

# Standardisation of waste management PFI contracts: guidance on SoPC derogations

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# 1 Introduction

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- 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 (the 4Ps Pack). The 4Ps' Pack will be updated to include drafting (where appropriate) to reflect the positions proposed on various issues by this Guidance. Until such time the 4Ps Pack is brought into line with this Guidance the positions in this Guidance should take precedence over those set out in the 4Ps Pack.
- 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 be applied in full 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 with assets which may or will revert to the Authority at the end of the Contract and where the Authority pays a Unitary Charge (subject to a performance regime) to the Contractor. Where projects are structured on a different basis (such as where facilities do not revert back to the Authority or where several off-takers share the facilities) Authorities should contact DEFRA at an early stage of the procurement process in order to discuss which Sections of this Guidance will be relevant to their projects.
- 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 the current edition of this 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 in force 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 acknowledged and thanked by DEFRA and PUK.
- 1.6 The issues addressed in this Guidance have been identified through consultation with the waste sector PFI market and the public sector. DEFRA and PUK wish to also acknowledge and thank all those who have given their time to this consultation and, in particular, those organisations 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), the Local Government Association (LGA) and the PPP Forum.

- 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), Insurance (Section 9), and Patents and Drawings (Section 10). These issues are not intended to be an exhaustive list of waste sector specific issues. The Guidance seeks to address some key issues faced by the sector which were raised in the context of waste projects currently in procurement and through consultation with various stakeholder groups. It is contemplated that further guidance will be provided on issues not covered in this Guidance such as issues arising from the use of MBT technology (e.g. the disposal of SRF/RDF) and guidance on benchmarking.
- 1.8 This Guidance is intended to facilitate more efficient procurement in this sector. Where Authorities choose to apply a standard SoPC position on issues covered in this Guidance they should do so on the basis that it will secure value for money and will not unduly protract the procurement process.
- 1.9 This Guidance is intended to cover sector specific and not project specific issues. It does not therefore address, for example, 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 tonnage processed targets.
- 1.10 This Guidance has been approved by HM Treasury and as such Authorities may adopt the positions set out in this Guidance without the need for derogations approval from DEFRA or HMT. Where Authorities are seeking to derogate from the positions set out in the Guidance or seek additional derogations, derogations approval will continue to be required from DEFRA (and, if they affect required drafting specified in Section 1.4.4 of SoPC, from HMT/PUK).

## 2 Glossary

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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
Key Facilit(y)(ies)	The main waste treatment facilit(y)(ies)
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. This risk also includes the Authority's lost opportunity to trade Landfill Allowances.
MBT	Mechanical Biological Treatment
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)
SRF	Solid Recovered Fuel
WML	Waste Management Licence

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 standard SoPC position on Compensation Events 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 are applicable to waste sector projects. The standard definition of Compensation Event 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 bidders 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, rather than offer blanket protection for breaches by the Authority of its obligations in the Services Period through the Compensation Event provisions. Two examples of such obligations and the manner in which breaches of such obligations may be dealt with are considered here: obligations to deliver contract 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 documentation, the throughput of waste (e.g. tonnage per annum) it expects to be processed and should specify the maximum and minimum levels of this throughput<sup>1</sup>. The specified maximum should protect the Authority from paying for greater capacity than it requires while the specified minimum will provide Contractors and funders with the certainty they need to assess the financial viability of the Project. Variant bids which contemplate increased capacity (initial or future) can always be considered if they offer

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<sup>1</sup> Whether this applies for the project as a whole or individual facilities is for the parties to determine and will be dependent on the nature of the facilities and the payment mechanism. The throughput is useful to determine the price per ton of the service provided, which is more relevant to a tonnage based service such as EfW than to the say for example a Household Waste Recycling Centre.

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:

- 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 type of payment mechanism used, this can be reflected, for example, through a take-or-pay mechanism<sup>2</sup> where the Contractor is guaranteed a certain base level of income if waste tonnages delivered are less than the agreed threshold (always subject to satisfactory Contractor performance); alternatively a price banding mechanism may be used.

3.2.2.2 Where the Contract provides for exclusivity in relation to all waste in the Authority's area any breach of such obligation may be treated as a Compensation Event. An Authority should however consider carefully whether it is in a position to or, indeed, should offer exclusivity in relation to waste arisings given the necessary constraint on flexibility in managing waste arisings that follows<sup>3</sup>.

