

STANDARDISATION OF WASTE MANAGEMENT PFI CONTRACTS: DRAFT GUIDANCE ON SoPC DEROGATIONS

October 2005

CONTENTS

1	<i>Introduction</i>	3
2	<i>Glossary</i>	5
3	<i>Supervening Events (SoPC: Section 5)</i>	6
3.1	Introduction	6
3.2	Compensation Events	6
3.3	Relief Events	7
4	<i>Third Party Income</i>	9
4.1	Introduction	9
4.2	Key Considerations	9
4.3	Conditions of Derogation	10
4.4	Early Termination – Compensation on Termination	11
4.5	Other events where the Authority is required to cover lost Third Party Income 12	
5	<i>Change in Law (SoPC: Section 13)</i>	14
5.1	Introduction	14
5.2	General Change in Law	14
5.3	Specific Change in Law and Foreseeability	16
5.4	The Importance of Due Diligence on Electricity Contracts in EfW Projects ...	18
5.5	Discriminatory Change in Law	19
5.6	Changes in PPC permit conditions	19
6	<i>Contractor Default and Compensation on Termination (SoPC: Section 20.2)</i>	20
6.1	Introduction	20
6.2	Additional Grounds for termination for Contractor Default	20
6.3	Compensation on Termination following Contractor Default	20
6.4	Rectification Period Following Termination	23
7	<i>Deferred Capital Expenditure</i>	24
7.1	Introduction	24
7.2	Short deferral period	25
7.3	Long deferral period	25
8	<i>Landfill Allowance Trading Scheme (LATS)</i>	28
8.1	Introduction	28
8.2	Recommended approach	29
9	<i>Insurance</i>	31
9.1	Introduction	31
9.2	Uninsurability Protection	31

Consultation Draft 10.10.05

9.3	First Loss Limits	31
9.4	Applicability of Reinstatement Test to Waste Projects.....	31
9.5	Business Interruption Insurance - Authority Insurable Interest	32
10	<i>Patents and Drawings</i>	<i>33</i>
10.1	Patents and Drawings.....	33
11	<i>Appendix: Contractor Default – Compensation on Termination / Phased Project.....</i>	<i>34</i>

1 Introduction

- 1.1 Experience in procuring early PFI projects within the waste sector has highlighted certain sector-specific issues which require addressing to improve the development and delivery of future projects in this sector. It is the purpose of this Guidance to summarise these issues and provide practical solutions that can be readily applied on projects currently in development or procurement.
- 1.2 Waste projects procured under PFI principles should continue to follow the HMT and 4Ps guidance on best practices and standardised approaches to help achieve timely and good value for money outcomes. This includes HMT guidance on standard drafting of contract terms contained in SoPC and 4Ps' Waste Management Procurement Pack, which will be brought into line with this Guidance.
- 1.3 This Guidance should be read in conjunction with SoPC and treated as a supplement which varies the positions taken in SoPC in certain limited but important ways which are specific to the waste sector. This Guidance may only be applied on projects in the waste sector that have been structured along PFI lines, that is: where facilities are built and used primarily to provide a Service to the Authority; assets may or will revert to the Authority at the end of the Contract; and the Authority pays a Unitary Charge (subject to a performance regime) to the Contractor.
- 1.4 Some of the issues covered in this Guidance reflect underlying long-term characteristics of the waste sector; other issues may however be viewed as transient issues more reflective of the relative immaturity of the waste-sector PFI market and so should fall away as the market matures. Accordingly, it is expected that this Guidance will be updated, from time to time, and that some of the derogations to SoPC applicable under this current edition of Guidance will, as the market matures, be withdrawn. Any such withdrawal will not, unless the parties to the contract otherwise agree, have retrospective effect so that terms once adopted within a contract remain for the duration of the Contract.
- 1.5 This Guidance has been developed by Defra and Partnerships UK (PUK) with 4Ps, Cornwall County Council and Nottinghamshire County Council whose support is also acknowledged and thanked by Defra and PUK.
- 1.6 The issues addressed have been identified through consultation with the waste-sector PFI market and the public sector. Defra and PUK wish to acknowledge and thank all those who have given their time to this consultation and, in particular, those organizations which have facilitated the consultation process on behalf of their members: the Institution of Civil Engineers (ICE), Environmental Service Association (ESA), Chartered Institution of Waste Management (CIWM) and Local Government Association (LGA).
- 1.7 The issues covered in this Guidance are: Supervening Events (Section 3), Third Party Income (Section 4), Change in Law (Section 5), Contractor Default and Compensation on Termination (Section 6), Deferred Capital Expenditure (Section 7), Landfill Allowance Trading Scheme (Section 8), In-

Consultation Draft 10.10.05

urance (Section 9), and Patents and Drawings (Section 10).

- 1.8 This Guidance is intended to cover sector-specific and not project-specific issues. So, for example, it does not address all the issues which arise if an Authority does (or does not) transfer existing landfill sites to the Contractor, or chooses to specify recycling targets instead of tonnages processed targets.
- 1.9 [This Guidance has been approved by HM Treasury]¹.
- 1.10 The purpose of this consultation is to consult on the principles set out in this Guidance. The final version of the Guidance will include, where appropriate, drafting to reflect these principles.

¹ It is intended to submit this Guidance for approval following completion of the consultation exercise.

2 Glossary

Capex	Capital Expenditure
EA	Environment Agency
Effective Date	the date of satisfaction of conditions precedent under the Contract
EfW	Energy from Waste
HWRC	Household Waste Recycling Centre
LDs	Liquidated Damages
LATS	Landfill Allowance Trading Scheme
LATS Risk	The financial risk associated with using more than the allocated Landfill Allowances and therefore either having to purchase further Landfill Allowances or pay the LATS penalty
Opex	Operating Expenditure
PPC	Pollution Prevention and Control
RDF	Refuse-Derived Fuel
ROCs	Renewables Obligation Certificates
SoPC	HM Treasury: <i>Standardisation of PFI Contracts</i> (Version 3, April 2004)

Capitalised terms defined in SoPC have the same meaning when used in this Guidance.

3 Supervening Events (SoPC: Section 5)

3.1 Introduction

This Section covers the following issues:

- a) Is it appropriate to extend the definition of Compensation Event to provide protection during the Service Period?
- b) Is it appropriate to extend the list of events included in the definition of Relief Event?

3.2 Compensation Events

3.2.1 Purpose

3.2.1.1 The Compensation Event regime in SoPC caters for those events which arise before the Service Commencement Date which are at the Authority's risk and which result in a delay to Service Commencement and/or increased costs to the Contractor. The principles applicable to Compensation Events are set out at SOPC Section 5.2 and are applicable to waste-sector projects. The standard definition of Compensation Events at SOPC Section 5.2.1.2 and required drafting at SOPC Section 5.2 still apply and do not require amendment.

3.2.1.2 An Authority may, however, receive requests from Contractors that where the Authority has continuing obligations in the Services Period, the Compensation Event regime should be extended to apply to the Services Period. Such a general extension to the Compensation Event regime is not appropriate. In the waste sector, the recommended approach is to expressly identify any key obligations of the Authority in the Services Period and deal with them specifically in the manner set out below, rather than offer a blanket indemnity through the Compensation Event provisions. Two examples of such obligations are considered here: obligations to deliver contracted waste (3.2.2); and transfer of used landfill sites (3.2.3). The issue of compensation for lost third party income is also considered (whether arising before or after the Service Commencement Date) (3.2.4).

