

Taking stock and moving on

Simmons & Simmons Partner Richard Dyton and Augusta & Co. Senior Adviser John Edwards take stock of the waste management market and look at what the future holds

March 2011

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Introduction

On the 29 November 2010 WIDP issued the long-awaited final version of its Residual Waste Treatment Contract. The new contract brings much-needed clarity to the risk profile on municipal waste management projects. However, its relevance is diminished by Defra's unexpected decision in October, as part of the Comprehensive Spending Review, to withdraw PFI credits from seven of eighteen pipeline projects. Further, it is anticipated that credits will not be available for future waste projects.

As a result, the future focus for the UK waste industry looks set to shift from central government funded plants towards merchant plants and smaller-scale facilities offering a diverse range of technological solutions. Whilst the announcement has introduced considerable short term uncertainty, it can also be viewed as creating an opportunity for providers of smaller facilities who had previously been marginalised. Whether, as Defra anticipates, the UK will still be able to meet its 2020 obligations under the EU Landfill and Waste Framework Directives will depend on the availability of finance to non-PFI projects and on the amenability of the planning regime.

Local authorities' present position

On the 20 October 2010, Defra announced as part of the government's Comprehensive Spending Review that it would be cancelling the provisional allocation of PFI credits to the waste authorities of: Cheshire West and Chester, and Cheshire East; Coventry, Solihull and Warwickshire; Gloucestershire; Leicestershire; Milton Keynes and Northamptonshire; the North London Waste Authority; and the South London Waste Partnership. The decision was understandably met with some consternation among those affected, with Councillor Clyde Loakes, Chair of the North London Waste Authority, describing the announcement as 'bitterly disappointing and bizarre'.

Defra's rationale

Defra published its supporting analysis on the 6 December 2010, providing insight into the decision-making process that led to the cutting of those seven projects. The analysis begins with an assessment of the likely waste arisings and treatment capacity in 2020. A market forecast was generated to establish how many projects could have their funding withdrawn so as to ensure that the EU Landfill Directive target for 2020 of a reduction to 35% of the 1995 level of Biodegradable Municipal Waste (BMW) sent to landfill would still be met nationally. Deemed 'reasonable' assumptions made in calculating the forecast included: recycling rates in 2020 were to be 50% for

household waste and 60% for commercial and industrial waste, while 68% of residual waste would be biodegradable. Based on predictions for waste arisings of between 51.5m and 62.4m tonnes per annum, and allowing for ongoing landfill of waste within landfill allowances, this would create a requirement for residual treatment of between 5.6m and 8.8m tonnes.

On the other side of the equation, Defra attempted to predict capacity to treat that residual waste. Defra assessed and risk-adjusted the capacity offered by the 21 existing PFI as well as PPP projects, the eighteen PFI projects in procurement and made projections for future merchant plant capacity. Notably, Defra considered that the planning success rate ratio for PFI waste projects was 2:3 and that the procurement success rate was 6:7 – giving a combined success rate of only 57% and a programme risk factor of approximately 45%. The result of the capacity forecast was that the existing projects would provide 4.4m tonnes per annum of capacity, the eighteen projects under review could provide 1.2m tonnes per annum and merchant facilities would provide 2.0m tonnes per annum, giving a total forecast capacity of 7.6m tonnes per annum. Balancing the demand for residual waste treatment against future capacity, Defra concluded that seven projects could be sacrificed without jeopardising the achievement of the 2020 target.

Having decided that seven was the appropriate number to cut, Defra set about ranking its pipeline projects with the lowest-scoring to be axed. Three criteria were applied: deliverability (worth 50% of the marks); benefits delivered relative to funding (40%); and the timing of the benefits (10%). The relative deliverability of the project was further broken down into two evenly-weighted sub-criteria, namely how far through the procurement process it had progressed, and planning deliverability. The benefits delivered relative to funding were assessed by dividing the forecast tonnage of BMW diverted from landfill for 2020 by the notional PFI credit. A score for timing was produced on the basis of the number of months to operational commencement, with lower scores for shorter time periods.

