| | |
|---|---|
| **REPORT TO:** | **Cabinet** |
| **DATE OF DECISION:** | **7th December 2022** |
| **REPORT TITLE:** | **Refinancing of Streetlighting PFI** |
| **LEAD OFFICER:** | **Jane West - Corporate Director and Section 151 Officer**<br>**Nish Popat - Interim Head of Corporate Finance** |
| **CABINET MEMBER:** | **Cllr Jason Cummings – Lead Member for Finance** |
| **WARDS:** | **All** |
| **CONTAINS EXEMPT INFORMATION?** | **Public with exempt appendices 1 and 2** |


**SUMMARY OF REPORT:**

This report seeks delegation from the Mayor to the Corporate Director of Resources and Section 151 Officer to review the potential gain achieved by the refinancing work that has been conducted on the Council's Streetlighting PFI contract (Agreement). The refinancing gain to be achieved for Croydon is being reviewed but is expected to generate a gain of over £0.500m to the Council and could lead to a potential reduction in annual contractual sum to the contractor.

The new senior lender to the Special Purpose Vehicle (SPV) in connection with the Agreement will be Aviva which will be the sole lender to the scheme at the time of the refinancing. Aviva replaces a syndicate of lenders (Lloyds Bank (17%), SEB (33%), NIBC (25%) and SEK (25%)) and the refinancing will not result in any changes to operation of the streetlights, or to other terms of the Agreement unconnected with the refinancing.

The refinancing supports the work to seek opportunities to generate income and identify savings to meet the financial challenges faced by the Council. The key risk to the Council, which arises from the refinancing, is an increase in breakage costs should the Agreement be terminated early. These costs could exceed £90m. However, the likelihood of an early voluntary termination of the Agreement is very slim and the Council would require Treasury approval to make a decision to terminate.


**FINANCIAL IMPACT:**

It is not possible to accurately provide a gain figure at this stage as the final amount will be calculated at the time of financial close. However, an indicative analysis has been provided in the confidential note from Local Partnerships (**LP**) at appendix 1.

Refinancing of the Agreement can deliver annual contract savings, or the Council can choose to take an upfront gain. In NPV terms both options yield the same outcome. However, having the cash upfront allows the Council to utilise that cash for other means such as paying down debt or investing to generate further income.

The financial advisory and legal costs will be funded directly from the gross gain generated by the refinancing exercise.

Confidential Appendix 1 (Note from LP) and Appendix 2 (Funding Responses) provides detailed analysis and commercial assessment carried out as part of the refinancing exercise.

**KEY DECISION REFERENCE NO.: Yes**

The Executive Mayor in Cabinet is recommended to:

**RECOMMENDATIONS:**

1. Delegate to Corporate Director of Resources and Section 151 Officer in consultation with Monitoring Officer and Cabinet Member for Finance to accept or reject the final outcome of the refinancing offer subject to due diligence.

2. Subject to outcome of Recommendation 1 Delegate to Corporate Director of Resources and Section 151 Officer in consultation with Monitoring Officer and Cabinet Member for Finance to consider taking an upfront gain through a cash receipt or a reduced Unitary Charge payment in future.

3. Subject to outcome of Recommendation 1 Delegate to Corporate Director of Resources and Section 151 Officer in consultation with Monitoring Officer and Cabinet Member for Finance to consider receiving the gain for Department of Transport (DfT) in return for reduced PFI credits over time.

4. Delegate to Corporate Director of Resources and Section 151 Officer in consultation with Monitoring Officer and Cabinet Member for Finance to vary the Project Agreement should the refinancing require commercial adjustment to be made to the agreements.

## 1. BACKGROUND

1.1 Croydon Council and the London Borough of Lewisham entered into a PFI agreement (the **PFI Agreement**) with Croydon & Lewisham Street Lighting Ltd (the **SPV**) in August 2011 to replace approximately 38,000 streetlights and 8,000 street signs and bollards in both boroughs as part of the core investment programme. The contract share between Croydon and Lewisham is 64% Croydon, 36% Lewisham. Furthermore, contract was supported by DfT and the initial equity investor to Croydon & Lewisham Street Lighting Ltd was Skanska (now Milestone) & John Laing at 50% each.

