Waste PPPs/PFIs

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Pennon Group Plc

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Colin Drummond

Executive Director, Pennon Group Plc

Chief Executive, Viridor Waste

The Challenges for UK Municipalities – Drivers of PPPs[1] / PFIs[2]

- Targets
  - 50% recycling by 2020
  - 65% reduction from 1995 levels in biodegradable municipal waste to landfill by 2020

- If they fail to meet targets
  - face steeply increasing landfill tax
  - potential Landfill Allowance Trading Scheme (LATS) fine
  - reputational impacts

- Up to £30bn will have to be spent on municipal waste infrastructure by 2020 according to Institution of Civil Engineers ('ICE')

[1] *Public Private Partnerships*

[2] *Private Finance Initiatives*

Services Required by Municipalities

- Services required may include
  - Household Waste Recovery Centres (HWRCs)
  - Transfer Stations and Bulk Transport
  - Materials Reclamation Facilities (MRFs)
  - Composting
  - Mechanical Biological Treatment (MBT)
  - Anaerobic Digestion (AD)
  - Energy from Waste (EfW) especially Combined Heat and Power (CHP)
  - Landfill

- Renewable energy generation and recycling are both key parts of typical PPP/PFI contracts
  - potential to benefit from long-term increasing renewable energy prices
  - recyclate/commodity prices very variable, depending on economic conditions

Waste and Renewable Energy Opportunity

- UK targets to generate 15% of total electricity from renewables by 2015 and 15% of total energy (30% to 40% of electricity) by 2020
  - compared to 4% of total UK electricity at present

- Waste currently accounts for largest portion of UK renewables (30%) and has grown six-fold over the past 10 years
  - landfill gas 24% and incineration 6%
  - represents around 1.5% of total UK electricity

- Could account for much larger proportion
  - up to 17% of total UK electricity per ICE

- Renewable Obligation provides market related financial incentives

Renewable Obligation (RO)

- Under RO, generators of renewable energy are paid
  - basic wholesale/brown energy price
  - value of renewable obligation certificate ROC
  - (climate change) levy exemption certificate
- Brown energy price set by world supply/demand
- ROC value depends on actual renewable production versus government target; if UK falls behind target prices go up
  - target 5% of electricity in 2005 rising to 10% in 2010 and 15% in 2015
  - ROC face value set in 2002 at £30 per MWH plus inflation (currently £35.76)
  - if target were 10% and actual production 5% then ROC value would be around £60 plus inflation (c£75 in 2010)
- Has led to 600% increase in UK landfill gas power generation in past 10 years and 60% reduction in methane emitted from landfills
  - huge environmental benefits (methane 21 times as harmful as CO_2) and good news for shareholders

Types of Contract

- In order to meet the above challenge UK municipalities are letting a large variety of contracts including
  - short to medium term contracts (up to 10 years) which typically have limited infrastructure provision

    versus

    medium to long term contracts (10 to 25+ years) with a significant element of infrastructure provision
  - integrated contracts covering multiple services (e.g. recycling, composting, residual waste treatment and disposal)

    versus

    individual contracts covering one or more related services (e.g. food waste digestion and green waste composting)
  - contracts covering more than one Waste Disposal Authority (WDA)
  - use of third party merchant facilities as an element of the service provision

Types of Contract Finance

- Contracts can be financed in a number of ways
  - with or without PFI credits (from council funding viewpoint)
  - corporately financed on waste contractor's balance sheet
  - project financed through Special Purpose Vehicle (SPV) with or without a recourse element

- Viridor sees huge commercial opportunities whatever the contract and financing structure and is already reaping the benefits

Public Private Partnerships

- Historically waste services have been delivered through a number of conventional contracts covering
  - collection
  - civic amenity/household waste recycling centre management
  - landfill

- Over the last 10 years, the PPP approach has increasingly been applied to waste to help address the scale and complexity of the challenge facing municipalities
  - PPPs are designed to fund the development and subsequent operation of the new infrastructure required
  - effectively these are DBFO (Design, Build, Finance and Operate) or BOOT (Build, Own, Operate and Transfer) contracts

Private Finance Initiatives

- PFIs are a sub category of PPPs
- In PFI, Councils bid to Government for PFI funding
  - allocated in series of tranches
  - if successful, a council will received additional funding (PFI credits) from central government to reduce the cost (to the council) of its project
  - involves greater complexity than for a standard PPP

