Local zeroes

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The UK has traditionally lagged its neighbours in Scandinavia and the Netherlands in developing new waste infra-structure. Britains geography, particularly its abundance of disused quarries, has bred a dependence on landfills not known in other northern European countries.

EU-inspired taxes and directives, however, have provided the impetus to catch up, because the EU has directed that by 2020 the UK must reduce its biodegradable municipal waste sent to landfill to 5.25 million tonnes, or 35% of its 1995 levels. Similarly, landfill taxes have been rising by £8 ($13) per tonne each year. They rose from £40 to £48 in April, and will not drop below £80 from April 2014 onwards.

STaGS sticks out

The only waste deal to close using commercial bank debt this year has been the South Tyneside and Gateshead Sunderland (STaGS) waste PFI. As is often the case for waste PFIs three local authorities acting as a partnership, in this instance South Tyneside, Gateshead and Sunderland, tendered the project jointly.

In September 2010 the South Tyne and Wear Waste Management Partnership selected a consortium led by GDF Suez subsidiary SITA as preferred bidder for the project, beating a rival bid from United Utilities. Both bids had to pass a minimum quality threshold, measuring their technical, financial and legal strength and their overall integrity. The two consortiums passed this stage, but SITA managed to undercut United Utilities price. At the time of the selection, the winning consortium was comprised of SITA (45%), Catalyst Lend Lease (35%) and Royal Bank of Scotland (20%), supported by RBS, Natixis, BBVA, Credit Agricole and Bank of Ireland.

In the months following the selection, however, two of the five banks decided to divest large chunks of their project finance business through portfolio sales. In November RBS agreed to sell a £3.8 billion portfolio to BTMU and said it would scale back its project finance lending. Despite a longstanding relationship with SITA, including closing the nearby Northumberland Waste PFI in 2006, RBS withdrew from both the equity and debt shortly afterwards. Bank of Ireland, a traditional lender to waste deals, started selling off its overseas project finance business in April, and also left the STaGS deal.

Despite these last-minute obstacles, the project closed towards the end of April. Japanese trading company Itochu stepped into the void left by the RBS departure, and took on the 20% stake through its subsidiary I-Environment Investments. The three remaining banks, Natixis, BBVA and Credit Agricole, all increased their takes on the projects £236 million debt package.

This debt package is chiefly comprised of a roughly £200 million 26-year term loan, priced at around 300bp over Libor. The term loan leaves a two-year tail to the projects 28-year concession length, which is split into a three-year construction phase and a 25-year operations phase. The remainder of the £236 million package is a three-year equity bridge loan. Natixis, BBVA and Credit Agricole are now looking to syndicate the senior debt, have offered tickets of £25 million to a select group of banks, and commitments are due at the start of July.

The project benefits from £73.5 million in PFI credits, which Defra awarded in 2008, and then gave final approval to after the partnerships successful presentation of the projects final business case. STaGS fared better than other waste PFIs in this regard; a month after a preferred bidder on STaGS was selected Defra, the UKs Department for Environment Food and Rural Affairs, withdrew PFI credits from seven local authority-procured waste projects.

The plant will be built next to SITAs existing 136,000 tonnes-per-year (tpy) Northumberland waste PFI, which closed in 2006. The STaGS project involves building a 190,000 tpy energy-from-waste (EfW) plant in Teeside and three waste transfer stations in the area. The cost of the transfer stations is £10 million, which will be financed separately, with the authority making a substantial completion payment after construction. The EfW plant also benefits from a long-term power purchase agreement, improving the projects long-term credit. Unlike other waste deals, the PFI does not include a sorting element, as the waste partnership awarded a materials reclamation facility (MRF) contract to HW Martin in 2010.

As many structures as configurations

Is STaGS the first of a slew of waste deals closing? Cameron Smith, a partner at Ashurst in London, believes that The short- to medium-term pipeline is very healthy at the moment and, as most of the projects are through to the latter stages of tendering, this year could see quite a few closings. Smith says, however, that the longer-term pipeline is less certain, as very few new deals are being proposed.

Defras cutting of PFI credits has not been as damaging to the pipeline as one might imagine. Ashish Anand, director and head of social infrastructure at Barclays points out Many local authorities that had their PFI credits cut have turned their projects into PPPs, such as Gloucester and North London. The long-term picture is less clear, however, with Anand adding The impetus for waste PPPs may not come from local councils in future, but more from merchant ventures, as contracts are stripped of their PFI credits.

But while waste projects constitute the bulk of deals left in the UKs constrained greenfield infrastructure pipeline, they are one of the most complex PFI asset classes and the sector is plagued by regulatory and planning difficulties.

