

Committee: Cabinet

Date: 1 October 2008

Agenda item: 5

Wards: ALL

Subject: The next stage of procurement for Merton's waste treatment and disposal arrangements, as part of the South London Waste Partnership (Phase B)

Lead officer: Lyn Carpenter, Director of Environment & Regeneration and Caroline Holland, Director of Corporate Resources

Lead member: Councillor David Simpson, Cabinet Member for Environment and Councillor Samantha George, Cabinet Member for Corporate Services

Forward Plan reference number: 656

Contact officer: Cormac Stokes, Waste Services Manager

Reason for Urgency: The Chairman has approved the submission of this item as a matter of urgency as this is the last available Cabinet meeting at which details and progress can be reviewed with respect to this matter.

Recommendations:

- A. To note the progress with respect to the development of the Outline Business Case required for the application for PFI credits.
 - B. To note that the authority to submit applications for PFI funding with respect to waste treatment and disposal procurement has been delegated to the South London Waste Partnership Joint Committee.
 - C. To support, in principle, the drafting of a PFI outline business case for SLWP, to be submitted to DEFRA by October 31 2008.
 - D. That a report outlining the final outline business case be brought back to Cabinet on 10 November for approval.
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1 PURPOSE OF REPORT AND EXECUTIVE SUMMARY

- 1.1. This report details progress made with respect to exploring funding options for the next stage of the waste procurement and that, in principle support be given to the drafting of an outline business case by the SLWP, which is required for the submission of an application for PFI credits. The report also indicates that a further report providing a greater level of detail regarding the OBC and implications would be brought back to Cabinet at its next meeting on 10 November 2008.
- 1.2. This report aims to clarify the decision making process required to approve the submission of an application for PFI credits, having fully considered all funding options for securing appropriate waste treatment and disposal technology, which is a requirement of the application process.

- 1.3. This report provides further information on alternative procurement options to PFI, most notably using prudential borrowing as a means of financing the capital expenditure required to develop waste treatment infrastructure in South London.

2 DETAILS

- 2.1 Members will be aware that a two phase waste treatment and disposal procurement strategy was agreed by the SLWP shadow board in February 2007, on the basis that the procurement of the longer-term residual waste treatment solution would require significant capital expenditure and that PFI may be the appropriate route for this type of procurement. However, it was recognised that the process to secure PFI funding and to procure new facilities if this were considered the optimal route, would take longer than the time available to procure contracts to commence on 1 September 2008 when the current waste disposal contracts came to an end. The Phase A procurement has been completed with the final contract (Contract 3) awarded to Viridor on 22 July 2008. All three contracts making up Phase A are for a term of 14 years with an option for the partnership to break after seven years or to extend for a further five years. It has also been agreed that there will be an annual review of the inter authority agreement, previously reported to cabinet.

- 2.2 Phase B involves the delivery of new waste treatment facilities within the region to provide long-term compliance with the LATS requirements. Following previous discussions at the SLWP shadow board meeting of 1 February 2007, the PFI route has been investigated further, and an expression of interest (EoI) for PFI credits was submitted to DEFRA in March 2008, as reported to the 24 April 2008 meeting of the SLWP Joint Committee. The EoI does not commit the authority at this stage to progressing with a PFI-type procurement, but does provide an opportunity (which it is unlikely would be available at a later date), to follow that route if it proves to offer the best value for money solution.

2.3 Reference Project

- 2.3.1 As part of the Outline Business Case, the Partnership is required to submit details of a Reference Project that demonstrates that there is at least one possible solution that can meet the outputs required of the Partnership. These outputs primarily centre of the required diversion of biodegradable waste from landfill in order to ensure compliance with the Landfill Allowance Scheme. It is important to note that the partnership is not committing to procuring the particular technology detailed in the Reference Project. The Partnership will be requesting solutions from the private sector that will deliver the required levels of landfill diversion and will not be specifying any particular technology requirement in order to do this.
- 2.3.2 Over the past few months, officers have been working with external advisors in the development of the Reference Project. This has involved long listing potential options and evaluating them on the basis of agreed evaluation criteria. Following a short-listing process and further detailed evaluation, the Partnership has confirmed the Reference project required for the development of the outline business case. The following table provides details of the outcome of the short list options non-financial appraisal:

No.	Option	Weighted score	Ranking
1	Landfill	68	5
2	Mechanical Biological Treatment (aerobic biodrying) – Secondary recovered fuel (SRF) to EfW	127	1
3	Mechanical Biological Treatment (Anaerobic digestion) – SRF to EfW	126	2
4	MBT (Anaerobic digestion) – Compost like output to land restoration	102	4
5	Energy from Waste – with combined Heat and Power	116	3

Source: *Options Appraisal (short listing), Entec 2008*

2.3.3 Option 2 has therefore been chosen as the Reference Project for the OBC. With respect to suitable site availability to deliver this project, it has been agreed to model this option based on using all three Council-owned sites currently used for waste management purposes within the Partnership area. These include Garth Road, Villiers Road (Kingston) and Factory Lane (Croydon). The costs modelled assume the need for two MBT facilities feeding into a third facility where the SRF is used to create energy. This could potentially be a Combined Heat and Power plant.