3.2.2 Obligation to deliver Contract Waste

3.2.2.1 The Authority should make clear, in the tender document, the throughput of waste (e.g. tonnage per annum) it expects to be processed and specify the minimum and maximum levels of this throughput. The specified maximum should protect the Authority from paying for greater capacity than it requires; and the specified minimum throughput will provide Contractors and Senior Lenders with the certainty they need to assess the financial viability of the Project. Variant bids which contemplate increased capacity (initial or future) can, of course, always be considered if they offer greater value for money – e.g. where waste streams are being sourced by the Contractor under more than one contract. The payment mechanism should provide for the Authority:

Consultation Draft 10.10.05

- a) to deliver waste according to the input specifications, (for example, a project involving EfW may specify calorific-value bands or thresholds). The payment mechanism should compensate the Contractor adequately for the Authority's breach of the input specification or for material change in waste composition; and
- b) to deliver waste at least to the specified minimum throughput. Depending on the payment mechanism methodology used, this can be reflected, for example, through a take-or-pay mechanism² where the Contractor is guaranteed a certain base level of income, if the waste tonnages delivered are less than the agreed threshold (always subject to satisfactory Contractor performance).

3.2.2.2 Where the Contract covers all the waste in the Authority's area (and an Authority should consider carefully whether it is in a position to or, indeed, should offer this³), the Authority would only be able to change this exclusive position through the operation of the Change Mechanism under the Contract. If however, the Authority were to breach its exclusivity obligations then this should be allowed as a Compensation Event.

3.2.3 Transfer of used landfill sites

3.2.3.1 If a Project involves the transfer of an Authority's existing landfill sites, the Authority should consider the extent to which it is possible and offers value for money to transfer to the Contractor the legacy liabilities (for example hazardous waste and latent defect at the sites) linked to such sites. Where it does not offer value for money to transfer such liabilities, the Contractor should be protected against any loss or liability arising from these agreed risks through a specific indemnity. The Contractor should, however, still be responsible for loss or liability arising from waste delivered or works conducted after the date of Contract award.

3.2.4 Calculation of compensation for lost third party income

If the Unitary Charge is supported by third party income, for which full benefit is given to the Authority through reduced Unitary Charges (or equivalent), within the Base Case financial model, then where a Compensation Event arises (whether before or after the Service Commencement Date) preventing the Contractor from generating the anticipated third party income, it is appropriate for the calculation of compensation to include provision for this loss of revenue opportunity (see Section 4 - Third Party Income, as well as the general SoPC principles relating to payment for loss of revenue under SOPC Section 5.2).

3.3 Relief Events

3.3.1 Purpose

² A take-or-pay mechanism may incorporate various mitigation provisions, for example a limited carry-forward (subject to plants' flexibility) where over use or under use of facilities can be transferred to future years, or alternatively may offer price banding.

³ An Authority may however afford itself some flexibility with regards to any exclusivity arrangements, if the exclusivity obligation only applies up to a certain tonnages of waste, or if, in part, it requires satisfactory performance of the Contract for a certain period before exclusivity applies.

Consultation Draft 10.10.05

- 3.3.1.1 Relief Events are events which, at any time, prevent performance by the Contractor of its obligations under the Contract and in respect of which the Contractor bears the financial risk of increased costs and reduced revenue; the Contractor is, however, afforded relief from termination for failure to provide the full Service.

3.3.2 **Additional Relief Events**

In addition to the events listed in SoPC Section 5.3.2, the following sector-specific events may if the circumstances warrant, be included as Relief Events:

- a) Protester action at the site of the key facility during the construction phase. Even if the Authority believes it offers value for money for the Contractor to take this risk and for the Authority to provide relief, it will still require the Contractor to mitigate and manage such risk as best it can. The Authority may therefore require the Contractor, as a qualification to the Contractor claiming a Relief Event, to demonstrate that it has acted properly in securing the Site, has taken reasonable measures under the circumstances to prevent entry and that it has taken such actions as are reasonable, proportionate and lawful to deal with protester action and, where necessary, in co-operation with the emergency services.

Some Contractors may request that the risk of protester action occurring at any Site should be treated as a Compensation Event. It is not appropriate for protester action to be included as a Compensation Event as the Contractor should manage such risk. Where a Project involves deferred construction of key facilities (i.e. the main waste treatment facilities) on Authority Site(s) however, the Authority should consider if it offers better value for money for the Authority to retain responsibility for the Site(s) (and with it the risk of protester action) and transfer the Site to the Contractor just before scheduled commencement of the construction of the relevant facility instead of at the Effective Date.

- b) The delivery of munitions, hazardous materials⁴ or human remains during the Services Period to the Site where the law or any relevant authority requires the Site to be closed (other than as a result of the Contractor's own breach or negligence).

3.3.3 **Relief from Liquidated Damages (LDs)**

In line with SoPC principles, the Authority should consider on a Project specific basis, whether or not the Contractor should be relieved of liability for any LDs, (although availability and performance deductions should continue to be made in respect of periods of delay or Service disruption caused by a Relief Event (see also Section 8 LATS)). Alternatively, the Authority can consider providing LD relief for those Relief Events not covered by insurance.

⁴ To be defined

4 Third Party Income

4.1 Introduction

Third party income (i.e. income from a source other than the Authority under the Contract) in waste projects may be derived from the following:

- a) sales of dry recyclables and compost;
- b) electricity and heat-related sales;
- c) “income” from RDF (Refuse Derived Fuel) disposal and/or ROCs (Renewable Obligation Certificates); and/or
- d) non-Contract waste (commercial waste, waste from other Authorities etc).

This Section addresses the issues related to third party income and how third party income should be treated following termination.

4.2 Key Considerations

The following factors should be considered in deciding the approach to third party income:

4.2.1 Authority’s affordability v Contractor’s long-term financial stability

Assumptions of third party income by the Contractor in the Base Case financial model assist value for money and affordability for the Authority. Authorities should however also consider that over-optimistic assumptions of third party income may have a significant impact on the long-term financial stability of the Contractor.

4.2.2 Changes in the market relating to the waste sector

4.2.2.1 Contracts should be flexible so as to afford both the Contractor and the Authority the benefit of changes in the market relating to the waste sector. For example, at present there is no established long-term market for dry recyclables or compost so the Contractor (and the Senior Lenders) are likely to provide for conservative price and volume estimates and attribute little or no value to any potential upside.

4.2.2.2 If the Contractor and Senior Lender does not value the possible upside in the Base Case, the Contract should still contemplate the possibility of such upside materialising. Unless there is a value for money alternative it is recommended that the Contract include a sharing mechanism and/or a price benchmarking exercise.

Examples:

- *If third party income e.g. dry recyclables, is x% above Base Case, the excess above Base Case (x%) is shared with the Authority (according to agreed percentages).*

- *The price of dry recyclables is benchmarked every y-z years and the price differential (compared to Base Case) above x% will lead to Unitary Charge adjustment (upwards or downwards).*

4.2.2.3 The approach to third party income in the Contract should avoid windfalls for the Contractor alone. For example, some of the Third Party “Income” may currently have a negative or zero value (e.g. RDF) but this value may change in the future (for example when the user market has developed or where there is a change in Government policy impacting market prices). The Authority should consider an appropriate sharing mechanism to ensure that it benefits from such changes by way of reduced Unitary Charge (or equivalent).

4.2.3 Preserving an effective right to Voluntarily Terminate the Contract

4.2.3.1 The third party income aspect of waste projects introduces a potentially significant liability for the Authority which may act as a practical fetter on the ability of the Authority to exercise voluntary termination rights. Under the market value approach (to compensating shareholders on termination), the cost of termination for the Authority implicitly includes the present value of forecast third party income for the remaining Service Period (at a market price estimated by the expert at the time of termination, which may be lower or higher than that assumed when the Unitary Charge was first determined). While the Contractor receives the forecasted value of third party income immediately, the Authority may or may not actually subsequently realise this third party income. This will present an issue for the Authority⁵, notwithstanding that the risk of realization by the Authority should be taken into account by the expert (e.g. through suitable risk adjustment) in determining the appropriate present value of third party income at termination date.