Strategic Partnerships

Strategic Partnerships are another sub category of PPPs

- In these, council works in direct partnership with the contractor
  - council and contractor jointly investigate and decide on infrastructure to be built
  - contractor procures infrastructure through third party
  - contract price not fixed at contract close, but contractors returns are

Procurement Rules

- Government has developed suite of standard procurement rules for PPPs
  - rules are evolving over time (current version SoPC4)
  - projects with PFI credits must seek DEFRA/PUK*/Treasury approval for any derogation from these rules
  - projects without PFI credits have more flexibility

- Under EU Law, virtually all waste PPP contracts must now be procured through Competitive Dialogue
  - involves more detailed discussions before choice of preferred bidder
  - adds to bidding costs

** Partnerships UK*

Viridor PPP / PFI / Similar Contracts - I

- **West Sussex PFI (April 2005)**
  - 25 years
  - HWRCs, MRF, transfer stations and transport
  - on balance sheet

- **Somerset PPP (May 2006)**
  - 25 years
  - running existing HWRC centres
  - building and operating proposed Anaerobic Digestion plant under Strategic Partnership
    - planning permission achieved (45kt, 1.5MW)
  - on balance sheet

Viridor PPP / PFI / Similar Contracts - II

- **Poole PPP (September 2006)**
  - 20 year extension to original 3 year contract
  - transfer and disposal (initially to landfill and thereafter landfill and Lakeside)
  - recycling (initially Crayford with potential development of dedicated MRF in Poole in co-operation with Bournemouth)
  - on balance sheet
- **South Lanarkshire (March 2007)**
  - conventional contract structure
  - 7 year recycling and disposal contracts
  - on balance sheet
- **South London Waste Partnership PPP (September 2008)**
  - awarded under competitive dialogue
  - 14 years at 450kt pa
  - transfer stations, transport, recycling, anaerobic digestion, (landfill)
  - key facilities Crayford and Beddington
  - on balance sheet

Uncertainties and Risks

- Various uncertainties and risks in PPPs/PFIs
  - waste volumes and mix
  - technology
  - capacity of technology suppliers
  - planning
  - input costs (including fuel/energy)
  - recyclate prices
  - legislation/regulation
  - etc

- Typically handled by
  - due diligence
  - contractual terms (including back to back with sub-suppliers)
  - residual risks are priced in

Other Viridor Municipal Contracts

- In addition to the above PPP/PFI/similar contracts Viridor has a large number of conventional municipal contracts
  - 24 landfill
  - 51 recycling / HWRCs

David Robertson

Finance Director, Viridor Waste

Accounting for Contacts
Current Rules

- International Financial Reporting Standards (FRS 5)

- Profit and loss account
  - revenue taken as paid by council
  - operating costs, including depreciation of asset, deducted
  - operating profit
  - interest on borrowings
  - PBT

- Balance sheet
  - operator owns the asset so included in fixed assets
  - related debt in borrowings

Accounting for Contracts

- If contract is in a wholly owned SPV
  - all lines consolidated into Group Accounts (P&L and balance sheet)
  - sub contract profit

- If contract is in a majority owned SPV
  - as above, except that there will be a minority interest in P&L and reserves

- If contract is in a joint venture SPV
  - share of SPV's PAT is taken into Group's PBT
  - interest receivable on loans to SPV
  - sub contract profit
  - the equity invested will be in investments and the loans in receivables on the balance sheet

Accounting for Contracts
Potential New Rules

NB: not yet adopted by EU Accounting Regulatory Committee (ARC)

- Pennon not currently planning to apply them in 2008/09
- International Financial Reporting Interpretations Committee (IFRIC) 12
- Service Concession Arrangement
  - operator undertakes the contract "For and on behalf of a Public Body"
  - council pays for the facility by means of a long term contract (25 years)
  - at end – facility is handed over to the council
  - operator does not 'own' the asset
  - therefore cannot be a fixed asset

Accounting for Contracts
Potential New Rules

- Revenue from council split into three elements:
  - construction revenue (taken as facilities are built)
  - funding revenue (to fund operator's borrowing)
  - operating revenue (to cover operating costs)

