The City of Edinburgh Council

10.00 am, Thursday 14 March 2013

Zero Waste: Edinburgh and Midlothian Capital Contributions

Item number	8.3
Report number	
Wards	City wide

Links

Coalition pledges	P49, P50
Council outcomes	C07, C08
Single Outcome Agreement	S01, S04

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Executive summary

Zero Waste: Edinburgh and Midlothian Capital Contributions

Summary

The Zero Waste Project has now progressed the procurement of residual waste treatment facilities to the stage at which it is ready to invite bidders to submit detailed tenders.

Prior to inviting tenders, the Joint Council Project Board is recommending to the Councils on a value for money basis that they consider offering to inject public capital into the project, funded by borrowing from the Public Works Loan Board (PWLB). This report examines the advantages and risks of doing so.

The overall project objective in the Residual Waste Business Case is to procure a long-term residual waste treatment contract that meets the needs of the Partner Councils and is clearly demonstrated to be affordable and deliverable.

Recommendations

It is the recommendation of the Director of Services for Communities that, subject to the agreement of Midlothian Council, the Council;

a) agree to offer to the bidders a capital contribution, to be injected when the plant is fully commissioned with a year's track record of service delivery and not to exceed 30% of the cost of the asset or assets constructed at the project site, providing said assets revert to Partner Council ownership at the end of the concession;

b) delegate authority to the Director of Services for Communities and the Director of Corporate Governance in consultation with the Convener and Vice-Convener of the Finance and Budget Committee to decide, in accordance with the established evaluation criteria of the Zero Waste Project, at the point of selection of Detailed Tenders, if the injection of public capital represents the optimal value for money solution and to pursue said injection, including entering into a suitable legal agreement with Midlothian Council should that be the case.

Measures of success

That the use of a capital contribution shall give rise to a greater value for money outcome to the procurement manifesting itself in a reduced per-tonne cost for the treatment of the Councils' residual waste. This benefit shall arise from the savings passed to the Partner Councils by the successful contractor outweighing the additional borrowing costs which the Councils would incur in pursuing this option.

Financial impact

Should members accept the recommendations the impact on the City of Edinburgh Council would take the form of a commitment to fund up to 24% of the constructed asset's capital expenditure. The magnitude of such a proportion would be on the order of £33.6m and the cost of borrowing to fund this injection of capital would be covered by the reductions in Annual Unitary Charge for waste (the cost per tonne paid by the Councils) arising from the contribution.

The injection of public sector capital into the procurement would displace more expensive privately sourced funding, allowing the bidders to reduce their required revenues from the Annual Unitary Charge payable by the Partner Councils over the concession. These savings to the Partner Councils would be partially offset by the revenue cost of funding the borrowing required to fund the capital contribution. The net effect would be a reduction in annual revenue costs to the Partner Councils throughout the concession.

The Council's capital plan will require revision to include the amounts required to be borrowed to fund the injection, timed to occur in late 2018. The revenue cost of funding such borrowing will be contained within the reduction to the current landfill budget which would arise from the Annual Unitary Charge reductions this injection would realise.

The indicative magnitude of borrowing required and the resulting net savings to the Council are outlined at 2.13 of this report, with further detail contained within the business case provided to members through a confidential data room. The final value of borrowing and savings will not be confirmed until the Preferred Bidder is appointed in late 2013, though material deviation from the savings presented in the Business Case are not anticipated.

Equalities impact

There are no equalities impacts as a result of this report.

Sustainability impact

While the overall Zero Waste Project has a significant impact on sustainability, these issues have previously been reported to Council and accepted. The decision to inject public capital into the project or otherwise has no further sustainability implications.

Consultation and engagement

A Cross-Party Cross-Council Group set up to receive regular progress reports on the Zero Waste Project met on 13th December 2012 when the potential for the Councils to make a capital contribution was included in the briefing.

In producing this report the following individuals and organisations have been consulted on the specifics of capital contributions.

- The Zero Waste Project Board
- Finance Officers of both Councils
- Lead Officers of both Councils
- Scottish Futures Trust
- Project Advisors
- Convenors of the relevant committees

Background reading / external references

- Zero Waste Project: Purchase of Land – Finance and Budget Committee, 29 November 2012
- Zero Waste: Edinburgh and Midlothian – update to the Transport, Infrastructure and Environment Committee, 21 February 2012
- Zero Waste: Edinburgh and Midlothian Commencement of Procurement – The City of Edinburgh Council, 14 October 2010
- Zero Waste: Edinburgh and Midlothian Commencement of Procurement – Transport, Infrastructure and Environment Committee, 21 September 2010
- Zero Waste Project – Progress Report – The City of Edinburgh Council, 15 October 2009
- Zero Waste Project – Progress Report – Transport, Infrastructure and Environment Committee, 22 September 2009
- Zero Waste: Edinburgh and Midlothian – Award of Food Waste Treatment Contract – The City of Edinburgh Council, 13 December 2012.
- Confidential data room provided to members in advance of Council meeting.

