NORTH LONDON WASTE AUTHORITY
REPORT TITLE: NORTH LONDON HEAT AND POWER PROJECT – FINANCING STRATEGY UPDATE
REPORT OF: FINANCIAL ADVISER
FOR SUBMISSION TO: PROGRAMME COMMITTEE
DATE: 02 NOVEMBER 2020
SUMMARY OF REPORT: This report is a progress update on the financing of the North London Heat & Power Project (NLHPP).
RECOMMENDATIONS: Members are recommended to note the contents of this report and to note that officers will liaise with Borough Directors of Finance and propose a way forward at the December Authority meeting for securing the next round of finance for the programme
SIGNED: Jon Rowney, Financial Adviser **DATE:** 21 October 2020

1. INTRODUCTION

1.1. The North London Heat & Power Project (NLHPP) has a total central estimated capital cost of £1.13bn. The Authority drew down £100m of Local Infrastructure Rate (LIR) finance from the Public Works Loan Board (PWLB) on 24 February 2020. The NLHPP has been progressing and as at 30 September 2020 the Authority had a positive cash balance of £66m with LB of Camden. At the expected spend profile of the project, further finance will be required in March 2021. The purpose of this report is to update members on progress towards identifying and securing the next tranche of finance.

1.2. In July the Authority commenced the procurement of the Energy Recovery Facility, and this procurement is timetabled to reach financial close in January 2022. Therefore, January 2022 represents a major programme milestone and an appropriate point to finance the programme up to, but not beyond. In August, the Authority appointed Taylor Woodrow as contractor for the EcoPark South contract (which includes building the Resource Recovery Facility). Meeting all of the Authority's commitments under the EcoPark South contract for its duration, plus other smaller project activities until January 2022 is estimated to require approximately £150m, therefore the financing to be sought in March 2021 should be of this approximate size but could be obtained in smaller tranches if required.

1.3. Officers continue to press government for additional financing support to the project, having already obtained Local Infrastructure Rate funding. In particular, officers have submitted a further bid for LIR funding – this may not be successful as the rules state that projects can only receive funding once, however, we have made clear that NLHPP is a programme containing a number of important individual projects, and moreover this maintains the profile of the project with government. We are also pressing for a meeting with the director of local government finance at the Ministry of Housing, Communities and Local Government. Whilst we await the outcome of these activities, officers have prepared a flexible financing approach based on the following factors:

1.3.1. The underlying Treasury gilts rates that determine the price of Authority borrowing remain low. See section 2.

1.3.2. PWLB borrowing is no longer the lowest cost option available to the Authority since the increase in margin that occurred on 9 October 2019. Authority officers have responded to a PWLB consultation process from HM Treasury. There is some speculation that PWLB margins will be reduced at some point in the future, but there is no certainty on when this will happen. See section 3.

1.3.3. Municipal public bonds currently offer the lowest interest rate for large scale borrowing available to the Authority, at the cost of some additional complexity. See section 4.