- The quantum of the split will be decided by assumptions made by the operator

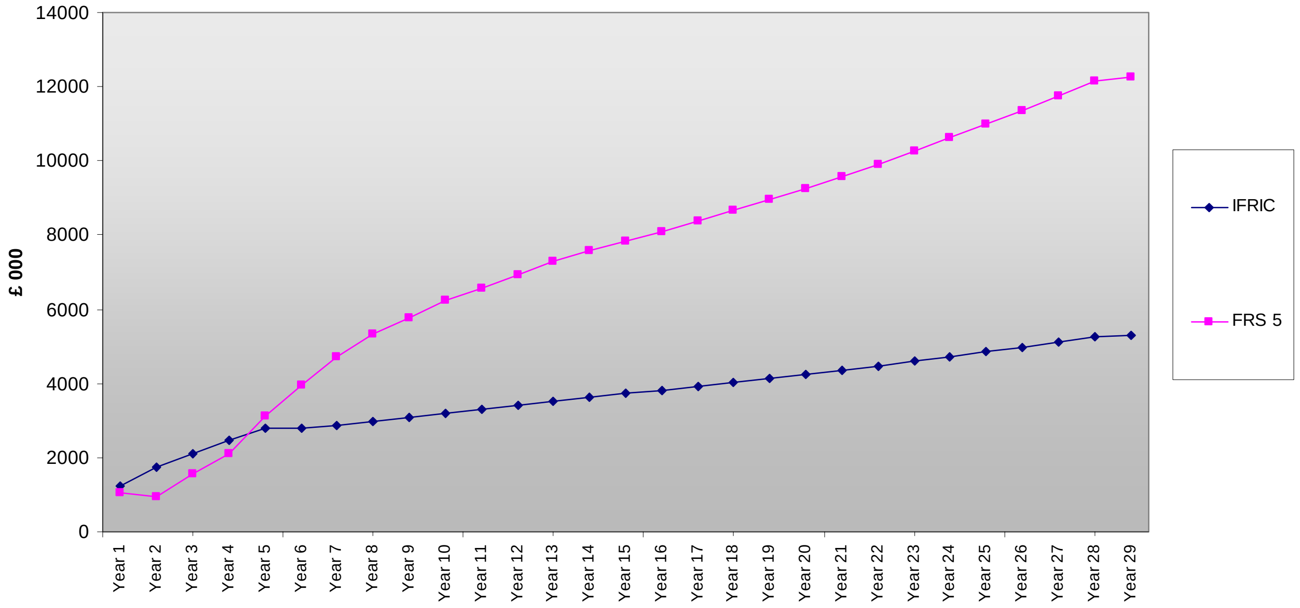
Accounting for Contracts
Potential New Rules

- Profit and loss account
  - construction revenue (early years as facilities are built) less construction costs
  - operating revenue less operating costs (Note: no depreciation as facilities not owned by operator)
  - funding revenue less borrowing costs (Note: contained within net financing charge)

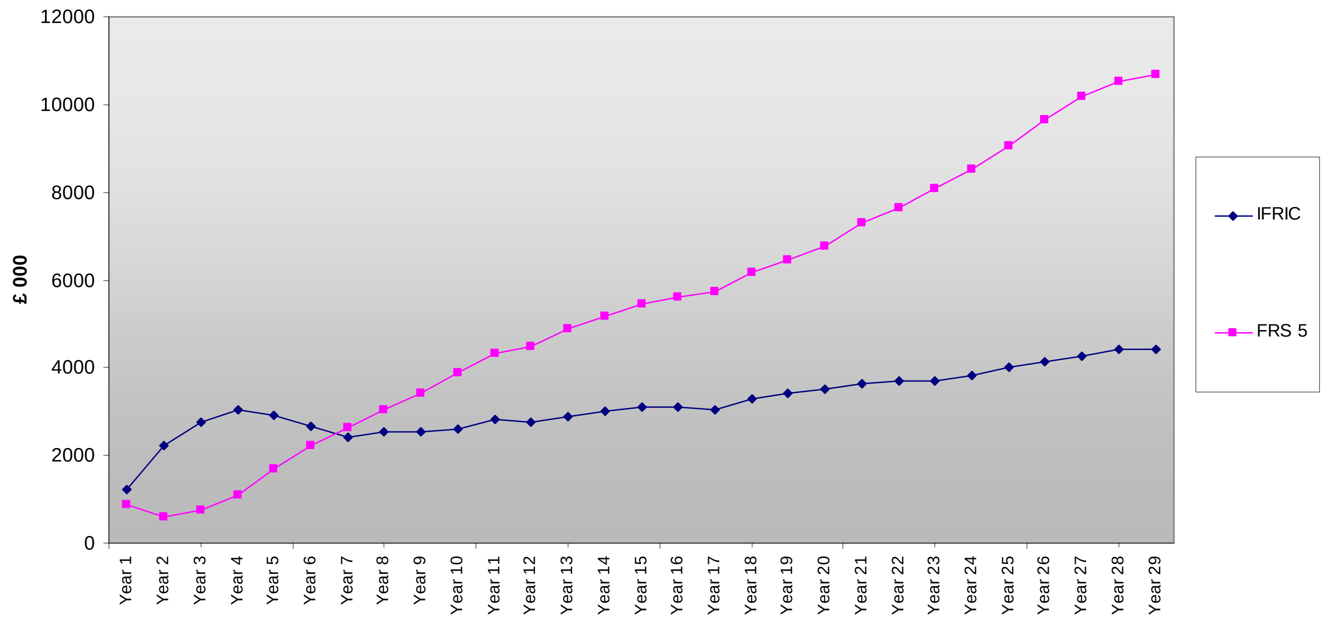
- Balance sheet
  - receivable – amount due from council (all costs to date less cash received from council)
  - related debt in borrowings