### **3.2.3 Transfer of used landfill sites**

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 the Contract.

### **3.2.4 Calculation of compensation for lost third party income**

The Unitary Charge may be supported by third party income, for which benefit is given to the Authority through a reduced Unitary Charge (or equivalent) within the Base Case financial model. In such cases where a Compensation Event arises (whether before or after the Service Commencement Date) which prevents the Contractor from generating the anticipated third party income, it is appropriate for the calculation of compensation to the Contractor 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).

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<sup>2</sup> 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.

<sup>3</sup> An Authority would only be able to change exclusivity in relation to waste arisings through the operation of the Change Mechanism under the Contract, with the Contractor being compensated on a "no better/no worse" basis. An Authority may however afford itself some flexibility with regard to any exclusivity arrangements; for example an exclusivity obligation may only apply up to a certain tonnage of waste, or require satisfactory performance of the Contract for a certain period before exclusivity applies.

### **3.2.5 Defining the Construction Phase**

Authorities should be mindful that, where the construction of facilities is deferred the Compensation Event regime should apply in respect of the relevant periods of construction only.

## **3.3 Relief Events**

### **3.3.1 Purpose**

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 Contract Period. If the Authority does consider it appropriate to provide such relief it should require the Contractor, as a qualification to the Contractor claiming a Relief Event, to demonstrate that it has acted properly in securing the Site relating to the Key Facility, has taken reasonable measures under the circumstances to prevent entry to such site and that it has taken such actions as are reasonable, proportionate and lawful to deal with protester action including, where necessary, 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 financial incentive for the Contractor to mitigate this risk and minimise its consequences should be preserved.

In any event, the treatment of protestor action as a Relief Event in practice involves elements of risk sharing between the Authority and the Contractor given that:

- i. where minimum waste delivery obligations are specified in the Contract the Contractor would be protected (through the take or pay mechanism) if the Authority breaches such obligations as a consequence of protestor action; and
- ii. where the Contractor cannot accept waste at the Key Facility because of protestor action the Contractor should receive the full Unitary Charge if it processes (i.e. not landfill) the waste elsewhere.

Where a Project involves deferred construction of Key Facilities on Authority Site(s) however, the Authority should consider whether it offers better value for money for the Authority to retain responsibility for such 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 an earlier date.

- b) The delivery<sup>4</sup> of munitions, hazardous materials or human remains during the Services Period to the Key Facility 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).

Parties may, if the circumstances warrant and as contemplated by SoPC, include further relief events in addition to those listed at paragraphs a) and b) above and those listed in SoPC Section 5.3.2. An example of such a possible Relief Event is, the discovery of fossils and antiquities at the Site during the construction phase of the Project.

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

In line with SoPC principles, the Authority should consider on a project specific basis whether on the occurrence of a Relief Event the Contractor should be relieved of liability for any LDs and if so whether this relief should apply only for those Relief Events not covered by insurance. Availability and performance deductions should in any event continue to be made in respect of periods of delay or Service disruption caused by a Relief Event). The guidance in this Section is intended to apply primarily to LATS LD's (see Section 8) but it is equally applicable to LDs for late Service Commencement if such LDs are considered appropriate (see SoPC Section 4.2).

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<sup>4</sup> This covers the discovery of munitions, hazardous materials or human remains amongst items delivered to the Site (but not the discovery of such items already at the Site which should be covered as appropriate in the contractual provisions relating to ground risk).

## 4 Third Party Income

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### 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:

- a) sales of dry recyclables and compost;
- b) electricity and heat-related sales;
- c) “income” from SRF/RDF 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 of the Contract.

### 4.2 Key Considerations

The following factors should be considered:

#### 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 estimates of third party income that prove to be over optimistic may have a significant impact on the long-term financial stability of the Contractor and as a consequence on the Service delivered to the Authority.

#### 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 funders) are likely to provide for conservative price and volume estimates and attribute little or no value to any potential upside. This is also the case for SRF/RDF at present.

4.2.2.2 If the Contractor and funder 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<sup>5</sup>. The use of such mechanisms should operate to avoid windfall gains from third party income accruing to the Contractor alone.

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<sup>5</sup> It may be the case that in some markets a simple sharing mechanism may not incentivise the Contractor to improve the quality of recyclates throughout the term of the Contract. If Authorities do have concerns in this area then they should explore, together with their financial advisers, other sharing mechanisms for income derived from such markets.

