

Briefing Note

Review of Mercia Waste Contract Indexation Options

Background

Worcestershire County Council and Herefordshire District Council ("the Councils") are joint parties to a pfi waste contract with Mercia Waste Management Limited ("the Contractor"). On 20th April 2017 the Contractor wrote to the Councils proposing an alternative indexation methodology due to a significant reduction in prices under the agreed contractual basis for that 2017/18. This arose due to a rebasing of the index which has occurred on an occasional basis during the contract life and can cause significant swings (up or down) in the index.

In order to properly evaluate options and to provide time for other contract issues to be discussed the Councils proposed, and the Contractor agreed, that the 2016/17 prices be held for a two year period as a without prejudice interim measure. To assist with the evaluation of options the Councils commissioned a review of the contract indexation methodology by an external professional advisor, KPMG LLP.

Review summary

The Councils requested a review to address the following:

1. Identification of best practice/ usual practice regarding waste contract price indexation
2. Modelling impact of Mercia waste proposal vs the current indexation method and best/usual practice indexation methods
3. Assessment of the level of risk associated with the modelled indexation proposals
4. Identification of other matters that should be considered as part of agreeing to an amended indexation calculation

The review identified four indexation options:

1. GDP deflator based from 1997 index (contractual method)
2. GDP deflator on an annual basis (Contractor proposed alternative method)
3. Indexation by CPI (best practice method)
4. Indexation by RPIX (alternative usual method)

Each option was assessed on the basis of affordability over the balance of the life of the contract, volatility and risk. The assessment is summarised below:

Method	Projected Cost	Volatility	Risk
GDP deflator from 1997	£282m		
GDP deflator annual	£286m		
CPI	£293m		
RPIX	£301m		

Note that no rebasing of the GDP deflator index (as occurred in 2016) is included in the above cost projection .

There were various other items of a technical nature included in the review but none of particular significance for this summary.

The review conclusion is that the most beneficial index for the Councils to adopt is the GDP deflator annual – as proposed by the Contractor.

Finance Recommendation

Based upon the consideration of affordability, volatility and risk it is recommended that the Councils negotiate with the Contractor to reach agreement to adopt the GDP deflator annual indexation method as proposed in their letter of 20th April 2017. It is considered that this option protects the Councils against the risk of significant movement in prices due to indexation volatility and rebasing whilst offering an affordable cost based on the forecasts prepared.

A key element of the negotiations will be agreeing the date of implementation of the change. At present the Councils have agreed a temporary price standstill with the Contractor. If contractual terms had been applied to indexation the Councils would have benefited from reduced pricing, estimated as totalling £755,000 in 2017/18 and £180,000 in 2018/19. Any negotiation should, therefore, ensure that the Councils retain this cost reduction.

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