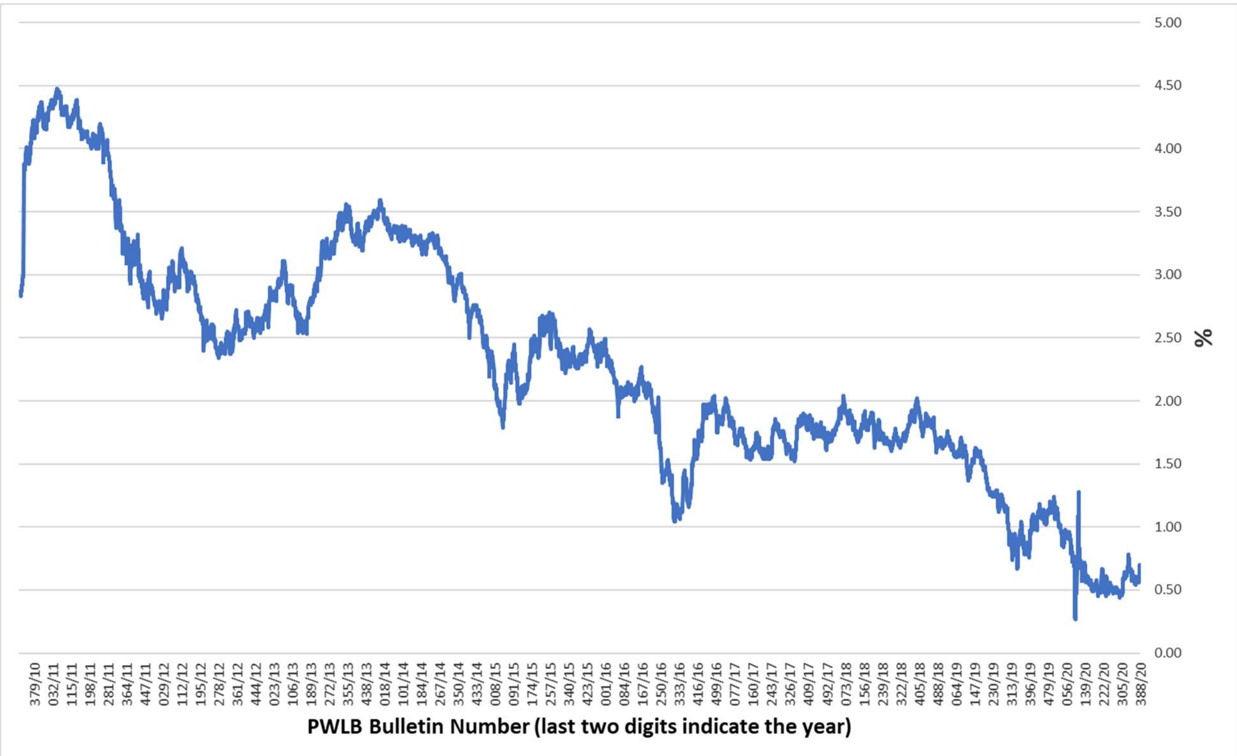
1.3.4. Municipal private placements offer a less complex alternative to public bonds and are readily available, but at an increased margin. See section 5.

1.3.5. Other forms of short-term liquidity are available to the Authority, to mitigate the risk of being unable to meet its contractual commitments in the event that the Authority chooses to delay large-scale borrowing. See Section 6.

2. THE CURRENT INTEREST RATE ENVIRONMENT

2.1. As a public sector body, the Authority has an advantage when seeking finance because its credit strength is derived from the UK public sector as a whole. Therefore, the rate at which the Authority can borrow depends on the rates that government can borrow in the form of Treasury gilts. These have seen persistent downward trends over the last 10 years, and this was exacerbated by the COVID-19 crisis, which caused gilts to drop to record lows. As figure 1 shows, the gilts rates have recovered slightly since the height of the crisis, but this remains a good time to borrow for large scale infrastructure.

Figure 1 – 30-year Treasury Gilts over the last 10 years (current as at 7 October 2020)



3. PUBLIC WORKS LOAN BOARD

3.1. On 9 October 2019, HM Treasury increased the margin over gilts at which the Authority was entitled to borrow from the PWLB from 80 basis points (0.8%) to 180 basis points (1.8%). This unwelcome development changed the PWLB from the cheapest form of large-scale financing available to the Authority to one of the most expensive. For comparison, from our market engagement activities we believe that the range of municipal bond margins is from 105 basis points to 160 basis points over gilts.

3.2. On 11 March 2020 the Treasury opened a consultation on future lending terms for the PWLB which Authority officers responded to prior to its close in July 2020. Officers expect that the results of this consultation will lead to PWLB margins being lowered again, though there is no certainty on whether the revised margin will go back to 80 basis points or the timeframe for this to happen. In addition, the consultation made repeated reference to Government's disquiet with borrowing to finance revenue generative assets, as opposed to financing infrastructure. As a result, any revised PWLB regime may offer preferential margins for infrastructure assets, which the Authority should qualify for but may require a bidding timeframe. As the Chancellor of the Exchequer has cancelled the Autumn statement in order to focus on the COVID-19 crisis, it seems unlikely that any announcement will be made prior to the budget in March 2021.

