Leeds CITY COUNCIL

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Report of Executive Commercial Solicitor

Report to Director of City Development

Date: 16th March 2017

Subject: Leeds Street Lighting PFI Share Sale and related matters

Are specific electoral Wards affected? If relevant, name(s) of Ward(s):	☐ Yes	☒ No
Are there implications for equality and diversity and cohesion and integration?	☐ Yes	☒ No
Is the decision eligible for Call-In?	☐ Yes	☒ No
Does the report contain confidential or exempt information? If relevant, Access to Information Procedure Rule number: Appendix number:	☐ Yes	☒ No

Summary of main issues

1. The Council entered into a PFI contract with Tay Valley Lighting (Leeds) Limited (**TVL**) in March 2006 for the provision and maintenance of street lighting and illuminated traffic signage in Leeds. TVL has sub-contracted the majority of its obligations to Scottish and Southern Electric Contracting Limited (**SSEC**).

2. The Council has been approached by the owners of TVL, Scottish and Southern Energy plc and Royal Bank Leasing Limited (together **SSE**), regarding their publicly stated objective of divesting themselves of their shares in the service provider.

3. SSE has set a tight timetable in this regard, which assumes the sale is completed by end-March 2017.

4. The Council's street lighting PFI is the subject of a peculiar structure more particularly described in this report. Therefore, in order to facilitate the proposed share sale, it is anticipated that a restructuring of the project, with various contractual amendments and a novation of the funders direct agreement, needs to take place and this requires the Council's approval.

5. In addition:

5.1. the contract is based around 7 Performance Standards, and TVL's entitlement to payment may be adjusted (reduced) on a monthly basis by the levying of deductions if these Performance Standards are not met. If no deductions are made, the Council pays TVL a monthly unitary charge of c£1.1m. A number of performance issues have arisen over recent years (as set out in more detail below, and together being the **Disputes**), which the parties have agreed give rise to a right for the Council to make deductions; and

5.2. the parties have agreed various amendments to the contract with a view to make the service more effective and efficient, and improve value for money for the Council.

6. Following detailed discussions with TVL and SSE, relevant contract amendments have been agreed to deal with the matters referred to in paragraphs 4 and 5, and to faciltate the related SSE share sale. A related settlement agreement has also been agreed pursuant to which TVL has agreed to pay the Council a lump sum amount of £2.78m in respect of the contract amendments and Disputes.
7. The parties have also agreed that the Council shall retain £250,000 from TVL as an incentive on TVL to undertake the completion of various rectification works, elements of this sum being release only on completion of work milestones.The Council is satisfied that the settlement of the Disputes (in the sum of c£900,000) reflects the Council's contractual entitlements, and avoids the costs and vagaries of litigation, and will free up officer resource, and that the £250,000 retention will provide an effective additional incentive to complete outstanding works. Consequently, this agreement is overall in Council's and the public's interests.In terms of the contractual amendments, there are essentially two types of amendment – a) those to facilitate the SSE share sale, and b) those intended to make the service more effective/efficient. Regarding amendments relating to paragraph 9a), the Council is satisfied that these amendments do not result in a change to the risk profile of the project and the Council is not materially disadvantaged by the amendments. Regarding amendments relating to paragraph 9b), again these do not change the risk profile of the project and will lead to an improved and better value service provision, based on experience over the preceding 11 years of the contract. In addition, these amendments result in £1.9m of operational savings to the Council. Finally, the novation of the funders direct agreement, does not result in a change to the risk profile of the project and the Council is not materially disadvantaged by it.

Recommendations

11. The Director of City Development is recommended to:

11.1. note the contents of this report;

11.2. agree to the terms of settlement of the Disputes; and

11.3. agree to the terms of the various contract variations and novation referred to in this report (and any other ancillary document).

1 Purpose of this report

1.1 The purpose of this report is to recommend that the Director of City Development agrees to the settlement of the Disputes and the various contract amendments outlined in this report.

1.2 The Director is advised that, in agreeing to the settlement referred to at paragraph 1.1, the Council will release its claims against TVL subject to TVL carrying out various rectification works.

1.3 Further, the Director is advised that, in accordance with the Government's agenda to make savings in operational PFIs, the contract amendments that the parties have agreed will realise a lump-sum saving of c1.9m.

