

Tips topped

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Since the Isle of White became the site of Britain's first waste PFI project 1997, the flow of deals coming through the pipeline has been more of a dribble than a cascade. While there has been a surge of hospital and school PFI deals in the intervening years, only nine waste PFI projects have closed.

The reason for this inactivity is that compared to other types of PFI projects, waste management is a sector laden with risks that are not easily priced. This has hampered negotiations between local authorities and sponsors, while a succession of mishaps in the planning process for such projects has hardly helped kindle enthusiasm amongst lenders. When it has come to devising ways of dealing with rubbish, the easiest option by far has been to continue shoving it into holes in the ground.

Against this backdrop, it is unsurprising that few banks have taken an interest in the sector. Among those few that have are NIB Capital, ABN Amro, Dexia, RBS and Bank of Ireland.

Stopping the rot

All this is now changing. Waste dumped at tips produces methane, a particularly climate-changing greenhouse gas, so the EU Landfill Directive was introduced in 2002, forcing local authorities to find ways of meeting stringent landfill reduction targets or face severe financial penalties. Suddenly, a waste PFI market appears to be emerging with 11 deals currently in tender, worth an estimated £15.3 billion (\$27 billion). A further eight projects are either being drawn up, or are in the process of being approved.

However, obstacles do remain and no deals have been signed yet this year. Furthermore, September brought a mixture of good and bad news – the announcement that Lancashire had selected a preferred bidder for its £2.8 billion contract was offset by developments in Gloucestershire, where the local authority ditched its own, smaller deal. Some authorities have decided to pursue non-PFI options to meet the Directive's targets, and at the beginning of October financing closed for an £180 million energy-from-waste incinerator at Colnbrook, near Slough, to be built on a non-PFI basis.

But a concerted effort is underway to tackle the problems that have made waste PFI such an unattractive proposition. PUK, HM Treasury, 4Ps (Public Private Partnership Programme) and the Department for the Environment, Food and Rural Affairs (Defra) are currently working on waste-specific derogations to the third version of the standardised PFI contracts (SoPC3) guidelines used for drawing up PFI contracts. Cornwall and Nottinghamshire are currently road-testing the new guidance, which should be launched in March 2006.

EU talks, the sector listens

The catalyst for the sudden glut of waste PFI deals is the EU Landfill Directive, which requires member states to reduce the amount of biodegradable municipal waste sent to landfill sites to 75% of 1995 levels by 2010 and 35% of 1995 levels by 2020. The realisation that, with time running out, the UK is lagging behind much of continental Europe has sparked the recent interest. Estimates vary over how much investment is needed to meet the targets, but it is reckoned to be at least £7 billion.

Central government has steadily increased its commitment to waste PFI projects over the past few years, making available £275 million in PFI credits in 2004 in addition to the £355 million already available from the 2000 and 2002 spending reviews. The 4Ps issued a waste management procurement pack for local authorities in 2004, collectively known as the 'Guidance', which local authorities have to follow in order to be eligible for PFI credits.

The range of technologies available, apart from landfill, for dealing with municipal solid waste has proved to be an obstacle to making PFI deals bankable, as many of these are untested and consequently carry a high degree of risk. They broadly fall into three categories: materials recycling, composting and incineration. These are not mutually exclusive and many proposed solutions involve a combination of all three. However, although incineration will have an important part to play in any national waste strategy, it is a controversial issue and obtaining planning permission for incinerators has proved tricky.

Another major problem facing the sector is a lack of capacity. Over the past decade and a half, the UK waste sector has become extremely concentrated: whereas the 20 biggest companies in 1992 controlled 30% of the market, now the six biggest control 60%. The last few years have been characterised by mergers and acquisitions, and several of the big players are now fairly highly leveraged. Given that the bidding costs for each project can run into the millions and the capex requirements for the larger projects range as high as £250 million for Greater Manchester, these companies are unable to bid for more than three or four projects at a time.

Chequered history

In first week of September, Gloucestershire County Council announced that it was dropping its waste PFI project, citing a funding gap of £250 million. The council had estimated that total costs over the project's 25-year life would be £650 million, but instead the nearest bid came in at £900 million. Council officials also said they were unable to successfully resolve risk allocation issues, complaining that there was no guarantee that Gloucestershire's landfill allowance tradable scheme (LATS) targets would be met under the project.

The Gloucestershire project was the latest in a series of setbacks for waste PFI. In August, the Northumberland project was put into doubt after two bidders – Shanks and Senrec – pulled out, leaving Sita as the only remaining bidder. Senrec said it was dropping out of the race because Sula, its parent company, wished to concentrate on the German market; Shanks cited overstretched resources as its reason for cancelling its bid. Proving 'best value' will now be difficult for the Northumberland authorities, which have asked Sita to submit a revised bid but have stated that they may drop the project.