Report

Zero Waste: Edinburgh and Midlothian Capital Contributions

1. Background

1.1 On 15 October 2009, The City of Edinburgh Council approved the Project Initiation Document for the Zero Waste Project, including the governance arrangements, procurement budget and the joint purchase of the Millerhill Site in Midlothian.

1.2 The overall aim of Zero Waste: Edinburgh and Midlothian is:

- To procure a long term waste treatment contract that will enhance household waste recycling levels and will recover value from residual waste that has not otherwise been recovered or recycled;
- To ensure that the treatment of residual waste, when combined with the source-segregated activities, is sufficient to enable the two Partner Councils to meet their targets for landfill diversion and contribute to their recycling obligations; and
- To contribute to the Councils' shared vision of a zero waste future.

1.3 The Residual Waste Treatment Procurement commenced on 21 December 2011 with four bidders being shortlisted. Initial dialogue with these bidders is nearing a close and the Project Board is ready to agree to invite bidders to submit detailed tenders.

1.4 Bidders have been asked to produce proposals for carrying out primary treatment at the Millerhill Site. The primary treatment includes reception of residual waste, sorting, extraction of recyclable material and production of a refuse derived fuel.

1.5 Bidders have the option of either constructing an energy from waste plant at the Millerhill site or alternatively sending the fuel produced at the project site to be used elsewhere via an offtake contract.

1.6 Bidders have been advised that the invitation to submit detailed tenders would be delayed to await the Partner Councils' decision on the potential for the Councils to provide a capital contribution to the Contractor. The original Contract Notice and Invitation to Participate in Dialogue allows this but a decision has to be made before detailed tenders are submitted to avoid potential breach of procurement rules.

1.7 A decision either way on this report will allow the following programme to be implemented:

Milestone	Timeline
Issue Invitation to Submit Detailed Tenders	End March 2013
Appointment of Preferred Bidder	January 2014
Award of Contract (subject to Planning)	April 2014
Service Commencement	1 October 2017

2. Main report

2.1 A Business Case has been prepared which focuses on the potential to offer a capital contribution from the Partner Councils to Bidders. The full Business Case containing highly sensitive commercial information on bidders' proposals is provided for Members in the confidential data room.

Business Case Objectives

2.2 The Business Case is designed to evaluate an opportunity for the Partner Councils to reduce their overall repayments towards residual waste treatment facilities built at Millerhill, without materially distorting the risk transfer achieved through entering into a Public / Private Partnering arrangement.

2.3 The Business Case considers the following aspects:

- the potential savings should public sector borrowing be used in place of private sector funds;
- an appropriate level of capital and the basis for concluding a 30% figure;
- the circumstances in which a capital contribution would be available;
- the impact on the Councils' affordability positions; and
- legal and procurement implications and risk.

The Financial Case for Offering a Capital Contribution

2.4 Under a 'classic' Design, Build, Finance, Operate (DBFO) procurement bidders would be required to source 100% of the capital cost of the assets constructed from private sector sources. The cost of financing such construction is then recovered over the duration of the concession with the contracting authority on an annual basis, known as the Annual Unitary Charge.

2.5 However, HM Treasury guidance[1] acknowledges that Local Authorities have access, via the PWLB, to borrowing rates cheaper than that seen in the private sector, and therefore allows for contracting authorities to inject public capital into the construction of assets, provided there is no material distortion of the risk transfer inherent with utilising DBFO structures. The injection is capped at 30% in order to preserve the risk transfer inherent in the DBFO nature of the project in accordance with Treasury guidance.[2]

2.6 By injecting public capital into the procurement, the Partner Councils would effectively fund construction of up to 30% of the assets, meaning that the successful bidder would need only to find the remaining 70% of the funding from the private market. This would manifest as a reduced Annual Unitary Charge throughout the concession.

2.7 However, the Partner Councils are then placed under an annual obligation to repay the debt they would undertake to facilitate the capital contribution. The repayment period would be aligned to the length of the concession, in this case c. 25 years.

2.8 The financial case for proceeding with a capital contribution therefore relies on the decrease in cost from a reduced Annual Unitary Charge outweighing the increase in cost realised by the need to fund the borrowing, and management of associated risk issues by the Council.

2.9 In order to assess the financial viability of injecting public capital, Bidders involved in the Zero Waste Residual Waste Treatment Procurement were asked to submit projections for the amounts that would be saved in their Annual Unitary Charge should the Partner Councils displace 30% of their capital funding requirement. These savings were then compared against projections of the annual borrowing cost required to fund the displaced debt.