4. MUNICIPAL PUBLIC BONDS

4.1. A municipal public bond is a bond offered by a local authority that is traded on a public bond market. Here we are considering fixed rate bonds, as whilst index linked bonds are also possible, these do not offer value for money at current gilts rates as the Authority can borrow for a lower all-in rate than the long term forecast for an index like CPI (2.0%). Municipal bond issuance has, historically, been low in the UK as HM Treasury maintained a policy of making competitive and accessible debt available, through the Public Works Loan Board at margins below those available through public bond issuance. However, since the rate increase in 2019, more authorities are exploring the option of a public bond. For example, Lancashire County Council placed a bond with the aid of the UK Municipal Bonds Agency (UKMBA) in August 2020. The Lancashire bond was for £250m, fixed rate over 40 years and achieved a margin of 107bps over gilts, some 73bps cheaper than the current PWLB rate. A 73bps saving on the margin equates to approximately £1.8m of avoided interest costs per year on a £250m bond. The UKMBA was established by the Local Government association and its members are made up of Local Authorities.

4.2. Municipal public bonds have the following characteristics:

4.2.1. A minimum size of £250m, with the maximum depending on market appetite but can exceed £1bn;

4.2.2. Require the entity placing the bond to have a credit rating by one of the 3 leading ratings agencies (UK public sector authorities tend to be rated by Moody's as they are most familiar with the sector);

4.2.3. Require a full suite of bond documentation, either provided by an organisation such as the UKMBA or through advisors; and

4.2.4. Require engagement with the bond market prior to placing the bond, to ensure a successful placement.

4.3. The costs of the bond issue are rolled up into the margin, with the exception of the ratings agency costs, which are circa £40k for the initial rating and then £15k/year while the bond is outstanding. Timescales are 4-6 weeks for a rating and an additional 6-8 weeks to place the bond. Given an element of parallel activity, it may be possible to place a bond within 2 months, but an assumption of 3-4 months would be more achievable. Whilst several local authorities are rated, current uncertainty around the impact of COVID-19, recent concern on local authority finances and borrowing, plus the unusual structure of a waste authority as opposed to a county council / municipal borough may extend the timescale.

4.4. Whilst there are several avenues and advisors that can assist with placing a municipal bond, the UKMBA has a suite of standardised documentation that aims to reduce the burden on local authorities wishing to use this financing avenue. Officers have requested copies of this standardised documentation.

4.5. Despite the Authority's current finance requirement of £150m being less than the minimum of £250m, it may still be possible to place a bond. In discussions with UKMBA, they noted that other London authorities are looking to place bonds and a combined bond with NLWA and 1-2 others may reach the minimum. Each party would only be responsible for its own element, without any cross-cutting risk. This option could be attractive in the right circumstances but would leave the Authority at some risk in relation to the other party withdrawing from the transaction, which could either cause delay or an increase to the margin for a sub-benchmark size.

4.6. In addition, the Authority could place a £250m bond with £150m drawn now and an additional £100m to be drawn at an unspecified future point (a deferred bond). It would be possible to cancel the future £100m without drawing it should the Authority not wish to proceed, but the unusual structure will add a premium to the margin achieved. If the Authority did decide to go ahead with the additional £100m, the price for this would depend on prevailing market conditions when it was drawn.

5. PRIVATE PLACEMENTS

5.1. There is also a market for what is called private placements, where the bond is issued directly to a single recipient or a small number of recipients at levels significantly below the public bond minimum size. This is usually facilitated by an advisor or institution who has a relationship with both the bond issuer and the parties seeking to buy bonds of that nature. Unlike the public bond route, investors do not require a public credit rating for entities such as the Authority, so this can be a form of financing for those local authorities who have chosen not to obtain a rating.