There are multiple technologies for managing waste, as Cameron Smith at Ashurst points out, Every authority has a different view on which technology is the best. Energy from waste (EfW) is the bread and butter of most waste projects, indeed STaGS consists of no other technology, and essentially burns waste to generate electricity or heat. Smith at Ashursts notes, EfW lends itself to project financing, and can be viewed in a similar light to an independent power project with large capital-intensive infrastructure on a single site. This all makes for a straightforward bankable technology, with revenues coming from the councils tipping fee and from the sale of any heat or power generated.

EfW facilities are typically set up to supply electricity only, but combined heat and power (CHP) facilities are becoming more common. MVV Umwelt won the contract for South West Devon Waste PFI in January largely because its plant will operate as a CHP plant from inception, whereas Viridors proposal only had the potential for CHP operations at a later stage. The MVV Umwelts proposal also benefited from it having a long-term steam supply contract with the Ministry of Defence.

Combustion-based technologies have to be operated behind a sorting facility, to ensure that any recyclables are reclaimed prior to incineration. Kwong-Wing Law at Natixis explains, Whether a sorting facility is included in a PFI is governed by the collection regimes and waste strategies of the councils in question. South Tyneside already had some sorting and recycling contracts in place, and in procuring the STWWMP they did not require it as part of the project. In contrast, SITAs neighbouring Northumberland Waste PFI combines an energy-from-waste facility with a materials reclamation facility (MRF).

Whereas an MRF simply separates recyclable material from general waste, mechanical biological treatment (MBT) plants carry out this sorting process, whilst producing fuel to be used by other facilities and employing a biological process such as anaerobic digestion to generate electricity and heat. MBT facilities are favoured over EfW by some authorities, and they typically generate a solid recoverable fuel (SRF), which can then be sent on to a separate EfW plant.

MBT plants are generally not as easy to finance as EfW, however. MBT combines several processes and as a result features more operating risk than EfW facilities. Smith at Ashurst also explains, If you opt for an MBT facility producing

SRF, your project is not bankable without a long-term offtake agreement for the SRF. An agreement introduces new counterparty risk, however, and if it falls through the solid waste may have to be landfilled. To tackle counterparty risk, North London Waste authority is procuring its waste facilities under two separate contracts one for the MBT facility and another for the use of the SRF. Only one bidder, Veolia, is short-listed for both contracts, however, and if different consortiums are selected this will introduce an element of interface risk.

Broad change-in-law clauses needed

This complex mix of technologies, with different emissions and by-products, make the waste sector heavily susceptible to changes to the regulatory environment. In particular, new environmental or air pollution controls affecting projects can be imposed from either Westminster or Brussels.

Regulatory changes are covered by change-in-law mechanisms that have a far broader reach than usual, explains Ashursts Smith. Its important to carve out anything that is foreseeable and devise a comprehensive law list a flow of EU directives that flags up any potential changes. Different laws relate to different technologies, and changes to emission laws will not concern an anaerobic digestion facility, for example.

Changes in the law can also cut a projects revenue streams, particularly given the sectors dependence on various counterparties. Anaerobic digestion plants are at present eligible for renewable obligation certificates, but this may not last, as the UK government looks set to retire the ROCs incentive regime over the coming years. Regulations governing offtakers further complicate the situation. An EfW facilitys offtaker could be a large emitter of carbon dioxide, for example, and a change in carbon emissions rules could spur them to try and amend their contract.

Regulatory change is one of the key challenges in the sector, explains one banker active in the market. As a result its really important to get the appropriate risk transfer. Whereas the sponsors often take on regulatory risk, the burden should fall more on the local authorities, in my opinion.

Last refuge of fat margins?

The diverse range of technologies, their interface issues, and the lack of a single preferred solution make waste the least standardised asset in the UKs PFI framework. Smith at Ashurst says Whereas for a BSF theres a pretty set template you can follow, all the different waste technologies make it harder to compare one project to the next. Counterparty strength is also a much larger concern with waste deals than other PFIs.

Waste deals carry more operational risk than more vanilla PFIs such as schools and hospitals. As a result, margins on waste PFIs are higher than their social infrastructure counterparts. Margins are higher as credit ratings for waste deals are at least one notch lower than those for other PFIs, says Kwong-Wing Law at Natixis, Whereas an accommodation PFI might have a BBB rating, a waste deal is likely to be BBB- at best.

Greater Manchester Waste, which closed in April 2009, has the dubious honour of having what is widely believed to be the highest margin for a UK PFI. If not refinanced, the deals 23.5-year senior debt is priced at 450bp from year 16 onwards. Although margins have fallen over the past two years, those on recent waste PFIs have still been nudging the 300bp mark. Law at Natixis comments: Although the margins are higher than other PFIs, they still dont always reflect all the added risk carried by waste deals. On some projects, they would be higher still if they better matched the projects risk profiles.

