DERBY CITY COUNCIL

COUNCIL CABINET
5 JUNE 2007

ITEM 10

Cabinet Member for Leisure and Direct Services

WASTE DISPOSAL – PROSPECTIVE LOAN TO FINANCE A NEW TREATMENT PLANT

SUMMARY

1.1 The Council is currently procuring a waste treatment contract jointly with the County Council to include the treatment of waste, landfilling of residues and management of the household waste recycling centre and a subsequent reduction in the amount of waste sent to landfill. This contract would commence in 2010. The rationale for the procurement is to reduce the extent of the additional costs that would otherwise be faced by both Councils in paying Landfill Tax and Local Authority Trading Scheme, LATS, penalties for waste sent to landfill, which will increase substantially over the next few years. Without access to a new facility, the costs of waste disposal will increase even more than the considerable additional sums already budgeted.

1.2 To enable the contractor to offer the councils the best price and in the shortest possible time, it is proposed to make a loan from the councils to the contractor. A loan of approximately £50m will be required, of which the City Council will be required to supply 50% - £25m, with the other 50% being supplied by the County Council. The sum advanced jointly will represent approximately 85% of the costs of a waste treatment plant and will be supplemented by private sector investment.

1.3 Subject to any issues raised at the meeting, I support the following recommendations:

RECOMMENDATIONS

2.1 To authorise the granting of a loan of up to £25m subject to commercial negotiations with the successful bidder for the contract

2.2 To add £12.5m each year to the capital programme for 2008/09 and 2009/10, funded by prudential borrowing.

REASON FOR RECOMMENDATIONS

3.1 The loan is required to supply capital to the project at the minimum cost. Other options such as Public Finance Initiative – PFI - and the private sector financing the project have previously been considered and rejected. By the Council making use of its powers to borrow capital the cost of the project will be reduced and the time to complete the project shortened.

3.2 The Council needs to formally add the project loan to the capital programme to start to plan for the relevant borrowing funded by additional funds already set aside.

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Report of the Acting Corporate Director of Resources

WASTE DISPOSAL – PROSPECTIVE LOAN TO FINANCE A NEW TREATMENT PLANT

SUPPORTING INFORMATION

1.1 The Council, jointly with the County Council, is currently in the process of procuring, under EU rules, a contract to deliver waste disposal services under a Public Private Partnership, PPP, contract. This followed decisions by the Council and the County Council in December 2005 that the project should proceed on the basis of prudential borrowing funding for a treatment plant, as this was likely to be the most cost effective and least time consuming route to procure the contract.

1.2 It is very likely that the contractor selected will be proposing the construction of a waste treatment plant for the southern half of the County. This plant could be financed in a 'traditional' Public Finance Initiative – PFI – or Public Private Partnership – PPP - manner – where a bank would typically lend - known as 'senior debt' - the contractor 85% to 90% of the construction costs. The interest rate would be expected to reflect the risk being taken by the bank, and is therefore likely to be around 1% above the prevailing market interest rate.

1.3 In a PFI funded project, such an arrangement would be necessary to assist in indicating sufficient risk transfer to the private sector in order to prove that the assets were not appropriately held on the Councils' balance sheets.

1.4 As the project is not seeking PFI funding the Councils are free to arrange alternative forms of finance, including prudential borrowing. It is anticipated that such an approach is likely to save the Councils around 1% interest on the capital sum – around £0.5m each year. This is, in part, reflective of the increased risk that is being borne by the Councils as a result of becoming the senior lender to the Project.

1.5 The increased risk is that if there were to be a serious problem for the contractor, it would also be a potential operational and financial problem for the Councils for an interim period while a replacement operator was found, as there would be a short term need to find other outlets for waste disposal, and that there could be a risk of the assets recovered being insufficient to pay off the outstanding loan. It should be stressed that such an outcome is not anticipated, but clearly has to be mitigated as far as possible.

1.6 To mitigate these risks, the intention is to require the contractor to contribute 15% of the capital sum in the form of an investment which would be at risk should the project get into difficulties – known as subordinated debt. The Councils will lend the sums required to the Special Purpose Vehicle, SPV, set up to run the contract, and will retain step in rights as lenders in addition to normal termination clauses in the main project agreement. The Councils will also seek Parent Company Guarantees from the bidders.

1.7 As further protection, the term sheet for the loan has been arranged as far as possible to look like a 'normal' banking term sheet. The Councils as lenders will be entitled to arrangement fees and other fees, as well as making a 'surplus' – reflecting the risk being taken - on the interest rate charged. In all these cases it is proposed to charge around half of the level of margin that a normal bank loan to the waste sector would charge.

1.8 It is likely that the land used to construct the plant would be owned by the Council. If this is the case, a commercial lease would be granted for the period of the contract, and the contract will be arranged so that the assets revert to the Councils at the end of the contract period. Nonetheless, there is a risk that the Councils would need to step in to the contract to recover assets in the event of a default by the contractor. The Councils would then have access not only to the land and assets but also to the assets of the SPV including any provisions made for future repairs. If the option chosen did not use land currently owned by the Council, alternative arrangements would need to be pursued to allow the waste disposal assets to revert to the Councils beyond the contract period.