5.2. Officers have engaged with the marketplace for private placements and believe that there is liquidity and an appetite to lend to the Authority. There is also significant flexibility in the bond structure, which could be repayment at the end of the term, amortising, or even deferred start to lock in today's gilts rates for future expenditure. The downside is the margin pricing, which we estimate to be a margin of 140 – 160bps above gilts. Whilst this is more affordable than the current PWLB certainty rate, it is materially more expensive than a public bond. This higher margin reflects the other opportunities to lend that are available to investors in the private placement market.

6. OTHER FORMS OF LIQUIDITY

6.1. Should the Authority wish to defer entering into large scale borrowing in anticipation of obtaining certainty about the future of the PWLB, there several viable options. Due to COVID-19, robust counterparties (of which the Authority is one) are being sought after as a safe haven for investment.

7. CONCLUSIONS

7.1. Officers continue to be proactive in pressing government for support for the NLHPP and certainty over the PWLB. However, with government resources focussed on the COVID-19 response, officers recognise that further support is not guaranteed, and certainty may take time to materialise. In the meantime, officers remain committed to meeting the objectives of the NLHPP financing strategy:

7.1.1. To ensure that NLWA has sufficient cash and liquidity facilities available to enable it to discharge its financial obligations arising from the NLHPP when they become due;

7.1.2. To minimise the impact of the financing costs of the NLHPP on the levy arising to the seven constituent boroughs; and

7.1.3. To arrange financing in such a way as to give a high level of certainty about the cost of finance throughout the useful economic life of the assets created by the NLHPP.

7.2. Despite the lack of certainty from government, the Authority's advantageous position as a UK public sector entity means that it has several avenues available to it for finance raising that are all at prices that are very low, historically. These have been described above and can be summarised as follows:

Table 1 – Comparison of current financing options

	PWLB	Municipal Public Bond	Municipal Private Placement
Complexity	Simple	Complex	Moderate
Timescale to implement	2 days	~3 months	~2 months
Credit rating required	No	Yes	Not usually
Estimated margin over gilts	180bps	105-115bps	140-160bps
30-year all-in rate (gilts as at 6 October 2020)	2.49%	1.74%-1.84%	2.09%-2.29%

7.3. Officers believe that two possible courses of action are viable for meeting the March 2021 financing requirement as follows:

7.3.1. Secure short-term liquidity (3-6 months) in order to allow time for further clarity on the PWLB or alternative forms of government support; or

7.3.2. Enter into the most value for money form of financing available at present, which is a municipal public bond of £150m, on the basis that benchmark size is achieved through co-issuance with other Authorities.

7.4. Officers believe that both options could be acceptable to the Authority but recognise that due to uncertainties on the impact of COVID, the future of PWLB and the availability (or not) of additional government support, a flexible approach is needed to enable officers and the Authority to react to changing circumstances. Whilst the municipal public bond option offers the most certainty and an attractive rate, changes that could occur before or during the process of obtaining a bond could reduce the attractiveness of the option. To manage this uncertainty, officers are progressing the following actions:

7.4.1. Continue current engagement with both government and the market to seek further clarity on any potential support, news on PWLB or alternative financing options. This will take place in October and November.

7.4.2. Produce a detailed plan that shows how the Authority would issue a municipal public bond if it were minded to do so, including obtaining a credit rating, appointing further advisors, producing the bond documentation and engaging with the market.

7.4.3. Conduct one-to-one meetings with all Directors of Finance of the constituent boroughs to obtain their viewpoint on the viability of the two options and the plan referenced at 7.4.2, with an additional group meeting on the issue. These meetings will take place in October and November.

7.4.4. Secure the option to short term liquidity funding to allow flexibility.

7.4.5. Present a recommended way forward to Members at the December Authority meeting, as agreed by officers, the Financial Advisor and DoFs.

8. EQUALITIES IMPLICATIONS

8.1. This report does not give rise to any issues as regards the Equality Act 2010

9. COMMENTS OF THE LEGAL ADVISER

9.1. The Legal Adviser has been consulted in the preparation of this report and comments have been incorporated.

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