### Examples:

- *If third party income (e.g. dry recyclables) is x% above Base Case, the excess above Base Case plus 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 (whether lower or higher when compared to the Base Case) above x% will lead to Unitary Charge adjustment (upwards or downwards (and such adjustment need not be symmetrical))<sup>6</sup>.*

### **4.2.3 Preserving an effective right Voluntarily to Terminate the Contract**

4.2.3.1 The third party income aspect of waste projects introduces a potentially significant liability for the Authority where the market value approach has been selected by a bidder as the basis for compensation on termination on Authority Default/Voluntary Termination. This potentially significant liability may act as a practical fetter on the ability of the Authority to exercise its voluntary termination rights. Under the market value approach, 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 at the time of termination (as agreed by the parties or failing agreement as determined by the expert), which may be lower or higher than that assumed when the Unitary Charge was first determined. As such, where the levels of third party income have increased significantly from the time the Contract was originally entered into, affordability constraints may operate to prevent the exercise by the Authority of its voluntary termination rights. Furthermore 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 also present an issue for the Authority, notwithstanding that the risk of realisation by the Authority should be taken into account in determining the appropriate present value of third party income at the termination date.

4.2.3.2 The recommended approach therefore where the market value option is chosen by a bidder as the basis for compensation in circumstances of Authority Default or Voluntary Termination is that:

- a) the Authority should consider capping the level of third party income for the purposes of calculating compensation on termination; or
- b) the Authority should require a variant mandatory bid with the amount of third party income capped for the purpose of this compensation calculation<sup>7</sup>, notwithstanding that the Contract may have excess cash-flow sharing which itself attenuates the compensation payable by the Authority.

If however the Authority is satisfied that the revenue sharing provisions in the Contract operate as a satisfactory constraint on the levels of third party income payable in circumstances of Authority Default or Voluntary Termination then a separate cap on the total level of third party income should not be necessary.

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<sup>6</sup> Authorities should be mindful of balance sheet treatment issues which may arise if it is exposed to demand or other market risks, whether through benchmarking or otherwise.

<sup>7</sup> 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.

### **4.3 Rationale for Positions adopted in Section 4.4 & 4.5**

4.3.1 Authorities should be mindful that the derogations set out in Sections 4.4 and 4.5 below assume that:

- a) Projected third party income is included in the Base Case financial model, (and reflected through a reduced Unitary Charge (or equivalent)), as well as the projected equity return and financial ratios of the Contractor; and
- b) the level of third party income set out in the Base Case financial model was reasonable (by reference to, for example, third party income amounts proposed by other bidders) and that it has not been artificially deflated by the Contractor or its funders.

If either of the above assumptions are not correct the positions set out below are unlikely to offer a balanced approach to the issue of compensation for lost third party income.

### **4.4 Early Termination – Compensation on Termination**

If the economics of the Project place 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 either the Base Case IRR or projected Base Case return methodologies 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.* 4.2.3.1), 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 potential third party income will be taken into account by prospective bidders in their bid price. 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 of 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 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 less amounts owing to the Authority through the operation of the revenue sharing mechanisms 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 a level of compensation commensurate with the level anticipated in the Base Case is considered appropriate and reasonable. A nuance to such an 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 Contractor<sup>8</sup>.

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 Sections of the Guidance to apply the principles set out above to Compensation Events, Qualifying Changes in Law, Authority Change, Force Majeure Events and Authority Step-In.

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<sup>8</sup> The period over which the Contract's historic performance should be measured may be agreed between the parties and should fairly reflect actual performance (i.e. seasonal factors that may affect performance should be smoothed out).

#### **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) 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 historic landfill risk). The Authority should recognise that if such circumstances arise, unless specified otherwise, the amount of compensation under the Compensation Event 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 for lost third party income at the lower of actual and Base Case levels, but this condition (if chosen) should be specified in the tender documents.

#### **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 Contractor’s compensation for lost third party income should be the higher of (i) the amount received by the Authority and (ii) at the lower of recent/current performance and Base Case level net of related costs. The Authority should also be under an obligation to act in accordance with Good Industry Practice whilst stepped-in. The obligation on the Authority to act in accordance with Good Industry Practice together with the financial incentives for the Authority to maximise third party income through the revenue sharing mechanism and the nature of the Authority’s Step-in right (i.e. exercisable in limited circumstances with the Authority’s costs of operating the Service being for its own account) operate to provide the Contractor comfort concerning loss of third party income.