Issues raised

The analysis raises a number of concerns. Whilst acknowledging that at present there is only one operational (and exclusively) merchant EFW plant in England (Lakeside), the forecast assumes that in less than ten years the merchant sector will grow from 200,000 tonnes per annum to 2.0m tonnes per annum capacity and a market share of nearly 28%. The suspicion is that this presents an overly optimistic picture. It is clear that in current market conditions, merchant plants are far more difficult to finance than an equivalent facility underpinned by credible long term waste supply contracts and merchant plants are subject to the same issues of gaining planning consent as public-sector projects. Critically in our view, in order to have any chance of providing the capacity required, waste providers (and in particular Local Authorities) need to be willing to underpin new plants with contracted waste streams. Without that, external finance will continue to be difficult to access.

The criteria for ranking the eighteen projects – drawn up in less than a fortnight – also leaves something to be desired. Projects in the early stages were presumably caught twice by both deliverability and timing criteria, and even a mature project like Cheshire was unduly penalised for its planning difficulties. The councils involved have already announced their intention to seek a judicial review of Defra's decision.

In conducting the Spending Review, the Coalition Government set as its objective the elimination of the structural deficit by 2015. Given that Defra has concluded that the cancellation of the seven projects will only yield savings of £3m per annum in 2014-2015 (from a budget of £2.3bn for 2010/11), rising to £26m per annum from 2017/2018 onwards,

the financial reasoning begins to look shaky. The logic becomes more questionable from the taxpayer's perspective when abortive procurement costs are factored in – the Cheshire project had incurred £4.5m in reaching preferred bidder stage.

Defra's review will do little to pay off the deficit in the medium term and in the long term will simply shift the financial burden away from central government and back onto the waste authorities in question, which will mean that council taxes need to rise. The flaw in Defra's reasoning is that while it looks at whether the EU targets for landfill diversion can still be met at the national level, it is individual waste disposal authorities which remain subject to landfill tax and LATS. There is therefore still a need for treatment of residual waste. For authorities like Milton Keynes and Northamptonshire, which has been forced to cancel its project, the outlook is uncertain.

The shape of things to come

The end of PFI funding for future waste projects is likely to introduce a greater degree of flexibility in local authority waste management procurement. Whilst large scale energy from waste incineration (EfW) and mechanical biological treatment (MBT) projects will still be built by the large integrated waste management companies and specialist providers, these facilities are likely to be focused on large urban waste streams, perhaps where source segregation is uneconomic or uncertain. The financing for such projects will by definition need to change. For a financing provider, there are a number of characteristics of such projects that make them attractive (long term waste supply contract, usually strong financial covenant of the waste operator, proven technology) and hence some such projects will undoubtedly be financed through traditional project finance and PPP schemes. One possible characteristic of new larger scale developments however is that facility ownership may rest with the waste contractor rather than reverting to the local authority (as it does under PFI) at the end of the contract term.

If Defra's predictions are taken at face value, it seems that private-sector driven capacity will need to fill the void left by the cancelled projects and will enjoy a significant expansion. To date, smaller waste management companies, unless included as a junior member of a larger consortium, have not been able to compete to provide alternative solutions for municipal waste streams. If local authorities are willing to think in more flexible ways, the demise of PFI could provide a significant opportunity for innovators in the sector. In addition, with fewer PFI projects to finance in the future and an improving outlook for debt and project finance, banks and other financial institutions are more likely to consider alternative projects to finance in the sector.

However if merchant plants of any significant scale are to be built they will require finance, and cautious financiers will require assurances that there are sufficient waste streams as inputs and may prefer to rely on tried and tested technologies. Providers who are able to draw on corporate (rather than external) finance will probably enjoy an advantage.

