Herefordshire Council

SUPPLEMENT TO THE AGENDA FOR

Cabinet

Thursday 12 December 2013

2.00 pm

The Council Chamber, Brockington, 35 Hafod Road, Hereford

KPMG
cutting through complexity

Herefordshire Council – Waste Contract Variation

Commentary on the processes undertaken for the proposed Contract Variation with Mercia Waste Management Limited

06 December 2013

Contents

1 Executive summary

1.1 Summary of our Terms of Reference

Herefordshire Council ("HC" or the "Council") and Worcestershire County Council ("WCC") (combined being 'the Councils' or 'Partnership') are in the process of reviewing proposals from its contractor, Mercia Waste Management Limited ("Mercia") in relation to the proposed contract variation to the original 25 year Waste Management Services Contract (the 'Contract') signed in 1998, for the development of an Energy from Waste Facility ("EFW") (the 'Contract Variation' or the "Mercia Proposal").

The proposed Contract Variation is planned to be signed by March 2014 once appropriate approvals have been obtained from the individual Council's Cabinet.

Herefordshire Council has commissioned KPMG LLP ("KPMG") to provide an independent assessment regarding the process undertaken.

1.1.1 Scope

The scope of our work has included:

a) Review of key documents namely the Variation Business Case (dated 6th Aug 2013), the Deloitte Options Appraisal paper and Deloitte assumption book paper for the options and optimism bias;

b) Undertake a high level review of the draft financial model "20130725_MERCIA_v18d" and subsequent updated versions of representing the EfW proposal from Mercia (covering the period from 2013 to 2024);

c) Review of supporting documentation from 1998 including the Working Agreement, Project Agreement and Payment Mechanism; and

d) Provide a commentary on the above as appropriate to assist the Council forming its own overall assessment on the process followed.

This report is provided in relation to point d) above.

1.1.2 Out of Scope

The KPMG scope of work does not include any formal analysis or assessment in relation to:

- The funding arrangement of the project and the funding due diligence approach;
- An evaluation of the alternative options that could exist for the Council; and
- Any review of costs.

A full options appraisal has been undertaken by the Council. KPMG understand that its participation in the Partnership's preferred option represents the preferred solution for the Council. This appraisal and any subsequent report developed by the Council have not been received or reviewed by KPMG.

Under the terms of our engagement our services shall not constitute recommendations to the Council as to whether or not the Council should proceed with the proposed transaction.

1.2 Summary of Partnership Analysis

1.2.1 Partnership Option Appraisal

The Partnership has carried out an options appraisal to support the selection and development of the Mercia Proposal as part of the Contract Variation. The options defined and used by the Partnership in its appraisal are:

Option	Detail
1	Execution of the Energy from Waste Facility Variation to the Contract with the Senior Term Loan Facility financed by a Commercial Bank
2	Execution of the Energy from Waste Facility Variation to the Contract with the Senior Term Loan Facility financed by the Councils through a drawdown from the Public Works Loans Board
3	Continue 'As is' with the existing Contract and do not execute the Energy from Waste Variation
4	Terminate the existing Contract with Mercia Waste Management, procure an Energy from Waste plant as a separate Design, Build, Finance and Operate procurement and procure all other services; or
5	Terminate the existing Contract with Mercia Waste Management, do not procure Energy from Waste plant and procure all other services.

The Partnerships options appraisal results are:

£m	Short Name	Green book (including OB)	RANK
		NPC	
Option 1	EfW (Bank Finance)	722	**2nd**
Option 2	EfW (Council Finance)	700	**1st**
Option 3	Continue As Is	828	**4th**
Option 4	Terminate (Procure EfW)	752	**3rd**
Option 5	Terminate (No EfW)	851	**5th**

The option appraisal including optimism bias work carried out by the Partnership and its advisors identifies, and concludes, Option 2 – the Mercia Proposal (at an NPC of £700m) is the most economical and represents value for money as per the Variation Business Case. This report relies on data that is still shown in draft format. Once commercial negotiations conclude the Partnership should update their Business Case.

1.3 Summary of KPMG Findings

Set out below is a summary of our key findings and conclusions

1.3.1 Option Appraisal Review

KPMG has not had access to the detailed option appraisal models used to undertake the option appraisal and as such it has not been possible to interrogate and validate the financial assessment in sufficient detail to confirm whether the selection of Option 2, the Mercia Proposal is best value for money in comparison to the other options The Council is therefore relying on the work undertaken at the Partnership level.

KPMG has focussed on a review of the assumptions contained within the draft assumption book papers provided. KPMG has not been able to assess, or confirm, how these assumptions have been applied across the options within the option appraisal models.

The observations and findings from the information provided are:

Extrapolation of costs used to develop Options 4 and 5 (where termination occurs)

For the period 2014 to 2023 the same waste management service cost (excluding EfW) is applied to Option 4 and 5 as used in Option 2 as a proxy for the cost of the waste management service provision under these options.

- KPMG have not been asked to evaluate this or alternative options and the Council are relying on technical advisors (AMEC) for this assessment..

Termination costs used in Options 4 and 5

The Termination costs assumed in Options 4 and 5 are £*confidential* each, quoted as being provided by Mercia. Based on our interpretation of the Contract (Schedule 13) and with reference to the original financial model we believe the termination costs could either be £ *confidential* via an "Event of No-Fault Termination" or £ *confidential* via a "Voluntary Termination". Indicative costs have been provided confidentially to the Council and not for public information as this could affect commercial negotiations.

- Given the NPC of Option 4 and 5 the resultant impact would not materially affect the ranking of Option 2. The materiality of the additive impact of the points above can only be carried out following appropriate technical advice and should be considered.

Optimism Bias methodology and approach

Optimisation bias values have been determined in a workshop environment involving professional advisors and the Partnership. It is a subjective assessment using a number of assumptions and professional judgement.While KPMG understands that Herefordshire officers have been fully engaged in the process, KPMG note that the report has only been addressed to WCC. We have no reason to assume this has not been undertaken with appropriate professional diligence and take comfort that it was attended by an advisory team that has experience in this sector.