The complexity of waste deals not only translates into high margins, but also creates a wider range of financial structures. Anand at Barclays says, Most PFIs are geared at either the high 80s or low 90s. For waste PFIs, however, there is far more variation in gearing due to the greater range of risk factors and sensitivities. Variation in gearing is also reflected in greater variation in debt service coverage ratios, say market sources. Although average debt service coverage ratios are often set at around 1.2x, in the standard range for UK PFI, it can be set as high as1.35x, with the loan life coverage ratio even higher.

Going corporate, or even prudential

Given the margins that they look for it is perhaps unsurprising that commercial banks account for a minority of the financings for waste PFIs this year. Viridor closed the Oxfordshire waste PPP in March solely using £205 million in intracompany debt from its parent company Pennon. Similarly, MVV Umwelt will raise Eu250 million in corporate funding from its headquarters in Mannheim to finance the South West Devon Waste PFI.

Some of the larger developers are prepared to fully fund projects themselves, whereas others with significant balance sheets often try to project finance as much as possible but make up any shortfall with corporate debt, explains Smith at Ashurst. The problem with a purely corporate financing is that third party lenders are not there to bear any project risk, so the sponsors have to be prepared to lose any money invested.

At the other end of the scale, projects can be fully funded by the public sector under a system known as prudential borrowing. Prudential borrowing involves local authorities obtaining a loan from central government, usually through the Public Works Loan Board. The loans reflect the full credit of the local authority borrower, rather than being tied to a specific project, and so carry lower interest rates than third-party debt.

Defra usually recommends prudential borrowing for large local authorities procuring small deals. Lincolnshire County Council closed the £145 million Lincolnshire Waste PPP in March, for example, through a £100 million loan from the PWLB, carrying an interest rate of 100bp over UK gilts. County council reserves are being used to fund the rest of the projects costs with no equity contribution from the developer, FCC-owned Waste Recycling Group. Many local authorities also favour prudential borrowing as they see it as a means to cut through the difficult balancing act of closing a PFI deal.

Seeking prudential borrowing where possible may be a foregone conclusion for many county councils, but it means that there is no third party to assume the project risk. Its hard to know whether some authorities really understand the risks entailed with assuming prudential borrowing, explains Ashursts Smith. Banks perform a large amount of due diligence as they want to be sure of their investment. In their absence, the authorities have to take up this role, employing a large number of technical advisers in the process.

Can prudential borrowing be combined with bank debt to finance deals? Smith at Ashurst explains, If you run prudential borrowing alongside commercial bank debt, seniority becomes an issue. Who controls what happens in the event of default if there is a 50:50 split between private and public debt?

A possible solution being mooted by project bankers is banks providing a short-term construction facility, to be replaced with a government loan in the operational phase. A construction facility replaced by prudential borrowing brings the best of both worlds, explains Barclays Anand. It addresses the difficulties banks face in offering longer tenors, while still allowing them to take on the key risks of construction financing. Although bringing in prudential borrowing at a later stage drives down funding costs during operations, Law at Natixis points out It has no real impact on the margins for the banks for the construction phase, as they are still taking on all the construction risk in the initial phase.

Perennial planning problems

Projects still suffer at the hands of the UKs overly parochial planning system. The power of local councils to kill projects at the planning stage is a real headache for those in waste market.

In March 2009, for example, Cornwall County Council rejected planning permission for an EfW built by SITA, even though it had already awarded it a 30-year waste treatment contract. The decision was reverted to central government and two years later, in May 2011, communities secretary Eric Pickles ruled in favour of SITA. Pickles does not always smile so favourably on projects in planning purgatory. A week after his decision on Cornwall, he overturned the planning permission Nottinghamshire County Council granted to an EfW facility to be built by Veolia.

Theres a real lack of joined-up thinking in government, says Smith at Ashursts, You have one side of government trying to develop green energy and divert waste from landfill, and yet another part of the government is pushing a localism agenda. A push towards localism, which Pickles claims will make local government more accountable to its citizens, would be a severe blow to the waste sector. Nearby waste incinerators rarely play well with local residents, many of whom have the power to put pressure on planning committees.

With local hostility a fact of life, those active in market want more support from central government. Theres no consistency at a national level, says one lender active in the market. If waste treatment really is a high priority then it should be classed similarly to roads, as large strategic infrastructure. Smith at Ashursts agrees. We really need some more centralised planning systems, he says. The Infrastructure Planning Commission put forward by Labour was an attempt at this, but theres been no such solutions from the new coalition government.