4.5.6.2 In circumstances where the Contractor is in breach, 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. Given that Authority’s action has followed a Contractor’s breach it is not considered appropriate that the Authority should be under an obligation to act in accordance with Good Industry Practice during the period of step-in. The financial incentives as set out in paragraph 4.5.6.1 above

and the nature of the Authority's right of Step-in remain unchanged and these factors afford the Contractor protection concerning the loss of third party income.

## 5 Change in Law (SoPC: Section 13)

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### 5.1 Introduction

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

- a) Where the construction of a 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 Key Facility be allocated?
- e) How should the interaction between General Change in Law and benchmarking be treated in the waste sector?

### 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, benchmarking and market testing (see Section 5.7 below).
- 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 (allocated in accordance with 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 the construction period is particularly lengthy or where part of the construction is deferred (“Deferred Facilities”) and the Authority requires the whole construction price to be fixed at Financial Close<sup>9</sup> (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 extends longer than 3 years from the date of the Contract.
- 5.2.4 For projects where the Construction Period lasts longer than 3 years, the Authority may use one of the approaches below.

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<sup>9</sup> Subject to indexation and interest rates.

## **5.2.5 Option 1: Reset during Construction Period (for projects with distinct phases)**

5.2.5.1 For projects where construction may be divided into distinct phases (whether by identifying construction phases within a project or where the project comprises the construction of a Deferred Facility) the Authority may agree a Reset Date (3<sup>10</sup> years or more after the date of the Contract). The Construction Period between the date of the Contract and the Reset Date is referred to as Construction Phase 1, and the period following the Reset Date is referred to as Construction Phase 2. Where construction of Deferred Facilities is scheduled to commence more than 3 years after the date of the Contract the Reset Date should be just before the date when construction of the Deferred Facility is scheduled to commence.

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 date of the Contract and which have taken effect in the past 3 years. In such case:
  - i. The resulting Capex costs relating to the works which should have been completed in accordance with the original construction delivery plan during Construction Phase 1 remain the risk of the Contractor; and
  - ii. The resulting Capex costs relating to works to be constructed during Construction Phase 2 should be shared according to the Capex sharing table.
- b) Any General Changes in Law which can now be foreseen and which will take effect after the Reset Date should be shared according to the Capex sharing table (effectively enabling the necessary changes to be incorporated before construction starts and for the Contractor to pass a portion of the unforeseeable law risks to the Authority according to the Capex sharing table). The Contractor is however required to price the effects of the change at the Reset Date - rather than waiting until later.

5.2.5.3 Capex costs arising following a General Change in Law in relation to Construction Phase 1 or 2 (and the service phase) which are not foreseeable at the Reset Date will also (when they arise) be shared.

## **5.2.6 Option 2: Year 3 Cut- Off <sup>11</sup>**

5.2.6.1 The Authority may agree that the Contractor takes all General Change in Law risk for three years from the date of the Contract and thereafter General Changes in Law that result in Capex which were not foreseeable at the date of the Contract are shared when the change in law takes effect (as per SoPC) according to the Capex sharing table.

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<sup>10</sup> Three years from Contract signature has been suggested as an appropriate period of time for the Contractor to take all the risk of a General Change in Law. It may be, however, periods longer than three years may also represent value for money. Authorities may of course seek to negotiate a longer period.

<sup>11</sup> See Footnote 10.

5.2.6.2 On this basis, the Authority will be required to go through the Qualifying Change in Law process as and when such Changes in Law take effect. Under Option 1 above, such Changes in Law are priced before the start of the construction of the deferred facility (i.e. at the Reset Date) and the risk and cost of complying with such laws has or should have been already allocated in accordance with the Capex sharing table.

