MEETING:	**CABINET**
MEETING DATE:	12 DECEMBER 2013
TITLE OF REPORT:	**Waste Management Services Contract**
REPORT BY:	**ANDY TECTOR, HEAD OF SPECIAL PROJECTS** **PETER ROBINSON, CHIEF FINANCIAL OFFICER**

1. Classification

Open

2. Key Decision

This is a Key Decision because it is likely to result in the Council incurring expenditure which is, or the making of savings which are, significant having regard to the Council's budget for the service or function to which the decision relates; and

because it is likely to be significant in terms of its effect on communities living or working in an area comprising one or more wards in the County.

NOTICE has been served in accordance with Part 3, Section 9 (Publicity in connection with key decisions) of The Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012

3. Wards Affected

County-wide

4. Purpose

To seek authorisation to conclude and execute a variation to the Joint Waste Management Services Contract with Mercia Waste Management to enable the construction of the EFW Plant at Hartlebury.

5. Recommendation(s)

5.1 **THAT CABINET:**

(a) agrees that the current position within the parameters set out in Annex 1

represents an acceptable position for Herefordshire Council to progress Mercia Waste Management Limited's ("Mercia") proposals for the Hartlebury Energy from Waste (EfW) plant by entering variation of the existing WMSC in accordance with the following recommendations;

(b) agrees that such proposals for the EfW plant are affordable (subject to 5.2) and deliver value for money if the councils secure funding for the project from the Public Loans and Works Board in accordance with Option 2 set out in the report;

(c) The Chief Financial Officer is authorised to come to an agreement with DEFRA on a reduction in Waste Infrastructure Grant (WIG) credits (as detailed in 11.5) in order to ensure the deliverability of Option 2;

(d) agrees that the council should enter a variation of the existing WMSC with Mercia to give effect to Option 2 to enable the construction and operation of a new EfW Plant at Hartlebury for the remainder of the WMSC as the most appropriate approach for Herefordshire Council's waste treatment arrangements;

(e) subject to 5.2 below, the Director for Economy, Communities and Corporate be authorised (in consultation with the Chief Financial Officer and in conjunction with Worcestershire County Council) to conclude a variation to the WMSC with Mercia including enabling the construction of the EfW Plant at Hartlebury and its operation for the remainder of the WMSC and to take all necessary steps to put Option 2 into effect including execution of that variation in accordance with the Council's constitution and its certification under the Local Government (Contracts) Act 1997;

(f) the Director for Economy, Communities and Corporate be authorised to update the Joint Working Agreement between Herefordshire Council and Worcestershire County Council to reflect the design life of the EfW Plant which will extend beyond the period of the WMSC;

(g) that Council be recommended through a further report direct from the Chief Financial Officer on the details of the council's position as potential providers of appropriate funding for the project, to:

- **i. amend its Treasury Policy Strategy and associated Treasury Management Statements and authorise a loan of up to £40 million (noting that Worcestershire County Council intend to loan £125 million) to Mercia for the purposes of the varied WMSC (Option 2);**
- **ii. add up to £40 million to the Council's Capital Programme in order to enable the Council to provide such a loan to Mercia;**
- **iii. authorise the Chief Financial Officer to take all necessary steps to obtain the funding for Option 2 from the Public Works Loan Board (PWLB);**
- **iv. amend the Medium Term Financial Strategy (MTFS) as appropriate;**
- **v. consider whether any arrangements are appropriate to ensure that the Council is able to properly take account of its interests as both the Waste Disposal Authority and as the funder; and**

vi. **authorise the Chief Financial Officer in consultation with the Solicitor to the Council to finalise a loan agreement with Mercia and advance funds as authorised above to Mercia by way of stage payments, properly authorised by the councils' joint independent certifier, as a loan repayable over the remaining life of the WMSC.**

5.2 **The authorisation in 5.1(e) be conditional upon (and the matter returned to Cabinet should any of those conditions not be met) :**

a) **The Council reaching an agreement with DEFRA on reduced Waste Infrastructure Grant (WIG) credits, formerly known as PFI credits, as set out in 5.1(c);**

b) **No objection being received in writing from DEFRA or Her Majesty's Treasury (HMT) to Option 2 before 20 December 2013;**

c) **Final discussions with Mercia to (i) bring the proposal within what the Leader in consultation with the Chief Financial Officer considers to be sufficiently close to the affordability envelope as set out in the report and (ii) conclude negotiations with the Engineering, Procurement and Construction Contractor, before executing the variation;**

d) **Worcestershire County Council giving approvals substantially in the same or a substantially similar form as those contained within 5.1 (a) to (e); and**

e) **agreement being reached with Worcestershire County Council on the terms of the revised Joint Working Arrangements between the two councils.**

5.3 **Cabinet notes the progress in relation to the Waste Management Service Contract (WMSC) since the reports to Cabinet in February 2012 and December 2012.**

6. Alternative Options

The following options have been considered in this report, for reference **Option 2** is the recommended approach:

Option 1: EFW Variation to WMSC with Commercial Finance
As envisaged in the WMSC this includes the requirement for Mercia to construct (at the Hartlebury Site), finance and be responsible for the operations and maintenance of an EfW Plant until the end of the WMSC (2023) and then for the Councils taking on these responsibilities after 2023 to 2042 (its useful life).

Option 1a: EfW Variation to WMSC financed by Private finance and Council's Prudential Borrowing ("co-financing")
Following discussions with DEFRA and Her Majesty's Treasury (HMT) a further option has been considered. This is essentially the same as Option 1 but with a mix of both public and private financing. This is assumed to be a minimum of 51% private financing and 49% public financing split.

Option 2: EfW Variation to WMSC financed by Council's Prudential Borrowing (PREFERRED OPTION)
As Option 1 but financed by the Councils.

Option 3: Continue 'As Is'
Continue within the current PFI WMSC without executing the proposed EfW variation. Following the expiry of the PFI WMSC in 2023, current forecasts are for the Councils' only landfill site to be full or nearly full. The Councils would procure new waste disposal services that may include the procurement of an Energy from Waste Plant or purchasing spare capacity from the merchant market. These services post 2023 have been modelled at a capped price of £125 per tonne based on appropriate technical advice. Therefore the choice of what type of waste disposal route will be made within a capped budget and this may include construction of or usage of other residual waste facilities if these can be delivered within the capped budget.

Option 4: Termination of the WMSC and Councils procure an EfW Plant and other services through a new Design, Build and Operate Contract
Terminate the existing WMSC and for the Councils to procure an EfW Plant (and operational and maintenance services), together with associated waste management services but with finance provided by the Councils.

Option 5: Terminate the WMSC and re-procure existing services without the construction of an EFW
Terminate the existing WMSC and procure all existing waste disposal services but not including procurement of an EfW Plant.

The Options are detailed at ***Appendix B***; this includes key assumptions and associated risks.

7. Reasons for Recommendations

7.1 The recommendations will secure Herefordshire Council's long term capacity to treat residual waste and fulfil its obligations as a Waste Disposal Authority (WDA). It will also avoid the potential substantial one-off cost of terminating the contract that could fall payable in 2013/14.

7.2 Doing nothing would cost the councils £128m, over the asset life, more than the Recommended option.

8. Background Information (Chronological Order)

8.1 The Waste Management Services PFI Contract (WMSC) was signed between Herefordshire and Worcestershire Councils and Mercia Waste Management Ltd (Mercia) in December 1998 for 25 years. Members are referred to previous reports to Cabinet setting out the detailed history of subsequent developments under the WMSC, which is summarised for convenience here. It is important to recognise that the WMSC was for an integrated solution to be delivered by Mercia for the disposal of all domestic waste arising within the 2 counties. The Councils' local authority waste disposal company (Beacon Waste) was transferred at the same time to Mercia which took on responsibility for disposing of all 'Contract Waste'.

8.2 The Waste Management Services Contract included requirements for; a Mixed Waste Material Reclamation Facility (MRF), Transfer Stations, Pre-Sorted MRF, Household Waste Sites (now Household Recycling Centres), Operations and Management of Hill and Moor Landfill, Construction and operation of a Waste to Energy Plant, Composting facilities. Mercia duly started the construction of the facilities required under the contract, other than the Waste to Energy Plant which required the land to be secured, planning and other consents. (The more modern terminology for 'Waste to Energy' is 'Energy from Waste'; this is normally shortened to EfW and is based on incineration of waste).

8.3 It is important to remember that the contract duly procured in 1998 was based on an EfW solution for dealing with residual waste. Mercia started the process to deliver such an EfW at the anticipated British Sugar site in Kidderminster. However, their planning application failed at appeal in 2002 and it was therefore acknowledged that the proposed EfW plant was undeliverable at that particular site.

8.4 Accordingly, the Councils and Contractor agreed a "standstill" position whereby the respective rights of the parties to terminate the WMSC as a result of the failure to obtain planning permission for the Kidderminster EfW plant by the anticipated 'longstop' date were 'frozen' to allow the parties to continue to discuss alternative solutions for the disposal of residual waste. The WMSC continued, subject to its potential termination should the standstill agreement be brought to an end. This standstill agreement has continued to date, but will drop away should a variation to the contract to deliver the EfW Plant at Hartlebury be entered into.

8.5 The loss of the anticipated EfW facility to divert residual waste from landfill as per the contract meant the landfill site at Hill and Moor was filling considerably more quickly than had been anticipated under the WMSC and therefore some means of diverting waste from landfill needed to be developed. Interim arrangements were made by Mercia to dispose of some of the residual waste at EfW plants outside the counties to ease the situation.

8.6 Various solutions for the residual waste were investigated including out of county disposal/ treatment and autoclaves. Planning permission was obtained in 2005 for an autoclave solution at Hartlebury Trading Estate (Worcestershire) and Madley (Herefordshire).

8.7 In 2006 Worcestershire County Council acquired the land at Hartlebury Trading Estate for the purposes of residual waste disposal, with the intention of developing an autoclave facility there. However, autoclave negotiations with Mercia broke down in 2007 due to the uncertainty about the end market for the process by-product. A satisfactory end market was a planning requirement but it became clear that this could not be met with any certainty and so the autoclave option was not deliverable.

8.8 The Joint Municipal Waste Management Strategy (JMWMS) sets out the policy approach to disposing of waste including how the councils will manage waste in accordance with the Waste Hierarchy. In line with national guidance Waste Prevention is prioritised in order to reduce the amount of waste produced by the two councils. We then, in order of priority, encourage Reuse, Recycling and Composting of waste. Any waste remaining is 'residual waste' which the strategy identified should be treated to Recover Energy. Only after all these things have been done can we consider landfill as a means of disposing of any waste that remains. Both councils have been very successful at reducing waste with some of the lowest waste per head of population in the West Midlands region. It should also be noted that government has imposed increasing financial penalties through Landfill Tax to promote the diversion of waste from landfill, and landfill is not a medium or long-term solution. Since 1996 landfill tax has risen from £8/tonne to £72/tonne and from April 2014 it will reach £80/tonne.

8.9 The JMWMS was originally adopted in 2004 and the 2009 JMWMS Review included a list of possible options for the treatment of residual waste and an appraisal of these was carried out by Environmental Resources Management Limited (ERM). This included; a financial assessment of Capital and Operational expenditure (CAPEX and OPEX) costs of the various options for comparative purposes and an assessment of the different options against environmental criteria undertaken using the Environment Agency's life cycle assessment tool – Waste and Resources Assessment Tool for the Environment (WRATE).

8.10 The Residual Waste Options Appraisal ranked EfW high, particularly with combined heat and power (CHP). On 17 September 2009, Cabinet adopted the revised JMWMS. This included a new policy to increase diversion away from landfill. The Residual Waste Options Appraisal (Annex D to the JMWMS) informed the method for treatment of residual waste, and Mercia was expected to bring forward proposals for disposing of residual waste in response to the JMWMS review.

8.11 In line with the JMWMS, Mercia proposed an Energy from Waste facility to deal with residual waste and commenced a site search. This resulted in the site at Hartlebury Trading Estate being selected as the best site available in the two counties for an EfW plant. The concept contained in Mercia's EfW proposal and it progressing to planning was supported in principle by the Cabinet on 17 December 2009.

