SURREY COUNTY COUNCIL

CABINET

DATE: **27 OCTOBER 2020**

REPORT OF: **MR MATT FURNISS, CABINET MEMBER FOR TRANSPORT**

LEAD OFFICER: **KATIE STEWART, EXECUTIVE DIRECTOR FOR ENVIRONMENT, TRANSPORT AND INFRASTRUCTURE**

SUBJECT: **STREET LIGHTING PFI CONTRACT - REFINANCING**

SUMMARY OF ISSUE:

Surrey County Council entered into a private finance initiative (PFI) contract in March 2010 for Street Lighting maintenance for 25 years with Surrey Lighting Services (the Service Provider). The scope of the services included the operation and maintenance of the streetlights for the 25-year period and during the first 5 years delivers a "Core Investment Programme" to replace most lighting columns and all the lanterns.

A feature of the PFI contract required the Service Provider to obtain finance to cover the cost of the initial investment phase to be repaid over the life of the contract period. The monthly payment made by the Council to the Service Provider (known as the Annual Unitary Charge) is a fixed sum indexed annually to cover the cost of the operation and maintenance of the assets plus the cost repayment of that finance less any deductions relating to performance standards not being met if applicable.

The contract includes a mechanism to carry out a refinancing exercise at any point (i.e. review and renew the existing loans in place for the contract to take advantage of improved market terms and reduce payments) if there could be a financial gain either in the form of a one off payment to the Council, a reduction on the annual cost of services or a combination of the two.

A review of the finance market has shown that proceeding with refinancing the remaining debt held by the Service Provider will generate a one-off payment to the Council plus a reduction in the annual costs of the contract. Full details of these savings are included in Part 2 of the Cabinet report.

The Council has an obligation to ensure ongoing best value in its contracts. The proposed estimated savings need to be considered against any changes to or additional risks for the Council created as a result of carrying out the proposed refinancing.

RECOMMENDATIONS:

It is recommended that Cabinet:

1. Approves, in principle, the application of the contract mechanism to refinance the Street Lighting contract which will result in a saving to the Council in the amount it pays for these services either as an annual cost reduction, a one-off saving or a combination of both.

2. Delegate the final decision to the Executive Director for Environment, Transport and Infrastructure (ETI) and the Executive Director for Resources, in consultation with Cabinet Member for Transport and Cabinet Member for Resources

REASON FOR RECOMMENDATIONS:

The principal of refinancing the street lighting PFI contract has been explored a few times over the past 10 years and until now any financial benefit from doing so has been outweighed by the costs associated with the refinancing itself. Despite the latest review having been conducted in the months since Covid-19 has impacted the Country, the refinancing gain available has improved significantly.

The balance of the financial return from refinancing is assessed to outweigh any amended/increased risk to the Council.

If the Council were not to proceed with the refinancing exercise, it would be paying more for the service than it needed to and so would not be securing Best Value.

DETAILS:

Background

1. In March 2010, the Council commenced a PFI contract with Surrey Lighting Services (the Service Provider) to deliver street lighting services. The scope of the contract included:
    a. Operation and maintenance of the street lighting equipment for the 25-year period of the contract
    b. Delivery of a Core Investment Programme covering:
        i. The replacement of approximately 70,000 street lighting columns
        ii. The replacement of approximately 89,000 lanterns
        iii. Installation of a Central management System (CMS) to control the street lights including self-reporting of faults

2. The essence of the PFI contract is that Surrey County Council, as the client, sets a series of required outcomes (known as Performance Standards), and the Service Provider develops a solution to achieve and exceed those Performance Standards for the duration of the contract. Failure to achieve any of the Performance Standards in any period results in a financial deduction which reduces the value of the Annual Unitary Charge for that period.

3. In most PFI contracts, the Service Provider's solution to the required outcomes will often require a significant investment in the asset to be delivered (which across the UK has included building of schools, hospitals and roads). Many Local Highway Authorities like SCC have entered into PFI contracts to deliver street lighting maintenance, with the majority resulting in street lighting columns and lanterns being replaced during the contract term and often during the early years to maximise performance from an early point in the contract period.

4. To facilitate that investment, the Service Provider is required to obtain the necessary financing from appropriate sources, such as banks, pension funds and the like.

5. An Annual Unitary Charge is paid by the Council to cover the operation and maintenance of the street lights for the 25-year term of the contract as well as the

repayments of the Service Provider debt. Part of this charge is funded by HM Treasury in the form of PFI credits paid each year of the contract term.