Perhaps one of the biggest problems encountered so far in the sector has been caused by a lack of joined-up thinking on the part of local authorities. Self-inflicted wounds have been the result of planning permission being denied to projects necessary for authorities to meet their LATS.

In February, planning authorities in West Sussex rejected a proposed materials recycling facility because of concern its effect on a 500m stretch of road. The implications are far-reaching for West Sussex, which will now struggle to meet its LATS targets. Elsewhere, a waste incinerator in Bexley, South London, has been delayed by successive public inquiries. Although the Bexley incinerator was not a PFI, its fate will not have gone unnoticed by sponsors and lenders.

"This is not the right message to be getting across," says Nigel Mattravers, waste specialist with Grant Thornton, which has advised local authorities on a number of projects, including Lancashire. "Local government must be supporting waste facilities."

Several other risks set waste management apart from other PFI markets. Chief among them are change of law risks, foreseeing what types of material future projects will need to handle, and technology risks. Some councils have expressed a strong preference for mechanical biological treatment (MBT) over incineration plants (even though the two can be combined, due to environmental concerns about the latter. However, MBT technologies are frequently unproven and lenders require certain guarantees for them to be bankable. If local authorities insist that sponsors carry the risks, then that will drive up the cost of the projects. Also, incinerators can generate considerable amounts of energy, another

reason why they are cheaper.

Enter the mandarins

The nine projects that have closed to date are: Isle of Wight, which was awarded to Biffa, Hereford and Worcester (Mercia), Kirklees, South Gloucestershire, Surrey (all Sita), East London Waste Authority (Shanks), East Hove and Brighton (Onyx), Leicester (Biffa) and West Sussex (Viridor). The first five of these projects were signed before the allocation of £200 million of PFI credits in 2000 spending review. The next four projects were signed between December 2002 and early 2004. Since then, no projects have signed, despite some being in tender since as far back as October 2002.

The reason for this abrupt halt was the publication in the spring of 2004 by the Treasury of the SoPC3 document. This document was largely designed with mature PFI markets in mind, such as hospitals, schools and road infrastructure – turnkey projects with risk profiles very different from those found in the waste sector.

Almost in parallel to this came the 4Ps' waste procurement pack. Though aimed at helping local authorities secure PFI credits for their projects, together with the SoPC3 guidelines it has had the effect of making already complicated contractual negotiations extremely complex.

"Local authority officials will probably only ever do one of these in their entire career," says Mattravers. "To go to a local authority, which has probably got a very small team who have been running very traditional contracts of collecting waste, taking it away and landfilling it, and to say to them 'you've got to go to the market with a contract that is probably going to be worth one and a quarter billion pounds, and you are going to be dealing with insurance issues that you've never even heard of,' – this is a huge challenge for any local authority."

Cameron Smith, a partner at Ashurst, which has advised on a number of projects, adds: "The fact that no project has yet financed on SoPC3 terms means that everyone is a bit nervous about being the first one, and getting it wrong."

Work is in progress to come up with waste-sector specific derogations to the SoPC3 guidelines and produce a first standardised waste PFI contract. PUK is working with sponsors, banks and authorities on two pathfinder projects in Nottingham and Cornwall that aim to test these derogations. Parallel to this, 4Ps is reviewing its waste management procurement pack. The process is designed to be both consultative and, for local authorities, educational. The scheduled launch date for the new guidance and standard contracts is 1 March.

Where there's a will?

In the same week that Gloucestershire pulled the plug on its PFI deal, Lancashire County Council announced that it had selected Global Renewables Limited (GRL), a subsidiary of Australian mining enterprise GR Minproc, as the preferred bidder for a waste project, with an estimated worth of £2.8 billion over its 25-year life. This deal confronts many of the problems facing the sector. The authority specified that it was looking for a MBT centre, thus ruling out incineration. GRL's MBT technology, pioneered in Sydney, has won praise for being an innovative and environmentally friendly option. But innovation comes at a risk, and Lancashire officials have cited the same affordability and risk issues that cropped up in Gloucestershire.

But there is a big difference between Lancashire and Gloucestershire: in the former, a politically unified local authority has been determined to press ahead and negotiate through tricky risk issues with sponsors and lenders. In Gloucestershire, where there was a change of political control in May's local elections, that determination to find a solution was lacking.

In choosing GRL, not previously a player in the UK market, the Lancashire project also eases the capacity constraints that have driven up costs for waste PFI and caused such problems in Northumberland. GRL is also bidding for the Wakefield project.

Eyes are now trained on the two pathfinder projects. Nottinghamshire selected Onyx in August as its preferred bidder to build an incineration facility. Council officials there say they have not had the same problems with risk allocation and

affordability that put an end to the Gloucestershire project and have plagued the Lancashire project. If they are able to achieve deals that satisfy all the parties, and it can be translated into a standard contract sufficiently flexible to deal with the sector's diversity, then waste management may prove to become the UK's next big PFI market.

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