme is currently highly geared, being initially 90% debt funded, any significant new debt taken out to meet the impact of swap breakage costs would apply pressure to existing debt limits within the contract.

2.5 A procurement of new funders would also carry increased risk, with no guarantee about either the willingness of funders to become involved or the interest rate that might be charged. In addition, a full replacement of funders would result in significant transaction costs. There would be a potential for abortive adviser costs of c£90k.

Option 3: Existing Funder Renegotiation

2.6 Under this option revised terms are negotiated with the existing funders to vary the arrangements with one approach being to agree the replacement of one funder with the other thus consolidating all the debt with one funder. In doing so a lower interest rate would be charged. In part this relies on the desire for one organisation to withdraw from PFI and the other to expand their involvement.

2.7 As the extent of change is less than would be the case with the full open market replacement of funders, the transaction costs for the Council are lower with fewer contractual changes and no swap buy out costs. However, as there would still be some uncertainty, the potential for abortive adviser costs remains.

2.8 The level of savings would vary depending on a number of factors including the interest rate achieved through refinancing, the exact level of transaction costs and the amount of replacement debt required and could potentially be taken as either an ongoing sum over the remaining 16 years as set out in the private report.

2.9 It has become clear during discussions with the relevant parties and the Council's financial advisors that the only realistic option is through renegotiation with one or both existing funders. In this case one of the funders agreed to buy out the other funder's share of the debt and refinance at significantly lower rates, and on other more preferable funding terms. In order to avoid swap breakage costs, the existing interest rate swap agreement would remain in place. On this basis, it is proposed that Option 3 be pursued as the method of re-financing the Council's Street Lighting PFI contract because this presents the best opportunity for the Council to maximise savings under the PFI Contract.

3. Results of consultation undertaken

3.1 There is no specific consultation on this issue.

4. Timetable for implementing this decision

4.1 It is intended that the re-financing is brought to financial close by the end of September. A delay beyond this date would reduce the level of saving bringing the possibility that the re-financing deal is no longer felt to be financially viable by the parties.

5. Comments from Director of Finance and Corporate Services

5.1 Financial implications

Any re-financing benefit can be calculated and taken as an ongoing annual sum over the remaining 16 years of the contract or as a one-off sum. In either case the financial benefit will be available to help balance the Council's future medium-term budget position.

The Council has engaged specialist financial and legal advice under delegated authority and costs arising from these advisers are expected to cost no more than £90k. The PFI provider has similarly arranged its own advisers. The one-off transaction costs of the re-financing for both the PFI provider and the City Council represent a first call on any re-financing saving prior to the splitting of the benefit in line with the contract. The savings quoted in the private report are shown after these costs have been taken into account. In the event of the re-financing not progressing each party will meet their own transaction costs incurred.

The range of potential financial benefits is set out in the private report.

As part of the re-financing, it is possible that some potential options would mean the Council accepting an initially higher cost of termination liabilities. These liabilities would only be incurred in the event of the Council seeking early termination of the contract. Termination can be seen as an option for significantly reducing the level of service provision and therefore cost, albeit within the potentially challenging wider context of the need to provide services through a different route and simultaneously financing the historic contract liabilities. The calculated cost of early termination under the existing contract is set out in the private report. The level of termination liabilities falls over time as contract debt is repaid. It is considered extremely unlikely that a termination event would be triggered by the Council either under the existing or an updated contract and therefore the risk of any additional costs being incurred is viewed to be extremely low.

Any benefits from re-financing are split between the PFI provider and the Council based on a nationally prescribed contractual formula.

Total Capitalised Benefit (after costs)	CCC Share
Up to £1m	50%
Over £1m to £3m	60%
Over £3m	70%

In addition, it is possible that the overall gain and the total value of Council's gain could be maximised by considering other combinations of the potential deal including where debt is maximised up to the limits allowed within the contract. Under these arrangements the Council's PFI partners could be disadvantaged and therefore reject options in which the overall gain is greater. Therefore, part of the delegated responsibility will involve seeking the most advantageous financial deal for the Council including consideration agreeing a commercial adjustment which would be acceptable to all parties to the deal. The Council will be informed by its financial and legal advisers in this matter and any final settlement would need to be approved by all parties to the agreement and the Department for Transport and HM Treasury. The figures quoted in the private report reflect an estimate of the likely commercial adjustment. The Council will ensure that the commercial adjustment

that is negotiated (and any other changes to the PFI Contract) can be authorised under public procurement law and will not involve the grant of unlawful State Aid.