6. In February 2020, a variation to the scope of services was agreed and the Service Provider commenced a 3-year programme of LED conversions for all street lights in the county to reduce energy consumption, costs and carbon emissions. This has been financed directly by the Council with borrowing from Salix Energy Efficiency Loans and Enterprise M3 Local Enterprise Partnership at 0% interest with the remainder provided through Public Works Loan Board borrowing. As this project has been managed as a separate project to the PFI contract, neither this project nor its funding has affected the Annual Unitary Charge and will similarly not be affected by the planned refinancing.

Refinancing

7. As described, the Service Provider is required to obtain sufficient finance to cover the cost of the initial core investment, which was secured following a competitive process, to ensure the best overall outcome. It should also be noted that the PFI contract was awarded following a substantial competitive procurement where price (in the form of the Annual Unitary Charge cost) was evaluated alongside quality of the solution being submitted by each bidder.

8. The terms of the financing are set at the outset of the agreement for the entire contract period of 25 years. Those terms are set in the context of the economic environment and market conditions at the time of its completion (in this case November 2009.

9. Similar to other types of long-term debt, the costs of borrowing vary as a result of the general underlying costs of borrowing in the UK, the risk appetite of funders in the market and the perceived riskiness of the project. The latter is important because on PFI projects, the funder does not get security of the underlying assets and is reliant on the contract performing well.

10. Where any or all of these factors improve from the position prevailing at the date the original financing was put in place, there is an opportunity to refinance on better terms. This can result in lower monthly costs, reducing the debt term or providing an upfront lump sum benefit.

11. Recognising that it is the Service Provider who borrowed the funds, it is responsible for instigating the exploration of the refinancing of that debt to determine what new funding options might be available that would maximise the financial benefit of the refinancing whilst minimising the exposure that the new debt obligations would create to its business. This is a complex process to ensure that the existing financing arrangements are ended at least cost and the new financing package delivers the best value going forward.

12. Although the Service Provider is responsible for the debt, the Council ultimately pays for it through the Annual Unitary Charge and so has a strong interest in the refinancing exercise and its outcome. How the refinancing is structured will determine both the overall quantum of benefit the Council receives from it, but also whether that benefit comes in the form of an immediate lump sum, an ongoing reduction in the service payment, or a combination of both. The Council has engaged a team from

within Local Partnerships, an organisation with experience in supporting other public sector organisations in carrying out refinancing projects, to help ensure that the Council's interests in the process are protected.

13. A PFI contract generally includes a mechanism which facilitates a refinancing exercise. The mechanism provides for the process, how the various costs of carrying out the process will be covered and a sharing mechanism for any gains that arise from the refinancing.

14. The sharing mechanism explains in detail how any net gains (i.e. gains after taking out the costs associated with carrying out the exercise) are shared between the Council and the Service Provider. **Table 1** shows how any gain is shared between the Council and Service Provider with the Council receiving a greater share as the value of the gain increases:

Table 1. Gainshare split

Value of Total Net Saving	Local Authority Share	Service Provider Share
£0-£1 million	50%	50%
> £1 Million to £3 million	60%	40%
Over £3 million	70%	30%

15. In general terms, as the value of the gain increases, the Council's share also increases in percentage terms so that at each threshold, the Council's proportion increases. The Council's share is based on a cumulative share of each banding where applicable (i.e. 50% of any saving up to £1 million + 60% of any saving above that up to £3 million + 70% of any saving over £3 million).

16. Every two to three years since the contract started, the Council has requested the Service Provider to carry out an initial analysis to determine the state of the market and the likely value of any gain (if any) that might be generated from refinancing the project debt. Previous assessments have resulted in a position that either did not generate a gain, or the value of the gain did not significantly exceed the costs of carrying out the refinancing exercise.

17. The contract is, however, now at a state of maturity with the initial replacement work successfully delivered and day to day operations being delivered satisfactorily that project risks are low. This has coincided with interest rates being historically low and there being funders in the market who have an appetite to refinance this type of project on good terms. Therefore, this is probably an optimal time to progress a refinancing.

Current Position

18. In 2019, at the outset of this latest exercise to explore the potential for refinancing, the Service Provider was asked to carry out an initial market assessment. The outcome of that "desktop" assessment indicated there would be a significant net gain from a refinancing exercise, and that the Council would receive a substantial return through its share.

19. This exercise was taken a step further by the Service Provider to engage informally with potential lenders to understand their appetite for providing finance to the project if it were refinanced. This reinforced the initial findings, and following consultation with the Cabinet Member for Transportation and the Service Provider's Board Members, it was agreed to formally commence a refinancing.