8.12 Worcestershire County Council, in consultation with Herefordshire Council, were tasked to negotiate with Mercia, a variation to the WMSC to give effect to the EfW proposal within certain parameters and report back to Cabinet should planning permission be obtained. The proposed site at Hartlebury Trading Estate (which had previously been acquired by the Council for the autoclave facility) was appropriated for planning purposes relating to the EfW proposal.

8.13 Mercia then sought planning permission for their proposal for an EfW plant at the identified Hartlebury site. Worcestershire County Council's Planning and Regulatory Committee considered Mercia's application for planning permission in March 2011 and decided they were "minded to grant planning permission". As the site is situated in the Green Belt, this provisional decision was subsequently referred to the Secretary of State for Communities and Local Government who subsequently made the decision to "Call in" the planning application and determine it himself.

8.14 The Secretary of State granted planning consent for the EfW Plant at Hartlebury in July 2012 following a comprehensive call-in Planning Inquiry. The consent requires any development on site to commence within three years, i.e. July 2015. All relevant issues associated with site selection, objections and process were dealt with at length in the inquiry and in the decision report.

8.15 In February 2012, the Cabinet had authorised the negotiation and conclusion of a variation with Mercia to the WMSC to provide the EfW Plant at Hartlebury subject to certain Planning, Financial, Contractual and Technical Parameters.

8.16 In December 2012, the Director of Economy, Communities and Corporate reported to Cabinet on progress of the variation negotiations and satisfaction of the Parameters. This report included a refresh by external experts of the JMWMS Residual Waste Options Appraisal which continued to rank EfW highly (with or without CHP).

8.17 In December 2012, Cabinet authorised proposals to pursue alternative methods of finance for the EfW plant given the relatively expensive bank debt financing which was being proposed.

8.18 In December 2012, Cabinet also authorised the procurement and commencement of enabling works at Hartlebury up to a maximum capital cost of £1.8m, in order to secure the planning permission. This is at Worcestershire' risk until the Contract Variation is agreed at which point the cost will be shared with Herefordshire.

8.19 The Director of Economy, Communities and Corporate was asked to report back in 2013 regarding proposals for financing and procuring the EfW plant either by variation of the existing Waste Contract or fresh procurement, to enable Cabinet to take a final decision.

8.20 As a consequence, this report assesses the position on the options and provides recommended proposals.

Purpose of Contract Variation

8.21 In delivering the waste management services, Mercia is required to meet certain performance targets with regard to the diversion of waste to landfill. To date the Contractor has; updated Household Waste Sites (to Household Recycling Centres), built and developed a number of waste transfer stations, developed a windrow composting site, constructed and operated a Materials Reclamation Facility at Norton and manages and operates a Landfill site in Worcestershire. An Energy from Waste (EfW) facility was included as part of the original 1998 WMSC with Mercia. This is the remaining part of the waste management infrastructure which is still to be delivered as anticipated under the original contract. Therefore if the proposal for an EfW plant at Hartlebury, as set out in ***Annex 1***, is approved this will be dealt with as a variation to the existing WMSC. It is not proposed to extend the WMSC beyond 2023 as originally contracted. However, if approved, the proposal will also offer a solution for treating residual waste well beyond 2023 as given the estimated 'life' of an EfW plant, which will be advantageous when making fresh arrangements for waste disposal at the end of the current WMSC in 2023.

The Energy from Waste Proposal

8.22 A detailed analysis of the proposal and alternative options are attached in ***Annex 1***. A summary of the Financial Implications including those solely for Herefordshire are summarised in section 11 below.

9 Community Impact

The proposed plant is sited in Worcestershire; however the proposal enables both Counties to move from their current reliance on the landfilling of residual waste.

10. Equality and Human Rights

The report and its recommendations do not have an impact on Equality or Human Rights.

11. Financial Implications

11.1 The full financial Implications of the proposal are set out in ***Annex 1***. The proposed building of an EfW under the current contract is demonstrated as the best value for money and is the most affordable option over the lifetime of the plant. The net present cost of the proposed contract variation is circa £678m over the lifetime of the plant being circa £128m cheaper than continuing as is. The financial risks of not approving the variation as proposed include;-

- The loss of WIG credit funding (formerly known as PFI Credits)
- The risk of landfill tax cost increases if contract continued without an EfW
- Possible substantial compensation costs if contract terminated
- The potential retendering costs if timescales slip
- The loss of a fixed capital construction price
- The potential lapse of planning permission if construction is delayed
- The cost uncertainty of waste disposal post PFI in 2023/24

The financial benefits of approving the variation include certainties in waste disposal costs for the remainder of the contract term plus the ownership of a plant post contract that can deal with all residual waste. After 2022/23, the expiry of the PFI contract, savings are anticipated, both from electricity generated and avoided landfill tax.

11.2 There are a number of financial reasons why continuing to landfill is not the preferred option, these are;-

- To do this would result in loss WIG credit funding
- To do this leaves the councils at risk of funding future possible landfill tax increases
- To do this would contradict the councils joint municipal waste management strategy
- To do this would result in higher costs being incurred post contract term
- To do this could result in expensive compensation costs

Revenue Costs

11.3 Herefordshire Council **currently (2013/14) budgets £8.3m per annum** for waste disposal costs; **this budget is net of £1.4m PFI credit receipts.** The recommendation to execute the contract variation to build an EfW will see an annual budget cost increase from EfW go live in 2017/18. An affordability envelope of £1.5m increase in the waste budget from 2017/18 has been set within which contract negotiations must remain to reach financial close. This affordability limit was agreed in the December 2012 Cabinet report which reviewed the potential revenue budget impact if landfill tax increases continued along the same trajectory as experienced to date. The contractor will use the increased income from us to make loan financing repayments. These repayments would be repaid to the authorities further supporting the affordability of approving the variation.

11.4 Commercial price negotiations continue and will continue until financial close, expected in March 2014. The councils have reached an outline agreement with Defra that from 1 April 2014, the councils WIG Credits will fall by £0.8m pa to recognise the fact that the capital expenditure incurred by Mercia to provide the EfW facility has not been procured through Private Finance.

11.5 The costs that Mercia pay for debt finance will be comparable to commercial finance, as required to comply with State Aid, so the Councils will make a surplus on its lending to Mercia that it can use to offset the Unitary Charge increase from Mercia and the loss of WIG credits from Defra. Defra has indicated that a proposal will be placed before either the Parliamentary Undersecretary of State or the Secretary of State on 13 December 2013 for a decision by 16 December. The loss of WIG credits makes the preferred option deliverable and acceptable to central government whilst remaining value for money.

Continuing as is would result in an **additional immediate annual revenue budget increase of £0.8m pa from 2014/15** to fund the loss of PFI credits as a result of not going ahead with the EfW variation.

The total revenue budget impact to 2042, the asset life of the EfW, of the different options are summarised in the table below:

Option	Herefordshire NPV including WIG credits £m	Worcestershire NPV including WIG credits £m	Total NPV including WIG credits £m
1 EfW with commercial finance	170	511	681
1a EfW with co-finance	170	509	679
2 EfW with council finance	169	509	678
3 Continue as is	201	605	806
4 Terminate and re-procure with EfW	187	560	747
5 Terminate and re-procure without EfW	211	635	846

Otions 1, 1a and 2 are fairly similar in costs terms, however options 1 and 1a would result in a significant delay and therefore higher risk of delivery without any benefit in cost.

Capital Costs

Indicative capital spend profile	Herefordshire £m	Worcestershire £m	Total £m
2014/15	11	34	45
2015/16	14	44	58
2016/17	15	47	62
Total	**40**	**125**	**165**

11.6 The above capital costs will be included in the capital programme and financed via prudential borrowing to be approved by Full Council in February 2014. Loan costs will be paid by Mercia until 2022/23, contract close, leaving an **outstanding loan balance of £31m**. Loan repayment costs will continue to be financed from the waste disposal budget until 2041/42.

11.7 During the EfW construction loan financing costs will be funded from the council's waste reserves. Following go live loan repayments will be paid by Mercia which will fund the cost of borrowing incurred.

12. Legal Implications

12.1 There are no alterations to the Waste Contract, its structure or financial basis (including models) resulting from the incorporation of the Variation, save for those that are necessary to give effect to the Variation.

12.2 Legal opinion from Leading Counsel has been obtained to check and validate the proposals.

12.3 The councils are working with Defra and HMT on points of clarification following submission of the draft Variation Business Case.

12.4 The councils have agreed to revise the current **Joint Working Agreement** to ensure improved governance and that Value for Money is delivered to both authorities (**see Annex 1, 104-107**).

12.5 A revised payment share mechanism has been agreed and implemented by Herefordshire from 1 September 2013; we are yet to receive final confirmation of this agreement from Worcestershire.

12.6 Herefordshire are also awaiting full settlement of accumulated funds which have been overpaid to Worcestershire over the last 4-5 years.Settlement is expected prior to financial close.

12.7 Please refer to the Parameters Report, ***Appendix A***, for further information.

13. Risk Management

The corporate Risk Register has been updated to reflect the status of the proposed Contract Variation.

Please refer to Annex 1, Appendix A and Appendix B for detailed explanation and analysis of risks and mitigation.

14. Consultees

Worcestershire County Council
Defra
HM Treasury

15. Appendices

15.1 Annex 1: Detailed Analysis of the Proposal
15.2 Appendix A: Parameters Report
15.3 Appendix B: Options
15.4 Appendix C: Frequently Asked Questions (FAQs)

16 Background Papers

16.1 The following are the background papers relating to the subject matter of this report:-

- Previous Cabinet Papers
- Joint Municipal Waste Management Strategy
- Planning Decision by Secretary of State

ANNEX 1: DETAILED ANALYSIS OF THE PROPOSAL

This section, Annex 1, sets out the proposal in detail, considering the implications to the councils of all the available options.

Executive Summary

Doing nothing would cost the councils £128 million (Net Present Cost) more than the recommended option.

1. The Waste Management Cabinet Report describes recommendations for handling Residual Waste for Herefordshire and Worcestershire County Councils. The report includes the background to the current Waste Management Service Contract (WMSC) with Mercia Waste Management (Mercia) that was let in 1998 for the disposal of all Local Authority Collected Waste arising within the two counties. This contract is for 25 years and whilst focused on recycling and recovery outputs it included the provision of waste management infrastructure, including: a Mixed Waste Material Reclamation Facility (MRF), Transfer Stations, Pre-Sorted MRF, Household Waste Sites (now Household Recycling Centres), Operations and Management of Hill and Moor Landfill, Construction and operation of a Waste to Energy Plant and Composting facilities. In 1998 this was a pathfinder PFI project for waste disposal.

2. As set out in previous reports, the original Kidderminster Waste to Energy Plant site did not receive planning consent, and Mercia were asked to come up with further proposals for the disposal of residual waste. Mercia proposed construction and operation of (what is now called) an Energy from Waste (EfW) plant processing 200,000 tonnes of residual waste per annum. The EfW proposal has been supported by the Councils in principle since 2009 and officers authorised to negotiate a variation to enable the EfW proposal to be progressed. Following a call-in planning inquiry by the Secretary of State, planning permission was secured in July 2012 to locate the proposed EfW plant at a site on the Hartlebury Trading Estate. Recognising this is at a different time and location to that initially envisaged in the 1998 WMSC, it would be progressed as a lawful variation to the existing contract. In December 2012, the Councils authorised officers to pursue proposals for alternative methods of finance for the EfW plant at Hartlebury.