- The Council should seek comfort that the assumptions used and judgements made hold at the date the decision is required. The Council should seek reliance through the contractual relationships it has with the professional parties involved and where required (prior to Financial Close) seek change to contractual arrangements so the Council can rely on its information. Prior to Financial Close, the advice should be issued by the advisory team in a final format.

1.3.2 Review of VFM Indicators

In the absence of competition, KPMG has reviewed the Mercia Proposal (i.e. Option 2 as defined in section 4.5) to measured indicators in line with H.M. Treasury guidance. KPMG has identified:

Indicator: Benchmarking of costs

EPC Contract Price for EfW

- Fichtner has carried out a market testing tender process to secure a preferred bidder for the EPC. The process undertaken has been evaluated by AMEC and it considers the procurement process adopted is appropriate to secure a market price.

Operational costs of EfW

- AMEC have confirmed that the O&M costs appear to be consistent with other EFW operational models reviewed by AMEC.

Income costs relating to EfW

- KPMG view the income monetary unit assumptions (i.e. income per MWhr and C&I gate fee) used in the draft financial model to be broadly on market.

Indicator: Sub Contractor Competition

- AMEC has assessed the appropriateness of the procurement process undertaken for the EPC contactor. AMEC have reported the process used and the evidence presented represents a sound position to allow the appointment of a preferred bidder.

Indicator: Validation of Costings and Returns assumptions

Blended Equity Return

- Compared with other similar waste infrastructure projects the overall projected return to the sponsor is at the high end of the market, but in comparison to the original transaction the return represents a reduction. The Council should confirm the acceptability of the return proposed.

Cost of Debt

- The cost of debt used in the draft financial model for the amortising term loan is not inconsistent with the market. KPMG are not in a position to comment on the pricing of bullet RV loan. The KPMG scope excludes any further work on the financing structure.

Indicator: Acceptability of specifications

- The target recovery rate is an improvement on the original Contract. The acceptability of the recovery rate and the specifications should be confirmed by the Partnership and seek professional advice as appropriate.

Indicator: Contractual and Performance Framework

- KPMG has not assessed this in detail but in principle the key contractual elements seem adequate to provide financial monitoring transparency and contractual protection. Reliance is placed on the Partnership and its advisors to ensure this remains the case.

1.3.3 Appraisal of the Original Working Agreement

KPMG has reviewed the original established Working Agreement, identifying two key elements for alteration.

Cost Allocation

- The cost split to the Council is to now be on a tonnage basis with incremental transport cost. In principle analysis undertaken by KPMG confirms this represents better value to the Council than the original mechanism.

Asset Ownership and Access on Expiry

- The issue over the ownership and right of access upon Contract expiry is currently being developed between the Councils. KPMG are aware of the changes to the principle so that access to the EfW facility can be secured post expiry, but we have not been required to review the current version of such agreement.

- The basis of the working arrangements between the Council and WCC will shape the transaction for the Council and it is therefore recommended these arrangements are carefully reviewed and the Council seek appropriate professional advice.

1.4 Summary and Conclusions

An options appraisal and optimism bias analysis has been undertaken and a Variation Business Case developed by the Partnership. These report and papers fail to make a clear recommendation as to whether the preferred option represents best VfM for the Partnership. In addition, KPMG are not currently aware of any statement from the professional advisors to the Partnership that confirms the preferred option represents best VFM. KPMG recommend this opinion is sought by the Council from the Partnership and the advisory team.

Review of the Partnerships Options Appraisal

With regard to the validation of the options appraisal approach certain information and assurance from other professional advisors remained outstanding at the point of our review.

Undertaking the options appraisal and optimism bias analysis does require the application of professional judgement, and as we were not present for this exercise, we are not able to confirm whether we confidently agree with the judgements. However, we can confirm in our opinion the professional team employed are experienced in the waste sector and that this should give the Partnership and the Council appropriate comfort, subject of course to reports and papers being finalised prior to Financial Close. Of particular note, the risk workshop assumption paper reviewed by us was in draft and a recommendation of this paper states that the assumptions paper should be updated where new information has been made available. Herefordshire Council officers have confirmed that where new information has subsequently become available this has been included in the final risk workshop assumption paper. KPMG have not received or reviewed any updates to the risk paper.

KPMG recommend the Council seek comfort that at the date the decision is required the assumptions hold and are relevant, with all papers being in final format. This should include the Council confirming the underlying waste assumptions remain appropriate, and as required seek technical opinion. The Council should seek change to the contractual arrangements with the professional advisors so it can rely on the information contained within the final reports.

Review of VfM Indicators

By following H.M. Treasury guidance and reviewing the elements of the Mercia Proposal against value for money indicators, the measures indicate the proposal has certain value for money attributes in relation to the components of variation (such as the competitive procurement for the EfW capital cost, benchmarking of the EfW O&M cost). The financing of the option is outside of the KPMG scope but we would expect, with the involvement of H.M. Treasury and DEFRA, such solution derived should provide value for money to the Council.

KPMG recommend the Council confirm its acceptability of the Blended IRR within the proposal. As is standard, the Council in due course, in its capacity as funder and as purchaser, should obtain a formal model audit opinion regarding the integrity of the financial model underpinning the Mercia Proposal.

Appraisal of the Original Working Agreement

A new Working Agreement is currently being developed, which we understand will incorporate an agreed change that the Council pay for its share of costs on a tonnage basis with appropriate incremental transport costs. The issue over the ownership and right of access upon Contract expiry is being developed on a principle that the Council will take a part ownership in the vehicle that owns the assets. KPMG has not seen an update to the Working Agreement to reflect these developments.

KPMG recommend the Council carefully review this arrangement and seek professional advice as appropriate before entering into the revised agreement.

