# The wild waste

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The recent closings of the Cornwall, Berkshire and Nottinghamshire deals have shown that the UK waste sector is waking up after a two-year hiatus. It is a sector that has traditionally been the preserve of only a few players, but now new entrants, attracted by healthy margins and the prospect of increased deal flow, are starting to appear.

Dogged by technological problems and political wrangles, UK waste has always been the black sheep of the UK PFI sector. But with lenders turned off by ever-decreasing margins in accommodation PFIs and fierce competition for arranging roles, many are re-evaluating the waste sector.

The UK PFI waste sector has never really made the same progress as other social infrastructure PFI sectors. In the eight years since the first waste deal (the Isle of Wight project), only twelve have reached close. This is despite central government putting local authorities under pressure to meet recycling targets and stop dumping waste in landfill.

The EU landfill directive requires member states to reduce the amount of biodegradable municipal waste sent to landfill sites to 75% of 1995 levels by 2010 and to 35% by 2020. The UK government has been trying to meet this with a carrot and stick approach. Firstly, it has steadily been increasing the amount of PFI credits for councils willing to go down that route – £630 million ($1.2 billion) of credits have been made available to date.

Furthermore, new waste-specific derogations have been added to the standardised PFI contracts (SoPC3). The aim of this is to homogenise waste contracts and speed up the whole process.

But the new regulations have also contributed to the lack of deal flow over the last two years. Complying with the rigours of the new guidance, as well as sorting out deals that are already very complex, has slowed projects that were in the pipeline. For instance, the recently closed Central Berkshire deal was originally approved in October 2002.
Chris Holmes, associate director at NIBC (sole arranger on the Central Berkshire, RE3 facility) says of the new regulations: "It is an extra layer of approvals and complexity. The aim is to enforce a standard UK contract that will protect local authorities and make the sector more attractive to newcomers. In other sectors that has sped things up, but in waste there are so many sector specific aspects and lots of variability between projects – it can only help up to a point."

**Template solutions**

Apart from the challenge of implementing the untested SoPC3 regulations, the other reason for the slow deal flow has simply been a lack of tenders. However, since projects for Nottinghamshire and Cornwall have been designated as pathfinders, Partnerships UK and the Department of Environment, Food and Rural Affairs (DEFRA) are hoping that lessons learnt speed up the process.

In other UK PFI sectors there has been a move towards template solutions that make it much quicker to award projects and reach financial close. Partnerships for Schools, for example, recently announced preferred partners that all have a supply chain in place in each region of the country. This means local authorities can pick their preferred contractor and everything is in place to move forward very quickly.

The aim of the SoPC3 regulations is to standardise contracts, which in turn should speed up the procurement and financing process. But waste management is not as straightforward as an accommodation project, as David Newman from RBS Infrastructure says: "It's not simple, because you're dealing with a process plant and a potential myriad of deductions under the payment mechanism which could put serious strain on the operator and the banks. The contractor is running a proper business and so risks are significantly higher."

No two waste deals that have closed are the same and this will always limit how much the contracts can be standardised, and how much the awarding-to-closing process can be sped up. Waste management contracts are often multi-facility and have different functions. While most plants are moving away from incinerators to mechanical biological treatment (MBT) facilities, these still come in many different forms.

A waste deal is not just about waste collection and treatment, it is also about what is done with the residue from the process. If the project includes MBT then some of the recyclable matter can be turned into refuse-derived-fuel (RDF). The local authority then has to decide whether it wants to also build an energy-from-waste plant to burn the RDF or whether it wants to sell it on. In the case of the 1 million tonnes per year (tpy) Manchester Waste PFI the local authority has asked the two final bidders (a Viridor/Laing consortium backed by Bank of Ireland and NIB; and a Sita/Peel consortium backed by RBS and HSBC) to submit two bids – one where the RDF produced will be dealt with on site and the other where the RDF will be sent to a regional plant.

**Risks**

Just as the huge differences between waste projects make it hard to standardise contracts, pricing those projects is equally complicated. The Cornwall deal was slowed by negotiating which party takes which risks and when. With a municipal waste deal the relationship is a triangle between councils, sponsors and banks. The MLAs on Cornwall – RBS and EIB – were concerned not only with having a reasonable balance between public and private risk but also wanted reassurances that another contractor could step in if Sita dropped out.

The Cornwall scheme was a 30-year concession to take over existing facilities and build a new energy-from-waste (EfW) plant. RBS and EIB provided £72 million of senior debt each with a 27-year tenor plus a £10 million standby facility (RBS also supplied a £20 million equity bridge). Margins on the senior debt are 120bp over Libor during construction of the 15MW plant dropping to 70bp for the EIB debt before climbing back up in 5bp steps over the life of the concession. The RBS debt mirrors the step up of the EIB debt but at a higher level.

Although in some ways the projects are difficult to price, the main problems for waste are still technology and planning. Richard Games, executive director of infrastructure at WestLB says the waste sector simply isn't worth the hassle. "They take a long time to do, you get objections from the public because no one wants it in their backyard. Then there's the difficult technology, it's not that it's unproven, it's just that it's not consistently reliable".

Technology has been problematic throughout the history of waste deals. The Dundee Energy Recycling Limited (DERL) waste-to-energy plant literally blew up soon after opening in 2000 and lenders suffered considerable losses. Port Neath and Talbot has suffered problems and the Kirklees incinerator had to shut down for a month from September to October after boiler failure – repairs will cost more than £1 million.