2.3.4 Key issues for the Partnership are:

- how much this Reference Project will cost
- how does this compare with the “do minimum”? (This option assumes achieving national recycling targets but continuing to rely on landfill as the primary means of disposal).
- how to finance the project and which option delivers the best value for money for the Partnership

2.4 Cost of project

2.4.1 The following tables provide an indication at this stage of the likely capital and operational costs of this option over the life of the project (28 years including construction). They include details of costs that are likely to be incurred through other disposal contracts procured through Phase A, taking into account the continued need to treat dry recyclables, garden and kitchen waste and the transfer and transport of waste materials to the various facilities. Furthermore, assumptions of all costings take into account the expected additional collection costs required to achieve national recycling targets (50% by 2020) and the costs of developing and implementing an extensive waste reduction programme. Other projected contract costs are detailed in the following table:

	Reference Project £'000s	Do Minimum £'000s
- Non hazardous landfill gate fee	86,074	384,851
- Non-hazardous Landfill Tax	88,065	320,381
- LATS	7,688	52,814
- Joint Waste reduction / education campaigns	52,065	52,065
- Additional collection costs	74,810	74,810
- Total C3 treatment	21,315	21,315
- Direct landfill bulking/ transport costs	17,570	125,291
- Other Contract 1,2, and 3 costs	459,489	459,489
Total	807,076	1,491,017

- 2.4.2 It must be stressed that the figures are purely indicative at this stage and are likely to change over the next few weeks as the OBC is developed further. They are being provided to give members a feel for the scale of the project. These figures are based on nominal prices and totalled across the life of the contract.

	Reference Project £'000s	Do Minimum £'000s
Total Capex	189,421	-
Total Opex	407,760	-
Anticipated income*	-102,931	-
Other contract costs	807,076	1,491,017
Total	1,301,326	1,491,017

* The anticipated income is based solely on the revenue from the sale of electricity. A prudent approach has been taken and the potential income from Renewable Obligation Certificates has been excluded at this stage due to uncertainty.

- 2.4.3 The above figures do not take into account the potential for between £80million and £90million PFI credits in the form a Revenue Support Grant over the life of the project. The PFI credit is normally based on up to 50% of the senior debt required for the capital investment. The senior debt normally makes up for around 85% of the total capital expenditure.

- 2.5 How does this compare with the “Do Minimum”?

- 2.5.1 It would appear clear that the “Do Minimum” will be the highest cost option, particularly when taking into account the potential for PFI credits detailed above.
- 2.6 Which financing solution offers the best value for money
- 2.6.1 The primary alternative options to PFI include procuring waste treatment infrastructure on the basis of a public private partnership (PPP) or financing the investment through Prudential Borrowing (PB).
- 2.6.2 In most respects PPP procurement is identical to PFI but does not include the provision of PFI credits. With respect to Prudential Borrowing (PB), in this case an authority borrows capital, normally through the Public Works Loan Board, to finance investment. It should be noted that this should not be viewed as an alternative method of procurement as it is not a procurement route in itself. It should be regarded simply as a source of finance.
- 2.6.3 It is a DEFRA requirement for the OBC to demonstrate value for money by comparing PFI funded (private sector) against traditional in-house procurement. Her Majesty’s Treasury use a standard model for all PFI contracts to demonstrate whether value for money would be achieved or not. This will be used with the assessment of the OBC.
- 2.6.4 With respect to waste infrastructure procurement the primary focus should be on contractual outputs and outcomes rather than inputs. The best overall value for money outcome, according to DEFRA will not necessarily involve the lowest cost of finance, nor the cheapest design or materials used in construction.
- 2.6.5 DEFRA’s Waste Infrastructure Development Programme (WIDP) has produced a paper providing useful information on the application of PB in the waste sector. Much of the following comments summarise the views set out in this paper (see notes on Background Papers).
- 2.6.6 There are three main approaches available with respect to applying the PB approach to financing waste infrastructure projects. These are set out below:
- Option 1: An authority lets separate contracts for the construction and the operation/maintenance of a facility. A variance to this approach could be that an authority lets a design, build and operate contract but still owns the facility itself.
- Option 2: An authority lets a PFI/PPP contract but provides up-front capital (through PB) to finance, for example, land purchase or payment towards construction costs. It would be anticipated that this capital contribution would reduce the gate fee from the level at which it would otherwise be set. The SLWP secured capital funding through the London Recycling Fund to part fund the construction and operation/maintenance of the in-vessel composting and Dano Drum facilities which resulted in reduced gate fees charged by the contractor, Viridor.
- Option 3: Following completion of construction an authority may use prudentially borrowed funds to make lump sum payments to the contractor which are required to pay-off a matching amount of private sector senior loan capital, the subsequent gate fee payable being reduce pro rata.