2 Background and Context

2.1 Introduction

Herefordshire Council ("HC" or the "Council") and Worcestershire County Council ("WCC") (combined being 'the Councils' or 'Partnership') are in the process of reviewing proposals from its contractor, Mercia Waste Management Limited ("Mercia") in relation to the proposed contract variation to the original 25 year Waste Management Services Contract (the 'Contract') signed in 1998, for the development of an Energy from Waste Facility ("EFW") (the 'Contract Variation' or the "Mercia Proposal").

The proposed Contract Variation is planned to be signed by March 2014 once appropriate approvals have been obtained from the individual Council's Cabinet.

2.2 Purpose and Terms of Reference

Herefordshire Council has commissioned KPMG LLP ("KPMG") to provide an independent assessment regarding the process undertaken.

2.2.1 Scope

The scope of our work has included:

e) Review of key documents namely the Variation Business Case v1.1 (dated 6th Aug 2013), the Deloitte Options Appraisal paper and Deloitte assumption book paper for the options and optimism bias;

f) Undertake a high level review of the draft financial model "20130725_MERCIA_v18d" and subsequent updated versions of representing the EfW proposal from Mercia (covering the period from 2013 to 2024);

g) Review of supporting documentation from 1998 including the Working Agreement, Project Agreement and Payment Mechanism; and

h) Provide a commentary on the above as appropriate to assist the Council forming its own overall assessment on the process followed.

This report is provided in relation to point e) above.

2.2.2 Out of Scope

The KPMG scope of work does not include any formal analysis or assessment in relation to:

- The funding arrangement of the project and the funding due diligence approach;
- An evaluation of the alternative options that could exist for the Council;
- Any review of costs; and
- This KPMG report does not represent a Value for Money assessment for the Council in comparison against it options. KPMG understand that a full options appraisal has been undertaken by the Council, and that its participation in the Partnership's preferred project represents the preferred solution for the Council. The appraisal and subsequent report developed by the Council has not been reviewed by KPMG.

3 Background

In 1998 Herefordshire Council and Worcestershire County Council signed one of the first joint Waste PFI Contracts within the UK, appointing Mercia Waste Management Limited as the Contractor. The Contract is for a 25 year concession, of which 10 years remain, which includes the provision of recycling, composting and treatment/disposal of household waste.

One of the key parameters under the Waste Management Services Contract was the provision of an EfW facility at the British Sugar site in Kidderminster for the treatment of residual waste. However the proposed EfW facility was met with considerable opposition and Worcestershire County Council (Planning Authority) refused the Planning Application for the plant. Mercia appealed the decision however the appeal was lost in 2002 and therefore no EfW facility has since been constructed. As a result of the planning application failure, the Contract permitted a 'no fault' termination however the Councils and Mercia agreed to defer this option and not terminate the Contract. Instead it was agreed to continue to operate the Contract in a 'standstill agreement' - operating the Contract as designed but without the provision of the EfW facility.

3.1 Current Position

3.1.1 Contract Operation

Whilst the Contract has been in standstill, the Partnership and Mercia have endeavoured to secure capacity at alternative EFW plants throughout the West Midlands to assist with compliance of diverting biodegradable municipal waste from landfill. A small amount of capacity (circa 15,000 - 20,000 tonnes per annum) has been secured by the Partnership and Mercia at Coventry's EfW plant, on a merchant basis under a rolling annual agreement. Currently, the key disposal and treatment arrangements for waste under the Contract are:

- **Recyclable Waste** – is sorted at the Material Reclamation Facility at Norton, Worcestershire, or at one of a number of Household Recycling Centres (HRC) and thereafter sent for reprocessing.
- **Garden Waste** – is processed at the composting facilities near Ledbury, Abergavenny, Pershore, and Leominster.
- **Food Waste** – which is collected at the Kerbside in Wychavon is sent to an In-vessel composting facility (IVC) at Dymock, Gloucestershire.
- **Residual Waste** – is sent for treatment at an EfW facility in Coventry or landfilled at sites near Kidderminster and Pershore, Worcestershire.

As we understand from the Council, with the current disposal and treatment arrangements in place Mercia are currently achieving 38% for recycling and 41% for value recovery - the comparable Contract target minimum levels are 26.5% for recycling, and 52.5% for value recovery. As part the standstill arrangement it was agreed the Contractor would not be bound to the recovery target rate. We understand various contract variations have been agreed to enable the Partnership to achieve its LATS targets.

3.1.2 Working Agreement

As the Contract had been entered into jointly by the Councils, in Partnership, a working arrangement document was established which governs the relationship and arrangements between the two Councils. This agreement was signed in 1999.

The key elements the Working Agreement cover and identify:

- Worcestershire County Council's role as Lead Authority;
- Instances where written consent of Herefordshire Council is required;

- The allocation of costs and payments between the Councils in respect of Contract;
- Responsibilities of the Joint Review Board formed of representatives of the Councils;
- How disputes between the Councils are resolved which cannot be resolved by the Joint Review Board;
- Events on termination; and
- The treatment of reversion of assets upon Contract expiry.

3.1.3 Joint Municipal Waste Management Strategy ("JMWMS")

The current JMWMS for Herefordshire and Worcestershire, published in August 2011, identifies EfW as the preferred technology. The Residual Waste Options Appraisal element of the JMWMS, which identified the EfW as the preferred technology, was subsequently refreshed in November 2012 to take account of any new technology options available to the Councils. The report identified that EfW continued to be the preferred technology and is the technology the Councils wish to pursue in accordance with the strategy.

3.1.4 Proposed EfW

In accordance with the JMWMS strategy, Mercia has pursued the development of an EfW facility under the Contract. The site at Hartlebury, Worcestershire, has been identified as the best site available in the two counties. Following a planning application submitted by Mercia for the site, in March 2011 Worcestershire County Council's Planning Committee decided it was "minded to grant planning permission". As the site is within the 'Green Belt' the application was passed onto the Secretary of State for Communities and Local Government for further consideration. Subsequently a Planning Inquiry took place which resulted in the Secretary of State granting planning permission in July 2012. In granting the planning permission the Secretary of State wrote that:

"there is a compelling and urgent need for the facility as proposed and that there is no other suitable alternative site within Herefordshire and Worcestershire."[1]

Given planning permission has been secured, Mercia and the Partnership are keen to develop the Mercia Proposal and deliver the EfW facility before planning permission expires despite there being only 10 years remaining life of the Contract.