1.2 The project scope included an initial 5-year core investment and build programme, which was completed in 2016 and subsequently moved to a 25-year ongoing planned and reactive maintenance liability (contract term ending 2036) for the entire street lighting and illuminated traffic sign inventory. The total capital value of the contract at financial close was £73.4m.

1.3 The final technical solution agreed during competitive dialogue incorporated the following technical features:

- A street lighting design solution with light levels compliant with the latest UK lighting standards which considers local crime levels and, the opportunity for energy usage reduction.
- A white light-based solution within all residential areas incorporating the latest Philips Cosmopolis light source.
- The latest in street lighting technology including solar traffic bollards, electronic control equipment and, galvanised treated & painted street lighting columns.
- A Central Management System (known as the CMS) that allows the Council to control & remote monitor lighting and based on agreed policy vary light levels at specific times.

1.4 The contract term is due to end in 2036 (in 15yrs) with an additional 5 year standard hand back on expiry period until 2041.

1.5 Since completion of the initial 5-year Core Investment Programme in 2016 the project has been in a steady state position, with good operational performance and therefore minimal performance related financial adjustment.

1.6 John Laing sold its equity stake in August 2017 to Equitix and Skanska sold its share, also to Equitix, in June 2019. The original lender were Lloyds, SEB (Nordic Bank), NIBC (Dutch Bank) and NBC (Dutch Bank) with each providing 17%/33%/25%/25% of the debt financing respectively. Lloyds and NIBC also provided interest rate hedging to the SPV in connection with the debt financing (**Existing Hedging**).

1.7 The Councils pay an annual Unitary Charge (UC) to cover the costs of planned and reactive maintenance, which is reviewed every year to account for inflationary uplifts and is then benchmarked every year. The Councils also receive £6.003m in PFI credits from DfT annually and these will continue at the flat rate until the Agreement expires or terminates.

1.8 When the refurbishment works were completed in 2016 the Councils were paying £10.218m in Unitary Charge. The Unitary Charge in 2022/23 is £10.861m.

1.9 Both the PFI Credits and UC payments are split 64% and 36% between Croydon Council and Lewisham Council respectively.

1.10 The Council entered into a Memorandum of Understanding in April 2022 under delegated powers to Corporate Director of Resources and Section 151 Officer. The MoU was an agreement for the SPV to identify new funders to refinancing the contract and see better commercial terms so that the Council is able to generate a gain.

1.11 The Council would have received greater gains if the refinancing had been done just after the project became fully operational in 2016 as the interest rates had fallen considerably to when the contract was first entered into in 2010. With a longer profile of outstanding debt would have meant that if the refinancing was done in earlier years, the SPV and as a consequence the Council, would have benefitted from lower financing costs for a longer period.

## 2. REFINANCING PROPOSAL

2.1 All standard-form PFI contracts contain drafting explicitly setting out how they may be refinanced during the contract term. The primary reason being that the PFI contracts have a long contract term, in this case 25 years. During this period there could be significant financial benefit in refinancing the project, for all involved parties, as the financing market shifts and/or the risk associated with the underlying project reduces as it becomes "steady state".

2.2 The ideal time to consider refinancing Street lighting PFI contracts is after completion of the initial core investment programme (in this case completed in 2016), the driver being that at this stage the projects are lower risk with good operational performance and therefore minimal performance related financial adjustments. With a further 14 years still go it still provides sufficient time frame to benefit from refinancing the debt but the gain is smaller than having done in prior years.

2.3 This PFI contract has 14 years till expiry in 2036 and so the optimum window to refinance will decrease with refinancing processes seldom undertaken with less than 10 years remaining.

2.4 Refinancing benefits are generated from seeking improved margins from lenders to the ones agreed at the start of the contract. Two key sources of gains achieved are:

i) A reduced bank risk margin which does reduce the annual interest costs and;

ii) Other changes to financing terms which release cash earlier than assumed at financial close:

(a) Release of cash reserves required by the senior lenders

(b) Changes to the debt service constraints which is the ratio of cash flow in the relevant period to the forthcoming debt service requirement allowing a higher level of debt to be raised.

2.5 As part of the 22/23 Budget Setting exercise the Council has an overall PFI review savings target of £150k and the potential benefits from the refinancing will contribute towards the 22/23 savings target. These savings are held corporately and will be devolved to the services once the saving has been achieved.