2.10 The analysis was conducted using a rate of borrowing matching the current Public Works Loan Board (PWLB) rate plus a 1% buffer. At this borrowing rate, the Business Case shows that the cost of borrowing to the Partner Councils would be outweighed by the savings from displacing private finance.

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[1] Standardisation of PFI Contracts Version 4 – HM Treasury, 2007

[2] Public Private Partnerships – Technical Update 2010 Guidance - HM Treasury, 2010

2.11 Further sensitivity testing was undertaken to ensure that the value for money case was not compromised unduly by fluctuations in the PWLB rate. This analysis demonstrated that the value for money business case is sensitive to changes in the PWLB rate. The risk arising from this is discussed in paragraph 2.20.

2.12 The value for money case of contributing capital to the facility will be tested at the point of selection of detailed tender via the mandating of variant bids showing the revenue impact of each bidder's proposals with and without the use of a Capital Contribution. The cost of borrowing relating to each bid will be assessed, and the optimal value for money solutions selected for further dialogue.

Magnitude of Capital Contribution

2.13 The confidential Business Case provided in the data room gives further detail on the projected amounts of capital required to fund up to 30% of the capital expenditure of constructing assets on the project site. Based on pre-procurement market analysis and initial modelling assumptions, the amount required for the City of Edinburgh's contribution would be of the order shown in the table below:

Element	**Projected Capex**	**CEC contribution (based on mid point)**
Mechanical / Biological Treatment	£20m - £25m	£5.4m
Energy from Waste	£110m - £125m	£28.2m
Total	£130m - £150m	£33.6m

Risk Considerations

2.14 The injection of public capital into the procurement involves a transfer of risk from the bidders to the Partner Councils. The risks identified as arising from the use of a capital contribution include:

Volume Risk

2.15 The use of a capital contribution opens the Partner Councils up to volume risk by introducing a fixed element to the contract (as the capital contribution is injected as a lump sum and not paid on a per-tonne basis.) This makes the value for money case sensitive to volume considerations, as the lower the tonnage delivered the less the value for money of the capital injection. Analysis on this issue has demonstrated that the value for money case is maintained at all levels down to and including the Guaranteed Minimum Tonnage, though the net savings arising from a capital contribution are diluted should annual delivery fall to this level.

Operational Risk

2.16 The Partner Councils could be exposed to a situation where they have paid up-front for service via a capital contribution, but a delay in service commencement means they have to pay a potentially inflated per-tonne gate fee at an alternative facility, in which case Partner Council monies would have been ‘sunk’ into a non-operational facility. This risk can be mitigated by injecting the capital contribution when the plant is fully commissioned with a year's track record of service delivery. In this way the Partner Councils would have sign off from an independent certifier that the plant was operational within agreed parameters, and the additional time would provide practical evidence that the plant was stable.

2.17 Further, in the unlikely event of total service failure, the Partner Councils would have the option of taking over the asset and re-letting the contract to a new contractor who would then return the asset to full operational capacity. If this were not deemed possible then the sale of component assets would allow for some recovery.

Obsolescence Risk

2.18 The assets procured under this contract are necessarily complex, and there exists a risk that the plant will become non-operational at some point throughout its lifecycle or that it will be of no value when it returns to the Partner Councils at the end of the concession. Though this risk arises regardless of the injection of public capital or otherwise, the capital contribution increases the risk, as monies would already have been paid in to fund the plant up-front. The mandate to use only tried and tested technologies and the selection of bidders with considerable experience in the waste treatment market helps to mitigate this risk and gives comfort that an operational plant can be delivered. In addition, deductions can be made to the Annual Unitary Charge payments should the asset not function over a long period, incentivising the private sector partner to construct a viable plant. Finally, the procurement has mandated a 5 year minimum residual life on the plant when it returns to Council ownership at the end of the concession.

Procurement Risk

2.19 The Zero Waste Residual Waste Procurement represents a significant undertaking by both the public and private sectors, and is therefore of considerable importance to the bidders involved. Advice has been taken from the project’s legal adviser which reiterated the need to avoid any issue which may lead to a perceived unfairness in the procurement process, specifically the selection of tenders to take through to the next stage of competitive dialogue. The use of a capital contribution therefore requires the firm commitment of both Partner Councils, as withdrawal of the offer after selection of detailed tenders could potentially create such a risk.

PWLB Rate Risk

2.20 Further to paragraph 2.11 there exists a residual risk that the PWLB rate could rise to a level whereby the savings no longer cover the borrowing costs. At this point the value for money case for making a capital contribution would be rendered invalid. The Contractor will lock in their cost of finance at Financial Close (c. Feb 2014) and the Partner Councils will be exposed to PWLB rate fluctuations until the point of injection (c. Dec 2018). This risk will be managed as part of the Council's overall treasury management strategy, and an interest rate buffer has also been included in the business case.