1 Source: VBC1.1

4 The Partnership's Value for Money Position

4.1 Process

As part the process of developing the Mercia Proposal as a variation to the Contract, the Partnership has appointed a number of professional advisors to assist them in their capacity as purchaser. The advisors are:

- Deloitte – Finance
- AMEC – Technical
- Eversheds – Legal
- Marsh - Insurance

4.2 Work undertaken at the Partnership level

We understand work has been undertaken has been on behalf of the Councils together at the Partnership level. We understand the advisors have been supporting the Partnership in developing the Mercia Proposal. Part of this work involves undertaking an options appraisal to clarify that the Mercia Proposal represents value for money in comparison to alternative options.

4.3 Partnership Options Appraisal

Following discussion with the Council, we understand the Mercia Proposal has been assessed as to whether:

1. *From a legal perspective*: - there any procurement issues/risk of challenge relating to its development; and
2. *From a finance perspective*: - it is the most economical for the Partnership and provides value for money.

Specifically, this has led to the Partnership undertaking an Option appraisal which compares the Mercia Proposal to other options that are considered to be available to the Partnership. In identifying and defining the options available to the Partnership, we understand the following key pieces of information have been obtained and used:

- A Queens Counsel ('QC') opinion letter, which considers the risk of challenge if the procurement of the residual waste treatment component of the Contract be with Mercia or if it were to be opened up to alternative contractors.

- The JMWMS published in August 2011 (as refreshed in November 2012), which identifies the EfW is the preferred technology option.

We understand the information has been used to determine the appropriate options for the Partnership which based on:

- The facility being delivered through the existing Contract with Mercia or under a new contract if the whole current waste management service provision is terminated. Procuring the facility whilst Mercia continued to provide existing elements of the Contract is ignored as it is considered to bring a significant risk of procurement challenge.

- The preferred technology throughout the options is an EfW, in line with the JMWMS strategy.

This led to the Partnership carrying out an appraisal of five options, which includes the Mercia Proposal.

4.4 Partnership Options Appraisal Outcome

From the information provided we understand the five options used in the Partnership appraisal (as extracted) are:

Table 1: Partnership option definitions

Option	Detail
1	Execution of the Energy from Waste Facility Variation to the Contract with the Senior Term Loan Facility financed by a Commercial Bank
2	Execution of the Energy from Waste Facility Variation to the Contract with the Senior Term Loan Facility financed by the Councils through a drawdown from the Public Works Loans Board
3	Continue 'As is' with the existing Contract and do not execute the Energy from Waste Variation
4	Terminate the existing Contract with Mercia Waste Management, procure an Energy from Waste plant as a separate Design, Build, Finance and Operate procurement and procure all other services; or
5	Terminate the existing Contract with Mercia Waste Management, do not procure Energy from Waste plant and procure all other services.

Source: Variation Business Case V1.1

We understand the considerations of the Partnership when appraising the options have been:

- The financial cost of payments required to be paid to the contractor for the provision of services under the option;
- The additional costs which would be incurred under the option such as termination costs where appropriate;
- The optimism bias cost relating to the option as determined by the Partnership and its advisors; and
- The impact on the revenue receipt from central government in the form of WIG / PFI credits (but not for value for money purposes).

In accordance with H.M Treasury's Green Book, the cost impact of the above is calculated in net present cost terms ("NPC"). Table 2 below, as extracted from the information provided, sets out the net present cost results and includes, in view of the Partnership and its advisors.

Table 2: Extract of option appraisal results

£m	Short Name	Green book (including OB)	RANK
		NPC	
Option 1	EfW (Bank Finance)	722	**2nd**
Option 2	EfW (Council Finance)	700	**1st**
Option 3	Continue As Is	828	**4th**
Option 4	Terminate (Procure EfW)	752	**3rd**
Option 5	Terminate (No EfW)	851	**5th**

The option appraisal including optimism bias work carried out by the Partnership and its advisors identifies, and concludes, that Option 2 – the Mercia Proposal (at an NPC of £700m) is the most economical and represents value for money as per the Variation Business Case.

4.5 Partnership Preferred Solution – Mercia Proposal

The options appraisal therefore concludes support for the case of the development of Option 2, the Mercia Proposal, by the Partnership for the whole life period from 2013 to 2042 (as presently being developed).

4.5.1 Overview of Mercia Proposal

The Mercia Proposal being developed is based on Mercia carrying out the EfW construction for a period of three years, commencing 2014, and following successful commission, Mercia operating and maintaining the EfW for the remainder of the Contract term (seven years). The proposal is based on funding being provided to the project at commercial rates by the Partnership, with the individual Councils acting as funders.

4.5.2 Definition of Mercia Proposal

The key assumptions of the Mercia Proposal are:

Mercia contract period (up to 2023)

- Waste arising are assumed to grow at 1.0% per annum for the Partnership, in line with population growth;
- EfW construction commences Jan 2014 for a 3 year period with the plant becoming operational from Jan 2017. The capacity of the plant is 200,000 tonnes per year;
- Financing is based on prudential borrowing being lent to the project by the Partnership at a commercial project finance bank lending rate which is higher than the cost of borrowing rate for the PWLB funds;
- At expiry of the Contract the EfW facility will revert to the Partnership as purchaser following payment by the Partnership to Mercia at an amount called the residual value sum. An amount to be financed by the Councils within the Partnership;
- In turn the residual value sum will be paid by Mercia to the Partnership, as funders, to repay the outstanding loan; and
- Financing of the residual value sum paid at expiry is to be funded by refinancing the original prudential borrowing.