4.2.3.2 The recommended approach in view of paragraph 4.2.3.1 above is therefore where the market value option is chosen by the Bidders as the basis for compensation in circumstances of Authority Default or Voluntary Termination:

- a) the Authority should consider capping of the level of third party income; and
- b) the Authority should require a variant mandatory bid with the amount of third party income capped for the purpose of this compensation calculation⁶, notwithstanding that the Contract may have excess cash-flow sharing which itself attenuates the compensation payable by the Authority.

4.3 Conditions of Derogation

4.3.1 The following issues should be satisfied as a pre-condition to the application of any of the derogations set out in Sections 4.4 and 4.5 below:

⁵ This is a general issue which is also relevant to other termination scenarios.

⁶ It would also be useful for the purposes of bid comparison to require the Contractor to price not only the market value but one other basis of compensation i.e. Equity IRR or NPV of distributions.

Consultation Draft 10.10.05

- a) Projected third party income should be included in the Base Case financial model, and thus be reflected through reduced Unitary Charges (or equivalent), as well as the projected equity return and financial ratios of the Contractor; and
- b) It should be clear that the level of third party income set out in this model was reasonable (i.e. that it has not been artificially deflated) by the Contractor or its Senior Lenders.

4.4 Early Termination – Compensation on Termination

If the economics of the Project places significant reliance on third party income, this should be recognised in various termination scenarios, as set out below.

4.4.1 Termination on Authority Default or Authority Voluntary Termination

- 4.4.1.1 If the Base Case IRR or projected Base Case return methodology are chosen as the basis for compensation on termination standard SoPC drafting applies. This is because the Base Case should reflect the benefit of the third party income.
- 4.4.1.2 Standard SoPC drafting should also apply where the market value approach is chosen. This is because the market value (taking account of any sharing mechanism or capping on termination (*cf.* 4.2.3.2), actual performance, future price forecasts and market appetite) should be used to estimate the value of anticipated third party income in the same way as it applies to other revenues and costs.

4.4.2 Termination on Contractor Default

- 4.4.2.1 Under the Retendering procedure, the value of third party income will be taken into account by prospective Bidders. Consequently, no changes to the standard SoPC drafting will be required.
- 4.4.2.2 Under the No Retendering procedure the expert in making the determination or the Estimated Fair Value of the Contract should take into account the value of third party income in addition to the Unitary Charge. Given the significance of third party income in waste projects it will be an acceptable derogation to permit an express reference to third party income in SOPC Sections 20.2.9(c) (i) and (ii). In addition all costs (and depreciation and other charges) that may be incurred in generating third party income should also be included in the calculation of the Estimated Fair Value of the Contract to reduce the third party income level to the level of net income which the Contractor would have actually received.

4.4.3 Termination for Force Majeure

Standard SoPC drafting applies.

4.4.4 Termination for Corrupt Gifts and Fraud

Standard SoPC drafting applies.

4.4.5 Post-Termination Service Amount

In order to accommodate third party income in the calculation of the Post-Termination Service Amount (see SoPC Section 20.2.8.4) third party income actually received by the Authority must be added to the Unitary Charge, and the costs of generating such third party income deducted, in the calculation of the Post Termination Service Amount.

4.5 Other events where the Authority is required to cover lost Third Party Income

4.5.1 General Principles

- 4.5.1.1 The general principle for determining the level of compensation applicable to loss of third party income is that the Authority should, where the Project is otherwise operating normally and actually capable of generating such income, stand behind the Contractor's loss to the extent the loss arises from an act of the Authority (i.e. an Authority Change or the breach by the Authority of an obligation that is treated as, in effect, a Compensation Event).
- 4.5.1.2 In cases where third party income is lost as a consequence of a Change in Law or Authority Step-in without Contractor Breach it would be unreasonable to treat these events in the same manner as occurrences of Authority breach. As such a level of compensation commensurate with the level anticipated in the Base Case is considered appropriate and reasonable. A nuance to such approach is, however, that the Contractor should not in such instances have levels of third party income in effect "topped-up" to Base Case levels if its own performance preceding such event was below levels anticipated in the Base Case – performance risk should, of course, remain with the Contractor⁷.
- 4.5.1.3 In circumstances where the Authority is required to act following Contractor breach (i.e. on Step-in or following termination of the Contract) the Authority's prime concern will be to discharge its statutory duties; and the drafting in these circumstances should reflect this prime concern.

The following paragraphs of the Guidance seek to apply the principles anticipated above to Compensation Events, Qualifying Changes in Law, Authority Change, Force Majeure Events and Authority Step-In.

4.5.2 Compensation Events

The standard SoPC "No better/no worse" test should be applied to include the revenue and the cost of third party income generation. As per Section 3.2 (Compensation Events), in some Projects, the Authority may agree to provide protection to the Contractor not only for Authority breach but also for circumstances that arise which the parties agree should be treated as Compensation Events (for example historical landfill risk). The Authority should recognise that if such circumstances arise, unless specified otherwise, the amount of compensation under the Compensation Event (or

⁷ The period over which the Contract's historic performance should be measured may be agreed between the parties and should be such a length that reflects actual performance (i.e. seasonal factors that may affect performance should be smoothed out).

indemnity) regime will include third party income which may be higher than the level in the Base Case. If this is a concern, the Authority may elect to compensate at the lower of actual and Base Case levels, but this condition (if chosen) should be specified in the ITN.

4.5.3 Qualifying Change of Law

Compensation should be capped at the lower of recent/current performance and Base Case level net of related costs.

4.5.4 Authority Change

The standard “No better/no worse” test should be applied to include the additional or lost revenue and the cost of third party income generation.

4.5.5 Force Majeure event

If the Authority chooses to continue the Contract following a Termination Notice from the Contractor then the ongoing payments of Unitary Charge must be adjusted to take account of the lost third party income at the lower of recent/current performance or Base Case level net of related costs.

4.5.6 Authority Step-in

4.5.6.1 In circumstances where the Contractor is not in breach, the Authority should pay the Contractor the amount of lost third party income (to the extent the Contractor does not continue to recover it) net of related costs, in addition to the Unitary Charge. Compensation must be capped at the lower of recent/current performance and Base Case level.

4.5.6.2 In circumstances where the Contractor is in breach, no such additional payment should be made, but the Authority should set off any third party income actually received by the Authority under the Contractor’s third party contracts against the Authority’s own costs of operation in taking the Required Action. The Authority should where the amount is positive pay the balance between the two sums.

5 Change in Law (SoPC: Section 13)

5.1 Introduction

The Change in Law risk allocation principles of SoPC are generally applicable to waste management contracts. Sector-specific considerations arise however as follows:

- a) Where the construction of a key facility is deferred for several years, should provisions which allow for capital-cost sharing on a General Change in Law in the Service Period also cover (whether wholly or partially) the construction period of the deferred facility?
- b) How should “foreseeability” be interpreted if the impact of waste laws is not sufficiently certain to enable bidders to price for them in a manner that represents value for money?
- c) In EfW projects, should the definition of Specific Change in Law be extended to allow cover for Changes in Law affecting electricity generation?
- d) How should the risks of changes in conditions attaching to permits that are required for operation of the facility be allocated?

