ThamesWey

January 2022

Woking Town Centre Infrastructure Strategic Plan – Approval of Heat Networks Investment Project (HNIP) Funding Offer

1. Purpose of this Report

1.1 This report seeks the Board's approval for acceptance of the offer of financial investment by Government in TEL's infrastructure growth and investment strategy for Woking town centre.

1.2 This report sets out the basis of the Department of Business, Energy and Industrial strategy (BEIS) offer to TEL following a bid for financial support through its Heat Networks Investment Project (HNIP) scheme. The report summarises the terms and conditions of a long-term interest-free loan facility offered to TEL, and the financial implications associated with it.

1.3 Board approval is required prior to consideration of the proposal by WBC Executive on 3 February.

2. Background

2.1 TEL's adopted Business Plan (2020 – 2023) recognised the opportunities for growth through new development in the town centre (including new housing sites south of the railway unlocked by the widening of Victoria railway arch). This ambition coupled with ThamesWey's decarbonisation plan to deliver against the Council's 2030 net zero carbon target, requires significant investment in new generation and distribution infrastructure.

2.2 The Business Plan set out the intention to seek funding to support investment in the new infrastructure required to meet these twin objectives through the Government's HNIP scheme.

2.3 In June last year the Board endorsed the application to HNIP for £7.0m funding support, and following a 3 month application process, a bid was submitted comprising a blend of £2.3m capital grant and £4.7m low interest loan. This funding would be core to a ten-year strategic infrastructure plan including:

- Extension of the new Poole Road network comprising an additional 1.6km of new heat and chilled water pipes
- Contribution to the costs for retrofitting existing customers' buildings to operate on lower temperature/lower carbon systems
- Installation of industrial heat pumps at Poole Road to complement (and ultimately replace) gas-fired plant and associated additional thermal storage
- Extension to energy data networks and new system controls

3. HNIP Funding Offer

3.1 The Government team assessing the HNIP bids concluded TEL's application and investment proposal was robust and has made a formal offer to TEL for funding support. However, TEL's status as an established district heat operator with a strong pipeline of future growth opportunities has persuaded HNIP that this support should be entirely in the form of project loan, and not grant. This offer comprises a £9.42m loan which is calculated to meet TEL's target IRR based on HNIP's funding formula.

3.2 The Board should note that whilst the original application to HNIP sought financial support in the form of grant funding, the decision by HNIP to offer loan support only, in place of a grant, has provided TEL with greater flexibility in planning the delivery of the infrastructure. In particular, the award of grant funding would have severely challenged TEL's ability to achieve the speed of construction-spend required by HNIP which was equivalent to over £2.0m of work committed by end of March 2022. Given the delay in commencing the 'HIF' funded Victoria Arch replacement scheme critical to TEL's plans, there was a risk that work would not have been able to commence within the required timescale to draw down the grant.

3.3 The delay to the Victoria Arch scheme (and the development that will be unlocked by it) has required TEL to re-negotiate the phasing of its plans with HNIP. Detailed negotiations have taken place with HNIP's financial advisors on the structure of the loan offer with the objective of ensuring its terms are sufficiently attractive to provide a viable proposition in the context of new development coming forward later than planned as a result of delays to the replacement of Victoria Arch. In addition to the core terms of the loan, a number of concessions have been agreed that together enable TEL to meet the principal requirements of its ten year investment plan.

4. Overview of the HNIP offer

4.1 The key components of the loan offer are:

- A £9.42m unsecured loan facility to be drawn down by 31 March 2022 and held by TEL to be used for 'eligible costs' only (i.e. the costs associated with design, construction and commissioning of the infrastructure defined in TEL's application and summarised in 2.3 above)
- Loan interest is to be charged at 0.01% fixed rate from the date of drawdown for the entire loan period
- The repayment of the loan will not commence until a longstop date up to 7 years after drawdown to coincide with anticipated revenue from sale of heat to new customers. Prior to commencing repayment of the loan, there will be an interest-only charge (equivalent to £1,000 per year)
- Annuity Repayment of the loan will be over 25 years commencing from the 7 year longstop date.

4.2 The original application to HNIP required a £5.3m shareholder loan by WBC as TEL was required to make a 'contribution' towards the scheme as a condition of Government investment. As a result of the improved terms sought from HNIP, the shareholder loan now comprises £4.6m, including a loan of £3.6M and cashflow to service the loan of £1M. . Drawdown of shareholder loan to support TEL's contribution will not be required until 2026. Table 1 below summarises the scheme and timescale. The capex and developers' contributions recorded in the table are stated at current values. However, the calculation of the shareholder loan includes 2% annual inflation due to the loan being deferred until initial drawdown in 2026.