2.6 The work to start refinancing began in August 2022 and this has been led by Equitix with the Councils appointing LP as the Financial Advisors and Browne Jacobson as the Legal Advisors. This was a joint commission between Croydon Council and Lewisham Council.

Contractual Arrangements

2.7 The provisions for refinancing within the Agreement and based on SOPC 4 (being the fourth iteration of the Standard form of Project Contract issued by HM Treasury, and on the basis of which PFI arrangements were entered into at the relevant time) standard provisions, are set out in clause 60 and Schedule 12 of the Agreement. The refinancing exercise proposed within this document is called “Qualifying Refinancing” which (A) requires the Council’s consent to implement and (B) entitles the Council to receive a share of any gain (**Refinancing Gain**) *, the share allocated to the Councils being

- 50% of the refinancing gain which arises up to £1m.
- 60% of any refinancing gain up to £3m.
- 70% of any refinancing gain above £3m.

* The value of the refinancing gain shall be calculated during the refinancing exercise.

2.7 The Council will seek to engage with DfT to test the possibility of retaining their share of the gain without any compromises, as this will help the Council’s financial position.

2.8 As set out in the draft initial note prepared by Local Partnerships (Appendix 1) for the Councils dated [November 2022] (the **LP Note**), Equitix have proposed a ‘commercial adjustment’ to the contractual position regarding the Councils’ share of the refinancing gain. More detail can be found in the LP Note but in summary this adjustment is necessary to incentivise Equitix to implement the refinancing and results in an improved refinancing gain position for the Council. A deed of variation to the PFI Agreement will be entered into in connection with the refinancing which will, *inter alia*, reflect this mechanic and deal with certain of the contractual implications set out in the LP Note.

2.8 The Councils are also required to share 50% of any gain share with the DfT as required under the PFI Credit agreement.

2.9 Under Schedule 12 as part of the refinancing exercise the SPV is required to provide the Council with full details of any proposed Qualifying Refinancing, including a copy of the financial model and the basis of the assumptions used in the model.

2.10 The Council is also entitled to have (before, during and at any time after any Refinancing) unrestricted rights of audit over any financial model and documentation (including any aspect of the calculation of the Refinancing Gain) used in connection with the refinancing.

2.11 Prior to the formal process to refinance the debt began, the SPV provided a summary presentation that detailed the estimated financial gain for the Council based on a series for high level and educated assumptions with regards to amended financing costs and assumed transaction costs.

2.12 The summary presentation provided by the SPV estimated that the refinancing gain will be within ranges set out in the table below.

| ID | Description | Amount (£) |
|---|---|---|
| 1 | **Refinancing (Gain Gross)** | **£4,115,081** |
| 2 | **Refinancing Costs** | |
| | New senior arrangement fees | £734,377 |
| | DSRF arrangement fees | £34,100 |
| | CILF arrangement fees | £14,830 |
| | Transaction Costs (Advisory/DD) Net VAT | £764,000 |
| | Total costs | **£1,547,307** |
| 3 | **Refinancing Gain (Net)** | **£2,567,774** |
| 4 | **SPV Gain share** | **£1,127,109** |
| 5 | **Authority Gain share *** | **£1,440,663** |
| | DfT share (50%) | £720,332 |
| | **LB Croydon Share (64%)** | **£461,013** |
| | LB Lewisham Share (36%) | £259,319 |

* Based on 50%, up to £1m, 60% £1m to £3m

2.13 The table above, under 2.11, were estimates however the actual gain based on the refinancing work indicate a larger gain will be generated. These figures will be finalised as part of the delegated decision when the due diligence and the margin rate is confirmed on the date of financial close.

2.14 The gains from refinancing can be taken in 2 forms which are:

- **A single payment on or about the date of refinancing.** This can be achieved as the SPV can take on more debt, but at a lower interest cost (while maintaining the same level of UC). By maintaining the same level of UC, a higher amount of debt than currently available can be taken out. This additional debt allows for an upfront gain to be shared.

- **A reduction in the unitary charge for the remainder of the contract**. Over time, through the payment of the UC by the Councils, the SPV is able to pay down some of its initial debt. Through refinancing at a lower rate, the costs of borrowing will be reduced, resulting in a lower UC. This is an alternative to the upfront gain approach referred to above.

