SHEFFIELD CITY COUNCIL

Cabinet Report

Report of:	Executive Director, Resources and Executive Director, Place
Report to:	Cabinet
Date:	11th November 2015
Subject:	Streets Ahead – Refinance
Author of Report:	Jayne Clarke and Steve Robinson
Key Decision:	Yes
Reason Key Decision:	Expenditure/savings over £500,000

Summary:
There is a clear strategic and economic case to justify the Council using the existing contract mechanism to instigate a contract Refinance in order to secure a saving of circa **£0.3m to £0.6m pa**. This saving can be achieved with minimal risk to the Council and without impacting on the delivery of the highway maintenance service and the ongoing improvements in the infrastructure asset.

Savings can be realised through reducing the cost of finance by the Contractor Amey Hallam Highways Ltd (Amey), entering into new funding terms, thereby increasing the value for money of the contract.

This report seeks approval to the Council pursuing a contract Refinance and to progress some minor operational contract changes.

Reasons for Recommendations:

The Streets Ahead contract (‘the Contract’) has been set a significant savings target in order to contribute to the Council achieving its reduced budget in the future.

As detailed in this report, it is estimated that the savings secured from these changes could between £0.3m and £0.6m p.a over the remaining 22 years of the Contract Term, with no loss of service for the people of Sheffield.

Failure to carry out the Refinance will result in more pressure on achieving the Council’s current and future budget and may result in more drastic cuts to front line services.

Recommendations:

It is recommended that approval be given to:

Reject Option 1 – Do Nothing as it has been determined by the Council and Amey that there is an opportunity during the CIP to make savings from refinancing the Contract.

Continue with the ‘twin track’ approach to refinancing with existing and potential new funders in order to determine the optimal route in terms of maximising savings and mitigating risks and subsequently take forward the preferred option; and

Continue the ongoing dialogue with the DfT throughout the refinance process and to submit a business case seeking DfT/HMT approval to complete the refinance which includes agreeing the optimal process for funding the DfT’s share of the refinance savings.

To provide the additional budget from the PFI Reserves to fund the conclusion of the refinance and the processing of the contract changes; and

Fundi any abortive project costs from the Refinance from the Streets Ahead contingency; and

Make staged payments to Amey in relation to the Refinance and Contract change due diligence costs subject to such costs being auditable; and in accordance with agreed estimates; and

Officers to explore the option of the Council providing up front capital in place of more expensive private finance and if this results’ in increased levels of saving that approval is delegated to borrow the requisite sums.

It is also recommended that Cabinet:

Delegates its authority to the Executive Director, Resources to:

i) monitor the progress made by Council officers in determining the optimal refinancing option and approve (if appropriate) the recommended option; and

ii) review and authorise the submission of a business case to the DfT/HMT including the methodology for funding the DfT's share of the refinancing savings; and

iii) complete the refinance of the Contract subject to the approval of commercially acceptable terms by the Director of Legal and Governance.

Delegates authority to the Director of Legal and Governance to process the High Value Changes under a Deed of Variation.

Background Papers: Cabinet Report: Streets Ahead – Securing Savings From The Funding Structure 12 November 2014

Category of Report: **Main Report – Open, Appendices - Closed**

Statutory and Council Policy Checklist

Financial Implications
YES/~~NO~~ Cleared by: Anna Peysner
Legal Implications
~~YES~~/NO Cleared by: Sarah Bennett
Equality of Opportunity Implications
~~YES~~/NO Cleared by: Ian Oldershaw
Tackling Health Inequalities Implications
~~YES~~/NO
Human Rights Implications
~~YES~~/NO
Environmental and Sustainability implications
~~YES~~/NO
Economic Impact
~~YES~~/NO
Community Safety Implications
~~YES~~/NO
Human Resources Implications
~~YES~~/NO
Property Implications
~~YES~~/NO
Area(s) Affected
N/A
Relevant Cabinet Portfolio Lead
Cllr Terry Fox Cllr Ben Curran
Relevant Scrutiny Committee
Economic, Environmental Wellbeing Scrutiny and Policy Committee
Is the item a matter which is reserved for approval by the City Council?
~~YES~~/NO
Press Release
~~YES~~/NO

REPORT TO THE CABINET

STREETS AHEAD – REFINANCE

1.0 SUMMARY

1.1 The Streets Ahead contract ('the Contract') has been set a significant savings target in order to contribute to the Council achieving its reduced budget in the future.