3. Further to previous Cabinet reports, a value for money assessment of various options has been carried out. In addition a number of potential financing options have also been considered. The options considered are:

Option	Description
Option 1	EfW Variation to WMSC with Commercial Finance
Option 1a	EfW Variation to WMSC financed by Private finance and Council's Prudential Borrowing ("co-financing")
Option 2	EfW Variation to WMSC financed by Councils' Prudential Borrowing
Option 3	Continue 'As Is'
Option 4	Termination of the WMSC and Councils procure an EfW Plant and other services through a new Design, Build and Operate Contract
Option 5	Terminate the WMSC and re-procure existing services Without the construction of an EFW

4. The recommendations to Cabinet are based on:

- Doing nothing would expose the Councils to significant risk of having no capacity for treating or disposing of waste in 2023, when the WMSC expires. Residual waste would continue to be landfilled in the meantime, leaving the only available landfill site in the 2 counties close to being full, exposing the Councils to additional landfill tax, the expiry of the EfW planning permission and failing to achieve national landfill diversion targets. The additional cost impact is estimated at more than £100 million (Net Present Cost) and over £400 million (Nominal Costs) over 25 years;
- Planning Permission for the proposed EfW Plant was secured in July 2012. This followed a comprehensive call in planning inquiry by the Secretary of State;
- The EfW plant is part of the national plan to achieve landfill diversion targets;
- Forecasts that the Councils' existing landfill may well be full in 2024;
- Not varying may lead to additional (immediate) termination costs, and the prospect of having to pay £100 per tonne landfill tax in 2023.

5. The recommended option – Option 2 – shows the best value for money for the whole life cost (to 2042). The costs include the construction and operation of an EfW Plant as well as the other aspects of waste disposal and management as per the existing WMSC. In addition there is less risk associated with delivery of this option over those requiring commercial / private finance. Progressing with this option would mean that construction can start in 2014 including the satisfaction of planning conditions ahead of July 2015 (when planning permission would expire if conditions not satisfied). The EfW plant would be operational in early 2017 diverting residual waste from landfill. Progressing with this option will incur a £6.6 million uplift in the Unitary Charge from the point of operation of the EfW Plant as compared to the £6 million indicative affordability envelope that has been set by both councils. As part of recommending this option it is recognised this will result in a reduced level of Waste Infrastructure Grant (previously called PFI credits).

6. The EfW, along with other operational facilities, would be handed back to the Councils at the end of the WMSC in 2023. The EfW would still have considerable operational life remaining at that point and would be a valuable asset for waste disposal from 2023 onwards.

Waste Flows

7. In 2012/13 the total Local Authority Collected Waste (LACW) in Herefordshire and Worcestershire was: 362,273 tonnes

   Of which:
   - 120,425 tonnes were Recycled
   - 42,400 tonnes were composted
   - 199,448 tonnes was Residual Waste.

8. By 2023/24 it is forecast that LACW in the two counties will be: 395,857 tonnes per year.

   Of which it is forecast that:
   - 134,355 tonnes would be recycled
   - 47,304 tonnes would be composted
   - 225,518 tonnes would be for Residual Waste treatment/disposal

9. Forecasts of future waste volumes take account of planned housing growth in the two counties.

10. Based on this, it is forecast that the current contracted landfill space in Herefordshire and Worcestershire will be full by 2023/24 and therefore a clear solution for residual waste disposal is required in Herefordshire and Worcestershire so as to avoid the Councils being hostage to the availability, or not, of sufficient out of 'county' landfill or residual waste treatment capacity, which on the basis of our current analysis is unlikely to be available.

11. Recent analysis has examined what capacity is currently available in operating facilities and what may be available in future years based on facilities that have been consented planning permission. This considered facilities within an 80 mile radius of Herefordshire and Worcestershire and therefore included facilities as far away as London and Sheffield.

12. The key findings were:

    - 22 of the 33 operational / under construction facilities are committed to other local authorities

    - Of the remaining 11 only 1 plant would be capable of accepting waste from the two counties without requiring pre-treatment, an EFW under construction by Viridor in Cardiff.

    - There are 31 consented plants that are not committed to Local Authority waste, of these only 6 have significant capacity available to accept waste from Herefordshire and Worcestershire without requiring pre-treatment. Only Avonmouth (Sita), Swindon (Swindon Commercial Services) and Newhurst Quarry, Leicestershire (Biffa) are within 50 miles of either Herefordshire or Worcestershire.

13. DEFRA has recently published a revised report to forecast the UKs likelihood of diverting enough biodegradable municipal waste to meet the 2020 EU Landfill Directive target. This presents a UK picture and the proposed EfW at Hartlebury Trading Estate is included within the assumed capacity in this report. DEFRA's report forecasts a decline in household waste arisings from 22.9 million tonnes in 2011/12 to 22.7 million tonnes in 2020. This differs from Herefordshire and Worcestershire's forecast of a 1% per annum *increase* in waste arisings based on population growth. This local assessment is considered to be a more accurate basis for our planning as detailed within this report.

Options

14. The Councils have considered the following options:

    Option 1: EFW Variation to WMSC with Commercial Finance
    Mercia would need to procure from commercial banks two tranches of debt to finance this variation. The first tranche of debt would act like a repayment mortgage that would be repaid by 2023. The second tranche of debt would act like an interest only mortgage so the outstanding balance in 2023 matches the forecast net book value of the plant. The councils would then take on this outstanding loan in 2023 and pay it down to zero by 2042. In the latter case, HM Treasury have indicated they would be willing to consider the provision of an IUK Guarantee to give comfort to the commercial banks that the councils would make the payment in 2023.

As envisaged in the WMSC this includes the requirement for Mercia to construct (at the Hartlebury Site), finance and be responsible for the operations and maintenance of an EfW Plant until the end of the WMSC (2023) and then for the Councils taking on these responsibilities after 2023 to 2042 (its useful life).

Option 1a: EfW Variation to WMSC financed by Private finance and Council's Prudential Borrowing ("co-financing")
Mercia would need to procure from Commercial Banks two tranches of debt and two tranches of debt from the Councils to finance this variation. The Commercial Bank debt would equal 51% of the total debt required and be provided on the same basis as Option 1 above. The Councils would mirror the two tranches of debt from Commercial Banks to the value of 49% of the total debt finance requirement and charge an interest rate at a Commercial Bank Rate. HM Treasury have indicated they would be willing to consider the provision of an IUK Guarantee to give comfort to the Commercial Banks that the Councils would make the payment in 2023 on the Commercial Debt.

Following discussions with DEFRA and Her Majesty's Treasury (HMT) a further option has been considered. This is essentially the same as Option 1 but with a mix of both public and private financing. This is assumed to be a minimum of 51% private financing and 49% public financing split.

Option 2: EfW Variation to WMSC financed by Council's Prudential Borrowing
The Councils will provide all debt finance under this option in the place of a Commercial Bank at a Commercial Bank rate to finance this variation. Under this scenario, there is no need to refinance this debt in 2023.

As Option 1 but financed by the Councils.

Option 3: Continue 'As Is'
Continue within the current PFI WMSC without executing the proposed EfW variation. Following the expiry of the PFI WMSC in 2023, current forecasts are for the Councils' only landfill site to be full or nearly full. The Councils would procure new waste disposal services that may include the procurement of an Energy from Waste Plant or purchasing spare capacity from the merchant market. These services post 2023 have been modelled at a capped price of £125 per tonne based on appropriate technical advice. Therefore the choice of what type of waste disposal route will be made within a capped budget and this may include construction of or usage of other residual waste facilities if these can be delivered within the capped budget.

Option 4: Termination of the WMSC and Councils procure an EfW Plant and other services through a new Design, Build and Operate Contract
Terminate the existing WMSC and for the Councils to procure an EfW Plant (and operational and maintenance services), together with associated waste management services but with finance provided by the Councils.

Option 5: Terminate the WMSC and re-procure existing services without the construction of an EFW
Terminate the existing WMSC and procure all existing waste disposal services but not including procurement of an EfW Plant.

15. The Options are detailed in ***Appendix B***; this includes key assumptions and

associated risks.

Energy from Waste Solution

16. As a Waste Disposal Authority, the key benefits of an Energy from Waste Plant are that it:

    - Supports achievement of the strategic objectives, principles and targets agreed in the Joint Municipal Waste Management Strategy.
    - Recognises the importance of treating waste as a resource and deriving value from residual waste.
    - Recognises that reliance on landfill is not a sustainable option.
    - Reduces the impact of future increases in Landfill Tax.
    - Recognises that doing nothing would mean that there would be no sizeable landfill space available in the two counties by 2023/24 and therefore without an EfW Plant in the near future, this would, under Option 3, require agreement with Mercia about how they would seek capacity (landfill or other residual waste disposal) at other locations.
    - Makes use of proven technology.
    - Has Planning Permission secured. Other solutions pose a risk of failing to bring the planning permission into effect within the three year period of it being granted (i.e. July 2015) which would result in the costs and risks of running the planning process again.
    - Provides an integrated waste management solution.
    - Is supported by the environmental impact assessment, as part of the planning process, which concluded that there were no significant or unacceptable impacts remaining.
    - Can be operational within 3 years recognising planning permission and permitting is in place.

17. The EfW Variation would achieve the original intention of the WMSC and is the "final piece of the jigsaw" in meeting the Council's waste disposal duties.

Key Features of the Proposed Contract Variation

18. The key features of the proposed Contract Variation (Options 1, 1a and 2) are:

    - As envisaged in the WMSC this includes the design, build and operate of a complete Energy from Waste Plant including; EfW Plant, site infrastructure, buildings, roads, services, offices, buildings, services, equipment, stores, workshops, security fencing, landscaping and other associated amenities. This will be at a different site and with a different start date to the WMSC.
    - The plant will be operational within 3 years, recognising planning permission and permitting is in place.
    - To be built on the Hartlebury Trading Estate.
    - To include works to comply with the conditions of the Planning Application and resulting Planning Consent and also the Environmental Permit.
    - A single waste thermal treatment line based on modern, proven EfW technology.
    - A competitive procurement process managed by Mercia to secure an Engineering, Procurement and Construction (EPC) contractor.
    - The technology used will comprise a forward moving grate combustion unit with integral water tube boiler of horizontal design provided by the EPC Contractor.
    - The Plant has capacity for 200,000 tonnes of residual waste per annum. Thereby diverting this from landfill.

- The plant will be Combined Heat and Power (CHP) enabled with electricity generation linked to the National Grid.
- Plant performance criteria and guaranteed performance levels with contractor.
- The Construction will be completed in 2016 to enable commissioning and then full operation by early 2017.
- The plant will be "handed back" to the councils in 2023, at the end of the WMSC. This is much earlier in its useful life than would normally be the case. Additional and more detailed hand-back arrangements are being progressed with Mercia.
- There are a number of other service/operational related changes which have been agreed over recent years. These will be picked up within the financial model and variation for the purposes of consolidating contract documents into one place.
- There is currently 255 operational staff (full and part time) employed by Severn Waste Services. If the EfW plant is constructed, this would create an additional c250 jobs during the construction phase and c45 once operational.

Issues Raised

19. A number of matters have been raised by members of the public in relation to the proposals for the EfW Plant at Hartlebury. A summary of these and responses are shown below.

Environmental: The facility would operate under a permit issued by the Environment Agency (EA). If built and once operational, the EA would monitor and ensure the plant runs within the strict controls they set. The plant would offer considerable climate change benefits as opposed to landfill as concluded by the Secretary of State for Communities and Local Government in his decision notice (July 2012).

Contamination: Concerns have been raised about potential landfill gas migration from the nearby landfill site. Surveys that have been carried out suggest that this is not a significant issue.

Recycling: Some concern has been expressed that recyclate from Recycling collections will be sent to the EfW Plant. This is not the case and the EfW Plant will deal with residual waste. Recycling will continue to be handled through the Household Recycling Centres and Material Reclamation Facility for dry recyclates at Norton, EnviroSort. The primary focus continues to be on waste prevention as per the Waste Hierarchy.

Whole Life Costs: A number of points raised have been in relation to the whole life costs for the proposal. These have been worked through as part of the Value for Money Options Analysis as summarised in the Finance Section of this report.

Technology Options: Some points have been raised regarding the rationale for the selection of the Energy from Waste option. Annex D to the Joint Municipal Waste Management detailed the Residual Waste Options Analysis in which EfW, both with or without CHP, scored highly. Following proposals brought forward by Mercia, Cabinet subsequently agreed to progress the variation subject to the satisfaction of the parameters.

Grid Connection: Connection to the electricity grid will be made locally.

Food Waste: There have been suggestions that the Councils should explore collection of Food Waste and use Anaerobic Digestion to treat this. The Councils' preferred approach in dealing with food waste, a largely avoidable waste stream, is through waste prevention measures. This is in accordance with the Waste Hierarchy.

