ABERDEEN CITY COUNCIL

COMMITTEE	Finance, Policy & Resources
DATE	23rd April 2015
DIRECTOR	Ewan Sutherland
TITLE OF REPORT	Purchase of Subordinate Debt
REPORT NUMBER	CG/15/48
CHECKLIST RECEIVED	Yes

1. PURPOSE OF REPORT

The purpose of this report is to provide details of the offer that has been made to the Council to provide the subordinate debt in different Council's schools projects.

2. RECOMMENDATION(S)

It is recommended that the Committee:

(i) Provide delegated authority to the Head of Finance and the Head of Legal and Democratic Services, in conjunction with the Convenor (and Vice) of Finance and Policy and Resources, to enter into agreement to purchase the subordinated debt in other Council PPP/PFI projects subject to due diligence and the availability of funds; and

(ii) Provide delegated authority to the Head of Finance and the Head of Legal and Democratic Services, in conjunction with the Convenor (and Vice) of Finance and Policy and Resources, to enter into agreement to purchase the subordinated debt in the South of the City project for this Council subject to due diligence and the availability of funds; and

(iii) Any such investment is reported back to this committee in due course for elected members to be aware of the investment that has been undertaken.

3. FINANCIAL IMPLICATIONS

The total cost is currently unknown at this stage as no project has reached financial close. The projects (for the North Territory) that are likely to reach financial close during 2015 are set out in the table below:

Projects in Development	Total Cost	Sub Debt	Status
Argyll and Bute	£33,000,000	£1,089,000	A&BC taking 100%. Unconfirmed.
Argyll and Bute	£16,000,000	£528,000	A&BC taking 100%. Unconfirmed.
Aberdeen City	£37,000,000	£1,221,000	AC taking 100%. Unconfirmed.
Moray	£26,000,000	£858,000	Available
Shetland Islands	£36,000,000	£1,188,000	SIC taking 100%
<u>Future Projects - Funding yet to be confirmed and procurement route still to be determined</u>			
Aberdeenshire	£45,000,000	£1,485,000	Likely to be available
Highland	£25,000,000	£825,000	Likely to be available
Moray	£25,000,000	£825,000	Likely to be available

It can be seen from the table above that the school project for Moray Council is available with an estimated cost of £858,000. Three other future projects are intimated to be likely to be available but details are awaited. The Council can also invest in its own project by way of subordinated debt.

The level of return is currently estimated to be in the region of 10% per annum and is subject to the contract conditions being fulfilled.

4. OTHER IMPLICATIONS

There are no other direct or immediate implications arising from this report. As with any investment and associated return there is a risk that the investment does not return the anticipated yield. However, given these projects are school projects and the covenant is being provided by local authorities the risk is estimated to be low.

Proper due diligence will be undertaken on any project before agreement to purchase the subordinated debt is entered into.

5. BACKGROUND/MAIN ISSUES

5.1 The Council was approached from Hubco to see if it would be interested in both providing subordinated debt in the South of the City school project and also similar school projects for other Councils who have indicated that they would not like to take up this offer.

5.2 An integral part of the hub model is that each participant authority who signed the hub Shareholders Agreement will have an opportunity (but not an obligation) to invest subordinated debt, when required into revenue projects being carried out in the North Territory.

5.3 These projects essentially are financed through a number of sources and are very like this Councils 3R's project. There is in essence a primary investor (usually a pension/bank type financier) and then further secondary investors. It is anticipated that revenue projects will be funded via a structure that is broadly 90% senior debt and 10% subordinated debt which will be provided by the shareholders.

5.4 Generally there are two methods by which subordinated debt can be injected into a revenue financed project. Firstly, the subordinated debt is injected into the project on financial close in a single tranche. The second method is to inject the investment at the end of construction (as this prevents interest being accrued and rolled up during construction which is more expensive for the commissioning authority).

5.5 As with all investments, there is a risk associated with the investment. The projects that the Council could potentially invest in still remain to reach financial close and the final rate of return is therefore still not finalised. Based on other projects that have reached financial close the return is likely to be around 10% per annum.

5.6 Given the financial landscape that the Council is facing over the medium term all commercial opportunities should be explored and analysed to determine whether there is any scope for a positive financial return.

5.7 Given that these projects are all to do with the provision of schools to other local authorities the risk of project failure appears to be very low. The Council can also take assurance that both the primary funder and the Scottish Futures Trust will all be undertaking due diligence. The Council will also undertake its own due diligence.

5.8 In examining the affordability of this investment (based on an investment of £1 million) the Council must look at the use of, and interest earned, by the Capital Fund. The Capital Fund currently receives less than 1% interest per annum and this investment will potentially return over 10 times that amount. Notwithstanding the underlying risk this therefore demonstrates the long term affordability of the investment.

5.9 The payback period of the investment is expected to be around 12 years, including the initial capital investment. This assumes inflation of 2% which is the government's target. Also, if the investment performs as expected, the return could be capitalised and therefore provide capital investment of approximately £2.7 million.

5.10 As each project will differ slightly it is recommended that subject to due diligence the Head of Finance and the Head of Legal and Democratic Services, in conjunction with the Convenor and Vice Convenor of Finance, Policy and Resources be given delegated authority to enter into agreement to invest in subordinated debt. Any such investment will be reported back to this committee to ensure elected members are aware of which projects the Council has invested

6. IMPACT

This request supports the Shaping Aberdeen Vision by providing a commercial return which in turn will allow for capital investment or provide a revenue stream that can offset future cost pressures that the Council may experience.