1.2 As identified in the 12 November 2014 Cabinet report, savings can be achieved through refinancing the bank debt owing to the more favourable interest rates being offered by the financial markets than those available when the Contract reached financial close at the end of July 2012.

1.3 Following the successful conclusion of an exercise to test the appetite of the existing funding group, this report seeks approval for the refinance to be completed which it is estimated will secure savings of circa £0.3m to £0.6m p.a. over the remaining 22 years of the Contract Term giving a total saving of between £7m and £14m.

2.0 WHAT DOES THIS MEAN FOR SHEFFIELD PEOPLE

2.1 There is no impact on the services received by the people of Sheffield.

2.2 The savings realised will contribute to the Council achieving its budget thereby reducing the risk of additional budgetary pressures being placed on other services delivered to Sheffield people.

3.0 OUTCOME AND SUSTAINABILITY

3.1 The Contract benefits are both direct and indirect for example, the improvements in the highway infrastructure aims to reduce vehicle damage and fuel consumption and people should feel safer at night owing to the improved street lighting. The Contract benefits are fundamentally linked to making Sheffield a great place to live.

3.2 It is envisaged that by improving the affordability of the Contract that it will reduce the risk of the Council having to significantly change the services delivered under the Contract thereby maintaining the integrity of the long-term Contract benefits.

4.0 BACKGROUND

4.1 Following the approval of the 12 November 2014 Cabinet report, where it was proposed that the Council would contribute additional capital contributions by way of public sector debt to generate savings, the refinance project team worked diligently with Amey to progress the change. However, following the submission of a business case to the Department for Transport ('DfT') and HM Treasury ('HMT'), the proposal was rejected on the grounds of central government accounting issues.

4.2 Consequently, the refinance project team met with DfT and HMT in London to discuss the accounting issues which, had only recently been fully explored by HMT despite the numerous meetings and correspondence exchanged between the refinance project team and the DfT.

It was explained by HMT at the meeting that had the additional capital contributions proposal been approved then this would change the way it was accounted for by central government. As a result, the DfT's balance sheet would have been adversely affected leaving them in a position where they would not have been able to fund other transport projects which was an unacceptable risk for them to accept. This would also result in an increase in Public Sector Net Borrowing (a key government economic measure) and so was unacceptable to HMT.

4.3 As the additional capital contributions was an innovative savings idea which, until it was proposed by the Council, the DfT and HMT were not aware of the wider accounting implications, it was agreed that the abortive costs incurred will be shared equally between the Council and DfT in the spirit of collaborative working.

4.4 Although the DfT and HMT rejected the additional capital contributions proposal, they are actively encouraging the Council to progress the refinance of the Contract during 2015 in order to ensure that the Council does realise savings to ease budget pressures.

4.5 The report to Cabinet in November 2014 also contemplated a scenario where under a refinance, the Council could put in a proportion of the debt as a loan alongside new funders. However this option has also been ruled out by DfT and HMT as they consider it would also lead to the reclassification of the accounting treatment of the Contract.

5.0 POTENTIAL REFINANCE OPTIONS CONSIDERED

5.1 Under the Contract, either party has the option to propose a refinancing of the bank debt should the financial market rates be trending at more favourable rates than those achieved at Financial Close at the end of July 2012.

5.2 At present, there are a number of funding institutions who are active in the long term lending market with a shortage of infrastructure projects in which to invest their funds, creating potentially high demand. Both the Council's external advisers and Ameys' investment experts are advising that there would be the capacity in the market to achieve competitive terms from a refinance. This is based on their knowledge of the funding institutions and also evidenced by a number of other high value contracts that are currently being refinanced at significantly reduced margins.

5.3 Whilst there is the capacity and competitiveness in the funding market at the current time, because the Contract is still in the Core Investment Period ('CIP') then it is unlikely to achieve the most competitive rates as funders will still consider there is a degree of construction risk remaining and will price in that risk accordingly.

Highway maintenance contracts are also somewhat unique and may not be considered as favourably as a more straight forward accommodation type PFI contract and so this might also limit the numbers of banks interested and the terms offered. This perception is not helped by other highway maintenance PFI contracts which are currently experiencing contractual difficulties between contractors and the public sector.

5.4 The refinancing gain realised is subject to a contractual sharing mechanism firstly with Amey as set out in the Contract and secondly, with the DfT under their PFI grant funding terms. The level of financial savings achievable from this option is subject to the rates that can be secured from the market but it is expected that the Council would realise savings of between **£0.3m** and **£0.6m pa**. There are a number of ways in which a refinancing gain can be secured and these options are set out below. The detailed assumptions and advantages and disadvantages of each option are set out in Appendix A to this report.