Timing of Injection

2.21 Numerous options were considered in order to maximise the value for money of the injection, however, in order to mitigate the risk represented in paragraph 2.16 above it is recommended that the Public Sector Capital be injected once the plant is fully commissioned with a year's track record of service delivery thereby ensuring that the plant is viable before the Partner Councils' capital is placed at risk.

Affordability

2.22 The cost of borrowing associated with the capital contribution discussed herein would be fully funded by the associated savings which would manifest in the Annual Unitary Charge from the contractor. The Business Case is predicated on the borrowing costs being significantly less than the associated saving, and therefore leaving the Partner Councils with a net overall cheaper solution than that without a capital contribution.

Accounting Treatment

2.23 The Partner Councils' relevant finance officers are currently formulating the strategy for the recognition of the asset constructed in this procurement, regardless of the use of a capital contribution or otherwise. This is not expected to present an insurmountable challenge in the implementation of a capital contribution. A formal legal agreement between the Partner Councils will be entered in to at the appropriate time in order to protect both Councils' positions in this regard.

Project Procurement Strategy

2.24 Should the Councils agree to offer a capital contribution as provided in this report, bidders would be asked to submit variant bids with and without the capital contribution, and the resulting bids, together with the associated revenue impact of borrowing to fund the capital contribution, would be evaluated to ensure that the most economically advantageous tenders are down-selected.

2.25 This offer would only be available for Bidders in respect of new facilities to be built at Millerhill and where they revert to the Councils at the end of the contract period. This is to comply with the mandated association of a capital contribution to a completed asset which reverts to the Partner Councils' control in compliance with the CIPFA Code of Practice on Local Authority Accounting[3].

2.26 The evaluation ensures that any benefits identified in this business case would be captured in the tendered prices and considered net of the additional cost of borrowing placed upon the Partner Councils. The financial evaluation will therefore continue to yield a true measure of the Most Economically Advantageous Tenders to be down-selected, taking into account the full impact on the Partner Councils.

2.27 The potential for a capital contribution was referred to in both the OJEU Contract Notice and in supporting procurement documentation.

Joint Working Implications

2.28 Midlothian Council is being asked to agree to support the injection of public sector capital into the project, in line with the established breakdown of capital costs associated with the project. This would see Midlothian Council contribute 20% of the required capital (i.e. 6% of capex) with the City of Edinburgh making up the remaining 80% (24% of capex).

2.29 Due to the joint working arrangements for the Zero Waste Procurement both Partner Councils will have to commit to the injection in order for it to go ahead.

Conclusions

2.30 The Business Case for capital contributions demonstrates that the injection of Public Capital into the Zero Waste Residual Waste solution offers the Partner Councils an opportunity to enhance the value for

[3] Code of Practice on Local Authority Accounting in the United Kingdom 2012/13 - Chartered Institute of Public Finance and Accountancy, 2012

money and affordability of the procurement as a whole, without materially altering the DBFO nature of the solution.

2.31 Modelling has shown that the cost of borrowing is projected to be less than the savings passed back through a reduced Annual Unitary Charge, and therefore the use of a capital contribution is expected to be self-funding, while delivering an overall better net position for the Partner Councils in the treatment of Residual Waste.

3. Recommendations

3.1 It is the recommendation of the Director of Services for Communities that the Council;

a) agree to offer to the bidders a capital contribution, to be injected when the plant is fully commissioned with a year's track record of service delivery and not to exceed 30% of the cost of the asset or assets constructed at the project site, providing said assets revert to Partner Council ownership at the end of the concession;

b) delegate authority to the Director of Services for Communities and the Director of Corporate Governance in consultation with the Convener and Vice-Convener of the Finance and Budget Committee to decide, in accordance with the established evaluation criteria of the Zero Waste Project, at the point of selection of Detailed Tenders, if the injection of public capital represents the optimal value for money solution and to pursue said injection, including entering into a suitable legal agreement with Midlothian Council should that be the case.

Mark Turley

Director of Services for Communities

Links

Coalition pledges	P49 Continue to increase recycling levels across the city and reducing the proportion of waste going to landfill P50 Meet greenhouse gas targets, including the national target of 42% by 2020
Council outcomes	C07 Edinburgh draws new investment in development and regeneration C08 Edinburgh's economy creates and sustains job

	opportunities
Single Outcome Agreement	S01 Edinburgh’s economy delivers increased investment, jobs and opportunities for all S04 Edinburgh’s communities are safer and have improved physical and social fabric
Appendices	N/A