The financial sector currently requires a waste management contract to cover at least the tenor (or timescale) of the debt finance. In reality this does not mean that a waste provider needs to commit to a 25-30 year PFI type timescale as many commercial project finance facilities will be for a much shorter tenor than this. However, a commitment by local authorities to provide some of the municipal waste stream for an 8-10 year period to newer, smaller and more innovative waste management companies could provide enormous credibility and impetus to the sector. Such smaller scale facilities are generally more

acceptable to local residents for planning purposes and could provide significant additional benefit in more efficient recycling and energy generation.

Approximately two thirds of waste arising in the UK is commercial and industrial, rather than municipal. However whilst some companies are beginning to provide long term waste supply contracts to waste management companies (particularly where there is perceived additional perception benefit in demonstrating recycling credentials), only a very few such companies provide sufficient waste by themselves to underwrite the financial viability of a waste management facility. Local Authority support will therefore be key to encouraging the development of a strong independent sector. In order to capitalise on this opportunity however, Local Authorities in particular must be willing to be a little more open minded and innovative about waste management solutions that make sense in their local environment.

A number of business plans, dependent on the technology adopted, are predicated on the ability to derive income from off-take contracts, such as electricity and heat, and on the ability to attract Government incentives (such as ROCs, FITs and RHIs). The Government seems keen to ensure that incentives remain in place and are developed further; plans exist to bring Anaerobic Digestion within the Renewable Heat Incentive scheme which will make the technology more financially viable. Defra is also committed to publishing its waste review in April 2011, which is expected to look at "green" taxes and the future of Anaerobic Digestion and Energy from Waste. In the short term however, there is uncertainty regarding the application of such incentives which is adding to the financing difficulties in the sector. Grandfathering of ROCs for biomass has been addressed recently but led to a complete halt in investment on plants dependent on such support in late 2009 and 2010. Financiers are currently focused on the ROC banding review in 2013 which may adversely impact facilities dependent on such support but not accredited by that stage. As larger scale facilities may take 2 years or more to be constructed, this is a looming issue. It would be helpful if Government could provide better certainty on eligibility at financial close. Additionally the quantum of support for the RHI has been announced, but not the mechanism so it is difficult for financiers to take account of this in their assessment of business plans. Hence whilst all the noises being made about the sector by public bodies are positive, there remains an underlying level of uncertainty which needs to be addressed. Increased stability and predictability of incentives will make innovative development in the sector more attractive for external investment.

Also unhelpful, and casting a shadow over the industry, is the Government's attitude to planning, which could hardly be said to be creating a friendly climate for commercial development. As Defra's analysis highlighted, planning remains a key determinative factor to the success or failure of a waste project. Although the establishment of the Independent Planning Commission did not go far enough, as few projects were large enough to fall within its jurisdiction, it was certainly a step in the right direction in so far as it represented a centralised body for the consideration of planning issues in relation to major infrastructure projects. The proposed abolition of its role under the Localism Bill, which also aims to give local communities more say over planning and development issues, seems retrogressive.

NIMBYism remains a significant barrier to ensuring planning permission is obtained, especially in relation to Energy from Waste plants, which traditionally attract a great deal of opposition and emotive debate. By way of example, the Independent recently ran a story stating that George Osborne himself had added his signature to a petition against the proposed 600,000 tonnes per annum Energy from Waste facility at Lostock near his Tatton constituency. Expanding central control of planning decisions therefore seems to be the only effective way of dealing with this problem – but it would mark a considerable departure from the current trend of Government policy.

Alternatively, if the localism agenda is here for the long term, it may be possible to create a more favourable and dynamic planning regime through the use of community – based incentives. In addition to the proposed local application of the Community Infrastructure Levy, more creative solutions will be needed, such as council tax rebates for those living close to a facility, or flowing down the council's share of income from third party waste and offtake contracts directly into the hands of the public.

In conclusion, there is now money available for investment in the sector and a requirement to invest significantly to meet infrastructure needs. The private sector is good at assessing project operating and technical risk but has found it difficult also to manage feedstock supply and regulatory risk in a changing industry. A new approach and an understanding by public bodies of the current barriers to private sector investment can help to solve this.

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