5.2 General Change in Law

- 5.2.1 Changes in operational costs as a result of a General Change in Law should be borne by the Contractor subject to the SoPC provisions for indexation, change in tax law, benchmarking and market testing.
- 5.2.2 For changes which involve Capex, under SoPC Section 13.8.4, a General Change in Law which was not foreseeable at the date of the Contract and which comes into effect during the Service Period, can be treated as a shared risk, based on a Capex sharing table. The risk of General Changes in Law arising and requiring Capex (regardless of whether such changes were foreseeable or not) before construction completion lies with the Contractor.
- 5.2.3 In waste projects where part of the construction is deferred and the Authority requires the whole construction price to be fixed at Financial Close⁸ (see Section 7 - Deferred Capital Expenditure), it may not be value for money to insist on transferring all General Change in Law risks during the Construction Period if the overall Construction Period is longer than 5 years from Financial Close.
- 5.2.4 For these projects, the Authority may use one of the approaches below to deal with such a lengthy Construction Period:

⁸ Subject to indexation and interest rates.

Consultation Draft 10.10.05

5.2.5 Option 1: Year 5 Reset

5.2.5.1 The Authority may agree a Reset Date (5 years or more after the Effective Date). The Construction Period between Effective Date and the Reset Date is referred to as Construction Period 1, and the period following the Reset Date is referred as Construction Period 2.

5.2.5.2 On the Reset Date, the Authority and the Contractor should review whether:

- a) There have been any General Changes in Law, requiring Capex which were not foreseeable at the Effective Date and which have taken effect in the past 5 years. In such case:
 - i. The resulting Capex costs relating to the works anticipated to be completed in accordance with the construction delivery plan during Construction Period 1 should remain the risk of the Contractor; and
 - ii. The resulting Capex costs relating to the works to be constructed during Construction Period 2 should be shared according to the Capex sharing table
- b) If Capex arises following a General Change in Law which was not foreseeable at the Effective Date but which has become foreseeable at the Reset Date such costs should be shared according to the Capex sharing table.

5.2.5.3 Following the Reset Date, the definition of Qualifying Change in Law should be adjusted to “a General Change in Law which comes into effect during the Service Period and which involves Capital Expenditure and which was not foreseeable at the Reset Date”.

5.2.6 Option 2: Phase Reset

5.2.6.1 A Reset Date that is linked to the deferred phase construction start date can be agreed in the Contract for a project where:

- a) The project comprises two or more discrete phases, e.g. Phase 1 transfer station refurbishment / new build and Phase 2 new treatment facility; and
- b) Phase 2 construction start date is deferred for more than 5 years from the Effective Date (the Deferred Facility).

5.2.6.2 This approach treats each discrete phase of the Project as a separate project, with a separate Service Period of differing lengths for each discrete phase (i.e. Phase 1 Service Period will start earlier than Phase 2 Service Period). The key principle is whether the General Changes in Law for Phase 2 are foreseeable before the start date of construction of the Deferred Facility. For a General Change in Law not foreseeable at Effective Date but which has become foreseeable at the Reset Date, the risk will be shared according to the Capex sharing table. The Contractor will be given the opportunity to take into account the implication of any General Changes in Law in the Phase 2 facilities prior to the start of the construction of Phase 2.

Consultation Draft 10.10.05

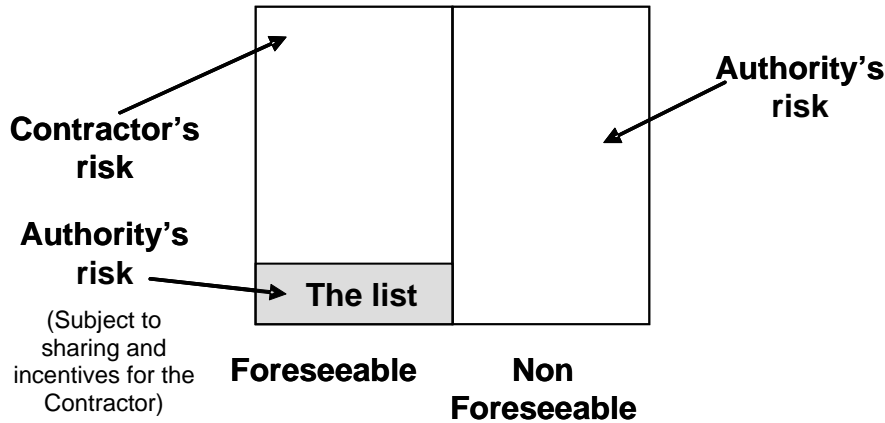
- 5.2.6.3 For the Phase 2 facilities, following the Reset Date, the definition of Qualifying Change in Law should be adjusted to “a General Change in Law, which comes into effect during the Service Period and which involves Capex and not foreseeable at the Reset Date”.
- 5.2.6.4 For Phase 1 facilities, the reference date of foreseeability will remain unchanged i.e. at the Contract Date.

5.3 Specific Change in Law and Foreseeability

- 5.3.1 In SoPC a Specific Change in Law, which was not foreseeable at the date of the Contract, is the risk of the Authority, while a Specific Change in Law which was foreseeable is the risk of the Contractor. The issue here is that many Changes in Law relating to the waste sector are potentially foreseeable but not with sufficient certainty to be adequately priced. It has been argued that it may be poor value for money to require the Contractor to take full exposure to this risk.
- 5.3.2 Several considerations arise:
 - a) The risk allocation should not take away the incentive for innovation; the private sector has traditionally proved adept at managing the effects of Changes in Law and minimising their impact on their businesses; and
 - b) Piecemeal changes to the facilities and their operation post contract award in order to comply with such changes in law may not be efficient. The Contractor is better placed to manage this risk by ensuring that the potential implications of complying with various foreseeable laws are implemented in a coordinated and efficient way.
- 5.3.3 In order to provide some certainty for both the Contractor and the Authority with regards to what is currently foreseeable for the purposes of the Change in Law provisions the recommended approach is that the parties should agree a specific list of waste-sector laws which, although foreseeable may not be priced at a level that represents value for money (the Waste Law List). It is clearly desirable for both bidders and procuring Authorities that this list be standardised and centrally managed, to avoid time consuming and repeated discussion of the same issues on project after project. Accordingly, it is Defra’s intention to develop and make available such a reference list to Authorities.
- 5.3.4 The Waste Law List and the cost of implementing such laws (particularly Opex implications) may vary depending on the technology and Service configuration proposed by bidders. It is important that Authorities and their advisers take into account the implications of implementing such waste laws (e.g. cost, Service disruption, sustainability and deliverability of current solution) given the foreseeability of these laws taking effect, during the bid evaluation and due diligence process.
- 5.3.5 By using this approach, the Authority effectively accepts that the Unitary Charge may be adjusted to take into account changes in waste laws early on in the Service Period, and it will bear the costs associated with such changes. While such cost implications should remain largely the responsi-

Consultation Draft 10.10.05

bility of the Authority, it is important that the Contractor should be incentivised to innovate and to minimize the cost of implementing the required changes. The Authority should consider implementing a mechanism (e.g. sharing thresholds, target cost⁹ or other), to promote a shared incentive the keep the costs of such a change in law to a minimum without exposing the Contractor to excessive risk.