### **5.3 Specific Change in Law and Foreseeability**

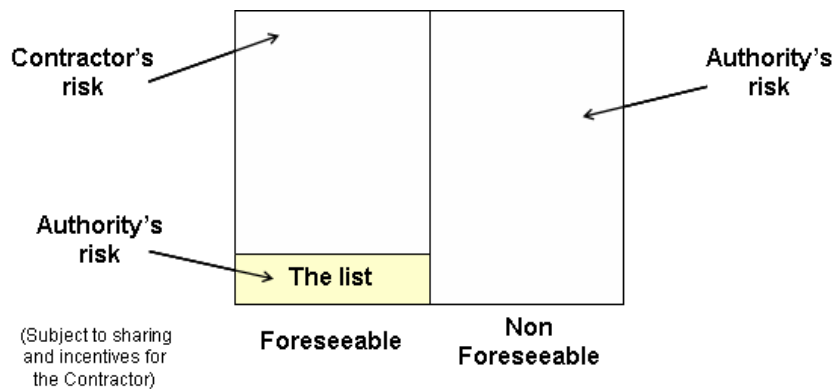
5.3.1 In SoPC a Specific Change in Law, which was not foreseeable at the date of the Contract, is the risk of the Authority, while a Specific Change in Law which was foreseeable is the risk of the Contractor. The issue here is that many Changes in Law relating to the waste sector are potentially foreseeable 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 In developing an appropriate contractual position to the issue set out in Section 5.3.1 above several considerations arise:

- a) Any risk allocation should not take away the Contractor's 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 signature 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 regard 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). DEFRA are currently considering mechanisms to promote sharing across projects as regards what laws are being included in such lists and further guidance will be made available on this issue.

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. The Authority and its advisers should therefore bear in mind that the affordability of a particular solution is driven not only by the contract price at Contract signature but also by the cost of implementing such laws. It is important therefore that Authorities and their advisers take into account during the bid evaluation and due diligence process the implications of implementing such waste laws (e.g. cost, Service disruption, sustainability and deliverability of current solution). The Authority should also be satisfied that no contingency for any such law has already been included in the relevant bid.



5.3.5 By using the approach set out above, 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 responsibility of the Authority, it is important that the Contractor should be incentivised to innovate and to minimise the cost of implementing the required changes. The Authority should consider:

- a) Implementing a mechanism (e.g. sharing thresholds, target cost<sup>12</sup>), to incentivise the Contractor to keep the costs of such Changes in Law to a minimum; and
- b) Developing a mechanism to incentivise the Contractor to implement the required changes efficiently. An example of such a mechanism would be requiring the review of the Waste Law List at pre agreed dates. If such a mechanism is used the Authority should specify it in the tender documents either by specifying the trigger dates for adjustment of the Unitary Charge (the "Waste Law Review Dates") or be asking bidders to bid dates for such reviews. Any such dates 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 laws may be reliably priced. Any further pricing risk on this then reverts to the Contractor. This mechanism should be developed with the objective of incentivising bidders to (i) incorporate flexibility into the design and operation plan for the initial period of the Contract thereby avoiding price renegotiation shortly after the Contract is awarded and (ii) co-ordinate the necessary works or changes in operation in order to comply with those foreseeable regulations.

5.3.6 If it is relevant to the particular project, Authorities may extend Specific Change in Law protection to include Changes in Law relating to emissions from the processing of waste (see also Section 5.4.3 for the treatment of Changes in Law relating to electricity generation).

5.3.7 Given the anticipated frequency of Specific Changes in Law in the waste sector, Authorities should be entitled to request that the Contractor fund Specific

<sup>12</sup> 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 maybe capped if the actual cost of implementing such regulations is above the target plus x%.

Changes in Law to the extent of what would be the Contractor's share of costs arising if a General Change in Law resulting in Capex had occurred. If a General Change in Law resulting in Capex subsequently arises then the Authority may need to fund the Contractor's share of such Capex to the extent such share has been applied to fund a Specific Change in Law.

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

- 5.4.1 On 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 (with the consequence that costs arising from such Changes in Law would be the Authority's risk). Any such allocation of risk should not be allowed for the reasons set out in Section 5.4.3 below; however where a Specific Change in Law affecting the waste treatment facility comes into effect, the impact of this on electricity generation receipts can be taken into account (see below at Section 5.4.3 c)).
- 5.4.2 The Authority and its advisers should conduct thorough due diligence on the electricity off-take regime proposed by the bidder or the off-take contract (if available at this time) before the appointment of preferred bidder. In particular, it is important to ensure that:
- a) any 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 off-take contract;
  - b) the Authority has a direct 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 by including an automatic termination right following either, for example, a change of Contractor or termination events arising under the Contract or providing for the payment of termination liabilities). To the extent such liabilities do arise they should, in the case of early termination of the Contract, be set off against any termination payment payable to the Contractor.
- 5.4.3 The Authority should take account of the following:
- a) It is not appropriate for the Authority to take Specific Change in Law risk related to electricity generation (for example, a law that requires a levy to be imposed on electricity sales or an increase in grid connection charges) given that the Contractor may be in a position to pass this risk through to the electricity buyer under the electricity off-take contracts and the financial implication of such laws will be reflected in the general market price for electricity.
  - b) This risk allocation set out in paragraph a) above in the Contract should incentivise the Contractor to negotiate robust electricity off-take contracts;
  - c) On the other hand, subject to paragraph d) below, if the Change in Law does directly 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 in-

clude the loss of electricity income in the same way as other third party income (*cf.* Section 4.5); and