A Frequently Asked Questions sheet is attached to this report and was provided by Scottish Futures Trust.

7. MANAGEMENT OF RISK

The main risk is that the project in which the Council invests defaults. If this occurs the subordinated debt holder (the Council) will not be repaid until the senior lenders have been repaid in full.

An important factor is that previous PFI/PPP projects have had a high success rate from an investor point of view. Private sector investors continue to be attracted to this asset class, which is indicative of the favourable risk versus reward balance.

Hub North Scotland will create a separate legal entity – a Sub HubCo – for each individual project. This means that if any other project fails it will not impact on the other projects.

Significant work will be undertaken by Hub North Scotland, the “Senior” debt holder, Scottish Futures Trust and the Council involved in the project through its financial advisors to ensure that the financial model underpinning each project is robust and is sufficiently resilient to be able to provide enough cash to meet all liabilities as they fall due.

The “Senior” debt holder for each project will require that Sub HubCo has sufficient cash flows in its model to cover 100%+ of the debt payments that will be actually due to them. In effect, this means that if this key requirement is made, Sub HubCo will also have enough cash to meet all “Subordinated” debt payments as they fall due.

These factors should, together, ensure that the risk of financial loss is minimised.

8. BACKGROUND PAPERS

None

9. REPORT AUTHOR DETAILS

Steven Whyte
Head of Finance
swhyte@aberdeencity.gov.uk
01224 523566

APPENDIX 1

Preamble:
The opportunity to invest sub-ordinated debt (sub-debt) within revenue financed projects is a new concept for the public sector as it is not core business and it is sometimes difficult to fully understand the opportunity. This simple question and answer paper seeks to inform the decision making process and allow the public sector to become better informed.

Q1: How successful has PPP/PFI subordinated investment been?
A1: There is no official study however given that the private sector are actively investing in sub-debt this a very good indicator of its success rate. The secondary market for acquiring sub-debt is also active and this further supports the first point. If success is measured on the basis “has the investment been paid back?” then the feedback is yes because of the mechanisms and support elements which SPVs/sub-hubcos put in place to de-risk the project. As an investment class, PFI/PPP has been historically very strong. There are many measures and mechanisms which are included within the structuring of PPP/PFI type projects to insulate holders of subordinated debt against the potential for their investment and return to not being repaid.

Q2: How is the contract structured?
A2: The contract will be between the participant and sub-hubco. Sub-hubco will enter into 2 main contracts; 1. Design and Build (fixed price) Building Contract and 2. Facilities Management and Lifecycle Maintenance Contract. The Participant will pay the unitary charge to sub-hubco and it will be sub-hubco who borrow the senior debt and subordinated debt – not hubco.

Q3: Why is the contract with sub-hubco and not hubco?
A3: By structuring the projects in this way it allows hubco to manage all of the individual projects whilst keeping the risks at the individual project level. This allows for each project to be kept separately from each other so that in the event of any issues in one project it will not cross-contaminate other projects being managed by hubco.

Q4: What protection does the participant have?
A4: The contract is structured in such a way that there are many different protections. These are as follows:
- Contracting with sub-hubco (see Q3/A3 above).
- The DBFM building contract transfers all building, utilities and design risk to the main contractor. Risks that cannot be appropriately transferred remain with the participant however these are few if any, and these will be known at the point of financial close so that the Participant can take active steps to manage any retained risk. This results in the investors having full protection from cost increases during construction.
- If the participant is operating the building they will be obtaining feedback from “on the ground” operations of the performance of the Facilities Management (FM) provider. If there are areas of non-performance then this is just one mechanism of communication and potential resolution at a local level.

- The FM provider is contracted on the basis of a payment mechanism and should any or all of the facility be unavailable then deductions will apply.
- There are also provisions within the FM contract for warning notices to be issued and if appropriate replacement of the FM provider.

Q5: What float provision is included within the model?
A5: AVIVA will insist on around 115% of the senior debt repayment to be available prior to the repayment being made at all times. This ‘Debt Service Cover’ ensures that the senior debt provider will, under normal conditions, will always be getting repaid fully. As the holders of subordinated debt are next in the cash cascade in the financial model this also means that there should be sufficient cash to repay these debt holders. This therefore provides another layer of protection for the sub-debt investors.

Q6: What is the proposed level of return?
A6: Circa 10% - 10.5% per annum fixed rate.

Q7: What is the drop dead date for the Participants decision to invest?
A7: Expectations are that participants should take time to consider the opportunity and confirm their intention in writing to invest around 3 months prior to Financial Close (FC).
If the investment parameters/assumptions change thereafter participants should confirm in writing that they no longer want to invest at least 4 weeks prior to FC as this provides SFTi with the appropriate time to make alternative investment arrangements.

Q8: When will the actual amount of sub-debt investment be known?
A8: The actual amount will be known once the project reaches commercial close (CC). CC being the point when agreement is reached on all capital, facilities management, life cycle maintenance and financial close costs.

Q9: Can an estimate of sub-debt investment be provided prior to CC?
A9: Hubco can provide this information to inform the participants’ decision making during stage 2.

Q10: When is the sub-debt initial investment paid back?
A10: Most are paid back towards the end of the operational contract, but this will vary from project to project depending upon the individual project characteristics and dynamics.

Q11: When will the financial model be fixed?
A11: This can only be determined once the gilt rate is fixed. This is normally known on the day of FC unless the gilt rate is pre-booked the day before.