Post Mercia contract period (2024 to 2042)

- Waste management services are expected to be outsourced to a third party under the same scope of services currently provided under the Mercia Contract;
- Waste arising are assumed to grow at 0.75% per annum for both HC and WCC;
- Third party revenue (such as electricity and spare capacity at the EfW facility) is assumed to be the same as those used under the Contract;
- All other costs and revenues are assumed to be the same as those used under the Mercia Contract; and
- An operating contractor return of 12% (a reduction in comparison to the return generated by Mercia in the model for the Contract) reflecting the lower risk profile of an operating contract.

Further detailed assumptions regarding the Mercia Proposal are set out in the assumptions book paper provided by Deloitte. We understand the Partnership has been party to the development of the relevant waste / technical assumptions underpinning the proposal and view such assumptions as reasonable.

5 KPMG Review and Observations

5.1 Information Supplied

To undertake the Scope of Work, KPMG has been provided with the following information in relation to the results of the options appraisal and optimism bias analysis:

- the Deloitte options appraisal output paper entitled 'HW Finance Section - Options Analysis Tables - DRAFT V1'
- the Deloitte risk workshop optimism bias output paper entitled 'Risk Workshop - 19 July 2013'
- the Worcestershire County Council Options Assumptions Book v.1.8
- the Councils Variation Business Case V1.1 submitted to DEFRA and WIDP as prepared by the Councils

No options appraisal models supporting the results have been provided to KPMG.

5.2 KPMG Process

In accordance with the Scope of Work and utilising the information as set out above, KPMG has:

- Reviewed the option appraisal and optimism analysis output papers (see section 5 – **Review of the Partnership Options Appraisal**);
- Considered given there is a lack of competition from other bidding entities, can the proposal be expected to deliver the 'best market price' (see section 6 – **Review of VFM Indicators**); and
- Reviewed the original Working Arrangement to determine if the allocation of costs and risks to the Council seem appropriate (see section 8 – **Review of Working Agreement**).

The questions and considerations are reviewed and assessed further in the remainder of this report.

6 Review of the Partnership Options Appraisal

6.1 Overview

KPMG has not been permitted access to the detailed option appraisal models used to undertake the option appraisal and as such it has not been possible to interrogate and validate the financial assessment in sufficient detail to confirm whether the selection of Option 2, the Mercia Proposal is best value for money in comparison to the other options.

As a result KPMG has only been able to carry out a review of the assumptions contained within the papers provided. KPMG has not been able to assess, or confirm, how these assumptions have been applied across the options within in the option appraisal models. KPMG has therefore relied upon the information supplied in the papers as being complete and a fair reflection of how assumptions have been used across the options. However it should be noted that such information reviewed by KPMG was documented by the author as being draft and there is no clear statement that the preferred option represent best VfM.

6.2 Observations and Findings

The observations and findings KPMG have made are:

6.2.1 Review of Option Appraisal Assumption Paper

6.2.1.1 Extrapolation of costs used to develop Options 4 and 5 (where termination occurs)

For the period 2014 to 2023 the same waste management service cost (excluding EfW) is applied to Option 4 and 5 as used in Option 2 as a proxy for the cost of the waste management service provision under this option.

This is a significant assumption as this may not be appropriate for use across option 4 and 5. It is recommended that clarification is sought that the Partnership has taken appropriate technical advice in the reasonableness of the application this assumption.

6.2.1.2 Termination costs used in Options 4 and 5

The Termination costs assumed in Options 4 and 5 are £ *confidential* m each, quoted as being provided by Mercia. Based on our interpretation of the Contract (Schedule 13) and with reference to the original financial model we believe the termination costs could either be £ *confidential* m via an "Event of No-Fault Termination" or £ *confidential* m via a "Voluntary Termination".

In isolation, given the NPC of Option 4 and 5 are £52m and £151m greater than Option 2, in the event the termination cost was lower at £ *confidential* in these options, the results would only be adjusted for by £ *confidential* which would not change the ranking of the options.

Consideration should be given at the additive impact of the points above which can only be carried out following appropriate technical advice.

6.2.1.3 Summary

For the avoidance of doubt the work we have undertaken in this area is limited given we have not had access to the option appraisal models that derive the option appraisal results and in addition we are utilising documents that are still presented in draft format. We cannot be sure if there are any key assumptions that have been omitted from the assumptions book paper and are reliant on the assumptions book being complete. There is no clear conclusion that the preferred option represents best VfM for the Partnership.

6.2.2 Review of Risk Workshop Assumptions Book Paper

KPMG has also been supplied with an assumptions book paper which sets out the approach and assumptions used by WCC in analysing and quantifying the risk relating to the options as derived through a risk workshop undertaken on 19th July 2013 (it is important to note the paper states it is solely for providing advice to WCC and not the Council). The paper is documented as draft and states it is subject to review by WCC. Furthermore the document states the risks should be subject to continual review and should be updated regularly as new information is available.

As the risk workshop assumption paper is draft and we are not aware or in receipt of such updates to the paper where any new information has been made available (as recommended in the paper) our observations are limited to the review of approach. As such, the Council should seek comfort that the assumptions hold at the date the decision is required and importantly seek change to contractual arrangements so the Council can rely on its information.

Set out below is our review of the approach:

6.2.2.1 Review of Approach

The paper documents that the methodology used to quantify risk is based on a three point estimate methodology to estimate future costs, using an Upper Limit, Lower Limit and most Likely Limit and the HMT Supplementary Green Book Guidance was used to determine optimism bias values. Attendees to the workshop included representatives from the Council, WCC, Deloitte and Amec. We understand that attendees all provided input into the process as appropriate.

The approach set out in the paper for determining the risk and optimism bias levels would seem appropriate. Undertaking a risk workshop with the appropriate advisor support and public sector stakeholder input provides further comfort that the approach undertaken was objective. However without being party to such workshop and not having access to the models to support the values determined, we would advise the Council to seek reliance that the process was conducted appropriately through the contractual relationships it has with these professional parties.