2.15 The Council can take a benefit that combines the upfront and reduced UC approaches. With this said, the PFI Agreement prevents the Council from taking a greater upfront gain than that received and as such the current proposal is for the Council to receive the largest upfront payment it can take within these constraints which leaves a minority proportion of the Refinancing Gain being implemented through a UC reduction. This is something being explored further by the Council with the aim of seeking to take the full Refinancing Gain upfront.

2.16 Section 3 of this report details the financial outcomes between the two options identified in 2.11. When the refinancing proposals are implemented the Existing Hedging that sits between the SPV and the existing hedge providers, called a swap agreement, will be terminated. As Aviva is a fixed rate funder:

- no new swap arrangements will be entered into between the SPV and Aviva;
- the new finance documentation will include 'make whole' protection for Aviva which aims to compensate them for early receipt of any monies given the fixed nature of their debt pricing; and
- the pricing of the new finance documentation will not be set until shortly before close given the reference point for such pricing will be the then prevailing SONIA mid-swap rate.

The price of the breaking the Existing Hedging and the final Aviva debt pricing each depends on the market at the time of refinancing. As such the amount of the Refinancing Gain will not be definitively known until close to completion of the refinancing.

2.14 In this respect, a specialist advisor will be engaged. The extent of that advisor's duty of care to the Council's is currently being resolved. The advisor's role is to ensure the swap breakage and Aviva pricing is appropriately benchmarked. Moreover, the refinancing process will involve a series of 'test closings' known as dry-runs which will provide visibility as to market movements and impact on refinancing gain in the lead up to completion.

<u>Issues and Risks</u>

2.17 Whilst all costs of the transaction are paid from the gross financial benefit (including those associated with the termination of the Existing Hedging), the entering into a new loan agreement – which will result in an increase in senior debt and include 'make whole' characteristic on early repayment as more detailed in the LP Note – could affect the termination sum that would be payable by the Council in a termination event. This mainly applies in the highly unlikely event of a Council Voluntary Termination (but could also apply if a termination occurs for force majeure but that is considered unlikely in a Project of this nature).

2.18 In any event, it is considered that Voluntary Termination of a successful PFI project is highly unlikely due to the satisfaction with the operational performance. The level of breakage costs is high even prior to any refinancing. However, the increase in termination liabilities is a risk which the transaction introduces and is something the Councils will be required to consent to as part of the refinancing.

## 3. REFINANCING OUTCOME

3.1 Section 2.11 refers to two options the Council has with regards to how it wishes to benefit from a positive outcome from refinancing. This analysis is still being finalised as the Council's advisors are conducting a review of the modelling provided by the SPV. Furthermore, with the changes in the macroeconomic environment there is considerable movement within the interest rate market which is making it difficult for the lender to confirm the exact gain available within the structure.

3.2 The refinancing is likely to be priced using margins to SONIA Swaps or UK Gilts and both metrics have fluctuated significantly over the past month due to uncertainties with regards to the UK economy. A lower UK Gilt or SONIA Swap rate reduces the margin charged by the lender which means a larger gain can be achieved for the SPV and subsequently to the Council.

3.3 From a net present value (**NPV**) perspective both options provide an equal outcome and, therefore, the key assessment is whether the cash upfront would deliver additional benefits in light of the current financial circumstances. For example, would an upfront gain allow the Council to reduce interest payments on existing debt and/or fund projects to explore further savings and income generation?

3.4 Paragraph 2.7 referenced the need to share 50% of any gains with DfT. The Council has the option to request the DfT gain to be shared with the Councils in return for a reduction of the PFI credits. The Council's proposal was to request that the reduction in PFI credits does not start immediately but if a 5-year grace period can be awarded. This proposal was discussed with DfT who are supportive of this request.

3.5 The impact of this request, whilst on NPV terms results in the same outcome, will mean that the Councils can retain £1.095m (£700.8k for Croydon and £394.2k for Lewisham). This is in addition to the gains to the Councils as explained in table under 3.1.

3.6 The NPV assessment is detailed in confidential appendix 2 on page 13. The table clearly identifies gains under the two options when the refinancing exercise has fully completed the NPV outcome will continue remain the same for the refinancing options.