5.3.6 In order to incentivise the Contractor to implement such changes efficiently, a regular review of the listed laws or reviews at pre agreed points should also be agreed in the Contract:

- a) Before appointment of preferred Bidder, the Authority and the Contractor should agree (or if possible the Authority should specify in the ITN) when the setting of compensation e.g. adjustment of Unitary Charge in relation to the Waste Law List should take place (the "Waste Law Review Date"). This date should be set well into the Contract Period (and at least 3 years after Contract signature) to allow for the effects of the listed laws to be known or sufficiently foreseeable such that the costs attaching to implementing such changes in law may be priced and shared. Any further pricing risk on this then reverts to the Contractor. If at the time of Contract signature it is felt that the impact of some of the listed Waste Laws may not be foreseeable at the first Waste Law Review Date, a further Waste Law Review Date may be agreed to allow for these laws. This procedure will help incentivise the Bidders to incorporate flexibility into the design and operation plan for the initial period (to avoid price renegotiation right after the Contract is awarded) and to coordinate the necessary works or changes in operation in order to comply with those foreseeable regulations.
- b) For projects with phased construction, consistent with the General Change of Law approach outlined in Section 5.2, the Waste Law Review Date may be set at the same time as the General Change in Law Reset Date. This will have a similar effect to treating the discrete deferred works as a separate project as the price implication of complying with foreseeable Changes of Law (be it General or Specific) is agreed before proceeding with the construction of the next phase.

⁹ For all or some of the list, as part of the competition process, the Bidders may provide a target cost estimate in order to comply with such regulations. A sharing mechanism may then be used to share the benefit beneath the target while the Contractor's exposure is capped if the actual cost of implementing such regulations is above the target plus x%.

- c) At the Waste Law Review Date, subject then to the SOPC Change in Law, mitigation and qualification provisions, the Contractor may invoke the Specific Change in Law procedure to estimate the effects of the Change.

5.4 The Importance of Due Diligence on Electricity Contracts in EfW Projects

5.4.1 In the context of EfW facilities, it is sometimes requested by bidders that the definition of the Service, in the context of the Change in Law regime, should be extended to include any Changes in Law affecting electricity generation, which would then become a risk of the Authority. This should not be allowed; however where a Specific Change in Law affecting the waste treatment facility comes into effect, the impact on electricity generation payments can be taken into account (see below at Section 5.4.3(c)). The Authority should, in any event, be closely concerned with the terms of the electricity off-take contract,¹⁰ given the impact it may have on the Unitary Charge payable under the Contract and any associated risks indirectly borne by the Authority for example any termination liabilities of the Authority.

5.4.2 The Authority and its advisers should conduct thorough due diligence on the electricity off-take contract before the appointment of preferred Bidder. In particular, it is important to ensure that:

- a) the electricity off-take contract is on arm's length terms and includes provisions commonly used to address changes in regulatory and other risks relevant to the length of the Contract;
- b) on termination of the Contract the Authority has a "step-in" agreement with the purchaser (in the same way as for its key sub contracts); and
- c) the electricity off take contract does not effectively fetter the ability of the Authority to terminate the Contract, for example no automatic termination following change of Contractor or termination events under the Contract, etc.

5.4.3 The Authority should take account the following:

- a) It is not appropriate for the Authority to take Specific Change in Law risk related to electricity generation to the extent this risk is normally passed through to the electricity buyer in an arms' length electricity supply contract.
- b) It is not therefore appropriate for the Authority to provide Specific Change in Law protection to preserve electricity income of the Contractor to the extent that the change in law does not have a direct impact on the ability or the costs of the Contractor to treat Contract Waste; An example of such a change in law, for example, a law that requires a levy to be imposed on electricity sales or an increase in grid connection

¹⁰ There may be a number of separate electricity supply contracts.

charges. This risk allocation in the Contract should incentivise the Contractor to negotiate a robust electricity contract.

- c) On the other hand if the Change in Law does affect the ability of the Contractor to treat Contract Waste (and the risks crystallised by such a Change in Law are not normally passed to the electricity buyers) the calculation of Change of Law compensation should include the loss of electricity income in the same way as other third party income (*cf.* Section 4.5).

5.5 Discriminatory Change in Law

The SoPC provisions in this respect do not require any change.

5.6 Changes in PPC permit conditions

- 5.6.1 The Environmental Agency (the “EA” - the issuing body for PPC permits) has a discretionary right to change the conditions of PPC permits. Such a right continues to be exercisable by the EA once the PPC permit is issued (e.g. to protect public health) and regardless of whether there is a breach or not of the existing terms attaching to the PPC permit.
- 5.6.2 The recommended approach is for any change to the terms of the PPC permit to be a Contractor risk, where such change arises as a result of the Contractors’ acts or omissions. For example, the Contractor should be expected to take the risk of the working hours of a facility being changed by the EA, as a result of residents’ objections to the Contractor’s operational practices. Clearly, the Contractor is best placed to use its expertise and experience, in operating waste facilities, to manage this risk.
- 5.6.3 Any change in the PPC Permit arising from any other cause (for example change in how the EA interprets or implements the meaning of existing law or regulation) may be included as a Qualifying Change in Law (i.e. Authority’s risk).
- 5.6.4 It should be ensured however that the Contractor is not protected under the Qualifying Change in Law provisions where there is a change in the PPC permit caused by an act or omission of the Contractor.

6 Contractor Default and Compensation on Termination (SoPC: Section 20.2)

6.1 Introduction

This Section addresses the following issues:

- a) Is it appropriate for the Authority to have additional grounds for termination for Contractor Default for waste PFI Contracts in addition to those specified at SoPC Section 20.2?
- b) Is a derogation for the calculation of Compensation on Termination following Contractor Default (SoPC Section 20.2) appropriate on sector specific grounds?

6.2 Additional Grounds for termination for Contractor Default

To take account of the specific characteristics of the waste sector, it is recommended that the following events of Contractor Default are provided in addition to those specified at SoPC Section 20.2.2.1.

6.2.1 Health and Safety (H&S)

H&S is a particular concern in this sector (as it is with all process industries). Accordingly, the Authority should have a clear and specific termination right for breaches relating to H&S.¹¹ The Contractor should, however, have the opportunity to take appropriate action in order to remedy the breach prior to any termination right arising. The H&S termination trigger should, therefore, be drafted so that breach of H&S resulting in H&S conviction may be a default if the sub-contractor/officer who committed the H&S breach is not replaced within 90 days. The Authority should only exercise its right to terminate the Contract on this ground if to do so would be to act in a reasonable manner having regard to the gravity of the offence.

6.2.2 Failure to submit planning application by a specified date

In order to try to ensure that the anticipated timetable for the Project is adhered to, it is appropriate for the Authority to include a specific termination right if the Contractor fails to submit the planning application by a specified date.

6.3 Compensation on Termination following Contractor Default

- 6.3.1 SoPC specifies two procedures for the determination of compensation on termination for Contractor default; the Retendering procedure (where there is a liquid market) or a No Retendering procedure .