1.9 The loan will need to be arranged so that it complies with EU rules on state aid to companies within the single market. In addition, the loan will need to be certified as 'vires' - that is within the powers of - the Councils. Legal advice to the project is being supplied by Eversheds, and they have advised that they do not anticipate any issues in these areas, as the same loan facility will be offered to all participants in an open EU procurement, and the provision of a loan to a third party for the discharge of a statutory obligation is within the powers of the Councils.

1.9 The loan is expected to be included on the Councils' balance sheets as an asset and written down over the period of the contract. The Councils will prudentially borrow the amounts required by the successful contractor and will receive repayments during the operational period. As the Councils will be advancing funds ahead of the operational period for construction purposes, the Councils are likely to take a new accounting option to defer the repayment of the principal until the start of the operational period. This will do two things – firstly it will defer the cost of repaying the principal loan until the benefits of the operating period arise, and secondly it will require a sum to be charged to revenue in the early years of the contract that may be greater than is received from the annuity repayment. This additional charge would amount to around £4m which will have to be added to the budget over a number of years as the costs arise. In the later years of the contract this charge would reverse and receipts would repay the deficit, costing no more overall over the full contract period. There would, however, be a real saving to the Council in terms of lower unitary charges amounting to well over £1m.

1.10 The SPV will fund the repayments to the Councils through a 'gate fee' levied by the SPV on all waste entering the plant. These costs will be charged to the waste disposal budgets of the respective Councils. This effectively charges the users of the plant according to levels of use rather than the level of funding supplied. The Councils are in effect acting in two capacities as operating client supplying waste and as funders to the project, reducing the overall cost by injecting funds borrowed from the PWLB.

1.11 The Council has currently budgeted for £2m additional costs of waste disposal in 2008/09 followed by a further £1m in 2009/10. The extension of the interim disposal contract for a further two years has used £70k of these funds, and the increase in landfill tax recently announced will cost a further £1.14m over this two year period - £0.38m in the first year and £0.76m in the second. There are therefore already commitments of £1.21m. If funds are advanced to the contractor during 08/09 and 09/10 relatively evenly, the Treasury management budget would face a short term loss of interest of around £1.5m over the two years. This would be recovered in the repayments from the contractor when the new treatment plant is operating.

1.12 It is therefore proposed:

- to authorise the granting of a loan of up to £25m – being half of the loan amount of up to 85% of the total cost of the construction of a waste plant - to the successful contractor for the construction of an appropriate waste treatment facility for the City and County as part of the existing procurement
- to add the advancing of such a loan to the capital programme to allow planning for additional borrowing for the project funded by the additional funds already set aside for this project.

OTHER OPTIONS CONSIDERED

2. The other options include:

Not proceeding with the procurement of the waste plant or relying solely on private sector funding to provide the necessary funds:

- the procurement of the waste plant is now more economically viable as a result of the increase in landfill tax rates from next year announced in the Chancellor's budget in March 2007, which increases the cost of landfill by £13 a tonne above previously announced rates.
- the private sector could supply the funding for the project, but this may take longer to arrange and would be more expensive than the Council taking the risk jointly with the County Council. All delays to this project increase the prospect of LATs penalties of £150 / tonne or having to purchase LATs permits at an unknown cost.

For more information contact:	Officer David Enticott Tel 255318 e-mail David.Enticott@Derby.gov.uk
Background papers:	Cabinet report December 2005, County Council Cabinet report December 2005; Advice received from Eversheds on legal matters (email)
List of appendices:	Appendix 1 – Implications

IMPLICATIONS

Financial

1. As set out in the report. The proposal appears to offer the best balance between cost and risk for the Councils. Current cost of funds for the Council from the PWLB for a 25 year loan are around 5%. This is around 1% lower than could be obtained by waste disposal companies for project related finance. In addition, arrangement fees and facility fees would be payable to the Council instead of a bank, which would save the project about a further 1% of the loan amounts. Against this, the Council is taking an enhanced risk compared to a 'traditional' PFI structure should the project company get into serious difficulty. There are, however, arrangements in place to secure the assets should this occur.

Legal

2. Section 25 (b) of the LA (Capital Finance and Accounting) Regs 2003 defines capital expenditure of a Local Authority to include certain items including 'the giving of a loan, grant of other financial assistance to any person, whether for use by that person or by a third party, towards expenditure which would, if incurred by the Authority, be capital expenditure'. This gives permission to capitalise that expenditure that would accrue as capital expenditure if we spent it directly.

   25 (e) adds a further category: expenditure incurred on works to any land or building in which the local authority does not have an interest, which would be capital expenditure if the local authority had an interest in that land or building'

   Under section 7 of the same regulations, repayments are to be treated as capital receipts. As the intention is to reduce the Authorities' debts with those funds, this should not be an issue.

Personnel

3. There will be no transfers of employees from either Council as a result of this arrangement.

Equalities impact

4. None.

Corporate priorities

5. The development of the treatment plant will reduce waste going to landfill, meeting the objective of leading Derby to a better environment and giving you excellent services and value for money.