20. However, as the Council and Service Provider were in the process of negotiating and agreeing a contract variation to facilitate the conversion of street lights to LED at that time, it was agreed to delay formal commencement of refinancing until all parties including the existing lenders had agreed to the details of the contract change. This process has taken some time to complete, and hence a delay in further progressing the refinancing initiative until now.

21. In June 2020, following informal engagement with several potential lenders, a funding competition was launched to understand the terms on which each entity would be willing to enter into a new set of financing arrangements. It was anticipated that carrying out this competition during a time when Covid-19 has affected the Country might have resulted in less favourable terms than the assessment carried out "pre-Covid". In actual fact, the results received were more positive than those indicated in the earlier assessment and so work has progressed to develop the terms including preparing the necessary changes to the contract documents to enable the parties to seek the necessary approvals ahead of completing the agreement in the coming weeks.

22. The exact value of the gain will be determined by the various rates applicable on the day of financial close and we anticipate a "window of movement" of no more than 10% in the value of the Council's share of the refinancing gain due to these factors. If the expected gain fell below this threshold it would result in the refinancing not proceeding without further review by Cabinet.

CONSULTATION:

23. The Council has worked closely with the Service Provider and its advisors to develop the refinancing package. It is in the joint interest of both parties (whose benefits are directly linked) to maximise the value of the gain through a combination of getting the best available finance package, whilst at the same time minimising any changes to or increases to risk alongside keeping a tight control on the costs of developing and completing the refinancing.

24. Whilst part of the Annual Unitary Charge is paid for by HM Treasury through PFI credits each year and is sponsored by the Department for Transport (DfT), all savings due to the authority under the refinancing exercise will be retained by the Council with nothing payable to either DfT or HM Treasury.

25. The Council has engaged with the DfT's team from an early point to ensure support for carrying out the refinancing, and any terms agreed are acceptable to them as sponsoring Department.

26. The DfT's Local and Regional Transport Investment committee require a business case to be submitted, which it will consider for approval in parallel with (and be contingent on) Cabinet's approval.

RISK MANAGEMENT AND IMPLICATIONS:

27. Refinancing the contract is a non-operational activity, and there will be no changes to terms relating to the delivery of the service is being made.

28. It is intended to capture the required changes to contractual documents by way of an "amend and restate" approach rather than create a new set of documents. In doing so, proposed amendments are made to existing documents, making it simple to identify the changes. It will also ensure any costs associated with the required changes are minimised.

29. There is a provision in the contract where the Service Provider is liable for any costs (up to a threshold) resulting from a qualifying change in law which would affect the services delivered. The current financial model provides for this to be covered with a sum of money reserved for this explicit purpose and is essentially a cash sum held by the Service Provider which they will receive in full as a dividend once their change in law liability expires at the end of the contract term. Under the refinancing exercise, it is proposed to restructure this to a debt facility – this will provide the Service Provider with the same level of access to the required funds to service its obligations in the event of a change in law event arising. However, in moving to a debt facility from holding the funds, those monies can be released as part of the refinancing to increase the overall value of the gain. The Service Provider incurs a one-off arrangement fee to set the debt facility up under the refinancing and ongoing annual commitment fees to maintain access to those funds for change in law should they arise. This is substantially cheaper than paying interest on a loan which is not being used.

30. An alternative consideration was for the Council to take the full cost risk of any future change in law liability to further increase the value of the gain (by the amounts payable to set up and maintain the described loan facility); however, the additional refinancing gain available that would result from this are not significant in the context of the wider refinancing gain and do not outweigh the future risk of a change in law obligation should the situation arise so this will not be pursued.

31. To facilitate the refinancing costs (which include termination fees for existing loans and arrangement fees for new loans), the Service Provider will be borrowing a greater value than is currently owed but at a cheaper overall cost which leads to the reduction in the Annual Unitary Charge and the potential for an up-front gain.

32. Immediately following the refinancing and for a period of approximately five years afterwards, the Council will be subject to increased financial liabilities should it wish to terminate the contract for any reason. These increased liabilities will initially be greater than the saving the Council will receive from refinancing; however, after this five-year period, the position will reverse, and the Council's additional termination liabilities resulting from the refinancing will fall to a level below the value of the upfront gain the Council will receive through the refinancing.

33. In practical terms, the Council are unlikely to enter into a voluntary termination during the remaining 14 years of the contract, and in the short term over that initial five year period, this is even more unlikely as a result of the fact that the contract is performing well with few performance deductions being applied. In addition, as set out earlier in this report, the Council has also recently commenced a 3-year conversion

programme to install LEDs on all streetlights to reduce energy consumption, costs and CO_2 impact. Finally, the Council would incur significant additional costs to procure an alternative contract to operate and maintain the streetlights following termination, further minimising the risk of the Council terminating the contract early.

