

## REPORT

To: Shetland Charitable Trust

24 June 2010

From: Financial Controller

Report: CT1006054

### **Viking Energy – Progress Report**

#### **1. Introduction**

- 1.1 The purpose of this report is to provide Trustees with an update on the Viking Energy wind farm project.
- 1.2 There has been a series of reports and updates to the Trustees since the Trustees took the decision to participate in the project in September 2007. I have included a diary of them as appendix A. This report continues that approach, and focuses on financial and administrative issues. Of course, there are other aspects to the project and these will be discussed on other days.

#### **2. Background**

- 2.1 Trustees have committed up to £3 million to fund a thorough evaluation of the project to the stage where further decisions will be needed on whether to build the wind farm or not (min ref CT/52/07). The shareholders in Shetland Aerogenerators Limited, which operates the Burradale wind farm have committed up to £0.333 million and together with the Trust own Viking Energy Limited, the Shetland part of a 50:50 partnership with Scottish and Southern Energy plc, SSE, which is taking the project forward. This means that SSE's financial commitment matches that of Viking Energy Limited, i.e. up to £3.333 million.
- 2.2 A key part of the evaluation of the project is the process of achieving consent from the Scottish Government. The developer in its application for consent must demonstrate to the Scottish Government that the project is technically and financially sound and that any environmental consequences are mitigated and are at an acceptable level.
- 2.3 Viking Energy submitted its application for consent a year ago (20 May 2009). Following various comments and objections from statutory consultees, non-statutory consultees and individuals and groups from the Shetland community, it has been agreed that Viking Energy will submit an addendum to its consent application that is intended to address the comments and objections in the expectation

that some of them can then be withdrawn. In the interest of balance, it is fair to say that the project has supporters as well as objectors.

- 2.4 The addendum is almost complete and, as it will contain the outcome of many compromises, it will undoubtedly feature less turbine sites than the original application. The reduction in turbine numbers must be achieved against a continuing need for Shetland to achieve a critical mass of electricity generation to economically underpin the required connection with the UK's national electricity grid. However, in this report all my figures quoted will flow from the unmodified consent application, and these figures are all in the public domain at present. They are based on 150 turbine sites giving 540 MW of capacity and a capital cost in the region of £800 million. I expect all of these numbers to decrease somewhat with the addendum, but with that warning, they are still useful at this stage.

### **3. The Viking Energy Partnership, VEP**

- 3.1 When the Trust bought out the Shetland Islands Council's interest in the project in September 2007, VEP was already in being. However, a partnership is a good way of constituting this 'joint venture' as the Trust and SSE are exposed to very different tax regimes and a partnership allows separate tax dealings for each partner. VEP is a Scottish Legal Partnership between Viking Energy Limited, VEL, and a subsidiary of SSE. It is governed by a partnership agreement, which deals with the administration, as one might expect. The main points are that all decisions require agreement through a partnership board which has three members from each partner. Each partner only has one vote and each partner takes it in turns to nominate a Chair year by year. As the Chair does not have a casting vote, decisions have to be made with the agreement of both partners. The VEL nominees to the VEP Board are the three Directors of VEL, Bill Manson, Alastair Cooper and Caroline Miller.
- 3.2 One of the decisions of the VEP Board is that my staff and I, here at the Trust, provide accountancy services for VEP, and this has also been useful to me in monitoring Trustees' investment to date. The origins of the Viking Energy Project were two separate projects being brought together, one by Shetland Islands Council (with the Trust buying that interest part way through), and one by SSE. Project costs have been incurred over several years (going back to 2003) by various past and present participants. The partners have agreed that VEP should bear all external costs. These are, principally, the array of third party work needed for the Environmental Impact Assessment, EIA, and other assessments that formed part of the Application for Consent and its Addendum. The partners themselves meet the internal costs (staff, premises, business support). There has been a great deal of work done over the last year to get all the various costs agreed by the partners and recorded in the accounts of the correct entity. I am pleased to say that this work is completed for VEP.
- 3.3 VEP has a year end of 31 March, and the draft accounts as at 31 March 2010, include all the relevant past costs originally paid by VEL, Shetland Islands Council and various companies owned by

SSE, and all have been agreed by the partners. At 31 March 2010 the total VEP expenditure is £2.8 million, financed 50% by VEL and 50% by SSE.