Accounting for Contracts
EBITDA Comparison

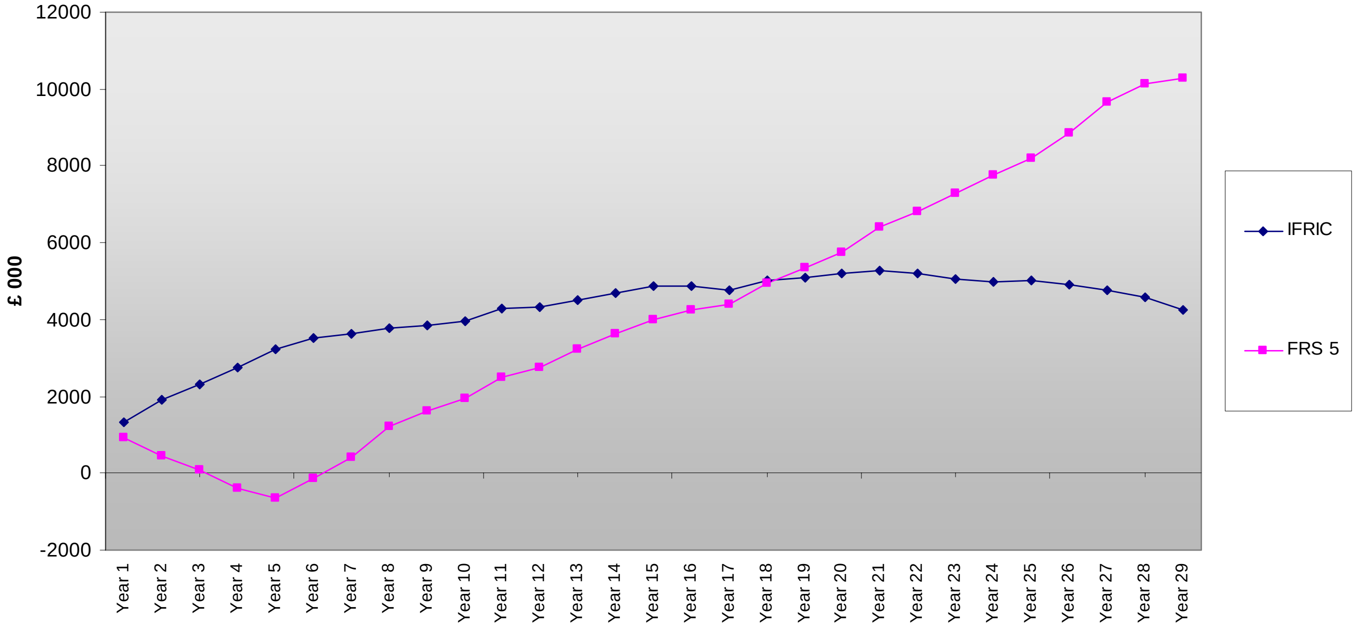
Effect best seen in graphical form:



Accounting for Contracts
Operating Profit (EBIT) Comparison



Accounting for Contracts
PBT Comparison



Accounting for Contracts

Please note that:

- Over the life of the contract PBT will be the same under both sets of rules
- IFRIC 12 does not affect the cash flow of a contract in any way

  It is an accounting construct <u>only</u>

Valuing PPPs / PFIs

- Valuation can be complicated
  - profit streams show up in different parts of Viridor or in SPVs/JVs
  - project may have value even before earnings come through eg Lakeside
- Simplest approach for on-balance sheet projects is usual metric of EBITDA or other multiples
  - however will undervalue if project is in early stages
- Alternative approach for off-balance sheet or early stage projects as for Lakeside