The structure of funding and corresponding spend periods is set out in the table below.

	£Ms	**Spend Period**
Total Capex	£ 19.2	2022 – 2030
Capex Funded by:		
BEIS 'HNIP' Loan	£ 9.4	2022 - 2054
Developers' Contributions	£ 6.9	2025 - 2028
WBC Loan for Capex	£ 3.6	2026 – 2038
WBC Loan Cashflow	£ 1.0	2026 - 2032
TOTAL Funding	£ 20.9	

4.3 The net benefit of drawing the loan from HNIP (as opposed to the equivalent capex provided by loan from WBC) is a saving of £5M over the 32 year period because the HNIP loan is effectively interest free.

5. Terms and conditions of the HNIP loan offer

5.1 The loan offer is subject to an agreement between BEIS and TEL defining the terms and conditions. The application to HNIP was based on a long term (10 year) investment strategy for Woking's energy infrastructure based on meeting the triple objectives of supporting growth in development; transitioning to lower carbon/non-fossil gas dependent energy systems; and improving energy security and resilience in the town centre. Inevitably there is risk and uncertainty associated with a strategy for this period of time as it is dependent on an assumed rate and volume of new development coming forward, the timing, size and location of which is not certain.

5.2 HNIP has set out a framework for management of the risk associated with this long-term project by defining a number of Conditions Precedent (CPs). The CPs define obligations to be met prior to the initial drawdown of the loan and/or prior to spend of the loan on each construction phase. CPs include securing rights and consents for installation of new infrastructure, demonstrating good practice in procurement, progress towards achieving anticipated levels of carbon savings and ensuring adequate project cash flow throughout the project period. CPs prior to committing phased expenditure will be discharged over the ten-year period through appraisal of individual network connections as development proposals come forward and techno-environmental assessment of lower carbon generating equipment to be installed.

5.3 If progress in network expansion is delayed or major elements are not taken forward (such as the replacement of Victoria Arch), there is provision for the loan to be repaid early without shareholder investment or penalty. Furthermore, conditions restricting the work that can be funded by the loan mean that it cannot simply be diverted or re-purposed for other uses that do not meet the same objectives of growth, resilience and decarbonisation.

6. Financial Review

6.1 Developer contributions will be paid to TEL at the point of contractual agreement to connect to the network and signed at the same time as the supply agreement. The basis of developer contributions is assumed at £1,250/ £2,000 per residential unit depending on Heat only / Heat & Cooling (pre-inflation).

6.2 WBC loan assumptions are in line with the Poole Road regeneration rate of 1%, plus PWLB, less certainty on a 12-year annuity basis. The modelled PWLB loan rate is 2.18% (current PWLB rate), plus 0.5% expected increase in the PWLB between 2022 and 2026. The shareholder loan is expected to be granted to TEL in 2026 and will be repaid by 2038. The peak debt is capped at the total loan amount of £4.6M.

6.3 TEL investments require a minimum IRR of 4.5%, the HNIP funded scheme delivers 6.7%, which is 2.2% above the minimum level. The IRR is significantly higher than the minimum level due to the inflationary risk associated with future development investment.

6.4 Sensitivity analysis has been carried out on the potential impact of inflation on development costs. The HNIP model requires base rate costs, however if development costs were to increase to 5% the impact would be the development costs would increase from £19.2M to £20.6M. Under the same inflation assumption, developer contributions would be increased from the current levels of £1,250/ £2,000 per residential unit depending on Heat only / Heat & Cooling to an equivalent inflated contribution. The opportunity to retain interest on the HNIP loan of £9.42M will be available for the period of holding the funds, this opportunity will also offset the risk of inflation. The potential impact on the resulting shareholder loan would be to increase the level of loan required to £5.7M.

6.5 It's important to understand the impact of recent sharp increases in natural gas prices is not considered a significant risk to viability of the project. The HNIP funding covers an investment period extending over more than one economic cycle, during which time the inflationary pressure on fuels is not expected to continue at levels experienced in recent months. Furthermore, the HNIP investment in lower carbon-intensity fuels will help TEL migrate its business model away from a heavy reliance on natural gas towards a more diverse fuel mix, ultimately replacing dependence on fossil carbon fuels.

7. Recommendation

The Board is requested to:

i) agree in principle the acceptance of the offer of a £9.4m loan to TEL by BEIS through the Government's HNIP scheme for the purposes set out in this report; and,

ii) subject to approval by Woking Brough Council of a shareholder loan of £4.6m (to be drawn down in 2026), authorise the completion of the loan agreement with BEIS.

REPORT ENDS