- 3.4 VEP has been fully operational in its own right for six months or so. This means that ongoing cost are met by VEP, which is in turn financed by monthly cash calls on the partners.

#### **4. Viking Energy Limited, VEL**

- 4.1 Shetland Charitable Trust agreed to buy the Council's 90% interest in Viking Energy Limited in September 2007. The other 10% of the company is owned by the shareholders of Shetland Aerogenerators. The shareholders provide finance by buying shares and the current position is that the Trust has bought 2,250,000 £1 shares and the minority shareholders have bought 250,000 £1 shares. The minority shareholders are automatically offered one tenth of any new shares, so their proportion remains the same as long as they produce cash to buy the shares. The minority shareholders cannot sell their VEL shares without the agreement of the Trust.
- 4.2 Trustees nominated three Directors, who are Bill Manson, Alastair Cooper and Caroline Miller. The Company Secretary is David Thomson, one of the minority shareholders, and this formally ensures that they are kept informed.
- 4.3 As explained above, VEP bears third party or external costs, with the partners meeting staff and other internal costs such as office rentals, travel costs, IT support etc. At present, four Shetland based people work full time on the project and their costs are met by VEL. As part of the exercise to get all the past project costs (back to 2003) accounted for and borne by the correct body, project costs that are internal costs, and so not attributable to VEP, are in VEL as at 31 March 2010. These amount to £1.1 million, over the seven years.
- 4.4 VEL has been functioning effectively as a financial entity for eighteen months or so, and this means we have completed the move to the model where VEL (and VEP) are active and costs are met directly from where they are borne.
- 4.5 It is proposed in a separate report on today's agenda that the remaining up to £750,000 of the Trust's £3 million investment budget be released to VEL as it is needed. I am not expecting any further request for funding for the evaluation stage, unless the consent application is referred to a public inquiry, provided a determination is made before 31 March 2011.

#### **5. Project Finance**

- 5.1 If consent is gained and the project goes ahead a series of contracts will need to be negotiated in detail and put in place covering procurement, construction, finance, and future operation and maintenance arrangements. It is not possible to have detailed negotiation on finance at this stage, as the overall costs will depend on key factors that are still subject to considerable movement, including the number of turbines. This last variable will be fixed if

consent is gained and that will trigger the setting of various other key numbers.

- 5.2 It is though possible to have useful and meaningful contact with sources of finance at this stage. I have discussed the project with the Lloyds Banking Group, Royal Bank of Scotland, BNP Paribas Fortis, Barclays and the European Investment Bank, EIB, the last one indirectly through SSE. Although the numbers are not fixed, it helps me to visualise what is possible by simply using £800 million as the total cost. This number comes from the consent application and is likely to be too high, but with that warning, I propose to continue using it in this section of the report.
- 5.3 The first message from the banks is that the project can be financed and that they all want to be seen as a provider of finance to this sort of project. The fact that SSE, a FTSE 100 listed energy company is a partner, has helped my discussions tremendously. We know that Shetland has world class wind, and Burradale has proved it over the past ten years. One of the Burradale turbines, named Betsy, is believed to be the most productive commercial turbine in the world. So the existence of Burradale helps my discussions as well.
- 5.4 What have I learnt? The bulk of the project cost can be met by finance attached to the project itself. Two of the banks have showed me outlines where 77% of the £800 million is raised by project finance. Project finance is contained within the Partnership and needs no security or guarantee from the partners. For this type of project the project finance picks up any overrun costs, this is known as 'non re-course' finance. For this discussion I am going to round the 77% up to 80%. Please remember that the £800 million figure will change and anything in this section of the report is my thinking at present rather than a settled proposal. Using £800 million as the starting point, means project finance of £640 million.
- 5.5 Discussing the details of borrowing £640 million is some way beyond my experience, and at this stage I have mostly left this to SSE. SSE have a good relationship with the European Investment Bank, EIB. SSE recently borrowed €400 million from the EIB for other wind farm projects. One possibility is the EIB lending a similar amount to VEP with the balance of the £640 million coming from a banking 'club' of say eight commercial banks including most of the four banks I have been speaking to directly. A very important point is that the banks do have money to lend, and they are under pressure to lend it, but to 'good' borrowers. The banks see renewables in general as something they want to lend to.
- 5.6 Most of my thoughts, have been about two issues. Where does the rest of the money come from and what happens to the Trust financially in the period between beginning to invest and first receiving returns?
- 5.7 Starting with £800 million (with my various warnings about that figure) and raising £640 million as project finance, leaves £160 million still needed. There are a number of possibilities here, but let us say for today that each partner needs to put in £80 million, and the minority shareholders of VEL put in £8 million, or 10%. The Trust then needs to provide £72 million. The Trust might consider selling

some of its shares to raise some finance as I believe they will be worth considerably more than the £1 paid for each, if consent is achieved. Selling shares means the Trust is giving up part of the profits, but this might be reasonable if the purchaser(s) was part of the Shetland Community in some way.