Possible Lakeside Valuation Methodology - I

- £160m capex undertaken on basis of 10% real after tax project IRR over 25 years
  - implied average cashflow of £20m per annum after tax
- 86% non-recourse debt at 6.25% gives average annual debt service cost (interest and capital repayment) of £9m after tax
- Net cashflow to shareholders of £11m pa after tax
- NPV of net cashflow to shareholders at 8% discount rate real after tax is £94m (£110m at 6% discount rate)
  - value of 50% owned by Viridor is £47m to £55m

Possible Lakeside Valuation Methodology - II

- In reality gate fees are c£20 per tonne higher than the model and electricity prices c£10 per MWh higher
  - total upside c£8m per annum post tax

- NPV of Viridor's 50% share of the upside is £42m at 8% real after tax and £50m at 6% real after tax

↓

- Total value of Viridor's 50% share in Lakeside on this basis is £89m-£105m

- Sensitivity: every £10 per tonne increase in gate fees increases Viridor share of the value by £15m-£18m

Greater Manchester PFI - I

- Preferred bidder with John Laing
- Largest waste PFI in UK
- Commercial terms agreed and preliminary works under way
- Key planning permissions secured (including strategic waste CHP plant in September 2008)
- Signing delayed by impact of current debt markets but substantial progress has been made
- Integrated 25 year contract with project finance
- Recycling/treatment via joint venture between Viridor and Laing
  - capex c £400m
- Residual waste disposal via 375kt energy from waste CHP facility at Runcorn
  - joint venture between Ineos, Viridor and Laing
  - capex c £215m
- Operation of recycling/treatment subcontracted to Viridor

Greater Manchester PFI - II

- The Energy from Waste/CHP facility is the first line (of two) due to be built on the Runcorn site
  - total capacity due to be 750kt pa, 70MW electricity plus heat

- Profit streams to Viridor
  - subcontract
  - interest on shareholder loans to SPVs
  - share of PAT in recycling and treatment and in energy from waste SPVs
  - sale of surplus phase 1 EfW disposal capacity on merchant market

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UK Local Authority PFI Contracts

- 15 operational totalling 4.9m tonnes pa
- 3 under construction totalling 0.5m tonnes pa

UK Local Authority PFI Tenders

Approximate Tonnes m per pa

Approved 2006/2007	
Wakefield	0.2
Greater Manchester	1.4
Cheshire	0.4
Merseyside	0.8
North Yorkshire/York	0.5
Sub Total:	3.3

Approved 2008	
Leeds	0.4
Suffolk	0.4
Bradford	0.3
Barnsley/Doncaster	0.5
Rotherham	
South Tyne & Wear	0.4
Staffordshire	0.5
Leicestershire	0.4
South West Devon	0.2
Gloucestershire	0.1
Sub Total:	3.2

Future Pipeline	
Norfolk	0.2
Milton Keynes/Northampton	n/a
Essex	n/a
Bedfordshire	0.2
Derbyshire	n/a
Dorset	0.2
Hertfordshire	n/a
Hull and East Riding	n/a
North London	0.9
South London	0.2
Warwickshire	0.4
West of England	0.8
Sub Total:	2.9+

Source: DEFRA

Prospects for PFIs - I

- PFIs have been preferred route for government to fund major infrastructure projects
  - increasing allocations of PFI credits to waste projects
  - private finance minimises impact on government borrowing

- Questions have sometimes been raised about value for money particularly profits made by contractors on refinancing
  - hence new Treasury rules on sharing of profits on refinancing
  - hence Scottish Futures Trust

The Scottish Futures Trust

- Because it believes that PFIs have not delivered value for money, the Scottish Government announced (September 2008) the formation of the Scottish Futures Trust (SFT)
- SFT is a non profit distributing limited company which is due to be financed through public bonds
- Role is to encourage, facilitate, plan, fund, procure and deliver assets, infrastructure and projects
- Unclear how this will develop

Prospects for PFIs - II

- Current debt market issues raise significant concerns about future of large PPPs/PFIs financed through SPVs
  - a major issue for UK public finances and the economy as a whole
- Somehow or other however the UK has to fund its waste management strategy
- PPPs/PFIs deliver effective private sector solutions to major environmental challenges

PPPs / PFIs
Summary

- Fundamental opportunity driven by Government recycling and landfill diversion targets
  - £15bn - £30bn capex
- Possible upsides of energy sales
- Contractual framework is secondary to the above basic opportunities
  - see PPPs/PFIs in light of above
- Viridor sees huge commercial opportunities whatever the contract structure and is already reaping the benefits

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