34. If for any reason the refinancing were to not go ahead (including the Cabinet not approving the refinancing), the Council would be liable for "abortive" costs of legal and financial advisors incurred to date, which are estimated to be £60,000. On the other hand, should the refinancing proceed, the Council's costs will be reimbursed as part of a successful refinancing and accounted for alongside other costs before the gainsharing calculations are made.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

35. Full details of the estimated refinancing gain and the Council's projected share based on the mechanism described in paragraph 12 is included in the Part 2 paper. Final amounts will be subject to various factors up to the day of Financial Close and will be agreed under the Delegated Authority requested.

36. The Council will be receiving its share of the refinancing gain in the form of a combined one-off payment and a reduction in the Annual Unitary Charge for the remaining years of the contract (to February 2035).

37. The refinancing restructures the debt to reduce the overall cost of repayments and in turn what the Council pays for the services. There are no changes to the services element of the contract with performance expectations and financial deductions for failing to achieve these remaining in place.

38. Acknowledging the risks described in paragraphs 29 to 34, the Council will receive the same services and level of performance but for a lower annual cost and a substantial one-off payment.

39. As described, the Council has engaged Local Partnerships to provide Financial Advice and assurance of the Refinancing. The Council has also engaged Pinsent Masons to provide Legal Advice – Pinsent Masons acted for the Council in both the original procurement of the contract and more recently in developing and agreeing the Deed of Variation for LED Conversion. The costs for these advisors along with those of the other parties including the outgoing and incoming lenders will be met from the Refinancing Gain before the shared calculation is applied.

SECTION 151 OFFICER COMMENTARY

40. Although significant progress has been made over the last twelve months to improve the Council's financial position, the medium term financial outlook is uncertain. The public health crisis has resulted in increased costs which are not fully funded in the current year. With uncertainty about the ongoing impact of this and no clarity on the extent to which both central and local funding sources might be affected from next year onward, our working assumption is that financial resources will continue to be constrained, as they have been for the majority of the past decade. This places an onus on the Council to continue to consider issues of financial sustainability as a priority in order to ensure stable provision of services in the medium term.

41. The Section 151 Officer considers that the process followed to refinance the street lighting PFI contract is robust, and the council has been supported by appropriately qualified and experienced specialist advisors, including legal and financial advisors, as well as by the Department for Transport.

42. The refinancing follows a competitive process, and the expected outcome is considered by the council's advisors to be positive. The refinancing gain will be shared between parties in accordance with the mechanism set out in the contract. There remains a risk that the position could change, including the council's share of the refinancing gain. This could occur for example through adverse movement in SWAP rates. These risks will be monitored and the refinancing will only proceed if the terms of the delegated decision are met.

43. As set out in the body of the report, increasing debt would potentially result in higher contract termination liabilities. This particularly applies to authority default or voluntary termination, where the increased liability would initially exceed the refinancing gain for a period of 5 years. However, this is considered an unlikely scenario given the performance of the contract to date and the council's ongoing investment in LED lighting which is being delivered through the contract. As such, the Section 151 Officer supports the proposed refinancing, which is expected to provide increased value to the council both through an upfront gain, and an ongoing reduction to the amount it pays though the contract.

LEGAL IMPLICATIONS – MONITORING OFFICER

44. Within the PFI contract, Schedule 12 - Refinancing sets out the terms and conditions for refinancing. It is clear from reading the draft Cabinet Report that Schedule 12 is being complied with by the Council and the Service Provider. This looks like a win-win for the Council and the Service Provider. As such there are no concerns about refinancing not being able to go ahead.

EQUALITIES AND DIVERSITY

45. This is a financial transaction undertaken by a 3rd party in the joint interests of their shareholders and the Council to generate a payment/reduced annual cost to the Council. As a result, there are no equalities and diversity implications.

WHAT HAPPENS NEXT:

46. Following approval by Cabinet the Department for Transport's Local and Regional Transport Investment Committee and the Service Provider's board, steps will be taken by the joint project team to complete the required steps in the refinancing to allow final terms to be agreed based on financial close on a specific date.

47. Final approval will be sought in line with the delegated authority to complete the transaction

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Consulted:

Cabinet Member for Transport

Cabinet Member for Resources

Shareholders of Surrey Lighting Services (the Service Provider)

Department for Transport

Annexes:

Part 2 Report