Emissions: The latest advice from the Health Protection Agency is as follows:

> ***After reviewing the latest literature the Agency's general position remains unchanged: Modern, well managed incinerators make only a small contribution to local concentrations of air pollutants. It is possible that such small additions could have an impact on health but such effects, if they exist, are likely to be very small and not detectable.***

The Secretary of State when making his decision following the Planning Inquiry concluded that he …

> **'concurs with the Inspector that there is no evidence to suggest that perceptions of health risk are objectively justified.'**

Parameters – Update

20. In order to maintain a consistent approach to the management and closure of issues and risks, previous Cabinet papers identified the planning, financial, contractual and technical parameters (the "Parameters") within which an agreement with Mercia could be reached.

21. ***Appendix A*** – *Parameters Report* - provides the current position regarding these parameters.

22. In the main, the Parameters are satisfied but the following warrant a mention:

    - The Councils have continued to seek opinion from Leading Counsel regarding specific aspects of the variation and proposals. This will continue as required.
    - Recognising the EfW Plant will be handed back to the Councils in 2023 relatively early in its useful life, some specific arrangements relating to this are being progressed with Mercia.
    - Dialogue continues with DEFRA and Her Majesty's Treasury (HMT) regarding the proposals. It is envisaged this will continue beyond the date of the Cabinet meeting on 12 December, this is reflected in the recommendations.

Planning Parameters

23. The Planning Parameters were satisfied when the Secretary of State granted planning consent in July 2012 following the call-in Planning Inquiry. The consent requires any development on site to commence within three years, i.e. July 2015.

24. In granting Mercia Waste Management the planning permission the Secretary of State wrote:

    "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."

25. The pre-engineering works to satisfy Planning Conditions have been defined and agreed and can commence following final negotiations with the EPC Contractor.

26. All Planning Parameters are closed.

Financial Parameter – Value for Money and Affordability

Financial Parameter Summary

27. The outcome of the work on Value for Money is summarised below with more detail provided in this section on a quantitative (financial) and qualitative (deliverability, risk and non-financial impact) basis:

a) From the Quantitative Analysis undertaken by the Council, supported by the council's financial advisors Deloitte, the options that include procuring an Energy from Waste plant (Options 1, 1a and 2) are between £125 million to £128 million lower in Net Present Cost (NPC) terms than the Option to Continue As Is (Option 3).

b) From the Quantitative Analysis undertaken by the Council and supported by the councils financial advisors Deloitte the options that include procuring an Energy from Waste plant are between £484 million to £517 million lower in Nominal Cost terms than the Option to Continue As Is over the asset life of the EfW;

c) In terms of the choice of procurement and financing route (Options 1, 1a or 2), the results of the Quantitative Analysis work suggests that based on the assumptions made, there is less than £5 million difference in Net Present Cost terms over the 25 year operational period.

28. The additional cost of continuing as is and the options that include the procurement of an Energy from Waste Plant is significant and so provides clear evidence of the potential lower cost to taxpayers of the variation.

29. Based on the similar Net Present Costs of the differing procurement and financing routes (Options 1, 1a and 2), the Councils Financial Advisor Deloitte has recommended that 'the Council's decision on financing route should not be based on a quantified analysis alone, but should also take account of qualitative matters. Therefore the results of the quantitative analysis need to be considered alongside the qualitative analysis.

30. The Councils have undertaken a qualitative analysis of the different financing options for the Energy from Waste Facility and when taken together with the quantitative analysis have confirmed that obtaining the variation supported by debt finance being provided by the Councils (Option 2) as opposed to Commercial Banks demonstrates best value for money. This Option presents the best opportunity to deliver the variation and project whilst mitigating risks of:

- Movement in foreign exchange rates, where a significant portion of the plant's construction price is in Euro resulting in an increased construction price;
- Movement in Interest Rates where discussions have started more recently on interest rate increases before the start of 2015 resulting in an increased cost of debt finance;
- Lapsing of the Planning Permission prior to the satisfaction of the planning conditions;
- Her Majesty's Treasury, through their IUK (Infrastructure UK) Unit, not

being able to satisfy their own due diligence requirements in order to offer a guarantee to a Commercial Bank;

- A Commercial Bank needing more time to satisfy themselves through detailed due diligence; and
- The Engineering, Procurement and Construction (EPC) Contractor raising their construction price as they are allowed to do if financial close is not reached by 31 March 2014.

31. The remainder of this section now sets out how the preferred Option from a Value for money perspective has been arrived at.

32. The Councils have been in discussions with Defra to confirm the impact on central government of providing supporting the variation from debt provided by the Councils. Defra have confirmed through work with HM Treasury that this would create a potential accounting issue for Central Government if the Councils continue to receive full Waste Infrastructure Grant (WIG) credits (as they currently have done since the project reached financial close in 1998, these were previously called PFI credits).

33. The Councils have worked up a proposal with Defra, now subject to authorisation by the Secretary of State or Parliamentary Under Secretary of State immediately following the Councils' Cabinet meetings, that would see the level of WIG credits received by the Councils reduce by £30 million from 1 April 2014 to the end of the WMSC in December 2023. Such a reduction does not affect the Value for Money assessment, as per the Green Book does not consider WIG Credits, but it does cause potential affordability issues for the Councils.

34. To mitigate the impact of the potential for reduced WIG Credits, the Councils intend to apply £8.5 million of their accumulated Reserves that have been established to smooth the uplift in the costs for the Energy from Waste Plant together with the anticipated surplus from the Councils' provision of debt finance for this variation.

35. From an affordability perspective the absolute uplift in Unitary Charge proposed by Mercia at £6.55 million, whilst representing Value for Money against the other Options available to the Councils, this is over the affordability envelope of £6million. The Councils will continue to negotiate with Mercia with the intension to bring this uplift to within the affordability envelope to ensure the contract variation is both affordable and represents value for money.

<u>Value for Money – Options analysed from a Value for Money Perspective</u>

36. In summary, the technical proposal incorporates:

a) the construction and operation of the Energy from Waste Plant (as envisaged in the WMSC albeit on a different site and with a different start date) over a 10 year period until the current WMSC comes to an end in 2023 (end of PFI Concession); followed by

b) the Councils taking on or re-procuring lifecycle replacement and operational and maintenance services for the remaining useful life of the Energy from Waste Plant until 2042.

37. Mercia has undertaken a competitive process to source an Engineering Procurement and Construction (EPC) Contract that will be responsible for the construction of the Energy from Waste Plant.

38. Following the technical assessment and approval, the Councils have focussed on comparing the Value for Money of the technical solution through the following routes:

- **Option 1 – EFW Variation procured through PFI with commercial finance**

As envisaged in the WMSC this includes the requirement for Mercia to construct, finance and be responsible for the operations and maintenance of an Energy from Waste Plant albeit on a different site – Hartlebury.

This will be until the end of the WMSC at December 2023 and then the Councils would take on these responsibilities after 2023 to 2041.

Of importance is that this Option requires the Councils to purchase the assets remaining in 2023 for their book value. Outline discussions have been held with HMT to confirm that they are willing to explore the potential for a Guarantee to be provided by a department of HMT, Infrastructure UK (IUK), to ensure that sufficient interest is generated by Commercial Banks to support this proposal. Therefore, this option has been modelled on not reaching financial close until at least the end of September 2013 as due diligence will be required by both IUK and Commercial Banks. **This will therefore delay the project by at least 9 months**.

In addition, the Councils will need to manage the risk that it is exposed to, where interest rates may increase by 2023. The Councils will do this through purchasing a financial product called a swaption in the Capital Markets to in effect lock in a rate of interest in 2023. This purchase will incur a one off cost of circa £7.8 million at financial close but will guarantee the Councils are not exposed to interest rate movements above those included in this value for money assessment. Should interest rates fall below the forecast levels then the Councils would just choose not to exercise this option, however Members should note that the Councils would have paid for a product that they did not need to use. The purchase of such a product is recommended under this option from a financial risk management perspective.

The payment for the EfW Variation will be through an "Energy from Waste Supplement" as envisaged in 1998 rather than a Gate Fee. This is payable based on the £/tonne incinerated and is in addition to the Baseline Fee of £25 payable on all tonnes of waste passed to Mercia to recognise the cost of discharging the Councils overall waste disposal responsibilities.

- **Option 1a – EfW Variation financed by Council's Prudential Borrowing and Private Finance (co-financing)**

This Option includes an EfW variation that will be made to the existing Waste Management Services Contract, including the requirement for Mercia to construct and be responsible for the operations and maintenance of an Energy from Waste Plant until the end of the WMSC and then for the Councils taking on these responsibilities after 2023 to 2041.

The payment for the Energy from Waste Variation will be through an Energy from Waste Supplement rather than a Gate Fee as envisaged in the 1998

Contract. This is payable based on the £/tonne incinerated and is in addition to the Baseline Fee payable on all waste tonnes.

This will be included within the Unitary Charge paid by the Councils and will be used by Mercia to service the debt. This element of the Unitary Charge will be passed through Mercia and repaid to the Council and a Commercial Bank in its role as the lender to the scheme. This is required to ensure the contractual mechanisms agreed in 1998 are not changed materially in relation to debt finance, with particular reference to the Council's reliance on WIG credits and Central Governments Balance Sheet Accounting rules around risk recognition.

Similar to Option 1, the project will suffer a delay, and therefore attract additional costs due to delay, as set out under Option 1 due to the need to secure the IUK Guarantee and for Commercial Banks to undertake appropriate Due Diligence. In addition, and again similar to Option 1, the Councils will need to purchase a financial product to manage interest rate risk in 2023 at a similar value.

The Councils do generate cash sums and have cash shortfalls prior to 2023 due to Mercia paying interest and capital repayments per the financial model to the Councils that is based on a different profile to that which Councils will use to repay PWLB debt until later years. The impact of this in terms of interest gained on cash balances or interest paid on in effect overdrawn balances has been included in the financial model.

- **Option 2 – EFW Variation financed by Council's Prudential Borrowing**

This Option includes an EfW variation that will be made to the existing WMSC, including the requirement for Mercia to construct and be responsible for the operations and maintenance of an Energy from Waste Plant until the end of the WMSC and then for the Councils taking on these responsibilities after 2023 to 2041.

The payment for the Energy from Waste Variation will be through an Energy from Waste Supplement rather than a Gate Fee as envisaged in the 1998 Contract. This is payable based on the £/tonne incinerated and is in addition to the Baseline Fee payable on all waste tonnes.

This will be included within the Unitary Charge paid by the Councils and will be used by Mercia to service the debt. This element of the Unitary Charge will be passed through Mercia and repaid to the Council in its role as the sole lender to the variation. This is required to ensure the contractual mechanisms agreed in 1998 are not changed materially in relation to debt finance.

The Councils can move more quickly to financial close when compared to Options 1 and 1a as an IUK Guarantee and Commercial Bank Due Diligence is not required as all required due diligence has been undertaken by the Councils as the sole provider of funding for the project during 2013.

In this scenario, there is no requirement to purchase any financial products to manage interest rate risks in 2023 as the Councils will purchase debt at the end of construction. The Councils borrowings are repaid in a similar way to a repayment mortgage until 2041. As such there is no need to purchase new debt in 2023. In this option, the Councils do generate cash sums and have cash shortfalls prior to 2023 due to Mercia paying interest and capital repayments per the financial model to the Councils that is based on a different profile that the Councils will use to repay PWLB debt until later years. The impact of this in terms of interest gained on cash balances or interest paid on in effect overdrawn balances has been included in the financial model.

- **Option 4 - Termination of the Waste Management Services Contract and for the Councils to procure an Energy from Waste Plant and other services through a new Design, Build, and Operate contract.**

The Councils would terminate the existing WMSC and procure separately the construction and operation of an Energy from Waste Plant, financed by Councils' prudential borrowing together with associated operational and maintenance services.

- **Option 5 - Terminate the Waste Management Services Contract and re-procure existing services without the construction of an Energy from Waste Plant.**

The Councils would terminate the existing Waste Management Services Contract and procure all existing waste disposal services but **not** including procurement of an Energy from Waste Plant.