- 2.6.7 PFI contracts differ in that the private sector will usually borrow required funds from a commercial bank at commercial rates and pay it back over a set period of time (usually the life of the contract). The unitary charge will include an element related to the loan and cost of finance.
- 2.6.8 Procurements using PB are often seen as having reduced borrowing costs and reduced procurement timescales. However, with respect to timescales, the focus of the procurement, irrespective of the financing approach adopted, should be on value for money over the economic life of the assets being procured. It is DEFRA's view that in this context a few additional months in procurement may be justified to ensure that these long-term value for money benefits are secured.
- 2.6.9 The following table outlines some key issues relative to each of the financing options, PFI and PB:

PFI (Private finance)	Prudential borrowing
A contractual fixed price (in real terms, i.e. fixed other than for general inflation)	Lower costs of borrowing. However, repayments on loan must be made whether or not the facility is performing as expected.
Long term solutions	With respect to Option 1 above, this does not provide the Partnership with protection for unforeseen life-cycle costs.
Performance related payments – that are linked to service outputs, i.e. partnership only pays for what it gets. The output specifications create a single-point responsibility in service delivery and greater scope for innovation in design of service delivery	In the case of Option 2, the Partnership's sunk capital is not recoverable in the case of a contractor insolvency. Option 3 substantially reduces incentives for private sector performance.
Private sector capital at risk: the invested capital providing both a stronger and long-term incentive for good performance than having profits-alone at risk. Third party due diligence aid improved project definition, cost transparency and delivery.	Funder (if PWLB) unlikely to perform a project assessment as not taking risk on project performance. Due diligence will be the responsibility of the Partnership.
PFI credits in the form of revenue support grant	No grant available

- 2.7 In summary, PB is most likely to offer value for money where finance is required for low risk assets such as land, the development of Household Reuse and Recycling Centres and in some cases, Materials Recovery Facilities. It is also more likely to be appropriate for assets whose capital costs are below £20million (HMT's recommended threshold below which the

use of private finance is not considered likely to offer value for money). Private Finance is regarded as the most appropriate method for funding large-scale residual waste infrastructure projects, particularly those involving process technologies or combustion engineering (e.g. MBT followed by CHP). Projects falling between the above two categories should be considered on a case-by-case basis.

2.8 The approval to submit the application for PFI credits in the form of the OBC has been delegated to the SLWP Joint Committee by each of the partner authorities when the Committee was established. Cabinet approved the establishment of the Committee and the authority delegated to the Committee on 10 September 2007. In order to sign off the application for PFI credits the total cost of the reference project versus the “do minimum” option must be clearly presented and the underlying impact of the reference project on budgets (affordability) and the impact of any sensitivity analysis understood. However, it is also a requirement that a standard form of letter be submitted with the application signed by the Leaders of each of the Partnership authorities, together with a separate sign off by the Section 151 Officer from each authority. No direct commitment to securing waste treatment contracts through PFI is being made at this stage. The submission of a Final Business Case will be required at the point in procurement when the preferred bidder is selected. This is expected between September and December 2011.

2.9 As stated earlier, the acceptance and approval by DEFRA and HMT’s Project Review Group will be dependent on demonstrating that PFI presents better value for money than alternative options of financing. In addition, the decision-making body must demonstrate its commitment to meeting its share of the costs (including procurement costs) and has understood the uncertainty in the cost estimates at this stage and the implications if key assumptions vary.

3 ALTERNATIVE OPTIONS

3.1 The section above sets out some of the details with respect to the procurement of residual waste treatment infrastructure and explores alternative financing options. As part of this process, the project costs must be compared to a “do minimum” option. This option assumes that the Partnership will deliver services capable of meeting the national recycling target of 50% by 2020. This in itself will require investment in additional collection infrastructure and waste reduction programmes.