With regard to optimisation bias, this is a subjective assessment performed in a workshop environment that is undertaken using a number of assumptions and professional judgement. These assumptions and the basis of the judgement have not been fully detailed and therefore we are not able to assess the reasonableness of the assumptions and therefore the appropriateness of the values derived. However, we have no reason to assume this has not been undertaken with appropriate professional diligence and therefore the Council could seek reliance through the contractual relationships it has with these professional parties. Furthermore, the Council should seek comfort that the assumptions used and judgements made hold at the date the decision is required.

6.2.2.2 Summary

The approach taken and the parties involved in the process appear appropriate. As we were not present at the workshop it is not possible to confirm how the workshop was conducted but you should take comfort that it was attended by an advisory team that has experience in this sector.

However we recommend:

1) The Council seek change to contractual arrangements with the professional advisors to the Partnership so it can rely on the work undertaken.

2) The Council obtain papers that are updated to provide comfort that the assumptions hold at the date the decision required and that the papers are issued in final format and not draft.

7 Review of VfM Indicators

7.1 Measures to identify VfM

Under normal circumstances, VfM would be largely derived from competitive tension applied throughout the procurement process where there are two or more bidders. In the absence of competition H.M. Treasury recommend measures/indicators ('additional steps') should be taken to deliver VfM.

Based on the H.M. Treasury guidance, we understand the Partnership and its advisors have been cognisant to this and have adopted the 'additional steps' in a bid to secure VfM from the Contractor for the proposal.

KPMG has sought to review whether additional steps have been undertaken and to independently ascertain whether the measured indicator presents value for money in the Mercia Proposal.

The key 'additional steps' (or measured indicators) identified are:

- Benchmarking of costs and unit prices against similar or equivalent procurements.
- Transparency with regard to the appointment of the Contractor's sub contractors, including sub contractor pricing.
- Open and transparent information supply for validation of the Contractors costing and return assumptions.
- Clarity around what constitutes an acceptable outcome in terms of price and quality of service as specified by the Councils' output specifications.
- Strong contractual and performance framework that clearly allocates risk to the appropriate party and which provides security around long term performance.

The section below looks at the measured indicators for the proposal

7.1.1 Benchmarking of costs

7.1.1.1 EPC Contract Price for EfW

Fichtner Consulting Engineers (Fichtner) have been appointed by Mercia to administer the procurement process for the development of the EfW facility through an Engineering, Procurement and Construction contract (EPC). The EPC will be to design, procure, construct, install, test and commission the EfW.

In its capacity, Fichtner have carried out a market testing tender process to secure a preferred bidder for the EPC through a staged open competition. The process undertaken has been evaluated by AMEC, on behalf of the Councils, and they consider the procurement process adopted is appropriate to secure a market price (see section 6.1.2 below).

7.1.1.2 Operational Costs of EfW

We understand both the Council and in turn it technical advisor, AMEC, have reviewed the operations and maintenance cost of the Mercia Proposal.

AMEC have confirmed that the O&M costs appear to be consistent with other EFW operational models reviewed by AMEC.

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7.1.1.3 Income Costs Relating to EfW

A draft financial model has been prepared by Mercia to support the EfW proposal for the period from 2013 to 2042. Mercia has assumed the following income assumptions in relation to the EfW proposal.

Table 3: Income benchmark

EfW Related Income Item	Mercia assumption (Price Base 13)	Benchmark
Electricity Price	£ *confidential* MWhr Indexed by CPI (1.875%)	£35MWhr to £50MWhr
C&I Gate Fee	£ *confidential* pt Indexed by CPI (1.875%)	£50pt to £70pt

Based on KPMG's experience and market information, KPMG view the above income assumptions per the relevant unit to be broadly on market.

7.1.2 Sub Contractor Competition

Under the terms of the Contract, Mercia is procuring the selection of the sub contractor for the construction of the EfW facility. Mercia engaged Fichtner to run the procurement process of the sub contractor, which we understand, has been based on a staged procurement process to provide a competitive environment.

The Councils have mandated AMEC to assess the appropriateness of the procurement process undertaken by Mercia and its advisor Fichtner. AMEC has reviewed the process from the BAFO stage which consisted of three bidders.

AMEC has examined the process undertaken by Fichtner which has led to Fichtner recommending the appointment of a preferred construction contractor. The AMEC report, dated May 2013, states:

"From a review of the evidence presented, the overall approach to the tender process, the companies pre-selected and prequalified, and the detailed technical specification used to obtain quotations, it is considered that the tender assessment process followed has been an open process in general accordance with industry expectations, with a robust methodology".

The AMEC report goes on to conclude that it considers:

"the process used to date and the evidence presented by Fichtner represents a sound position which allows appointment of confidential as preferred bidder".

Therefore the Council has placed reliance on the AMEC report conclusion that identifies there has been an open and transparent competitive process for procuring the construction sub contract in a bid to deliver value for money on this aspect.

7.1.3 Validation of Costings and Returns assumptions

We understand over the course of the development of the Mercia Proposal various iterations of the draft financial model have been shared with the Partnership and its advisers to validate the information contained within. The draft financial model contains details regarding the costs and returns of the project.

As part of this validation process, KPMG has carried out a high level review of the outputs of the draft financial model to provide a high level view on the reasonableness of key components compared to the market. As part of this process, where KPMG has identified potential issues or items for clarification, questions have been raised with the Council or discussion with Mercia. For the avoidance of doubt KPMG have not reviewed the draft financial model in detail and have not carried out an audit of the financial model. In due course, we would expect the Partnership financial advisers to confirm they are satisfied with the build up of the unitary charge based on the underlying cost data. In addition we would expect the Partnership, acting as funder, to require an audit of the model with the issuance of an official opinion before financial close.

The outputs reviewed for reasonableness by KPMG are as follows:

7.1.3.1 Blended Equity Return

The draft financial model shows the following nominal blended internal rate of return to sponsors (BIRR) as follows:

Table 4: BIRR from models

Period	Original Model BIRR	EfW Proposal Model BIRR
From Dec 1998 to Dec 2013	*confidential* %	*confidential* %
From Dec 1998 to Dec 2023	*confidential* %	*confidential* %

The original BIRR as set out in the original financial model in 1998 is *confidential* %. The table above indicates that:

- From Dec 1998 to Dec 2013, the expected BIRR was *confidential* %. As extracted from the draft financial model, which we understand reflects actual cash flows to sponsors to date, Mercia will have achieved a BIRR of *confidential* %.
- From Dec 1998 to Dec 2023, the expected BIRR was *confidential* %. As extracted from the draft financial model the projected BIRR is now *confidential* %.