5.4.1 <u>Option 1 - Do Nothing – Wait Until Completion of CIP in 2017</u>

5.4.1.1 Under this option no further action would be taken now and any consideration of the other options set out below would be deferred until the CIP is complete.

5.4.1.2 Owing to the disadvantages for Option 1 detailed in Appendix A, it is not recommended that this option is progressed. However, if a refinance is secured now it would still be possible to carry out a further refinance after the completion of the CIP if the prevailing conditions are favourable and the savings outweigh the further transaction costs.

5.4.2 <u>Option 2 – Existing Funders Margin Reduction</u>

5.4.2.1 Under this option the Council and Amey would negotiate with the existing funders to reach agreement on a reduction in their funding margins.

5.4.2.2 All of the current funders are still actively lending in the infrastructure market and in recent discussions, they all have expressed a desire to retain their investment in the Contract. The level of saving they are prepared to offer differs between each funder with some having more flexibility to reduce margins than others.

5.4.2.3 On the basis of the estimate of bank margins and fees for Option 2 as set out in Appendix A being achieved then the net saving to the Council after transaction costs and arrangement fees is **£0.3m p.a**.

5.4.3 Option 3 – Full Open Market Funding Competition

5.4.3.1 Under this option the Council would go the banking market to seek a new set of funders on revised terms. All of the existing funding agreements would be cancelled and new agreements put in place. This could result in more or less funders than the current four banks.

5.4.3.2 There have been some initial informal discussions with a small number of potential new lenders and all have expressed an interest and indicated that they would be able to offer more competitive terms than initially proposed by the existing funders.

5.4.3.3 On the basis of the assumed bank margins being achieved then the net saving to the Council after transaction costs and arrangement fees is **£0.4m p.a**. The detailed terms and basis of the saving for Option 3 are again set out in Appendix A.

5.4.4 As detailed in the options set out above, there is not a significant difference between the levels of saving achievable at the two modelled margins. However, it is possible that lower margins than the ones assumed in the scenarios could be achieved from new funders and from further negotiation with some of the existing funders. Therefore a more likely refinance scenario is securing a margin reduction from a combination of existing funders and new funders with the savings potentially being in the region of **£0.4m to £0.6m p.a**. Some examples of alternative potential refinance scenarios are also set out in Appendix A.

5.4.5 There is a low-medium risk that if the Council approach the market for replacement funders and preferential terms cannot be achieved, then the existing funders may withdraw their offer of reduced margins resulting in the Council having to fund the abortive transaction costs.

6.0 PREFERRED FUNDING OPTION

6.1 It is recommended that Option 1 – Do Nothing is rejected as it has been determined by the Council and Amey that there is an opportunity during the CIP to make savings from refinancing the Contract.

6.2 However, it is not possible at this stage to determine which of the other refinancing options is the preferred option until further negotiations can be carried out with the existing funders and until more formal market soundings are undertaken.

6.3 Any proposal to Refinance the contract has to be approved by DfT through the submission of a Final Business Case once the terms of the refinance are known.

6.4 Cabinet approval is requested for Council officers to:

(i) continue with the 'twin track' approach to refinancing with existing and potential new funders, in order to determine the optimal route in terms of maximising savings and mitigating risks and subsequently take forward the preferred option; and
(ii) continue the ongoing dialogue with the DfT throughout the refinance process and to submit a business case seeking DfT/HMT approval to complete the refinance which includes agreeing the optimal process for funding the DfT's share of the refinance savings.

6.4 In order to progress the refinance within the time constraints described in this report, Cabinet is requested to delegate its authority to the Executive Director, Resources to:

(i) monitor the progress made by Council officers in determining the optimal refinancing option and approve (if appropriate) the recommended option;
(ii) review and authorise the submission of a business case to the DfT/HMT including the methodology for funding the DfT's share of the refinancing savings; and
(iii) complete the refinance of the Contract subject to the approval of commercially acceptable terms by the Director of Legal and Governance.

The Executive Director, Resources and/or the Executive Director, Place will liaise with the Cabinet Member, Finance and the Cabinet Member, Environment and Transport to provide regular updates on progress.

7.0 CONTRACT CHANGES

7.1 In parallel with the refinance, a number of contract changes are being negotiated with Amey with a view to submitting a batch of changes to the funders to reduce transaction fees.

7.2 The changes are varied in nature with some attracting low value savings contributing to reducing the Contract's savings target.