39. These options have been considered against one key comparator as would normally be expected within a value for money assessment, that is:

- **Option 3 – Continue As Is**

Continuing within the current WMSC without executing the proposed Energy from Waste variation.

Following the expiry of the WMSC in 2023 the current forecasts are for the Councils only landfill site to be full or nearly full. The Councils would procure new waste disposal services that may include the procurement of a new Energy from Waste Plant or purchasing spare capacity from the merchant market. Whilst, this option is agnostic to the choice of how the Councils residual waste is disposed of, these services post 2023 have been modelled at a capped price of £125 per tonne based on appropriate technical advice and therefore the choice of waste disposal route will be made within a capped budget.

The £125 per tonne price cap is calculated by taking the current baseline gate fee paid for the disposal of all waste plus a forecast of landfill tax costs in 2023 in accordance with most recent Central Government guidance.

40. The Councils have now had an opportunity to scrutinise the current Mercia proposals and complete appropriate due diligence. Mercia has refined the financial model, particularly with regard to ongoing clarifications with the preferred bidder. The Councils have confirmed through appropriate due diligence that the information used to develop comparative models is robust.

41. DEFRA and HM Treasury have undertaken a review of these models since July 2013. Their scrutiny process has added significant value to the Councils in terms of support and challenge and has resulted in some improvements to the analysis undertaken. Whilst no formal notification of the completion of this process has been provided, DEFRA and HMT have not identified any tests or scrutiny in terms of the Value for Money analysis that raise concerns that

cannot be addressed as the Councils move to financial close. More detail is provided below on work that has been undertaken by HMT and DEFRA with regard to how each option is financed and whether this is compliant with PFI and Central Government accounting requirements due to the existing stream of funding from PFI (now WIG) credits.

42. Given the degree of difference in the Quantitative Analysis between 'Continuing As Is' and procuring an Energy from Waste Plant variation the Councils are clearly able to arrive at a judgement around Value for Money. However, from a commercial perspective the requirement remains for further negotiations with Mercia to obtain a better price than currently contained in the financial models as late changes from Mercia have increased the year 1 step up in Unitary Charge to £6.55 million, £0.55 million above the Councils indicative affordability envelope.

43. It is anticipated at this stage that the information used to support the quantitative value for money analysis is sufficient to consider a ceiling price and demonstrate a preferred option.

Value for Money – Sources of Information

44. The information used to deliver the Value for Money appraisal in this report has been sourced in two ways:

- **Option 1, 1a and 2**

Through a Variation Financial Model provided to the Councils by Credit Agricole, the Financial Advisors to Mercia, that has been subjected to appropriate Due Diligence.

This consists of a Financial Model developed by Credit Agricole fed by cost and activity inputs from the Shareholders of Mercia together with Severn Waste Services who are the current Operation and Maintenance contractor under the WMSC. Capital Expenditure for the Energy from Waste Plant has been sourced from the submission made by Mercia' current preferred bidder for the EPC Contract. This has been subject to appropriate technical, financial and legal Due Diligence with the costs confirmed by the Technical Advisor, AMEC, as in alignment with current market expectations.

45. Operating expenditure for the Energy from Waste Plant as well as existing service expenditure has been supplied by Severn Waste Services who will be the contractor responsible for the delivery of Operational and Maintenance services for all waste disposal streams until 2023.

Operation and Maintenance services post 2023 have been validated by the Councils' advisor team.

Financing costs post 2023 have been provided by the Councils' internal Finance Team based on forecasts from the Public Works Loans Board. The Councils Financial Advisor, Deloitte have supported this process including the linkage of the Credit Agricole and Councils Financial Models.

The Credit Agricole Financial Model will be subject to a detailed Model Audit by an independent auditor once it has been finalised.

This Value for Money analysis is based on the costs within these Options remaining the same or reducing from this point.

- **Option 3, 4 and 5**

  This consists of a Financial Model developed by the Councils' Financial Advisor Deloitte with the Councils.

  Option 3 and 5 costs were developed based on advice from the Councils' technical team, AMEC.

  Option 3 assumes a ceiling price for the disposal of residual waste after 2023 and is agnostic to the facility used to dispose of this waste, including landfill. However, due to the likelihood that the Councils landfill site at Hill and Moor is full, any landfill may need to be procured outside of the counties.

  Option 4 costs were developed through a mix of the Councils' technical team, AMEC and forecast Energy from Waste Costs developed as part of Options 1 and 2. These inputs were then adjusted for the profit levels expected on newly negotiated Energy from Waste deals from the market knowledge of the Council's advisors.

  The Councils' Financial Advisor, Deloitte has provided the output iterations of these Financial Models for scrutiny by DEFRA and HM Treasury since July 2013.

46. A summary of the Options is shown at Appendix B.

Value for Money – Methods of Financial Evaluation

47. Even though only 10 years of the WMSC remain, it is important to undertake the Value for Money assessment over the estimated useful life of the Energy from Waste Plant to ensure there is comparability across each option. Whilst this will be the focus for the Quantitative Analysis, a comparison will be made of costs incurred to the end of the WMSC to understand what the impact of the preferred option will be in the short term.

48. Reliance will need to be placed on the comparison over the useful life of the Energy from Waste plant as this sets out the whole life cost of the different options. This allows for a full analysis of the costs and benefits of each option to be undertaken on a comparable basis. The accepted basis by HM Treasury of undertaking this quantitative analysis is on a Net Present Cost Term to ensure the different timing of cash flows in each option are set out in an equivalent present cost today.

49. To arrive at Net Present Costs, Nominal costs are established that describe the actual forecast cash flows of each option after taking account of inflation forecasts. The reason for presenting costs in this way is to provide Members with the ability to consider the actual costs that have been forecast for each Option, making allowances for inflation and other risks.

50. The HM Treasury's Green Book sets out how these nominal costs are then adjusted to consider risks relevant to each Option to arrive at the nominal costs included below. Each relevant risk has been considered by the Councils' Advisor Team alongside Council Officers to ensure there has been independent rigour to the development of each Options Nominal costs.

51. Within the Options presented in this report, the Councils will spend cash at different times and be exposed to different risks at different points. In order

for these different cash flows to be comparable the Councils have reviewed the Options over the forecast asset life of the Energy from Waste Plant and rebased those costs to determine their present day equivalent value in Net Present Cost terms.

52. Net Present Cost is the way in which the costs of projects are able to be assessed on a comparable basis. The Nominal Cash flows (described above) are discounted back to 2013 prices to ensure each option can be directly compared to each other in today's prices. This is to ensure the time value of money and opportunity cost of spending that money is taken into account. For example, you can buy more with £1 today than £1 in ten years' time.

53. The Councils' Net Present Cost analysis has been undertaken in accordance with HMT Green Book to ensure that the Councils make a decision based on a comparable methodology to similar projects across the UK.

54. The Councils' Financial Advisor, Deloitte, is one of only a few accredited Green Book practitioners and so the Councils can take comfort that the methodology used is consistent with HMT and DEFRA requirements.

55. For clarity, Members should consider the Net Present Cost analysis presented below to provide the best and most appropriate judgement of Value for Money from a financial and quantitative perspective.

Value for Money – Outcome of Financial (Quantitative) Analysis

56. Set out below is the outcome of the Councils' quantitative assessment of Value for Money in respect of its role as the Waste Disposal Authority. The provision of funding for Options 1a, 2 and 4 is intended to come from the Councils and should the Councils become the funder of any variation it would be taking on some new risk, as a lender rather than as Waste Disposal Authority.

57. The assessment of funding risk is set out later in this report as a key consideration against the deliverability and affordability of the Option that presents the best value for money in order to be consistent with the Parameters Report endorsed at the December 2012 Cabinet.

58. This section is solely focused on the Value for Money of the different options from a procurement perspective. The table below summarises the outcome of this Quantitative Analysis that has been developed with the support of the Councils Financial Advisors, Deloitte and describes:

a) Net Present Cost calculated over the estimated useful life of the Energy from Waste Plant (until 2041) on a whole life cost basis to be used as the basis for decision making;

b) Nominal Cost calculated in accordance with the HM Treasury Green Book: appraisal and evaluation in Central Government over the estimated life of the Energy from Waste Plant (until 2041) on a whole cost basis included for information but is not a basis for appropriate decision making; and

c) Nominal Cost calculated in accordance with HM Treasury Green Book: appraisal and evaluation in Central Government' over the remaining life of the WMSC (2023) to provide a sense of the short to medium term cash flow impact, again included for information but is not a sound financial basis to support option appraisal decision making.

59. The lowest cost option under each analysis is highlighted in bold.

Table 1: Financial Analysis summary

Option	Net Present Cost (including optimism bias)	Nominal Cost (including optimism bias)	
	Whole Life Cost to 2042	Whole Life Cost to 2042	Within PFI Concession / WMSC - to2023
	£ million	£ million	£ million
1. EFW (Bank Finance)	722	1,689	543
1a. EFW (Co-Finance)	720	1,685	539
2. EFW (Council Finance)	700	1,656	512
3. Continue As Is	828	2,173	475
4. Terminate (Procure EFW)	752	1,649	586
5. Terminate (No EFW)	851	2,043	604

60. The key headlines from the table above are:

- **In terms of Net Present Cost over the useful life of the Energy from Waste Plant**

The Option with the lowest Net Present Cost is Option 2, execution of an Energy from Waste Variation supported by Councils' provision of debt finance. In accordance with acknowledged best practice in the financial assessment of projects, this represents the best value for money option for the Councils from a quantitative perspective.

The Net Present Cost of Option 2 is £700 million over the full asset life of the Energy from Waste Plant.

The options analysis demonstrates that Options 1, 1a and 2 all have a significantly lower net present cost than Option 3, 'continuing as is'. This illustrates the delivery of a residual waste solution demonstrates clear value for money when considered against not doing anything.

Option 3, Continue as is' is Ranked 4 out of the 5 Options assessed in Net Present Cost terms over the forecast asset life of the Energy from Waste Plant.

As indicated above, Net Present Cost is the industry and government standard for assessing the real costs of the project rather than nominal costs, however, for the sake of clarity and information then in terms of Nominal Costs over the forecast asset life of the Energy from Waste Plant for information:

Option 4, the Termination and re-procurement of all Waste Disposal Services with a newly procured Energy from Waste Plant financed by the Councils is forecast to have the lowest nominal cost.

Option 2, the lowest Net Present Cost Option has a nominal cost of £7 million more than Option 4 over 25 years.

In terms of Nominal Costs, which are not used to support decision making, nominal costs offer a way of comparing likely inflated cashflows under each option, over the remaining life of the WMSC to 2023:

Option 3, 'Continue as Is' is forecast to have the lowest nominal cost over remaining period of the WMSC;

Option 2, the lowest Net Present Cost Option over the forecast life of the Energy from Waste Plant has a nominal Cost of £37 million more than option 3 during the remaining life of the WMSC contract.

61. The above analysis does not incorporate the effect on each Option of any changes to the current Waste Infrastructure Grant (WIG) credits which were formerly known as PFI Credits that the Councils have received since 1998. This is due to the HMT Green Book not permitting these to be included to arrive at a Value for Money conclusion as this conclusion is reached on a pan-public sector basis with WIG credits at this level cancelling out. The Councils have therefore not included WIG credits at this stage to ensure Green Book Compliance with DEFRA and HM Treasury. WIG Credits are considered further below.

Value for Money – Confirmation of the best Value for Money Option from the financial quantitative analysis undertaken

62. Option 2 is ranked as the lowest Net Present Cost option and a comparison is made in the table below of the difference in Net Present Cost over the life of the proposed Energy from Waste Plant against each option. Each option's difference to Option 2 in Net Present Cost terms is set out in the following table.

Table 2: Comparison of each Option's Net Present cost in comparison to the lowest cost Option 2.

Option	Difference to	
	Net Present Cost	Difference to Option 2
	£ million	£ million
2. EFW (Council Finance)	700	-
1. EFW (Bank Finance)	720	20
1a. EFW (Co-Finance)	722	22
4. Terminate (Procure EFW)	752	52
3. Continue As Is	828	128
5. Terminate (No EFW)	851	151

63. The Net Present cost of Option 2 is £128 million less than Option 3, 'Continue as Is' over the estimated Asset Life of the Energy from Waste Plant

and £20 million less than the next closest, Option 1a.