One further variable factor is whether the Council and Equitix choose to take refinancing benefit up-front or over time. This assessment will need to take into account the net present value of gains (that it is taking into account the impact of factors such as inflation on any future flow of benefits) and the relative risk of receiving money up front or in the future.

The approximate range of financial benefit that may flow from these options is captured in the private report. These may available as one-off or on-going benefits or a mix of the two depending on the final agreed structure of any deal. It is important to reiterate that achievement of a benefit towards the top-end of the available range will require negotiation and agreement with the other parties involved and potentially movement away from the existing gain-share contractual position.

Successful completion of the deal will be subject to agreeing arrangements with the Council's PFI partners and the Department of Transport (DFT). One potential outcome is that it will not be possible to complete a mutually agreeable deal although the strong focus will be on ensuring that agreement is reached.

5.2 Legal implications

The Council is empowered to participate in any re-financing of the PFI Contract pursuant to:

- Section 1, Local Government (Contracts) Act 1997;
- Section 111, Local Government Act 1972 together with Sections 1(2), 41, 64 and 97, Highways Act 1980 and Section 65, Road Traffic Regulation Act 1984; and
- The General Power of Competence under Section 1, Localism Act 2011.

The Council has engaged legal advisers alongside the in-house legal team to review the current documentation and advise on any risks arising from the proposed re-financing together with the process to follow. The Council will need to ensure that the re-financing proposals and any gain-share comply with the terms of the PFI Contract. Any change to the PFI Contract can only be agreed where it is permitted by public procurement law. It is not anticipated that the proposals for re-financing will result in any alterations to the operational service delivery but some alterations may be required to the financing sections of the PFI Contract to reflect the final proposal. The Council will ensure that the commercial adjustment that is negotiated (and any other changes to the PFI Contract) can be authorised under public procurement law and will not involve the grant of unlawful State Aid.

In addition to complying with public procurement law, the Council must ensure that the final proposal does not involve the grant of unlawful State aid by the Council to any of the other parties. It is anticipated that the final proposal will be on fully evidenced commercial terms and so not result in any unlawful State aid. Ongoing legal advice will be obtained from external and in-house legal support prior to the final proposal being approved by the Director of Finance and Corporate Services and prior to any documents being entered into to implement the proposal.

The Council has previously issued certificates under the Local Government (Contracts) Act 1997 in respect of several of the agreements documenting the PFI. To the extent that any further certificates are required, then the Director of Finance and Corporate Services will, pursuant to the delegations set out in this report, have authority to issue such certificates.

The final proposal will need the approval of the Department for Transport and discussions are already underway.

6. Other implications

Any other specific implications

6.1 How will this contribute to the Council Plan (www.coventry.gov.uk/councilplan/)?

The key aim of the re-financing is to reduce the costs of the PFI scheme to the Council over the remaining life of the contract but leave the operation of the Street Lighting scheme unchanged. This is directly aligned to one of the key aims of the Council Plan to deliver the Council's priorities with fewer resources.

6.2 How is risk being managed?

As the interest rate swap arrangements are not being broken and re-set this does not expose the refinancing to the risk of potential volatility of financial markets which is significant at the moment due to Brexit issues. Therefore, the fundamental risk is that the re-financing might not proceed, meaning that the Council incurs abortive legal and financial advice costs up to £90k. As a re-financing relies on the agreement of all parties there is a risk that it might not be possible to reach an approach that is acceptable to all, and that a re-financing therefore does not proceed. However, this risk is minimised due to: the track record of Equitix undertaking similar re-financings; the fact that initial discussions have been undertaken with the funders about the scope for re-financing; the fact that proposed approach entails a renegotiation with existing stakeholders rather than their replacement, and the Council's engagement of Local Partnerships as advisor.

Achievement of benefits towards the top-end of the achievable range may involve an increase in the termination liabilities in the event of the Council ending the PFI voluntarily. This is viewed as a highly unlikely scenario.

Legal and financial risk is being managed through the engagement of experienced advisers to negotiate the terms of the final proposal and advise on risk mitigation strategies.

6.3 What is the impact on the organisation?

The debt re-financing has no direct impact on the organisation, other than the potential financial saving. The re-financing should not impact the delivery of services under the PFI Contract.

6.4 Equality and Consultation Analysis (ECA)

There are no equalities implications.

6.5 Implications for (or impact on) climate change and the environment

There are no environmental implications.

6.6 Implications for partner organisations?

Agreement will need to be reached with other stakeholders including Equitix, as majority owner of the PFI provider, Coventry Roads Connect, and other current PFI lenders to the scheme. In addition, PFI is heavily regulated and has been part funded by government

grant. Significant changes in the structure or financing of the PFI will require the approval of government.

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