2 Background information

2.1 The Council entered into a PFI contract with Tay Valley Lighting (Leeds) Limited (**TVL**) in March 2006 for provision and maintenance of street lighting and illuminated traffic signage in Leeds. TVL is owned 50:50 by Scottish and Southern Energy plc and Royal Bank Leasing Limited (together referred to as **SSE**). TVL has sub-contracted most obligations to Scottish and Southern Electric Contracting Limited (**SSEC**), a subsidiary of SSE. The project is now in the 11th year of its 25 year term, and over 80% of the street lighting and illuminated traffic signage in Leeds has been replaced. The contract is based around 7 Performance Standards, and TVL's entitlement to payment may be adjusted (reduced) on a monthly basis if these performance standards are not met by the levying of deductions. If no deductions are made, the Council pays TVL a monthly unitary charge of c.£1.1m.

2.2 The Council has been approached by SSE regarding their publicly stated objective of divesting themselves of their shares in TVL. SSE has set a tight timetable in this regard, which assumes the sale is completed by end-March 2017.

2.3 Ordinarily, at this stage of an operational PFI, a share sale would have little impact on the wider PFI and the Council would have little say in whether such a share sale may be made as its approval rights are very limited. However, the Council's street lighting PFI is the subject of a peculiar structure:

- unlike normal PFI SPVs, TVL are 100% debt funded by RBS, with only £1 of equity invested by each of the shareholders;
- the loan agreement prevents any distribution of dividends to shareholders;
- the sub-contract is not drafted on a wholly arms-length basis given the intra-group relationship. In particular, other than debt and secretariat payments, all TVL income flows through to SSEC (the **Management Fee**). Further, SSEC is obliged to ensure that TVL has sufficient cashflows to meet its liabilities to repay the debt to the funders, and this obligation is supported by a guarantee from SSE

plc (the **Make-whole Guarantee**). Further still, SSEC does not enjoy the benefit of appropriate liability caps on its exposure under its sub-contract.

2.4 It would appear that the SSE shares may be unsellable without structural amendments to the relationships of the parties – for example, SSEC would not wish to be on the hook via the sub-contract for the liabilities of TVL if it its parent company is not a shareholder and will want appropriate liability caps in place; and any new shareholder currently has no right to dividend returns as these all flow down to SSEC.

2.5 Consequently, in order to facilitate the SSE share sale, the Service Provider is requesting appropriate amendments to the contractual documents and loan agreement to put the project on terms that would allow for a more standard PFI structure. The amendments in this regard are relatively limited.

2.6 However, as they necessitate amendments to the PFI contract and sub-contract, such changes require the Council's consent.

2.7 Over recent years, a number of performance issues have arisen which have remained unresolved (the **Disputes**). The parties agree that these performance issues have given rise to rights for the Council to make deductions in the sum of c£900,000.

3 Main issues

3.1 Council officers and representatives of TVL have undertaken detailed negotiations regarding the various contract variations (including the potential benefits which may be realised from changes to the contract), and have systematically and forensically reviewed the various contract Disputes.

3.2 In terms of the contractual amendments, there are essentially two types of amendment – a) those to facilitate the SSE share sale (the **Share Sale Variations**), and b) those intended to make the service more effective/efficient (the **Operational Variations**). Agreement of each category of variations is conditional upon agreement of the other. In addition, the Council is required to novate the existing funders direct agreement to the new funders.

Share Sale Variations

3.3 The Council is not materially disadvantaged by these Share Sale Variations and they do not result in any material change to the contract risk profile agreed at financial close and preserve the Council's position on termination liabilities. The Share Sale Variations include placing the sub-contract on wholly arms-length terms, including removing the Management Fee concept, removing the Make-whole Guarantee and introducing sub-contractor liability caps in order to reflect a more standard project finance structure for a PFI project.

3.4 The new purchaser of 100% of the shares in TVL is an entity called Dutch Infrastructure Finance (**DIF**). DIF is an independent fund management company with c.€ 3.5 billion of funds raised. Through five investment funds, DIF invests in high-quality infrastructure assets that generate long-term, stable cash-flows, such as PFI projects and other core infrastructure projects in Europe, North America and Australia. Consequently, DIF has significant experience of operating PFI contracts and owns shares in the Council's Swarcliffe Housing PFI contractor.

3.5 As part of the Share Sale Variations, new funding arrangements will be put in place to reflect a more standard PFI structure with 10% of the project funding being replaced by equity investment by DIF.

3.6 The involvement of an additional party in DIF (compared to the current arrangements that are entirely internal to the SSE group) and the likelihood that the removal of the Make-whole Guarantee will trigger greater interest in the funders to protect their investment may make future variations and management of the contract more complex in practice. However, the normal contract change processes will still apply, and there are no changes to the contract in this regard.