From the above, the projected BIRR of *confidential* % for the EfW proposal as compared to the original financial model of *confidential* % represents a reduction to the original contractual BIRR. Compared with other similar waste infrastructure projects the overall return to sponsors would be at the high end of the market.

The Partnership and its advisers would need to confirm whether the BIRR proposed is acceptable.

7.1.3.2 Cost of Debt

The draft financial model assumes the following build up for the cost of debt:

Table 5: Cost of debt

Component	Model value	KPMG comment
Amortising Loan		
■ Swap rate	2.23%	Based on average loan life of 7 yrs which is consistent with market at 30th Aug 2013
■ Buffer	0.50%	Consistent with value used for projects where Financial Close is 3+ months away
■ Credit Spread	0.25%	Typically 0.25% to 0.30%
■ MLA	0.03%	Consistent with market

Component	Model value	KPMG comment
■ Margin	3.00% to 3.50%	Consistent with market
All in rate	**5.98% to 6.48%**	**Overall consistent to market at Aug 2013**
Bullet Loan		
■ Swap rate	2.76%	Based on average loan life of 10 yrs which is consistent with market at 30th Aug 2013
■ Buffer	0.50%	Consistent with value used for projects where Financial Close is 3+ months away
■ Credit Spread	0.30%	Typically 0.25% to 0.30%
■ MLA	0.03%	Consistent with market
■ Margin	3.25%	No comparators available
All in rate	**6.81%**	**No overall comparators available**

The cost of debt used in the draft financial model for the amortising term loan is not inconsistent with the market. However we are not in a position to comment on the pricing of bullet loan as we are not aware of any such residual value financing being used in the waste market to compare against. Only by a means of carrying out a market test could the terms be assessed for reasonableness.

Apart from the debt costing review, the KPMG scope excludes any further work on the funding structure.

7.1.4 Acceptability of specifications

The Mercia contractual proposed recovery rate, as against the original contractual target rate and the Partnership JMWMS target are set out below.

Table 6: Recovery rate

	Recovery Rate[2]
Mercia contractual proposal	*confidential* %
Council Target (original)	*confidential* % (as per Schedule 5)
Council Target (from JMWMS)	78.0%

We understand the proposal is designed to contractually achieve a recovery rate of 65%. At this level this would be an improvement in comparison to the original contractual target but would be lower than the aspiration in the JMWMS.

We also understand the proposal will build upon the existing output specification and service specifications so they more aligned to the Councils requirements given the market has changed since the Contract was signed in 1998.

However we are not in a position to comment on the development of these enhancements and therefore the Partnership and its advisors would need to confirm whether the specifications and target recovery rate being proposed are acceptable (although they are an improvement on the original position).

[2] Includes recycling, composting and energy recovery

7.1.5 Contractual and Performance Framework

The payment to the Contractor will be dependent upon its performance against certain standards within the Contract. Schedule 4 sets out the Performance Criteria which needs to be achieved by the Contractor. Failure to achieve these standards will lead to deductions to the Unitary Payment – a key feature acting as an incentive for the Contractor to perform to the required standard.

Schedule 23 contains specific obligations relating to information the Contractor needs to provide when reporting on contract performance. Clause 38 of the Contract affords the Council's Superintendent Officer to dispute such report and calculation of the Unitary Payment.

Annex 2 contains the original 'Base Case' financial model which is the Contractors financial model at contract signature. This has been used by the Partnership in the past as a baseline tool against which to measure and monitor the contracts financial performance and should continue to permit the Partnership to do so going forward.

In principle the key contractual elements above look to be present to provide financial transparency and allow the Partnership to monitor the Contract, although, KPMG has not assessed the content of these documents and the Partnership should seek reliance from the group of advisors engaged. As part of the commercial development of the proposal these contractual elements are likely to be required to be updated. Reliance is therefore placed on the work the Partnership and its advisors are undertaking to make any appropriate alterations to the Contract so the Council continues to have contractual protection and transparent monitoring capability to assess delivery of contractual outcomes.

8 Appraisal of the Original Working Arrangement

8.1 Allocation of risk and right to Assets

In paragraph 5.1 of the original Working Arrangement it states the staffing support and other costs of the Waste Services Unit and all other costs and payments arising under the Agreement or the Project documents ('Contract Costs') shall be shared between the Councils on the basis set out and reviewed further in section 7.2 below. The exception is, as per paragraph 5.5 of the Working Agreement, to the extent that any payments or other obligations arise as a result of any breach, default or neglect of a particular Council such liability will be for their account.

The Working Agreement is relatively silent on who has the rights to waste assets after the concession. However it does refer to Schedule 17, Property Transfer Agreement, which looks to detail how the assets are treated at the end of the concession under the Contract. Our interpretation of this part of the Contract is that the assets will pass back to the relevant Landlords, therefore any assets in Herefordshire will pass back to the Council and so is the case for WCC. With regards to this position, in particular under the proposal, where the new EfW facility would be located in Worcestershire, at the end of the Contract the asset will revert back to WCC and potentially leave the Council with no right of access to use the asset for which it will have paid a share for.

8.2 Allocation of Costs and Payments

One of the key elements of the Working Arrangement for determining the value for money position for the Council is the provisions in relation to the allocation of costs and payments.

Under the original established Working Arrangement, payments under the Contract are shared in the same proportion as the Council's respective Council Tax bases, varied up or down pro rata according to each whole percentage variation in the delivered tonnage of each Council as compared against the base line figure from 1998.

For the fiscal year 2012/13 the percentage allocation to the Council is 26.38% as calculated in Appendix 1, and is subject to change year on year.