- d) Where there is a Change in Law that discriminates against the sale of electricity generated by EfW facilities the Contractor may be compensated for losses arising from such Change in Law (the basis of such compensation being that set out in Section 4.5.3).

## **5.5 Discriminatory Change in Law**

The SoPC provisions do not require amendment.

## **5.6 Changes in PPC and WML 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 conditions attaching to the PPC permit.
- 5.6.2 The recommended approach is for any change to the conditions of the PPC permit to be a Contractor risk, where such change arises as a result of the Contractor’s acts or omissions (other than where such act or omission results from an obligation under the Contract). For example, the Contractor should be expected to take the risk of the working hours of a Key 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 a change in how the EA interprets or implements the meaning of existing law or regulation) should be included as a Qualifying Change in Law (i.e. Authority’s risk).
- 5.6.4 We would not normally expect changes in the conditions attaching to WML to be treated in the same manner as changes to conditions if PPC permits. The Contractor should, given its experience as a waste operator, be familiar with managing changes to WML conditions. If however the Authority considers that it offers value for money to extend protection to WMLs which relate to a Key Facility, then such protection may be granted but limited to changes in the WML’s conditions which are required by the EA as a consequence of the discharge of its statutory duties.

## **5.7 General Change in Law, Benchmarking and Indexation**

- 5.7.1 The operating cost structure of waste projects varies from one project to another depending on the scope of services and technology chosen. For example for a residual treatment and disposal service, the initial capital required may vary significantly (e.g. 3-5 times) depending on the technological solution chosen. Capital costs are likely to have an inverse relationship with operating costs. The structure of the operating costs may also differ from one project to another.
- 5.7.2 While not all Services can be benchmarked, key cost items or services (for example transportation service, landfill service or operation of transfer station/HWRC<sup>13</sup>) can be benchmarked and/or market tested. As part of the tender process, the Authority and its advisers should specify their requirements concerning the Services and costs that will be benchmarked and the frequency of the benchmarking exercise. The Authority and its advisers should also ensure that the payment mechanism can accommodate the benchmarking exercise.
- 5.7.3 Indexation can be used to mitigate the impact which General Changes in Law may have on operating expenditure. The Authority should however take into account the ability of private sector to innovate and utilise its skills in minimising the impact of changes on their business. Further guidance on the operation of benchmarking generally in waste PFI projects is planned.

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<sup>13</sup> To the extent no significant initial capital is involved.

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

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## 6.1 Introduction

This Section addresses the following issues:

- a) Is it appropriate for the Authority to have grounds for termination for Contractor default for waste management 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 included in the Contract 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<sup>14</sup>. The Contractor should, however, have the opportunity to take appropriate action in order to remedy a 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 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, the Authority may include a specific termination right if the Contractor fails to submit the planning application by a specified date.

As specified in SoPC further project specific events of Contractor Default may, if relevant, be included.

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<sup>14</sup> As is also the case for other key PFI sectors such as education and health.