3.7 In addition, it is a requirement that the Council provides Local Government Contracts Act certificates (**LGCA certificates**) confirming that the Council has the power to enter into the contract Share Sale Variations. The Council considers that it has the necessary powers to enter into the new contractual arrangements and to issue the LGCA certificates. Consequently, it is considered that there is minimal risk of a successful challenge to the Council's decision.

3.8 SSE has also offered an "incentive payment" as consideration for the Council's timely agreement to the Share Sale Variations.

Operational Variations

3.9 The various Operational Variations allow for the more effective and efficient operation of the contract, and are based on understanding developed and lessons learned over 11 years of contract operations to provide value for money and to obtain the benefit of provisions now common in newer PFI contracts. This includes:

- insertion of drafting allowing the Council the right to require a refinancing;
- insertion of drafting requiring TVL to provide to the Council the information it shares with its funders;
- limiting the application of PS7 deductions to reporting failures discovered by the Council in order to incentivise TVL to continually review and give notice of previous reporting failures;
- photometric testing and, where necessary, existing lanterns to be replaced with LED lanterns to meet the Output Specification requirements and parties to share the resulting energy savings;
- various change notices, including schemes for installation of LED lanterns.

3.9 A sum of £250,000 is to be paid to the Council by TVL and retained by the Council to incentivise satisfactory completion of the rectification works identified below. Each element of the rectification works is supported by an agreed programme. Retentions specific to each element of rectification works will be released to TVL following completion of simple milestones. Rectification works relate to: rectification traffic signs to the relevant standards where such apparatus had been historically de-accrued; instalment/replacement of apparatus which had historically had bracket arms removed by TVL when they were designed to have bracket arms; install bracket arms to apparatus which had historically been knocked down and replaced without bracket arms when they were designed to have bracket arms; completion of painting of appropriate apparatus within conservation areas; completion of re-numbering of apparatus; completion of private cable network certification and labelling; and rectifying tunnel lighting points failures.

3.10 The Disputes relate to the following:

3.10.3 Emergency Fault at Boar Lane;

3.10.4 Lights In Light at Woodhouse Tunnel;

3.10.5 Faults at Middleton Grove, Beeston;

3.10.6 Faults and updates to the management information system regarding York Place;

3.10.7 Faults and Updates to the management information system regarding Otley Road, Headingley;

3.10.8 Emergency Fault at Great George Street;

3.10.9 Emergency Fault at Back Lane, Allerton Bywater;

3.10.10 Temporary deemed to comply apparatus;

3.10.11 PS7 adjustments for reporting failures;

3.10.12 Bulk lamp change and clean issues;

3.10.13 Accruals/de-accruals reconciliation;

3.10.14 Energy/electricity consumption;

3.10.15 Compensation for the costs of the Council’s monitoring team;

3.10.16 Removing additional, unused lighting units which may be installed at the Council’s option from the contract; and

3.10.17 Non-reporting of the Revenue Sharing Equity IRR.

3.11 The settlement only applies to the Disputes and as such if any further past issues come to light of which the Council was not aware, the Council has reserved its position and would be entitled to raise further claims/take further action.

3.12 A settlement agreement has been drafted which provides for settlement and release of the Disputes in return for appropriate compensation, and consideration/savings in respect of the Share Sale Variations and Operational Variations. A deed of variation has also been drafted which provides for the various Share Sale Variations and Operational Variations.

4 Corporate Considerations

4.1 Consultation and Engagement

4.1.1 City Development/Highways and Transportation officers, the Executive Commercial Solicitor PPPU, and the street lighting PFI project board have been involved in and consulted in respect of this matter. In addition, the Executive Member for Regeneration, Transport and Planning has been consulted. Throughout the process, external legal advice and support has been sought from DLA Piper LLP and financial advice has been sought from EY LLP. The Department for Transport has been informed of progress throughout and has confirmed that, on the basis that this share sale and the subsequent re-structuring does not materially alter the balance of risk between the authority and its private sector partner, they are content for the Council to proceed as proposed, and that there will be no change to the PFI revenue support.

4.2 Equality and Diversity / Cohesion and Integration

4.2.1 This was not considered as part of this decision process the subject matter of the decision and the related share sale transaction is not relevant to equality considerations. However, such issues were appropriately considered at the time of procuring the Project.

4.3 Council policies and City Priorities

4.3.1 This decision supports numerous Council values, and ambitions. Some examples being spending money wisely, being open honest and trusted, treating people fairly, having a strong economy, facilitating successful communities and being an efficient and enterprising organisation.