64. Therefore Option 2 offers the best Value for Money from a quantitative financial Value for Money Analysis perspective in accordance with the HM Treasury Green Book.

<u>Value for Money – Confirmation of the reasons why the lowest nominal cost options are not the best Value for Money</u>

65. Whilst a Net Present Cost assessment across the remaining WMSC period and a nominal cost assessment across the useful life of the Energy from Waste Plant identifies Options 3 and 4 respectively as providing the lowest cost option, caution needs to be exercised on the usefulness of these results from a financial appraisal perspective as it is not the best method for assessing true cost and spending power. The three key reasons for caution on considering Net Present Cost over the short term are captured below.

    a) Whilst the 'Continue as Is' Option provides the lowest Nominal Cost in the short term the Councils are exposed to significant pressure on budgets as the Councils roll out of the current PFI Contract in 2023. This is due to an absence of locally available landfill space in which to dispose of a significant volume of waste.

    b) Given the absence of local waste disposal capacity, the Councils would need to seek waste disposal capacity from other Waste Disposal Authorities and Merchant providers. This will present a significant risk to the cost of waste disposal as the Councils are open to full supply and demand pressures in the market place where the current supply of new waste disposal streams as an alternative to landfill are not significant.

    c) After attempting to gain appropriate planning permission since 1998, the Council currently has an extant planning permission on a site in Hartlebury, Worcestershire, to develop an Energy from Waste Plant. Should Option 3 be chosen, there is a risk that the Planning Permission would expire and there would remain a significant risk to the project of extending the current planning permission or obtaining a new one in time for the end of the PFI concession in 2023.

66. In terms of nominal costs over the forecast asset life of the Energy from Waste Plant, whilst the Terminate and re-procure option inclusive of a new procurement of an Energy from Waste facility provides the lowest nominal cost, a significant actual cost will need to be immediately recognised and financed to terminate and pay Mercia in accordance with the Compensation on Termination provisions within the existing WMSC.

67. Notwithstanding the immediate cash flow implications and risks that this will present the Councils, the significant cost incurred almost immediately has a high value in Net Present Cost terms as it occurs immediately and this can be seen in the nominal cost comparison to the end of the WMSC where the nominal costs of Option 4 are significantly above Option 2 and 3. In addition, that termination cost, should it be spent, would not be provided against any provision of services that the Councils and residents would benefit from.

<u>Value for Money – Clarification of the key differentiating factors in the financial analysis between each Option</u>

68. A summary of the key differentiating factors that set each Option apart in Net Present Cost terms is provided here to set out further detail that has led to the order of ranking against the lowest cost Option, Option 2.

- **Option 1 and 1a**

This option includes the additional costs that are forecast to be incurred due to the additional time needed to secure private finance. In addition costs are incurred to secure interest rate certainty in 2023 through the purchase of a financial product called a swaption.

The option of financing the Energy from Waste variation was developed after the report to Cabinet in December 2012 which indicated that bank financing was a relatively expensive method and Mercia's request to the Councils following their market soundings with Commercial Banks.

Since December 2012, further market soundings have been undertaken with the Commercial Banking Market by Mercia who has confirmed that subject to further work on structuring the security that may be provided by the Councils, private finance could be available. This work has also identified indicative fees and margins that would be charged. Even in the last few months, the Councils have seen new entrants to the market and an increasing willingness to consider this variation proposal for Private Finance.

However, the latest estimate is that it would take around 12 months from this point for a Commercial Bank to conduct its appropriate Due Diligence and agree for the provision of lending to Mercia, or 9 months should IUK provide a guarantee behind the Councils ability to make the payment in 2023 to Mercia of the Residual Value of the Plant. This would have a significant impact on the affordability of this variation due to the condensing of the remaining WMSC period, the EPC Contractor no longer being able to hold their price after 31 March 2014. Mercia would then need to allow the EPC Contractor to submit a new price for itself and its entire supply chain as well as further index quotes for operating and maintenance costs.

These additional costs have been included within the Quantitative Analysis and result in an immediate additional cost to Options 1 and 1a. Otherwise, all costs remain the same as Option 2 for Option 1.

In addition, 1a requires the Councils to set aside additional cash up until 2023 to support the shortfall between the repayments made to Mercia for debt issued by the Councils and the Councils own payments to the PWLB. The interest that these cash deficits attract has been added to the cost of this option.

- **Option 3**

This Option forecasts the ongoing cost of continuing as is. This includes facilities around the Counties to sort co-mingled waste prior to Waste Disposal in order to maximise recycling within the current service model. The increased Net Present Cost is due to two main reasons.

- Firstly, the forecast that landfill tax continues to escalate for one more year by £8 per tonne to £80 per tonne and then at 2.5% per annum from that point forward in accordance with the latest Central Government guidance.

- Secondly, costs after 2023 have been modelled on the need for the Councils to procure residual waste facilities either within or outside of the Counties for a ceiling price. Both the costs of landfill within the Counties and outside of the Counties will be at a premium as capacity reduces. In addition, the Councils will then incur haulage costs for out of County waste disposal.

- **Option 4**

  This Option includes the costs of termination that will be incurred by the Councils at the point that it would choose to terminate the existing WMSC. These costs have been calculated and included on the without prejudice basis of a 'no fault' termination based on the failure to obtain planning permission on the original site for the development of an EfW Plant in Kidderminster.

  The valuation of termination costs have been developed in consultation with the Councils' external Legal and Financial Advisors and have been validated against a without prejudice view from Mercia prior to their inclusion in the financial model. The specific value of these costs is commercially sensitive and may harm any future negotiations and so has not been set out in this report.

  The potential termination costs are intended to compensate Mercia for assets purchased over the last 15 years that have been supported by the Councils with the aide of WIG credits which are not fully depreciated as well as one off costs of terminating the Waste Management Services Contract and Mercia subcontracts. The principal for this reimbursement of costs are set out in the WMSC

  In addition, the costs of procuring a new EfW Plant have been incorporated alongside costs for the continued provision of existing operational services. Estimates for these costs have been developed by the Councils' Financial and Technical Advisors alongside Councils' Officers to ensure that the costs are robust and realistic. These costs have been adjusted for the risks that actual costs may be above those currently forecasted in accordance with HM Treasury's Green Book.

- **Option 5**

  This Option includes the costs of termination that will be incurred by the Councils at the point that it would choose to terminate the existing WMSC as included in Option 4.

  Comparison of Options 1, 1a, 2 and 4 illustrates that over the life of the Energy from Waste Plant, the Net Present Cost of waste disposal, including the construction of an Energy from Waste Plant is lower than continuing to landfill on a Whole Life Cost basis. Therefore Option 5's Net Present Cost is higher than Option 4 as it carries that cost premium included in Option 3. In summary, the main reasons for this are continued escalation of landfill tax and shortage of local capacity for landfill and residual waste facilities post 2023.

69. The 1998 WMSC that envisaged the construction of an Energy from Waste Plant demonstrated Value for Money when landfill tax was as little as £7 per

tonne. Landfill Tax is now forecast to increase to £80 per tonne in 2014/15 and therefore this has a significant bearing on the value for money assessment and the costs of Option 3, 'continuing as is' in comparison to all other Options.

70. The financial analysis has been undertaken with the support of financial, Deloitte and technical advisors, AMEC. The Councils are continuing negotiations with Mercia, particularly following the conclusion of PFI Credit discussions with Defra (see below) and the need to see Unitary Charge reductions to confirm affordability. It is therefore envisaged that the Net Present Cost of Options 1, 1a and 2 will reduce further, therefore widening the gap to Option 3 – 'continue as is' prior to financial close.

Value for Money – Consideration of WIG Credits

71. As previously referenced, the Councils are 15 years into an existing WMSC and have been in receipt of WIG credits since 1998. Therefore to ensure validity of its Value for Money analysis, the Net Present Cost of Options is presented in two ways specifically for the Councils:

- to ensure HM Treasury Green Book Compliance and without PFI Credits (as above) ; and
- to consider all income that the Councils may receive against each Option given that it is currently in receipt of WIG Credits (now following).

72. Whilst not required by Central Government as the impact is neutral at that level it is right for the Councils to consider the value for money of each option inclusive of the potential impact of WIG credits currently received from Defra.

73. The Councils recognise that the preferred option of financing the variation to the WMSC whilst utilising borrowing from the PWLB does not include Private Finance. Defra has confirmed through HM Treasury that the absence of Private Finance presents some accounting issues for Central Government and related PFI credits in terms of how Central Government recognises risk transfer. As part of the WMSC, the Councils have already incurred significant Capital Expenditure through Mercia in accordance with the principles of Defra's PFI Credit support following the financing of capital expenditure from Private Sector finance.

74. To secure the achievement of the residual waste facility at the lowest risk to delivery and at the best Value for Money, the councils acknowledge that they need to find a way that does not result in "On Balance Sheet for Central Government". Therefore the Councils have explored the option of financing the project through Public Finance, recognising that a pragmatic view will need to be taken on the continuing level of WIG credits.

75. The Councils' existing budgets are based on the 2013/14 Financial Year as approved by both Councils at their respective February 2013 meetings inclusive of £5.5 million of WIG credits per annum with a part year effect in 2022/23.

76. The Councils have reached an outline agreement (in principle) with Defra that from 1 April 2014, the Councils WIG Credits will fall from £53.5 million in the period to 31 December 2023 to £23.5 million based on Option 2 being the preferred option. This represents a reduction of £30 million to recognise the fact that the capital expenditure incurred by Mercia to provide the residual

waste facility would not be procured through Private Finance. Whilst the costs that Mercia bear for debt finance will be comparable to commercial finance the Councils will make a surplus on their lending to Mercia that it can use to offset the Unitary Charge increase from Mercia and fall away of WIG credits from Defra.

77. The table below completes the Councils' Quantitative Analysis setting out the Net Present Cost of the variation inclusive of assumptions on ongoing WIG Credits. The lowest cost option in Net Present Cost Terms is set out in Bold.

Table3: NPC Analysis inclusive of the potential impact on WIG credits

Option	£ million (Adjusted for PFI Credit Assumptions (including optimism bias))
1. EFW (Bank Finance)	681
1a. EFW (Co-Finance)	679
2. EFW (Council Finance)	678
3. Continue As Is	806
4. Terminate (Procure EFW)	747
5. Terminate (No EFW)	846

78. A summary of how the continued receipt of WIG credits have been assessed under each option is set out below:

- **Option 1 and 1a**

  These Options assume the retention of all current WIG credits at a level committed to by DEFRA in its unconditional letter of 1998, but these credits may be subject to a deferral during the construction period.

- Option 2 and Option 3 include a reduced level of WIG credits that recognise the level of WIG credits that Defra has now indicated would be received by the Councils based on the delivery of infrastructure and recycling and recovery outputs to date and forecast through to 2023 excluding expenditure on the proposed Energy from Waste Plant.

- Options 4 and 5 recognise a further level of reduced WIG credits as the Council would terminate the WMSC and therefore sever the PFI link. There may be a significant risk that WIG credits will be withdrawn in full.

79. The table above demonstrates that the Net Present Cost of Option 2 and Option 3 reduces by £22 million as a result of including the effect of WIG Credits. Option 2 is £128 million less in Net Present Cost terms than Option 3 – 'Continue As is' when considering WIG Credits.

80. In both the Quantitative Analysis ignoring WIG Credits and the Quantitative Analysis inclusive of WIG Credit assumptions, the Option with the lowest Net Present Cost remains the same – Option 2 and therefore the retention of WIG credits does not change the best value for money option from a HM

Treasury Green Book appraisal and the Councils appraisal. However, it is clear, that once WIG credits are taken into account the difference between the Options that include the procurement of a residual waste facility as part of the WMSC (1, 1a and 2) essentially from a Quantitative perspective represent an equivalent value for money.

81. Based on the similar Net Present Costs of the differing procurement routes, the Councils Financial Advisors Deloitte has recommended that ' the Council's decision should not be based on quantified analysis alone, but should link to a qualitative assessment of the options.