3.2 The “do nothing” option, by which the council continues to recycle at current levels and remains wholly reliant on current waste disposal contracts (procured through phase A) will have significant financial impacts with respect to the increasing landfill costs (Landfill Tax increases and the need to purchase landfill allowances). There are potential reputation risks as the Partnership, or Merton, significantly falls behind with respect to levels of recycling. Furthermore, this option would not be in accordance with agreed policy with respect to the Council’s Municipal Waste Management Strategy or Climate Change Strategy and the SLWP’s Joint Waste Statement.

4 CONSULTATION UNDERTAKEN OR PROPOSED

- 4.1 Due to the strict DEFRA deadline of 31st October and the fact that the next meeting of the Sustainable Communities Overview and Scrutiny Panel is not until 5 November, it is suggested that consultation is conducted via email, with the relevant Joint South London Waste Partnership Committee papers being released to the panel on 14 October, for a response by 21 October. Comments can then be passed to the Merton representatives of the South London Waste Partnership Joint Committee in time for their meeting on 23 October.

5 TIMETABLE

- 5.1 The anticipated timetable for completion of the OBC is detailed below:

Activity	Responsibility	Date
Detailed technical appraisal of short listed options – using WRATE model	Entec	5 Sept 08
Drafting of OBC	Management Group/Advisors	September
Workshop for members of the SLWP Joint Committee and their deputies	Officers/Advisors	24 Sept 08
Finalise VfM work	External Advisors	3 Oct 08
Finalise draft OBC	Management Group	8 Oct 08
Report OBC to Joint Committee for approval	Joint Committee	23 Oct 08
Report with recommendations	Cabinet	1 Oct 08
Report notifying Cabinet with outcome of Joint Committee decision to submit application	Cabinet	10 Nov 08

- 5.2 The longer term timetables with respect to the procurement, commissioning and implementation of Phase B is outlined below:

Confirmation from DEFRA of approval and award of credits	February 2009
OJEU Notice published	June 2009
Contract award	February 2012
Contract commencement	Spring 2014

6 FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

- 6.1 There is further work to be done with respect to the completion of the OBC. This will include identifying any financial implications and associated budgetary gaps and affordability issues. The OBC will contain an indicative affordability position with respect to the individual authorities and the Partnership as a whole. It is important to note that at this stage this can only be indicative and will be dependent on the outcome of the procurement process and agreement of the Final Business Case. The details currently available are contained within the body of the report.
- 6.2 A full scrutiny of the models used to develop the OBC will be carried out internally to verify and validate the submission in advance of the SLWP Joint Committee on 23 October 2008.
- 6.3 With respect to PFI contract, costs will not be incurred until such time that the services commence. As set out in the timetable above this is anticipated to be in Spring 2014. During the interim, the Partnership will continue to rely wholly on Phase A contracts. However, it is anticipated that landfill costs will continue to reduce as the Partnership puts in place the required improvements with respect to waste reduction and recycling.

7 LEGAL AND STATUTORY IMPLICATIONS

- 7.1 The SLWP Joint Committee have been given the necessary authority by each of its partner boroughs to submit the application for PFI credits. Without such initial application the limited availability of such PFI credits would be lost to the Partnership. However it will remain necessary to keep any chosen procurement route under continual review to ensure that at the point of legal commitment it continues to represent the best value for money option open to Merton Council. These Recommendations appear to be consistent with that approach. The partnership's financial advisers Price Waterhouse have stated that they will continue to monitor the value for money aspect of PFI v prudential borrowing on behalf of the partnership.

8 HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

- 8.1 None

9 CRIME AND DISORDER IMPLICATIONS

- 9.1 None

10 RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

- 10.1 A highlighted benefit of the PFI approach is the transfer of risk to the private sector. As part of the development of the OBC it is a requirement to quantify the financial impact of this risk transfer in order to assess value for money against the public sector comparator (that is, prudential borrowing).
- 10.2 the Partnership has maintained an ongoing risk register as part of the first stage of the procurement which is being updated to incorporate Phase B. The register is regularly reviewed and reported to the SLWP Joint Committee.

11 APPENDICES – THE FOLLOWING DOCUMENTS ARE TO BE PUBLISHED WITH THIS REPORT AND FORM PART OF THE REPORT

12 BACKGROUND PAPERS

- 12.1 SLWP Phase B: Residual Waste Treatment, Options Appraisal: Outcome of Stage 1 (Long listing), (Entec, 2008)
- 12.2 SLWP Phase B: Residual Waste Treatment, Options Appraisal: Outcome of Stage 2 (Short listing), (Entec, 2008)
- 12.3 WIDP Residual Waste Procurement Pack Module 3: Prudential Borrowing in the Waste Sector (DEFRA, Waste Infrastructure Development Programme, 2008)