4.3.2 Robust management of contracts is a key objective of the Council's procurement strategy, and in this case has achieved the outcomes for the Council set out in this report.

4.4 Resources and value for money

4.4.1 The decision will agree changes to allow the contract to be operated more effectively and efficiently and settle the Disputes. It is considered that the agreed overall settlement sum of £2.78m is a significant lump-sum receipt for the Council at a time when Council budgets are stretched.

4.4.2 The parties have also agreed that the Council shall retain £250,000 from TVL as an incentive on TVL to undertake the completion of various works, elements of this sum being release only on completion of the works.

4.4.3 The position agreed avoids the costs and vagaries of litigation, and will free up officer resource, and the £250,000 retention will provide an effective additional incentive to complete outstanding works.

4.4.4 As the agreements reached have stemmed from the SSE share sale proposals, SSE have committed to pay the Council's advisor costs in respect of the variation and settlement.

4.4.5 As noted at paragraph 4.1, this decision will not change the PFI revenue support grant received from Government.

4.5 Legal Implications, Access to Information and Call In

4.5.1 Agreement to the recommendations of this report will result in contract variations and the settlement and release of the Disputes, and the receipt by the Council of £2.78m. The decision is consequently a key decision pursuant to Article 13.4 of Part 2 of the Council's constitution.

4.5.2 Key decisions taken by officers are eligible for call in. However, it is recommended that the Director should exempt this decision from call-in given the urgency of agreeing the variation and settlement by end-March. The timing of the share sale process and the related variation and settlement negotiations has been necessarily driven by SSE. Agreement in principle has only recently been reached by the parties, and therefore (given the need to publish and provide 28 days of the decision on list of forthcoming key decisions) a decision in this regard may not be made prior to 24th March 2017. Any further delay to putting such decision into effect (i.e. call-in) would put the achievement of SSE's share-sale by end-March 2017 in jeopardy. This would result in the Council not receiving the agreed £2.78m lump sum payment, potentially further protracted negotiations to agree the Dispute elements of the settlement (with additional cost and resource implications) and the lost opportunities to agree project efficiencies which are conditional upon agreeing the overall variations. This would be seriously prejudicial to the Council's and the public's interests.

4.5.3 The City Solicitor has been consulted on and has approved the terms of settlement insofar as such approval is required by the Officer Scheme of Delegation in the Constitution.

4.5.4 It is considered that the Council has the power to enter into the new contractual arrangements and to issue the LGCA certificates.

4.6 Risk Management

4.6.1 Advice has been sought from DLA Piper and EY regarding the impact of the variations which are required to facilitate the SSE share sale. It is considered that the Council is not materially disadvantaged by these changes and the variations do not result in changes to the contract risk profile agreed at financial close.

4.6.2 While managing future variations may prove to be more complex than it currently is (where the Council is only essentially dealing with SSE), adequate consideration is being provided as part of the settlement to mitigate the potential additional resource/cost of dealing with more parties. In addition, the normal contract change processes will still apply, and there are no changes to the contract in this regard.

4.6.3 The various other variations allow for the more effective and efficient operation of the contract, and are based on understanding developed and lessons learned over 11 years of contract operations to provide value for money.

4.6.4 In terms of the Disputes, the Council considers that the position reached in settlement reflects Council's entitlements under the contract. Settlement now allows the parties to constructively move forward with the operation of the contract (allocating resources accordingly, and avoid wasting further costs on the Disputes), and to avoid the vagaries of a dispute resolution process.

5 Conclusions

5.1 Following a long and intensive period of review of the Share Sale Variations, the Operational Variations and the Disputes, the opportunity for a reasonable settlement which will provide contract efficiencies and significant financial benefit to the Council is available, while at the same time facilitating the SSE share sale. This will enable the Council, TVL and SSEC to move on in partnership over the remainder of the operational period of the contract, providing a valuable service to the residents of Leeds and the opportunity for the Council and TVL to work together to consider how continued efficiencies, savings and environmental benefits may be achieved and to deliver a better value service (which savings accord with the Government's operational PFI savings agenda).

6 Recommendations

6.1 The Director of City Development is recommended to:

6.1.1 note the contents of this report;

6.1.2 agree to the terms of settlement of the Disputes; and

6.1.3 agree to the terms of the various contract variations and novation referred to in this report (and any other ancillary document).

7 Background documents[1]

7.1 None.

[1] The background documents listed in this section are available to download from the Council's website, unless they contain confidential or exempt information. The list of background documents does not include published works.