¹¹ As is also the case for other key PFI sectors such as education and health

Consultation Draft 10.10.05

- 6.3.2 The concern arises that on termination of the Contract due to Contractor Default, if the Retendering procedure is used, it is possible that there will be no Compliant Tender because no other Bidder could (or would be prepared) to operate the technology used in the Project. Under SoPC provisions, if there is no Compliant Tender, the Contract value is deemed to be zero and this may not reflect the fair value of the Contract in the hands of willing and capable operator. This issue may be acute in waste projects, whilst the sector is developing and whilst performance requirements and mechanisms, and technical solutions tend to vary from project to project with few common standards yet evident.
- 6.3.3 EfW plants may, however, be considered proven technology, with numerous facilities around the world including within the UK operating successfully for many years. Given the worldwide operational track record of some EfW technologies, once the facility has become operational, the technology risk should be manageable because there are several established alternative operators who are capable of operating the technology.
- 6.3.4 Some non-EfW solutions such as MBT have recently been chosen as the preferred technology solution by some procuring Authorities. MBT is neither a single technology nor a complete solution, but is a term that has come to embrace the use of several types of biological and mechanical process elements combined in a wide variety of ways to meet a range of objectives. MBT systems thus vary greatly in their complexity and functionality. It is understood that there is no shortage of commercially viable MBT processes, however the functionality, complexity, cost, environmental performance, standard of engineering and reliability of commercial systems varies widely. At this stage in the development of MBT, it is apparent that different waste players tend to adopt different MBT processes.
- 6.3.5 From a technological perspective, MBT may be less complex to construct than EfW, however, it has a shorter operational track record and, to date, its usage has been concentrated in only a few countries.
- 6.3.6 In view of the concerns set out above it is recommended that either (but not both) of the derogation options outlined below is permitted for projects scheduled to reach financial close by 31 March 2008. The limited duration of these derogation options is considered appropriate given that it is anticipated that the concerns of the waste industry with regards to compensation of termination provisions for Contractor Default will diminish as the market matures. The Authority should, however, give recognition in the bid evaluation process to projects where no derogation, or only a temporary derogation (not during the whole Contract Period) is required. The following key principles must be preserved regardless of the derogation option chosen:
- a) The risk of delivering the facilities is the risk of the Contractor; if the Contractor fails to deliver the facility (regardless of the technology chosen) by the Long Stop Date, a default will arise. The parties should, however, agree an appropriate period between Target Commencement and Long Stop Date to enable the Contractor to manage construction risks; and
 - b) Following termination, the retendered Contract should be offered on the

Consultation Draft 10.10.05

original Contract terms. It is not appropriate for the Authority to agree to change the performance requirement in the Contract for the purpose of Retendering. A bidder is expected to have taken a view on whether it can attain the performance targets set out in the Contract; the Authority should not re-set the regime if the Contractor has incorrectly assessed its ability to perform the Contract.

6.3.7 **Option 1:** If there is No Compliant Tender under the Retendering route, rather than an automatic zero market value, the No Retendering route can be used to calculate the compensation amount payable on Contractor default. This option will be applicable during both the construction and operating phase. This is a sector specific (and temporary) derogation – with no wider application in other PFI sectors.

6.3.8 **Option 2:** This option allows for ring-fencing of Senior Debt in the circumstances set out in paragraph 6.3.8.1 below. The ring-fencing protection may only be applied during the Construction Period.

6.3.8.1 This derogation may be used in an integrated waste Contract where:

- a) There are two classes of assets in the Project – lower construction risk assets (e.g. a transfer station) and higher construction risk assets (e.g. a treatment facility). The higher construction risk asset is usually deferred, subject to planning permission being granted, and the majority of Capex will be spent on this (i.e. the deferred Capex of this facility is significantly higher than the expenditure for the initial facilities¹²);
- b) It is possible to structure or split the integrated project into two separate sub-projects. The payment mechanism and Base Case financial model must be sufficiently transparent to enable the Authority and its adviser to verify that there is no cross subsidy between the separate parts of the project and it must be possible for the expert to value each separate part upon termination; and
- c) The treatment facility is based on a mature technology with a track record such that banks may take the view that the technology is operationally proven and alternative operators are likely to be available. The standard SoPC Compensation on Termination provisions would then apply when construction was completed.

6.3.8.2 It has been argued that, during the construction phase, protection on both the Retendering and No Retendering procedure is required so that the construction risk profile of the integrated Project is no worse than that of a project whose sole asset is a treatment facility. For this type of Project (as described in 6.3.8.1 above) the following structure may be used, if it demonstrates better value for money:

- a) During the construction phase, the Senior Lenders' investment in the lower risk assets will be protected from value erosion from the high risk assets in the calculation of compensation of termination, if the termination is triggered by failure to complete the higher construction risk facility;

¹² See Section 7 on deferred Capex generally.

Consultation Draft 10.10.05

- b) No protection should be given to equity because the performance of all facilities is the Contractor's risk; and
- c) Once the higher construction risk facility is completed, construction risk ceases to be a factor and the termination provisions will revert to the standard SoPC position.

Details of this protection mechanism are set out in the Appendix.

6.4 Rectification Period Following Termination

- 6.4.1 A suitable rectification period for a new Contractor should be allowed in the Contract. This principle is contained in the SoPC definition of New Contract (SoPC Clause 20.2.8) because the Service Commencement Date for the New Contract will be extended by a period to allow a new Contractor to achieve Service Commencement and the concept may be extended to allow rectification in the operational period as well. Availability and performance deductions would still apply during this period.

7 Deferred Capital Expenditure

7.1 Introduction

7.1.1 Capex that will be incurred some time after Contract signature (Deferred Capex) may arise in waste projects because:

- a) planning permission may need to be obtained post-Contract signature; and/or
- b) it is anticipated that the need for a new facility, to accommodate demand growth given projected levels of residual waste, will only arise some time in the future.

7.1.2 As a result of the above factors, the overall construction period for waste projects may be unusually long (e.g. 5-7 years), raising further and different risks from those in a standard PFI project. Deferred Capex also gives rise to issues in the context of the Change in Law mechanism which are discussed in Section 5 – Change in Law, above.

7.1.3 Deferred Capex raises the following issues for Authorities:

- a) To what extent does it represent value for money for the Authority to request a fixed price in relation to an asset which may only be constructed some time in the future? This is a particular issue given that any price offered today will contain a risk premium reflecting the future start date for construction.
- b) What should the Authority's approach be in relation to issues that arise which relate to the funding for such projects?

7.1.4 The Authority should recognise that, depending on when the facility is expected to come on stream, the following pricing mechanisms (or a combination of them should be considered):

- a) fixed price;
- b) price subject to indexation; and
- c) price subject to market testing.

The Authority and its advisers should always ensure that, given that waste projects typically involve some Services commencing on Contract signature, the payment mechanism is properly structured so that the Authority does not pay for a Service that has not been delivered.

7.1.5 In addition the issues above are considered in two different contexts: a short period during which start of construction is deferred and a relatively longer period of deferral before construction starts.

7.2 Short deferral period

7.2.1 This Section considers the situation where the principal facility is required as soon as possible but Capex is deferred due to the time required to complete the planning and licensing process.

7.2.2 When preparing for, or during the course of a procurement, the Authority may take measures to reduce the period of deferred construction as follows:

- a) the Authority may undertake consultation with the relevant planning authority and the general public to identify feasible sites; and
- b) it may even be possible for the Authority itself to apply for planning permission even if this is not transferable. The Authority should at least consider the cost benefits of going through the planning application in advance of the planning application process by the Contractor.¹³ In such a scenario (where the period for deferral of construction is relatively short) it is likely that a fully fixed price for the facilities may still represent value for money and any risk premium in the Contractor's bid should be marginal.

7.2.3 Depending on the length of construction deferral, a fixed price or a combination of fixed price until certain time has elapsed, followed by indexation, may be used. The Authority should in its bid evaluation process give recognition to those Bidders who provide for a marginal risk premium relating to the construction of the deferred facilities and do not require construction indexation adjustments. If the Authority does consider that such indexation offers better value for money, the Authority should only accept indexation using appropriate, commonly used, frequently published, objective and independent construction indices.

7.2.4 The Authority should be satisfied that funding (either corporate or project finance) will be available for the Project once planning has been obtained. The underlying interest rate applicable to such funding maybe fixed by the bidder in its bid or be subject to adjustment post-financial close. The Authority and its financial advisor should specify its requirement relating to interest rate fixing adjustment in the ITN together with a request for a mandatory variant bid covering the alternative scenario. There should, in any event, be a transparent and preferably competitive process for any fixing of the underlying interest rate applicable to the funding (i.e. Libor), whenever this occurs, (fees, margins and all other key terms of finance having, of course, been fixed within the bids received). The risk that arises from a deferred fixing of underlying interest rates (i.e. Libor), can either be borne by Contractor equity, or by the Authority managing its own affordability position, beyond Contract signature until interest rates are fixed, through suitable project budget provisions.