7.3 Some of these changes are deemed to be High Value Changes under the Contract therefore, in accordance with the Leader's Scheme of Delegation, these changes require Cabinet approval. The changes are detailed in Appendix C.

8.0 FINANCIAL IMPLICATIONS

8.1 Project Development Budget

8.1.1 In order to conclude the refinance and the operational savings negotiations; undertake the necessary approval processes; prepare the changes to the Contract; and realise the financial savings, the Council will need to incur significant costs. These costs will include internal financial and legal resource supported by the continued appointment of external financial and legal advisors. In addition, under the terms of the Contract, the Council also has to reimburse Amey and the funders' reasonably incurred due diligence costs.

8.1.2 The level of Project Development Costs will differ dependant on whether the existing funders are to be retained or replaced.

8.1.3 The estimated costs to conclude the refinance and operational savings changes are set out in Appendix B.

8.1.4 It is proposed that the costs are funded from the Council's PFI Reserve and the Reserve will be replenished from the refinance savings achieved.

8.1.5 The Council incurred £265k of abortive costs in relation to the Increased Capital Contribution proposal detailed in section 4 above. In accordance with the Cabinet approval granted in November 2014, such costs are to be funded from the PFI Contract contingency. However, as the DfT have agreed to cover 50% of these costs from their share of the refinance gain then only half of those costs will be required from the contingency.

8.2 Other Transaction Costs

8.2.1 In addition to the refinance development costs relating to resources, the Council will also have to fund the costs incurred in breaking or restructuring the hedging agreements and funding the lender's arrangement fees. Whilst the level of arrangement fee is likely to be the same under any scenario, the fees for changes to the hedging arrangements will differ depending on the extent of the changes and hence it is the inter-play between margin reduction and hedging fees that determines the optimal solution.

8.2.2 These fees will be financed by Amey and the costs of this set off against the interest rate savings.

8.3 Borrowing Requirement

8.3.1 There would not generally be a requirement for borrowing as the Project Development Costs will be funded from reserves and the other up-front costs funded through the Amey Financial Model. However, the Council is also considering whether it can use its prudential borrowing powers and access to relatively cheap finance to fund some of the upfront fees and/or to make up front payments to Amey or DfT of their share of the savings thereby increasing the level of savings achieved by the Council.

8.3.2 It is recommended to Cabinet that officers explore the option of the Council providing up front capital in place of more expensive private finance and if this results' in increased levels of saving that approval is delegated to borrow the requisite sums.

8.4 <u>Financial Savings</u>

8.4.1 The savings set out in this report are derived from the reduced interest costs that Amey will bear in future compared to the existing interest costs which the Council is currently funding through the Unitary Charge.

8.4.2 As set out in section 5 the level of savings is expected to be between £0.3m and £0.6m p.a. It is expected that the savings will be effective from the start of the financial year 2016/17 but it is possible that if a margin reduction scenario with the existing funders is implemented then the shortened timeline may result in a proportionate share of savings in 2015/16.

8.5 <u>Financial Risks</u>

8.5.1 The Council will carry a number of risks in proceeding with this process as set out below:

8.5.1.1 *(a) Abortive Costs*

It is possible that the refinance cannot be completed either because:

i) it does not get DfT/HMT approval;
ii) the Contract cannot secure sufficient funders at rates that are more favourable than in 2012; or
iii) interest rates move such that the break costs of any hedging arrangement make the level of savings untenable. However, this is felt to be a minor risk as there should be a natural set-off of break costs against the revised new underlying interest rates.

If this were the case, the Council will have to bear any abortive costs incurred up to that point.

In order to mitigate this risk, the Council's refinance project team are fully engaged with the DfT and will continue to work closely with them and the Council's external financial advisers, PriceWaterhouseCooper, to develop the required business case.

The Council and Amey will also gather as much market intelligence as possible before it instructs external advisers to commence the costly market refinance option.

The Council will also monitor the movement in interest rates and will work closely with its financial advisers; PriceWaterhouseCooper and its interest rate hedging advisors; JC Rathbones, to model the impact of any movement.

If there are any abortive costs it is proposed that these are funded from the Streets Ahead contingency budget that was set aside as part of the affordability provisions.

8.5.1.2 *(b) Project Development Budget Overspend*

The budget figures set out in Appendix B of this report are an estimate of the costs of the two base options for completing a refinance and the other operational changes described in this report. They have been estimated on a prudent basis and include significant contingency amounts. Expenditure will be monitored closely throughout the refinance project. It is possible however that the costs could be higher as we move towards concluding the transaction and this will be offset against the refinancing gain.