3.7 The refinancing arrangement does not extend the life of the contract and will still come to an end in 2035/36.

**DfT Gain Share**

3.6 As indicated within paragraph 2.11, the DfTis also a beneficiary of the gain share that would be achieved from the refinancing. DfT provides the Council with PFI Credits annually, which total £6.003m and these are split 64:36 (as per the PFI split) with Lewisham. These credits were awarded to the Councils as financial support for entering into PFI schemes and these were based on the final costs of the PFI.

3.7 As the refinancing generates a gain it reduces the overall costs of the Agreement and, therefore, DfT as a counterparty are also entitled to share in the refinancing gain.

3.8 The Council has requested LP to help the Council explore opportunities to retain the DfT gain which will provide the Council with additional upfront funding. Through a number of engagements with colleagues at DfT this request was agreed on the basis that PFI credits would in return be reduced annually. This was done to ensure the net NPV benefit to the DfT remained the same.

3.8 The Council has requested LP to model the cost benefit of receiving DfT gain upfront against reductions in PFI credits. This analysis is being developed and needs to be discussed with DfT, however three key options are being considered which include:

i) Receiving the DfT gain with immediate reduction in PFI credits
ii) Receiving the DfT gain with reduction in PFI credits to take place in 5 years time

The consequence of a reduction in PFI credits would result in a revenue budget growth required to support the Medium-Term Financial Support (MTFS). As a result, this will increase any budget gaps for the MTFS cycle. However, receiving the cash upfront will allow the Council to avoid potential borrowing, reducing future interest costs associated with taking on new debt. The current macroeconomic climate, where interest rates are increasing with direct impact on the PWLB rates, means that (option ii) may yield a better outcome.

3.9 The reduction in PFI credits under Option ii would be greater than Option i, however it provides the Council with time before PFI credits reduce. This will not require the immediate budget revenue growth within the MTFS. It also supports the Council from reductions in borrowing costs as explained in 3.11.

## 4. CONSULTATION

4.1 The refinancing of the senior debt is allowable under the existing legal agreements and the Council is only required to agree to this proposal if there are gains.

4.2 The Council has been working, via its advisors, closely with Equitix to proceed with the refinancing. The costs of the refinancing are funded from the gains share and if the refinancing does not proceed due to the financial benefit not being sufficient to cover the costs of the transaction (i.e., no financial gain), then each party (Council, Lewisham and SPV) will bear their own abortive costs.

4.3 During the refinancing process the Councils have been engaging and updating DfT on the progress of the process and DfT have been supportive.

## 5. OPTIONS CONSIDERED AND REJECTED

5.1 Not proceeding with the refinancing was considered but rejected as the Council would have lost out on the gain generated from refinancing.

## 6. FINANCIAL AND RISK ASSESSMENT CONSIDERATIONS

### Revenue and Capital consequences of report recommendations

6.1 The costs, which include financial and legal advisory, are covered by the refinancing project with the gross gains generated by the refinancing review.

6.2 The Council will benefit from a one-off upfront capital receipt which can be used for capital purposes and generates additional cash flow which will help with Treasury services.

6.3 The refinancing proposal can generate a gain through a reduction in unitary charge or an upfront capital receipt. Both generate the same NPV and therefore, over time, the Council will receive an equal benefit under each option. Having a capital receipt upfront gives the Council greater flexibility as to how it uses the funds. For example, to pay down debt and reduce minimum revenue provision, or use the capital receipts to fund capital expenditure. The additional cash will also support the need for less cash flow borrowing.

6.4 Key risk with accepting an upfront gain is it increases the costs of terminating the PFI. This is because as the LP Report details, additional debt is taken on which is then dispersed as additional gain. However, the additional debt means increased costs if the PFI were to be terminated as more would need to be paid back to the lenders. However, it is important to note that the ability voluntarily to terminate a PFI arrangement is limited as this would not usually be value for money and requires approval from Central Government.

Approved by: Matt Davis – Interim Director of Finance

## 7. LEGAL CONSIDERATIONS

7.1 The Council may enter into contracts and variations of contracts under the general power of competence (Localism Act 2011), which gives local authorities the power to do anything that individuals generally may do.