Even those banks that do lend on waste deals remain cautious. David Newman at RBS says, "We remain to be convinced of the bankability of some peripheral and unproven technologies. It must be reliable core technology. Suez [the company building the Cornwall EfW plant] have got 50 EfW plants around the world, it's tried, tested and proven".

For many lenders the business involves accepting there are risks but picking their projects wisely.

The Lancashire project is worth around £2.8 billion over the lifetime of the project with a debt package of more than £350 million. It is an MBT project that uses a relatively new technology – UR-3R – which involves a machine that can sort waste for recycling and has never been used in the UK before. Despite this and the complexity of the three-facility plant, there was stiff competition among banks to get an arranging role: Lloyds TSB, Commonwealth Bank of Australia, Bank of Ireland, NIBC and HVB were eventually mandated as leads.

In addition to technology risk there are other less tangible variables that make waste deals difficult. For example, in the UK there is not much of a market for RDF. Even in Germany, which has a more advanced market for RDF, there are RDF stockpiles because there are not enough EfW plants as buyers.

The problem in the UK will only worsen as more MBT plants are built and EfW plants are refused planning because of the high population density in the UK. Earlier this month plans for Europe's largest resource recovery park on the Manchester Ship Canal, which included a significant EfW facility, were unanimously rejected by Cheshire council.

Another problem dogging the waste market is that the price of electricity and recyclables is running at historically very high levels. If newcomers to the market come in and price their bids on assumptions based on current electricity prices and the reliability of untested technology, they could lose a lot of money. As Chris Holmes at NIBC says: "These are mechanical plants, no one expects them to run 100% for twenty-five years. It's a question of how long reference plants have been running for, what efficiency they have and basing assumptions around that".

**Future**

The increasing pressure on councils that are still relying on landfill for waste management to put new facilities in place is not going to diminish. In fact the UK government plans to charge councils for missing their targets on diverting from landfill at a punitive £150 a tonne.

However, many question whether this will actually happen. So far the Landfill Allowance Tradable Scheme, which allows councils that are recycling more than their target to sell tonnes to those that are not, has not taken off. Because no councils have been fined, the credits have been selling for only £5-20 a tonne – not an incentive to councils to go down the waste management route. Cambridgeshire, which is already exceeding its target on recycling and has just appointed Donarbon to build its new waste management facility, has welcomed the government's latest announcement that it will definitely be enforcing the fines from 2010. This should create a real market in landfill tradable credits.

Despite the risks and the uncertain state of the market, new banks are interested in breaking into waste. The sector has had a chequered history – although many say that the lessons of early failures like Dundee have been learnt. But as new lenders come into the market the current pricing norm of 100bp-130bp may start to drop and as Richard Games at WestLB says, "Even if only one in ten deals go bad – at those margins it's not worth it".

**Waste developments**

But there are significant changes that may affect the sector. The first is DEFRA's plan to split waste management projects up into smaller contracts. Up until now, projects have been tendered as whole schemes that can involve construction (including cutting-edge technology), maintenance, operation (handling, sorting and dealing with the waste afterwards). As David Shepherdson at Bank of Ireland says: "If you were wanting a complete integrated solution there were only a few providers, and this is an attempt to open up the market to newcomers and specialist technology providers".

One project that will probably be tendered in separate parts is the Telford and Wrekin waste scheme. In fact a new procurement pack for local authorities with guidance on splitting up contracts will be issued shortly. The upside for banks is that if the contract is split up then it is much easier to price risks. In a sector as notoriously complex as waste this should encourage new banks to come in, although margins will most likely fall. The downside is that the smaller the capex the more likely a contractor will be able to fund this on balance sheet. The irony would be that just as the waste market was set to take off the need for bank debt may shrink. This is not hypothetical – the Nottinghamshire waste PFI, which was awarded to Veolia, was funded on balance sheet.

Splitting up contracts should also help counter the increasing concentration of the market on just a few contractors. In 1992, the 20 biggest private waste companies controlled 30% of the market, but by 2005 the six biggest controlled 60%. The past few years have seen mergers and acquisitions between contractors (most recently Cleanaway was bought out by Veolia). Given the scale of a lot of these schemes, and the fact there are only six or seven big players (Biffa, Sita, Shanks, Viridor, WRG and Veolia) there is a limited amount of projects that each can handle. In fact for the Northumberland scheme two bidders (Shanks and Senrec) dropped out and only Sita was left. Shanks in fact blamed overstretched resources as the reason for cancelling its bid. Government is keen to prevent a lack of bidders and so has decided to split contracts.

One problem banks foresee with splitting contracts is interfacing issues. It is easier to price risks for one asset, but if that asset is completely interdependent with other aspects of a facility then pricing would be much more complex. For instance if a bank was to lend solely to an EfW plant and it relied on RDF and the facility that produced that RDF broke down, for two months it is difficult to decide who would take that risk. The local authority may end up having to make guarantees to every different contractor. The Telford and Wrekin PFI may end up being a test case for this method.

A growing aspect of the waste sector is standalone EfW plants. At the moment the amount of RDF being produced at waste management facilities exceeds the capacity of existing EfW plants to deal with it. A new facility – Grundon/Viridor's Lakeside Energy in Berkshire – has been overwhelmed by councils asking it to take their RDF. That facility was backed by £155 million of debt underwritten by Bank of Ireland, RBS, Fortis, Natexis, and AIB, with a margin of 130-160bp over Libor. With decent margins and very solid demand, standalone EfW plants could be the next big thing in the sector. The only problem is getting the planning permission to build them.