8.2.1 Application on the Working Agreement to the proposal

To determine the cost and payment allocation to the Council as purchaser in a bid to ascertain whether the allocation of cost is disproportionate, the projected payments of the proposal from the financial model (being the unitary charge for 2013 to 2023) have been applied through the Working Agreement.

Table 9 below shows the payments projected to be for the account of the relevant parties under the proposal based on the split being 26.38% throughout. The table shows the equivalent price per tonne each Council is paying in relation to its share the contract tonnage delivered.

Table 7: Projected payments under Working Agreement

Payment streams 2013 to 2023 (£m)	Preferred solution (nominal)	Preferred solution (real)
Preferred Solution		
Total Unitary Charge	*confidential*	*confidential*
HC Share at 26.38%	*confidential*	*confidential*
WCC Share at 73.62%	*confidential*	*confidential*
HC equivalent price per tonne cost*	**n/a**	**£113.5pt**
WCC equivalent price per tonne cost*	**n/a**	**£98.8pt**

*The price per tonne is based on the total projected contract tonnage delivered for 2013 to 2023 of *confidential* tonnes, with 23.77% relating to HC and 76.23% relating to WCC on the basis of 2012/13 waste tonnage split.

The price per tonne derived in real terms shows that under the original established Working Arrangement, the Council are projected to pay disproportionally more than WCC for each contract tonne delivered. This identifies that the original established Working Arrangement payment allocation may not be offering best value for money for the Council

8.3 Alterations to the Working Agreement

We understand the Partnership recognise the 1998 Working Agreement is no longer fit for purpose. As part of the Contract Variation, our understanding from conversations with the Council is the Partnership has agreed to the following:

- A new allocation of payment applies from September 2013, based on the Council paying on a tonnage basis for its own tonnage with appropriate incremental transport costs being for its own account. KPMG have not reviewed the revised drafting of the Working Agreement

To address the issue over the ownership and right of access upon Contract expiry, we understand from the Council, they will take a part ownership in the vehicle that owns the assets. We have not seen an update to the Working Agreement to reflect this development and it is recommended this arrangement is carefully reviewed.

9 Summary and Conclusions

Following the work undertaken in accordance with the Scope, KPMG conclude the following:

An options appraisal and optimism bias analysis has been undertaken and a Variation Business Case developed by the Partnership. The final report has not been reviewed by KPMG. As such KPMG have reviewed the draft reports. These report and papers reviewed by KPMG do not make a clear recommendation as to whether the preferred option represents best VfM for the Partnership. The report advised a qualitative as well as quantitative assessment should be undertaken and this is included in the Council's Cabinet report recommendations. KPMG have not reviewed the qualitative assessment.

Review of the Partnerships Options Appraisal

With regard to the validation of the options appraisal approach certain information and assurance from other professional advisors remained outstanding at the point of our review. . In addition the financial model is in draft format and we are not aware that the model has been subject to a model audit. The Council confirms this will be obtained before Financial Close which will be following the decision to conclude negotiations within the agreed parameters as recommended to Cabinet.

Undertaking the options appraisal and optimism bias analysis does require the application of professional judgement, and as we were not present for this exercise, we are not able to confirm whether we concur with the judgements. However, we can confirm that the professional team employed are experienced in the waste sector and that this should give the Partnership and the Council appropriate comfort, subject of course to reports and papers being finalised. Of particular note, the risk workshop assumption paper remains both in draft and a recommendation of this paper appears outstanding. The paper states that the assumptions paper should be updated where new information has been made available. We are not aware of any updates or whether an updated assessment has been undertaken regarding the validity of the risk assumptions made since July 2013.

As a result KPMG recommend the Council seek comfort that at the date the decision is required that the assumptions hold and are relevant, with all papers being in final format. This should include the Council confirming the underlying waste and technical assumptions remain appropriate, and as required seek further technical opinion. The Council should seek change to the contractual arrangements with the professional advisors so it can rely on the information contained within the final report.

Review of VfM Indicators

By following H.M. Treasury guidance and reviewing the elements of the Mercia Proposal against value for money indicators, the measures indicate the proposal has certain value for money attributes in relation to the components of variation (such as the competitive procurement for the EfW capital cost, benchmarking of the EfW O&M cost). The financing of the option is outside of the KPMG scope

KPMG recommend the Council confirm its acceptability of the Blended IRR within the proposal. In addition, as is standard practice, KPMG recommend the Council in its capacity as funder, and in its capacity as purchaser, obtain a formal model audit opinion regarding the integrity of the financial model underpinning the Mercia Proposal.

Appraisal of the Original Working Agreement

A new Working Agreement is currently being developed, which we understand will incorporate an agreed change that the Council will pay for its share of costs on a tonnage basis with appropriate incremental transport costs. The issue over the ownership and right of access upon Contract expiry is being developed on a principle that the Council will take a part ownership in the vehicle that owns the assets. KPMG has not seen an update to the Working Agreement to reflect these developments.

As a result KPMG recommend the Council carefully review this arrangement and seek professional advice as appropriate before entering into the revised agreement.

Appendix 1 – Calculation of Working Agreement cost split %

Calculation of Working Agreement cost allocation

Table title	Value	As a %
HC tonnage base line	85,661 tonnes	22.31%
WCC tonnage base line	291,955 tonnes	77.69%
Total base line	**377,616 tonnes**	**100.00%**
HC tonnage delivered 12/13	65,025 tonnes	23.76%
WCC tonnage delivered 12/13	208,704 tonnes	76.24%
Total	**273,729 tonnes**	**100.00%**
HC Council Tax Base 12/13	72,472	25.38%
WCC Council Tax Base 12/13	213,029	74.62%
Total	**285,501**	**100.00**

Source: Waste Contract PFI Budget Monitoring April 2013.xls supplied by WCC.

The cost allocation split of 26.38% is calculated as the Council Tax Base percentage being 25.38% plus 1% as HC tonnage delivered is 1.40% greater than the baseline.