9.0 LEGAL IMPLICATIONS

9.1 The Contract provides for a refinance therefore the conclusion of this exercise carries no legal implications.

9.2 In terms of the other changes proposed, the Contract contains a High Value Change mechanism that allows the proposed changes to be made. In addition, the Council has a general power under section 1 of the Localism Act 2011 to do things an individual may generally do (including vary a contract in accordance with its terms) provided, it is not prohibited by other legislation and the power is exercised in accordance with the limitations specified in the Act e.g. around charging for the provision of a service.

9.3 When it was procured the Contract was above the public procurement financial thresholds and consequently was procured under a regulated procurement procedure. If the Contract is changed to a material degree, it may be held that there is, in fact, a new contract, which should have been re-tendered in accordance with European and national procurement law and the resultant contract could be held ineffective.

9.4 The proposed changes are not considered to be material changes to the existing contract because there will be no variation to the services to be provided and Amey will not make any additional profit as a result of the changes.

10.0 EQUALITY IMPLICATIONS

10.1 As this refinance proposal is purely related to financial restructuring of the Contract and has no material effect upon the services received by the people of Sheffield then there are no equality impacts. The proposal is equality neutral affecting all people the same regardless of age, race, faith, disability, gender, sexuality and so forth.

10.2 The changes proposed to the Contract as set out in Appendix C do not have any effect on the services provided by Amey therefore there are no equality implications.

11.0 REASONS FOR RECOMMENDATIONS

11.1 As outlined in this report, there is a clear strategic and economic case to justify the Council concluding the refinance in order to realise saving of circa **£0.3m to £0.6m p.a**. This saving can be achieved with low risk to the Council and without impacting on the delivery of the highway maintenance service and the ongoing improvements in the infrastructure asset.

11.2 Failure to progress the refinancing of the Contract will result in more pressure on achieving the Councils current and future budget pressures.

12.0 NEXT STEPS

12.1 Determine Optimal Refinance Solution

12.1.1 The Council and Amey are continuing to work closely with their external financial advisers to test the interest in the funding market and to press the existing funders to improve their terms.

The Council is also working with its Financial Advisors to verify the financial modelling work undertaken to date in order to quantify the financial savings to be realised across a range of scenarios to inform the key thresholds at which options become more or less viable.

From this work a decision on the direction of travel will be taken within the coming weeks.

12.2 Project Management

A joint Project Plan has been developed with Amey detailing all of the key stages and associated tasks to be completed to conclude the refinance and process the Contract changes.

It is anticipated that the refinance will be concluded by March 2016 for a full refinance and January 2016 if a margin reduction only option is pursued.

12.3 DfT/HMT Department Approval

The refinance project team has liaised closely with the DfT in the planning and development of the refinance proposal to date and they are supportive of the actions proposed. This liaison will continue on an informal basis and will culminate in the submission of a business case which will justifies the refinance and evidences that the margin reduction being offered is broadly comparable to market rates.

13.0 RECOMMENDATIONS

13.1 It is recommended that approval be given to:

(a) Reject Option 1 – Do Nothing as it has been determined by the Council and Amey that there is an opportunity during the CIP to make savings from refinancing the Contract.

(b) Continue with the 'twin track' approach to refinancing with existing and potential new funders, in order to determine the optimal route in terms of maximising savings and mitigating risks and subsequently take forward the preferred option; and

(c) Continue the ongoing dialogue with the DfT throughout the refinance process and to submit a business case seeking DfT/HMT approval to complete the refinance which includes agreeing the optimal process for funding the DfT's share of the refinance savings.

(d) To provide the additional budget from the PFI Reserves to fund the conclusion of the refinance and the processing of the contract changes; and

(e) Fund any abortive project costs of the Refinance from the Streets Ahead contingency;

(f) Make staged payments to Amey in relation to the Refinance and Contract change due diligence costs subject to such costs being auditable; and in accordance with agreed estimates; and

(g) Officers to explore the option of the Council providing up front capital in place of more expensive private finance and if this results in increased levels of saving that approval is delegated to borrow the requisite sums.

13.2 It is also recommended that Cabinet:

Delegates its authority to the Executive Director, Resources to:

(a) monitor the progress made by Council officers in determining the optimal refinancing option and approve (if appropriate) the recommended option; and

(b) complete the refinance of the Contract subject to the approval of commercially acceptable terms by the Director of Legal and Governance.

Delegates its authority to the Director of Legal and Governance to process the High Value Changes under a Deed of Variation.