7.2 The Executive Mayor has the power to exercise executive functions pursuant to s9E of the Local Government Act 2000.

7.3 There is a strong argument that the refinancing merely implements an element of the Agreement in accordance with its terms. On this basis, the refinancing would not constitute a modification to the Agreement. In the unlikely event that the refinancing was deemed to be a modification, the Council must comply with the Public Contracts Regulations 2015 (PCR) when varying contracts. Regulation 72(1)(a) of the PCR provides that:

*(1) Contracts and framework agreements may be modified without a new procurement procedure in accordance with this Part in any of the following cases:*

*(a)where the modifications, irrespective of their monetary value, have been provided for in the initial procurement documents in clear, precise and unequivocal review clauses, which may include price revision clauses or options, provided that such clauses—*

*(i)state the scope and nature of possible modifications or options as well as the conditions under which they may be used, and*

*(ii)do not provide for modifications or options that would alter the overall nature of the contract or the framework agreement*

7.4 Accordingly, the deed of variation to the Agreement (**DOV**) (and other documents) required to implement the refinancing would, if deemed to constitute a variation to the Agreement,, be a permissible variation under Regulation 72(1)(a) of the PCR. This is because the modification being made follows “clear, precise and unequivocal review clauses”, as set out, for example, in the detailed refinancing provisions.

7.5 The DOV includes consent by the Councils to the refinancing, and implements those changes to the Agreement which are required as a result of the refinancing proposals. For example, inclusion of “Mid Co” as part of the financial structure. Browne Jacobson, as external legal advisers, have confirmed that save as set out above, no additional risk is raised by the terms of the DOV and transaction documents.

7.6 A new Lender’s Direct Agreement (**DA**) will be required in order to reflect the revised financing arrangements. This DA restricts the ability of the Councils to terminate the Agreement (for poor performance for example) allowing lenders the opportunity to protect repayments under the finance documents (such repayments being dependent on income from the project) by intervening. Only following this intervention can termination occur. The new DA should not impose any additional risks on the Councils, relative to that under the original PFI arrangements. The only changes should be those required to reflect the new structure and refinancing.

7.7 At the time of the original PFI transaction, the Councils were asked to provide a certificate under the Local Government (Contracts) Act 1997 (**LGCA Certificate**). The LGCA ensures that, should the Agreement be found to be ultra vires, the “relevant discharge terms” can be enforced against the Councils. The relevant discharge terms are the requirement to pay compensation on termination to SPV (and ultimately its lenders) on early termination of the

Agreement. This ensures that lenders' interests are protected in the unlikely event that the Agreement (and all obligations set out in it in relation to payments by the Council) are held to be ultra vires.

The Councils will be asked to enter into a further LGCA Certificate in relation to the amended Agreement, DOV and DA. The new LGCA Certificate will not increase the exposure of the Councils, relative to the pre-refinancing position, as the existing LGCA Certificate already requires the Councils to stand behind the relevant discharge terms as a condition of funding.

Approved by Kiri Bailey – Head of Legal on behalf of the Director of Law and Governance & Deputy Monitoring Officer

**8. HUMAN RESOURCES IMPACT**

8.1 There are no immediate HR implications arising from this report for Croydon Council employees or staff.

Approved by: Gillian Bevan, Head of HR, Resources and Assistant Chief Executives on behalf of the Chief People Officer

**9. EQUALITIES IMPACT**

9.1 There are no equality implications, arising from this report.

Approved by : Denise McCausland- Equalities Programme Manager

**10. ENVIRONMENTAL IMPACT**

10.1 None

**11. CRIME AND DISORDER REDUCTION IMPACT**

11.1 None

**12. DATA PROTECTION IMPLICATIONS**

12.1 **WILL THE SUBJECT OF THE REPORT INVOLVE THE PROCESSING**

**OF 'PERSONAL DATA'?**
**NO**

12.2 **HAS A DATA PROTECTION IMPACT ASSESSMENT (DPIA) BEEN**

**COMPLETED?**
**NO**

---

**CONTACT OFFICER:** *Nish Popat – Interim Head of Corporate Finance*

**APPENDICES TO THIS REPORT:**

*Confidential Appendix 1 – Local Partnership CROYDON AND LEWISHAM STREET LIGHTING PFI PROJECT - INITIAL NOTE*

*Confidential Appendix 2 – Croydon & Lewisham Streetlighting Refinancing – Funding Responses*

The Appendices are confidential as they contain commercially sensitive information which could impact the final outcome of the Refinancing exercise.