82. The potential reduction in WIG credits is a major factor for the councils to consider; however it is viewed that a reduction would make the preferred option deliverable and acceptable for Central Government whilst still remaining Value for Money for local taxpayers when considered against the alternative options that have been discussed with Defra.

83. Defra has indicated that a proposal in line with the Councils' request will be placed before either the Parliamentary Undersecretary of State or the Secretary of State on 13 December 2013 for a decision by 16 December 2013, following both Cabinets' consideration of the recommendations on 12 December, as contained in the Councils' Cabinet reports.

84. For clarity, the Councils need to consider Value for Money primarily excluding the impact of WIG credits from Defra's perspective but it is important to incorporate WIG credits forecasts from an affordability perspective.

85. The conclusion of the Councils Quantitative Value for Money analysis is that the delivery of an Energy from Waste Contract Variation does present value for money.

86. The Councils have included within Option 2 a prudent set aside of half of the forecast surplus that will be generated by the Councils from the provision of public finance to support the Contract Variation. However, further detail is provided on financing later in this section that sets out the Council's Advisors view, from the financing perspective, that the most significant risks have been transferred either to Mercia or Mercia's EPC Contract.

87. Notwithstanding this prudent estimate of risk, there is real importance in the Councils considering the qualitative aspects of the Value for Money Assessment prior to arriving at a preferred option.

<u>Value for Money – Sensitivity Analysis</u>

88. The Councils have assessed the impact of changes in some key assumptions used to model the costs of each Option. A series of sensitivities have been incorporated within the Councils financial analysis that include:

- Changes to waste volumes;
- Increases to Landfill Tax,
- Increases to Landfill gate fee; and

- Increases to termination costs.

89. In all cases where more pessimistic assumptions were modelled, Option 2 remained the preferred Option from a financial Value for Money perspective.

Value for Money – Assessment of Funding Risk

90. The detailed analysis of Funding Risk will be set out in a paper to Full Council when it agrees to increasing the Council Credit Ceiling prior to Financial Close.

91. From a VFM perspective, the Councils have worked with their Financial Advisors on the funding side, in this case, Ashursts as legal advisors, Deloitte as financial advisors and Fitchner as technical advisors to understand the basis on which Commercial Banks reserve elements of the margin they make from providing debt finance against risks that may emerge.

92. The Councils have effectively negotiated a security package with Mercia and its EPC Contractor during the construction phase that has left only a minimal risk that costs are borne by the Councils should issues occur during construction. From a funding perspective, almost all of the debt finance is repayable during the operating period should termination on any basis occur.

93. The Councils have therefore worked to ensure risk is effectively retained where it resided in the 1998 contract or any new risk is transferred to Mercia and its supply chain.

94. The one area where the Councils are taking some more risk when compared to the 1998 contract is during the Construction Phase. For this reason, the Councils are not recognising in the Value for Money Assessment the full forecast surplus generated from providing funding from the Public Works and Loans Board. Instead, a reduction of 50% has been made to this surplus based on the need to recognise that the Councils may be exposed to residual risks that costs rise during the construction phase that may not be covered by either the EPC Security Package or Security Package provided by Mercia. The Councils advisors have estimated that this residual risk is low.

Value for Money – Qualitative Assessment

95. It is essential when making an assessment of value for money that the financial quantitative assessment is accompanied by a qualitative assessment of the available options. This analysis is set out below together with an assessment as to whether this has an impact on the preferred Option identified within the financial assessment above.

96. Option 2 has a number of qualitative benefits over the other options. These are described below:

Option 1 and 1a – EFW Variation to WMSC with Commercial Finance

EfW is the most proven technology for treating Municipal Solid Waste, with over 1,000 facilities operating across the world, including around 20 in the UK alone.

This option will divert the majority of waste away from landfill, reducing landfill tax costs and help meet national landfill targets (Landfill Directive

(1999/31/EC)). The EfW will provide a means for the councils to treat residual waste beyond the expected remaining life of our currently contracted landfill site at Hill and Moor near Pershore.

An EfW has the added benefit of reducing our carbon emissions and further aid the government in meeting its Climate Change Commitments. This is because EfW has lower emissions than any comparably efficient fossil fuel plant. It also displaces methane production by waste in landfill, a gas which has a far higher global warming potential than CO2.

Option 1 and 1a adheres to the principles established within our Joint Municipal Waste Management Strategy (JMWMS) that waste should be viewed as a resource. The public agreed with this view. Consultation on the Strategy identified that 98% of responders favoured an approach in which residual waste should be used as fuel to produce energy such as electricity.

Option 2 – EfW Variation to WMSC financed by Council's Prudential Borrowing

This option represents the best value for money and most affordable option for the councils. It would secure similar benefits to Options 1 and 1a, however it would deliver more favourable financing arrangements to the councils.

In addition, recognising the time required to secure commercial finance, this could happen more quickly.

This would avert the risk that:

- planning permission may expire;
- interest rates on which over £150 million of borrowing may go up given the recent indications from the Bank of England;
- the EPC will reprice its tender which it is able to do if financial close is not reached by the end of March 2014; and
- Sterling may appreciate against the Euro as the UK economy may continue is rise from recession that has been seen since the middle of 2013.

Option 3 – Continue As Is

To continue “as is” would provide only a short term solution for the councils. The remaining capacity at our currently contracted landfill site is expected to last only until 2023/24, based on forecast rate of use, at which point the councils would have to find a suitable disposal alternative. With other landfill sites in the region similarly close to capacity and, as yet, no other Residual Treatment options identified that could accommodate our waste, the councils would run the risk of not having anywhere in the proximity to dispose of their waste.

As described in our JMWMS, landfill is no longer considered a favourable means of dealing with residual waste and European and national policy is aligned to a reduction in its significance for municipal waste disposal.

Option 4 - Termination of the WMSC and procure an EfW Plant and other

services through a new Design, Build and Operate contract (with the councils providing the finance)

In terminating the contract the council would be exposed to the additional compensation costs that would be payable to the contractor on termination of the existing service contract. The councils would also lose the financial support provided by PFI Credits as well as incur additional costs associated with re-procurement and delay.

The councils could mitigate the risk of planning expiring by agreeing pre-commencement works so that the planning permission will be secured beyond 3 years. It is a requirement of the planning permission that work starts within 3 years of planning permission being granted. If the pre-commencement works are not carried out it is possible the councils would not be able to re-procure prior to the Planning Permission lapsing in July 2015.

With the Landfill Site expected to be full by 2023/24 the council run the risk that we would be unable to re-procure a suitable alternative before this time. Furthermore it is unlikely that the councils would be able to secure a similar or more favourable price for an EfW through a re-procurement process.

Option 5 - Terminate the WMSC and re-procure existing services without the construction of an EfW Plant

Similarly to Option 3 this would be a short term measure for the councils. The councils would incur Termination Costs payable to the contractor as well as loss of PFI Credits.

With the limited capacity at existing regional Landfill Sites this option carries the risk that the authorities would not be able to secure a means to dispose of its residual waste and European and national policy is aligned to a reduction in its significance for municipal waste disposal.

Table 4: Qualitative Assessment

	Reduction in Landfill	Mitigating Effects of Climate Change	Dealing With Waste Within the Two Counties	Recovery Performance	Commercial and Financial Certainty	Conforms to Policy Objectives	Preferred Option(s)	Explanation
Option 1	✓	✓	✓	✓	✓	✓	✓	Meets all criteria. Deliverable now.
Option 2	✓	✓	✓	✓	✓	✓	✓	Meets all criteria, yet with less favourable financing arrangements
Option 3	×	×	× (until 2023 only)	×	×	×	×	Uncertainty over landfill tax and alternatives post 2023. Does not align to waste hierarchy. Regulatory uncertainty of future landfill availability.
Option 4	✓	✓	✓	✓	×	✓	×	No certainty that disposal arrangement could be achieved post 2023.
Option 5	×	×	×	×	×	×	×	Uncertainty over landfill tax and alternatives post 2023. Does not align to waste

								hierarchy. Regulatory uncertainty of future landfill availability.

Councils' Affordability and Deliverability of the preferred Option

97. Each council has assessed internally its affordability envelope for this variation ahead of any formal approval by each Cabinet and Full Council.

98. The forecast completion of construction of Option 2 is by early 2017. The Councils would then need to pay an increased Unitary Charge from this point (modelled as January 2017) and therefore incur full year uplift in costs from the 2017/18 financial year. Both councils are in the process of rolling forward their MTFS to include 2017/18 for approval at February 2014 Full Council.

99. In the absence of formally setting their budgets each Council has indicated a potential affordability envelope of £6 million (Herefordshire Council and Worcestershire County Council) in the first full year post construction.

100. Worcestershire County Council's share of this in accordance with the current and proposed joint agreement between the Councils is circa £4.5 million. Capacity to fund this initial affordability envelope was included within Worcestershire County Council's Medium Term Financial Plan approved by its Council in February 2013. Given the slippage in the construction date, this capacity will need to be moved into the 2017/18 financial year.

101. The Financial and Qualitative Assessment of Value for Money has identified Option 2, an Energy from Waste Variation financed by the Councils to be the best value for money option from a Project perspective. The Unitary Charge levied by Mercia following Energy from Waste Services Commencement is identical for Options 1 and 2 below in diagrammatic and tabular form.

Figure 1: Unitary Charge Step up analysis following the Energy from Waste Variation

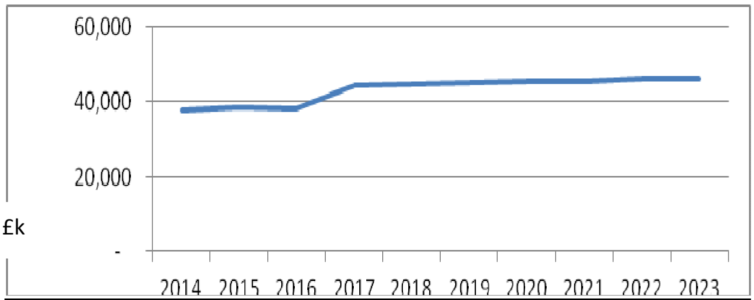

Table 5: Cost uplift in first year of operation of the EfW: Options 1 and 2 (Calendar Year 2017)

Cost type in 2017 (first year of EFW)	Real (£ million)	Change from 2016 (£ million)
Baseline Payment	9.1	0.2
Household Waste Site (HWS) Payment	1.9	-
Recycling Supplement from HWS	2.7	-
Recycling Supplement from	3.4	0.1

Comingled Materials Reclamation Facility		
Composting Supplement	0.3	-
Waste to Energy Supplement	19.5	19.9
Other Variations Payment	4.3	(2.5)
Landfill Tax	3.0	(11.1)
Total	**44.2**	**6.6**

102. The preceding table illustrates that the current net uplift in Year One Unitary Charge (2017/18) is forecast to be £6.6 million excluding inflation. Therefore the proposed cost uplift is above the Councils' initial affordability envelope. Inflation increases in relation to existing services are already included in growth estimates with the Council's MTFS.

103. The difference between Option 1, a privately financed Energy from Waste Variation and Option 2 on average across the WMSC is £2.1 million within the Value for Money Analysis. This relates to the difference between what the Councils can borrow money at from the Public Works Loans Board and its lending to Mercia on Commercial Terms. Cabinet should note that this does not relate to a profit on lending but instead represents the gross surplus achieved through making funds available to Mercia that can either potentially be used to offset the Unitary Charge step-up or set aside to provide for the risks during construction that the Council will be exposed to as it becomes the Funder. This surplus will need to be considered alongside the reduced WIG credits from Defra.

104. The Councils have received appropriate advice that the Council can act in the capacity of Funder to this Contract Variation and purchase the required financial products referenced in Options 1 and Option 1a, and have determined the appropriate set aside to manage Construction Phase Risk. Existing Compensation on Termination provisions ensure that the Funder is repaid the majority of any outstanding debt in any termination event during the operating period of the variation.