- 5.8 However, I have been thinking about how the Trust might raise £72 million without selling VEL shares. The Trust is large enough at over £200 million to simply use its own cash to invest. This means selling other investments, mainly or wholly stock market shares, to do so. The Trust is also large enough, and with a strong enough balance sheet to borrow some or perhaps all of the £72 million. Two of the four banks I have spoken to have indicated that they would consider lending half of what is required, so £36 million in our example, secured only on the basis of the future income coming to the Trust from the Viking Energy project. This lending, of say £36 million, would require no further security from the Trust. All the banks are keen to discuss loans of, say £36 million, secured on the Trust's portfolio of Government Bonds.
- 5.9 Any form of borrowing has consequences, and there will be detailed negotiations over the interest rates, duration, the possibility of only paying interest for a few years and other issues. However, should the need arise to produce £72 million or something thereabouts I expect to be able to offer Trustees the choice of borrowing it all in some form, borrowing none of it and borrowing say half of it. At this stage the last option looks potentially the most attractive with the Trust borrowing £36 million secured perhaps on the project's income stream alone and providing £36 million as an investment out of its own reserves.
- 5.10 The other area I have been thinking about is what happens to the 'ordinary' finances of the Trust in the period between investment and first return of profit. This period could be as short as three years, but it will be longer than that before the Trust receives back as much cash as it has invested. The borrowing all the £72 million option, leaves the rest of the Trust financially untouched, other than perhaps using the Government Bonds held as security. The Trust could continue investing its £220 million or thereabouts and continue charitable spending at £11 million a year.
- 5.11 Putting in some of the Trust's own money, say £36 million, and continuing to spend at £11 million a year will require careful monitoring. The Trust's capital available to support annual expenditure will go down by £36 million plus the costs of meeting the shortfall between reduced income and expenditure of £11 million. The reserves are then rebuilt out of income from Viking Energy. I have modelled various possibilities, and the numbers show a manageable situation if I assume steady, average returns from the stock market. That assumption is not valid and I believe that Trustees will need to reduce exposure to volatile shares in some way. Perhaps a straightforward switch to Government Bonds, but there are more sophisticated ways to de-risk. At this stage I simply want Trustees to know that I have been thinking about this issue and discussing it with appropriate advisers and some of the fund managers.

## **6. Conclusion**

6.1 Trustees will be faced with a number of interesting decisions if the Viking Energy project achieves Consent from the Scottish Government. This report contains my thoughts at this stage on some of the financial aspects that may be in prospect.

## **7. Recommendation**

7.1 I recommend that Trustees note this progress report.

Reference: JPG/IS3

Report Number CT1006054

## APPENDIX A

<b>Date</b>	<b>What</b>	<b>Subject</b>	<b>Who</b>
24/06/2010	Update Report & Drawdown Report	Finance & Administration	Financial Controller
11/02/2010	Presentation	Finance	Richard Simon-Lewis Lloyds Banking Group
03/11/2009	Presentation and Update report	Construction experience	Morrison Construction And Ecological QS
17/09/2009	Presentation	Project Finance SSE Experience	Philip Soden, SSE
01/09/2009	Reception	General	Ian Marchant, SSE
06/08/2009	Seminar	General	Aaron Priest
02/07/2009	Seminar	General	Aaron Priest
18/03/2009 & 19/2/2009	Drawdown report	Finance	Financial Controller
08/12/2008	Presentation Presentation	Ecology/Peat Economics	David Thomson Stephen Kerr, Avayl
13/11/2008	Verbal Update	General	Financial Controller Aaron Priest
24/10/2008	Investment report	General	Financial Controller
11/09/2008	Presentation Presentation	General SSE position	David Thomson Simon Heyes, SSE
17/09/2007	Report	Up to £3m investment decision	Financial Controller
23/08/2007	Workshop	Finance	Brandon Rennet, SSE