7.3 Long deferral period

¹³ Although the Contractor will need to apply for planning permission, a previous Authority-led planning exercise may assist in mitigating the potential delays attaching to the planning process. The planning process for the Contractor may then be smoother, since key aspects of the proposed planning arrangements should be already known and possibly agreed.

Consultation Draft 10.10.05

- 7.3.1 This Section considers the scenario where one or more key treatment facilities are only required to be built after a significant period, for example, 5 years or more after the Effective Date or where a lengthy planning period is expected.
- 7.3.2 Depending on the timetable for the future development, the technology may improve or become obsolete and/or the level of proposed third party income may change. As a result, it may not be sensible for value for money reasons to fix the Unitary Charge at Contract signature. Similarly, if the planning period is long, although the technology is chosen, it may only be possible to obtain fixed / indexed prices from sub-contractors of key facilities so far ahead (and without a firm delivery date) if a substantial premium is paid.
- 7.3.3 Before commencing the procurement process, the Authority and its advisers will need to analyse the advantages and disadvantages of having the future facility forming part of the PFI procurement of the initial facility. The Authority should consider whether the Contract should be structured along the lines used in LIFT or other partnering PPPs which provide for flexible but robust mechanisms to deal with future uncertainty, for example:
- a) Obtaining agreement from the Contractor that the scope of expansion (or as much as possible) will be subject to competitive tendering;
 - b) Benchmarking; and
 - c) Open book accounting.
- 7.3.4 If the decision is to include the future facility in a standard PFI procurement:
- a) The Authority should satisfy itself that the fixed / indexed price requirement still provides value for money. The Authority should include, in the Contract, market-testing requirements and mechanisms to deal with significant discrepancies between indexation and market-testing results.
 - b) The Authority should recognise that fully-committed project finance funding is unlikely to be available for this kind of project on a value for money basis. The bid evaluation should recognise certainty of a funding commitment (e.g. availability of any corporate guarantee) if this is provided by a bidders.
 - c) If committed funding is not available or not value for money, the Authority will need to manage the risk of funding not being available (either because the incumbent funder for whatever reasons is not willing to lend or the terms proposed by the incumbent do not represent value for money when required). This may be done by:
 - structuring the Contract so that it can be terminated on the non-availability of funding, on a similar compensation basis as for breach of refinancing if incumbent funders only provide funding for phase 1 of the Project or as for Contractor Default with Phase 1 ring-fencing (see Section 7 and the Appendix) if incumbent funders have provided conditional commitment for funding the whole Project. This will help incentivise equity to procure appropriately priced funding; and

Consultation Draft 10.10.05

- the intercreditor arrangements being structured in such a manner as to facilitate an alternative funder being introduced to the project for the new facility; or
- the Authority having the right to instruct the Contractor to undertake a refinancing competition if the incumbent funder is not willing to lend or the terms proposed by the incumbent funder do not represent value for money. In such cases, the Authority should ensure that any interest rate hedges (typically swaps) are not terminable as a consequence of the refinancing being effected.

8 Landfill Allowance Trading Scheme (LATS)

8.1 Introduction

- 8.1.1 Under the European Union Landfill Directive (the Directive), each waste disposal authority will be allocated landfill allowances (Landfill Allowances),¹⁴ which taken together will enable England to meet its targets under the Directive. Landfill Allowances will convey the right for a waste disposal authority to landfill a certain amount of biodegradable municipal waste in a specified scheme year.¹⁵
- 8.1.2 The Landfill Allowance Trading Scheme (LATS) was launched on 1 April 2005. LATS allows waste disposal authorities to trade Landfill Allowances with other authorities, save them for future years (bank them) or use some of their future Landfill Allowances in advance (borrow). This flexibility has been afforded to waste disposal authorities so that any individual waste disposal authority may determine the most efficient allocation of its Landfill Allowances as part of its overall waste disposal strategy. A fixed penalty of £150/tonne will be incurred if a waste disposal authority breaches its Landfill Allowance target in the scheme year.
- 8.1.3 One issue that needs to be considered is to what extent the “LATS Risk” (which is effectively the financial risk associated with using more than the allocated Landfill Allowances and therefore either having to purchase further Landfill Allowances or pay the LATS penalty) can be passed onto the Contractor under the Contract?
- 8.1.4 Contractors are reluctant to take LATS Risk because:
- a) Although the maximum penalty is known, it is difficult to quantify the market value of buying excess Landfill Allowances; and
 - b) The Contractor cannot compel an Authority to bank or borrow Landfill Allowances and can therefore not practically take all steps necessary to effectively manage this risk.
- 8.1.5 The party who takes the LATS Risk will need to have the ability to trade, bank or borrow Landfill Allowances (as envisaged above). Not all Authorities are, however, keen to transfer this activity to the Contractor. Contractors also at present have reservations with regards to the transfer of this activity to them because they do not have experience of managing this activity. It does not, therefore, represent value for money for the Authority to pass LATS Risk in its entirety to Contractors. The passing of such risk to the Contractor will also give rise to bankability issues.

¹⁴ The Waste and Emissions Trading Act (2003) provides the legal framework for the scheme and for the allocation of tradable Landfill Allowances to each waste disposal authority in England.

¹⁵ The separate issue of allocation of Landfill Tax risk is dealt with in the 4Ps Waste Procurement Pack.

8.2 Recommended approach

- 8.2.1 LATS Risk may materialize if the Contractor fails to complete the treatment facilities on time or fails to operate the facilities to the expected performance level. In such circumstances, waste may not be diverted from landfill as planned and the Authority may have to either buy or borrow Landfill Allowances or pay the fixed penalty to Defra.
- 8.2.2 The Contract must, in accordance with SoPC principles, ensure that the Authority is protected against delay in Service Commencement and Service interruption/poor performance by the Contractor (including failure to process and divert the agreed quantity of waste). The protection should be designed in a way which gives the Authority value for money, taking into account the type of loss the Authority may suffer. It is therefore recommended that the Authority retains LATS Risk but should seek to mitigate this as set out below.
- 8.2.2.1 In the first instance, the Contractor should be given the opportunity to process the waste elsewhere. If this can be done (within an appropriate timeframe) then, the full Unitary Charge should still be paid.¹⁶ If the alternative waste processing utilised by the Contractor requires more Landfill Allowances to be used, a liquidated damages regime can be agreed to compensate the Authority for the additional costs, expenses and losses it will suffer as a result of the Contractor's failure to perform the Service.
- 8.2.2.2 To deal with a situation where no alternative Service is provided (not even landfill), the Authority should estimate the losses above the portion of the Unitary Charge that it will not pay under the Contract payment mechanism, including the cost of meeting additional Landfill Allowances, the cost to process the waste at an alternative facility and/or to landfill.
- 8.2.2.3 It is important that the payment mechanism is calibrated appropriately to ensure that the deduction reflects the portion of Unitary Charge linked to the Services failed to be delivered. This is especially important in an integrated Contract where several Services are combined. The Authority and its financial advisers should ensure that there is no cross subsidy of Unitary Charge from one facility to another.¹⁷
- 8.2.2.4 It is likely that the deduction from the Unitary Charge may not cover all costs, expenses and losses incurred by the Authority as a result of breach by the Contractor of its obligations to process Contract Waste. An LD regime can be agreed to compensate the Authority for the additional costs, expenses and losses it will suffer if the Contractor fails to perform these obligations.
- 8.2.2.5 In the case of both construction delay or operational failure when structuring the level of LDs the Authority must be mindful that any level of LDs should

¹⁶ Landfill tax is usually reimbursed by the Authority for waste that is supposed to be landfilled. If the Contractor fails to process the waste and waste to be diverted from landfill is landfilled, the resulting landfill tax should be the liability of the Contractor (i.e. no reimbursement) but the Contractor should still receive the full Unitary Charge.