105. The decision as to whether the Council should become the Funder requires that the Councils:

a) Make changes to their Treasury Policy Strategy and associated Treasury Management Statements to permit the provision of funding to Mercia including the increase in Authorised Borrowing Limits and Council credit ceilings;

b) Make changes to their Statement of Prudential Indicators, Minimum Revenue Provision Plans and Capital Programmes in advance of the years where funding will be advanced to Mercia to support the construction payments profile;

106. These powers are reserved to each Council's Full Council.

107. The Councils have been working with HM Treasury and Defra to confirm the basis on which the Councils have the powers to provide funding to Mercia, the required safeguards that need to be put into place as well as

how to arrive at a robust valuation of risk that it will take on. HM Treasury has not raised any concerns with the negotiated position reached with Mercia and the actual transfer of risk, but HM Treasury have fed back through Defra that an issue exists with how risk is assessed in Central Government Accounting.

108. The intention is to reflect helpful advice from HM Treasury to ensure there is independence in the provision of funding to the variation by making a detailed report to Full Council early in 2014 informed by the work of each Council's Section 151 Officer on the outcome of the Councils work on risk associated with the provision of public finance. This will include a detailed assessment of the level of risk that the Councils need to consider against the Gross Surplus achieved by the decision to provide funding to the project and make proposals as to future governance as informed by the Councils advisors.

109. In terms of deliverability, Funding from the Councils provides the opportunity to retain some of the gross surplus referenced above to offset the uplift in Unitary Charge and improve affordability as well as ensure any delay in the provision of private finance does not impact of the delivery of the variation.

110. It is recommended that Full Council considers the risk and rewards of providing financing to Mercia to support the execution of the variation to the PFI Contract as envisaged in Option 2, as this is the preferred Option.

111. Based on the Councils' current assessment of risk taken on as the funder, it is assessed that there will remain a potential net surplus from the Councils providing funding to Mercia for the variation, The risks that Full Council is asked to consider against the gross surplus indicated above include:

a) Counterparty risk with Mercia's Shareholders and the major Construction and Operation subcontractors;
b) The Security package available from the Construction team and the Shareholders to cover the Construction period;
c) Key income generation assumptions in the Financial Model;
d) General Industry Risk
e) Specific risks to this particular project; and
f) Interest Rate Risks.

112. Cabinet is being recommended that Full Council approve the provision of Lending for this variation (Option 2), and Council can consider that the risks to the Councils do not outweigh the financial benefits to the Councils of becoming the Lender.

113. Cabinet should note that, whilst it is related only to the construction and operation of an Energy from Waste Plant and is not a PFI, Lincolnshire County Council has recently started commissioning tests on an Energy from Waste Plant funded from Prudential Borrowing that is based on materially the same technical solution included as presented by Mercia for this variation.

114. This Analysis has demonstrated a preferred Option, Option 2, from a

quantitative value for money and qualitative perspective as a Waste Disposal Authority, Cabinet is asked to approve the principle of agreeing a Contract Variation to achieve Option 2 subject to the Councils achieving a step up in Year 1 of the Contract Variation within the £6 million affordability envelope.

115. Given the current position with regard to affordability, Cabinet is being recommended to request Full Council to consider a more detailed report on the Councils ability to provide project Finance to Mercia for the variation to improve the affordability of Option 2.

116. Should Full Council not approve the decision to provide funding for the variation then Cabinet will need to reconsider its position.

Impact on Herefordshire Council

117. For clarity, this report considers the Options analysis for the project as a whole across both Herefordshire Council and Worcestershire County Council. The Joint Agreement as currently drafted and entered into by both parties in 1998 essentially apportions costs on approx. 25:75 basis with Worcestershire responsible for the majority share of costs.

118. The Value for Money and Qualitative analysis is a comparative exercise for determining the right Option for both Councils and as such the results are of equal relevance to both Councils. The Affordability analysis is dependent on each Council's own revenue budget assumptions. For clarity, Herefordshire Council has set an indicative Year One budget uplift of £1.5 million, noting that this full year has now slipped to 2017/18 based on the revised timing for completion of construction.

119. Given that both the affordability envelope and cost will be split on the same 25:75 basis the conclusions on affordability have the same relevance for Herefordshire Council.

120. Specifically for Herefordshire Council the provision of project finance through draw down from the PWLB is forecast to reduce the NPC of Option 1 by £21.5 million for the Partnership and therefore £5.4 million for Herefordshire Council. This would result in, on average a reduction of circa £0.5 million per annum for Herefordshire Council over the remaining life of the PFI contract to 2023.

121. Should the Councils not need to access the existing PFI waste reserve, currently in excess of £2.4 million, the intention will be to release this reserve to either reduce the Unitary Payment uplift over the life of the remaining PFI contract.

<u>Summary</u>

122. In summary, Option 2, the Energy from Waste Plant Contract Variation with financing from the Councils, is the preferred solution for the Waste Disposal Authorities. The Value for Money Options Analysis shows that this option represents a cost to the Councils of:

- Circa £700 million in Net Present Cost Terms over the whole Useful Life of the Energy from Waste Plant.

- In Net Present Cost terms, **the EfW Variation is £128million cheaper than the "continue as is"** option for the disposal of residual waste for Herefordshire and Worcestershire over a 25 year period post construction.

123. Cabinet recommends that Full Council consider and approve the Councils' ability to provide project funding into Mercia to improve the deliverability, affordability and value for Money of the variation. A decision to allow the Councils to provide project finance into Mercia could reduce the Net Present Cost of Option 1 by up to £21.5million dependent on Full Councils' assessment of risk taken on during Construction. Whilst the risk may not result in actual expenditure incurred, Cabinet recommend that Full Council approve the amount of set aside from the Gross Surplus to potentially fund residual construction risk

Contractual Parameters

124. The previously outstanding parameters have been progressed and are now considered to be met, primarily through seeking opinion of leading counsel on specific matters. It is anticipated that a certificate will be provided under the Local Government (Contracts) Act 1997 to confirm that the Council is acting within its powers and which Mercia will be able to rely on for protection under the act

125. The remaining parameter outstanding relates to no objection being received from DEFRA or the Councils external auditors (now Grant Thornton) to the proposed contract variation. Following the submission of a draft Variation Business Case, the Councils are liaising with Defra regarding specific issues and points of clarification.

126. An existing Joint Agreement is in place between Herefordshire Council and Worcestershire County Council. This agreement was put in place in 1998 and covers; duties, cost sharing and payment mechanism, liabilities, the Waste Management service and review arrangements.

127. The Joint Agreement will be updated to reflect the impact of the signing of the EfW Variation if approved by the 2 councils. If the changes are approved, the current agreement will be amended to include the following:

- To reflect current Waste Infrastructure Delivery Programme (WIDP) best practice guidance.

- The revised cost sharing mechanism between the two authorities will be adjusted, moving away from a council tax base methodology to a contract waste share split between the two authorities. **This will be applied with effect from 1st September 2013.**

128. If the EfW Variation is agreed, a separate Joint Agreement will cover the life of the new EfW Plant and will detail:

- Asset partnership ownership rights. The EfW will be excluded from the property asset transfer agreement in the main joint agreement and will continue under partnership ownership for the asset lifetime.

- Specific arrangements in relation to Financing and associated Governance.

- Governance, decision making and dispute resolution procedures in line with current best practice.

- That costs, liabilities, revenues and benefits are shared between the authorities in line with their relative stake in the EfW Plant.

- That neither party can make decisions relating to ownership, management and operation of the plant without the consent of the other.

- That neither party can prevent access to the plant during its lifetime.

- That both parties commit to delivering their share of waste to the EfW from the end of the current contract with Mercia in line with the agreement

129. Financial Close of the EfW variation will be subject to both parties confirming and signing of the detailed joint agreement based on the above heads of terms.

Technical Parameters

130. When last reported, in December 2012, the main outstanding point was the requirement for major component warranties to be requested in Mercia's contract documents for the facilities.

131. Mercia Waste Management has considered the warranties offered as part of their evaluation of the tenders, and have pressed their suppliers on the level of warranty offered. The Councils' Technical Advisors have seen evidence of these warranty discussions and confirm that the contract documents include the required component warranties.

132. It is now considered that all Technical Parameters are met.

Deliverability

133. The value for money analysis demonstrates that Option 2 – EfW financed through prudential borrowing – is the best value for money. In addition this has a number of further benefits over the other options in terms of deliverability and mitigating risk.

134. To summarise, these benefits are:

a. Enables the councils to move to conclude the variation with Mercia in the first part of 2014;

b. Enables planning permission to be secured;

c. Construction can start in 2014 to deliver a plant that is operational thereby diverting waste from landfill by 2017;

d. Provides certainty regarding future costs;

e. Allows for letting of an Operate and Maintain contract in 2023;

f. Engineering, Procurement and Construction Contractor procurement almost complete subject to final negotiations with Mercia;

g. Provides certainty regarding the cost of the engineering, Procurement and Construction contract if the contract is let before the end of March 2014;

h. Makes use of proven technology;

i. Removes uncertainty regarding future landfill and waste treatment capacity and costs.

Defra / Her Majesty's Treasury (HMT)

135. DEFRA are providers of funding through Waste Infrastructure Grant (WIG) and are responsible for the Waste Infrastructure Development Programme (WIDP).

136. The Councils have continued to work with DEFRA including keeping them up to date and providing information relating to; background to the contract, strategic waste management objectives, waste flows, site selection, project team (including advisors), finance and timescales. This has also been shared with Her Majesty's Treasury (HMT).

137. Members of the Project and Funder Teams continue to work closely with Defra and HMT to explain and discuss the proposals and deal with any issues regarding them.

138. At the point of writing this report, the Councils have not yet received the final position of either Defra or HMT.

139. This is one of the defined Parameters and remains outstanding, and therefore the recommendation is subject to there being no written objection received from central government before 20 December 2013.

140. On 1 October 2013 the National Audit Office (NAO) notified the councils of their intention to review Defra's oversight of three local authority Waste PFI Projects, of which Herefordshire and Worcestershire is one. The others being; Norfolk County Council and Surrey County Council. The NAO are meeting with representatives from the Councils in November / December in order that they contribute to the review. The NAO have confirmed that this is a review of DEFRA's oversight and not a review of the project. Therefore, this does not cause any delay to the project.

Programme

141. Should the recommendations be accepted, a summary of key Programme Milestones is shown in the table below:

Activity	Date
Submit Variation Business Case to Defra	July 2013
Variation Business Case Clarification	August / Sept 2013
VBC Feedback from DEFRA and Treasury	Sept 2013

Financial Model Confirmation	August 2013
Contractor Negotiations	August – Dec 2013
Joint Agreement – Heads of Terms	August / Sept 2013
Cabinets – Herefordshire and Worcestershire	Oct 2013 - postponed
Councils (Funding) – Herefordshire and Worcestershire	Oct 2013 - postponed
Member Briefings	WCC: Oct 2013 HC: Nov 2013
Revised Financial Model Confirmation	Nov 2013
Rescheduled Cabinets – Herefordshire and Worcestershire	Dec 2013
Rescheduled Councils (Funding) – Herefordshire and Worcestershire	Feb 2014
Written confirmation of "no objection" from central government	Dec 2013
Complete Legal Drafting	Q1 2014
Financial Close	Q1 2014
Notice to Proceed	Q1 2014
Start Construction	Q1 2014
Construction end	31 Dec 2016
Operations Start	1 Jan 2017
Handback to Authorities (end of Contract)	31 Dec 2023

Outstanding Matters

142. There are a small number of outstanding matters and therefore the recommendations are based on various conditions:

- Herefordshire Council passing resolutions in the same or similar form;
- No objection from government to the Variation;
- Securing financing for the Variation;
- Final negotiations with Mercia to; improve the position in terms of affordability, resolve any outstanding matters and complete the required documentation.

Supporting Information

- ***Appendix A***: Parameters Report
- ***Appendix B***: Options

Further information on the subject of this Report is available from
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Contact Points

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Background Papers

In the opinion of the proper officer (in this case the Director for Economy, Communities and Corporate) the following are the background papers relating to the subject matter of this report:-

Joint Municipal Waste Management Strategy including Annex D – Residual Waste Options Appraisal

Agenda papers and background documents accessible to the public for the meetings of the Cabinet held on: 17 September 2009, 17 December 2009, 9 February 2012, 13 December 2012

Planning Decision by Secretary of State on Hartlebury EfW