¹⁷ The Authority should be careful in using a uniform handling charge regardless of whether waste is landfilled or treated. The concern here is that uniform handling charges do not reflect the risk premium that should attach to waste treatment that diverts residual waste from landfill or may involve cross subsidy from one facility to another.

Consultation Draft 10.10.05

be set at a level that represents a genuine ascertained pre-estimate of the losses that the Authority will suffer as a result of the breach of the obligation and not a penalty.

8.2.2.6 The Contractor's liability under such regime should, however, be capped. In setting the level, the Authority should consider how the LDs will be funded and the value for money implications, in accordance with the principles in SoPC Section 4.2. (See also SOPC Section 3.3.3 – Relief from Liquidated Damages, above.) It should be noted that:

- a) Not all LDs will be financially borne by the Contractor. To the extent the event causing the completion delay or disruption of Service is insurable, the cost of LDs may be covered by the insurance.
- b) In circumstances where the completion of the facilities is delayed and the cause of delay is not covered by the insurance (e.g. bad project management, sub-contractor problems, etc), the Authority should consider:
 - where it provides better value for money for the Authority than an immediate claim against the Contractor, carrying forward the LDs as a claim repayable out of the Unitary Charge, but only after current senior debt service but before junior debt and equity; and
 - setting a cap on the amount claim that is carried forward on. The cap should be set in such a way that it is not so high (i.e. wiping out the equity return) that it will take away the incentive for the Contractor to solve the issues altogether or so low that it does not provide adequate incentive for the Contractor to solve the issues delaying the plant completion as soon as possible. Loss beyond the amount of the cap would remain with the Authority.

9 Insurance

9.1 Introduction

The new Insurance Guidance published by HM Treasury on [] (revised Chapter 24 of SoPC) is applicable to waste projects.

9.2 Uninsurability Protection

Only those insurances which are designated Required Insurances benefit from uninsurability protection. As with other PFI projects there may be requests from Contractors to include project specific insurances such as environmental impairment insurance. The Authority and its advisers should assess whether it is appropriate to define any such insurances as Required Insurances.

9.3 First Loss Limits

For those waste projects where the assets are geographically dispersed, the Authority should consider the extent to which insurance should be placed on a 'first loss basis'. This is where the sum insured equates to the maximum probable loss, rather than the full potential loss. If the Authority elects to have insurance effected on a first loss basis then the estimated maximum loss should be calculated in accordance with the Association of British Insurers guidelines.

9.4 Applicability of Reinstatement Test to Waste Projects

9.4.1 An Economic Test for reinstatement of assets is not normally required where a project's assets are geographically dispersed. However, where a single asset is large, or the revenue associated with the asset is disproportionately high (e.g. a single large MBT or EFW plant) relative to the other project assets, it is possible that Senior Lenders will request a reinstatement test in relation to that asset.

9.4.2 The need for an economic test may be accentuated on account of the more limited scope of Business Interruption cover sometimes effected for waste projects. The total period required to rebuild a key facility in case of its total destruction could be very lengthy, and as such an indemnity period under the Business Interruption policy to cover the whole of this period may either not represent value for money or not be available. If the indemnity period under the Business Interruption cover is less than the period required to fully rebuild the key facilities, then this may increase the need for an economic reinstatement test.

9.4.3 It will be for the Authority, in conjunction with its advisers, to determine whether an economic reinstatement test is appropriate, taking into account the level of geographical concentration and the length of the indemnity pe-

riod under the Business Interruption insurance. Each project will need to be judged on its own merits.

9.5 Business Interruption Insurance - Authority Insurable Interest

Depending upon the third party income sharing provisions, the Authority may have an insurable interest in third party income generated by the project. For a waste project this can represent a high share of total revenue. Accordingly the Authority may wish to be named as an additional insured under the Business Interruption policy with respect to this insurable interest, and its interest noted in the Required Insurance Schedule. The Authority, in conjunction with its advisors, should however first assess the cost of effecting and maintaining such cover and consider whether this represents value for money. In the same schedule, the Contractor's insurable interest will also be noted. The sum insured for the Contractor's interest should correspond to the unavoidable fixed costs (a definition for which is included in Annex 5 of the revised insurance guidance). Unavoidable fixed costs include senior debt service.

10 Patents and Drawings

10.1 Patents and Drawings

- 10.1.1 The Authority and its advisers should satisfy themselves through the usual due diligence process that the Contractor has unfettered right to patents and drawings.
- 10.1.2 The Authority should have access to patents and designs etc. of the Contractor free of the Senior Lenders' security rights. The standard way of doing this is by including appropriate provisions in the Direct Agreement with the Senior Lenders.

11 Appendix: Contractor Default – Compensation on Termination / Phased Project

This Appendix is intended to provide an illustration of the regime set out in Section 6.3.8 (Option 2)

This mechanism assumes that:

- a) equity is contributed on a pro rata basis across both Phase 1 and Phase 2 Assets; and
- b) the payment and performance mechanism has been structured such that it is possible for the expert to determine the value of each element (Phase 1 and Phase 2) of the Contract.

Definition:

Phase 1 Assets: Initial Assets with lower construction risk

Phase 2 Assets: Subsequent Assets with higher construction risk

"Tranche 1": Senior Debt invested in Phase 1 Assets outstanding as at the date of termination.

Step 1

Standard SoPC approach (Retendering / No Retendering) is used to determine the value of the Contract as a whole ("X")

Step 2

If "X" is less than Tranche 1 and the Contractor believes that this shortfall is wholly or partly caused by the negative effect of Phase 2 of the Contract (i.e. the value of Phase 2 is lower than zero), then the parties should agree this effect. In the absence of agreement, an expert will determine whether Phase 2 has a negative value.

If there is no negative effect, the usual SoPC mechanism will continue to apply.

If there is a negative effect, and X is less than Tranche 1, then step 3 applies.

Step 3

The expert determines the negative value of Phase 2 ("Y"), and the revised Highest Compliant Tender Price / revised Estimated Fair Value of the Contract is the lesser of:

- (i) $X + Y$ (taking Y as a positive figure); and
- (ii) Tranche 1.

Consultation Draft 10.10.05

Example:

Capex for the immediate works of the Contract is for refurbishment or new build of HWRC and transfer stations (Phase 1 Assets).

Total Capex: £30m

Funded by:

Debt - £27m

Equity - £ 3m

Phase 2 of the Contract is a new-build EfW plant (Phase 2) with the same debt:equity ratio.

There is a problem with the construction of the EfW plant and the Contractor fails to resolve the problem and complete the EfW plant by the longstop date. The Contract is terminated for Contractor Default. Tranche 1 debt outstanding is £27m. Debt on the Phase 2 Assets at the time of termination is, say, £50m making £77m in total.

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
The Highest Compliant Tender Price (if Retendering procedure is used) or the Estimated Fair Value of the Contract (if No Retendering procedure is used) ("X")	£65m	£ 25m	£5m	£19m
Expert determination of the value of Phase 2 of the Contract (if X is less than £27m) ("Y")	n/a	£2m	-£24m	-£3m
The revised Highest Compliant Tender Price / the revised Estimated Fair Value of the Contract.	£65m	£ 25m (No erosion of value from Phase 2 of the Contract)	£27m (The lesser of £(5+24)m or £27m)	£22m (The lesser of £(19+3)m or £27m)