### **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) and the No Retendering procedure.
- 6.3.2 A concern arises that on a termination of the Contract due to Contractor Default, where the Retendering procedure is used, there may be no Compliant Tenders received because no other bidder could (or would be prepared) to operate the technology used in the Project. Under standard SoPC provisions, if there is a liquid market and no Compliant Tenders are received, the Contract value is deemed to be zero. The chances of no Compliant Tenders being received is recognised given that sector is developing as performance requirements and mechanisms and technical solutions as yet vary from project to project with few common standards evident.
- 6.3.3 The concerns specific to the waste sector set out in Section 6.3.2 above may not be relevant for all types of waste projects. EfW plants may, for example, be considered to represent proven technology, with numerous facilities around the world (including within the UK) operating successfully for a number of years. Given the worldwide operational track record of some EfW technologies, once the facility has become operational, the technology risk should be manageable given there are several established alternative operators who are capable of operating this type of technology.
- 6.3.4 On the other hand, some non-EfW solutions such as MBT have been chosen by some procuring Authorities as the preferred technology solution. 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, different waste contractors 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. This date will however be kept under review and if the issues concerning diverse technical solutions, performance requirements and short operational track records of some technologies are no longer apparent then the derogation may be withdrawn at an earlier date. The limited duration of the derogation options below is considered appropriate given that it is anticipated that the concerns of the waste industry and funders with regards to the standard SOPC provisions on 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 any 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 Contractor 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, unless the issues set out in Section 6.5 below are relevant, be offered on the original Contract terms. It is ordinarily 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 no Compliant Tenders are received when the Contract is retendered, rather than the Contract being valued at zero, the No Retendering route can be used to calculate the compensation amount payable on Contractor default. This option may be applied both during the construction and operating phase.
- 6.3.8 **Option 2:** This option allows for limited ring-fencing of Senior Debt in the circumstances set out in Section 6.3.8.1 below. The limited ring-fencing protection may only be applied during the Construction Period.
- 6.3.8.1 This derogation may be used in an integrated waste project (a project that provides for a number of services (for example, management of HWRC's and transfer stations, recycling, treatment and landfill)) 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 incurred on this asset (i.e. the deferred Capex of this facility is significantly higher than the expenditure for the initial facilities<sup>15</sup>);
  - b) It is possible to split the integrated waste project into two separate sub-projects. The payment mechanism and Base Case financial model must be sufficiently transparent to enable the Authority and its advisers 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 of the Project upon termination; and
  - c) The treatment facility is based on a mature technology with a track record such that funders 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 is completed.
- 6.3.8.2 It has been argued that, during the construction phase, protection relating to both the Retendering and No Retendering procedure is required so that the construction risk profile of the integrated waste project is no worse than that of a project whose sole asset is a treatment facility. For this type of project (described in

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<sup>15</sup> See Section 7 on deferred Capex generally.

6.3.8.1) above) the following structure may be used, if it demonstrates better value for money:

- a) During the construction phase, the funders' investment in the lower risk assets will be protected from any negative value of the high risk assets in the calculation of compensation of termination, if the termination is triggered by failure to complete the higher construction risk asset;
- b) No protection should be given to equity as performance risk should remain with the Contractor; and
- c) Once the higher construction risk asset 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.

6.3.9 The above two alternative options are sector specific (and temporary) derogations relying on a combination of new technologies, new market conditions in the waste sector and the particular profile of waste projects – with no application to other PFI sectors.

#### **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 which already applies to contracts terminated prior to the Services Commencement Date (see SoPC definition of New Contract (SoPC Section 20.2.8)) may be extended to allow rectification in the operational period as well. Availability and performance deductions would still apply during this period.

#### **6.5 Revision of Performance Targets**

6.5.1 Some waste management PFI contracts may include (i) recycling targets and/or diversion targets as a ground for termination if such targets are not met and/or (ii) targets as part of the performance regime/payment mechanism. Funders have raised concerns that the use of targets in waste management contracts may operate to unfairly prejudice the use of new technologies where the performance ability of the new technology by reference to the proposed target is not sufficiently proven. The following Sections of this Guidance deal with the approach to targets generally (where such triggers are used) and to any request that such termination triggers are relaxed if a New Contractor takes over the Contract.

6.5.2 a) Where targets are included in a Contract the termination triggers which relate to such targets should in the first instance be set at a realistic level. In setting the termination triggers, the Authority and its advisers should decide what the optimum performance standards are, and then consider whether the target termination triggers are essential and affordable (taking into account the experience of other similar projects)<sup>16</sup>.

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<sup>16</sup> Bidders may be invited to provide a variant bid using any threshold that bidders think offer better value for money.

- b) The negotiation of realistic termination triggers in a Contract should be sufficient to accommodate concerns with regards to the ability of certain new technologies to perform at a level above the termination triggers in a Contract. Authorities should require that bid submissions provide full details of any proposals relating to the relaxation of such triggers. The Authority should, as part of the original tender evaluation for the award of the Contract, give serious consideration to any justification put forward a proposed relaxation of any termination trigger. In particular the Authority should consider whether this request is an indication of the underlying robustness (or lack thereof) of the proposed technological solution. If the Authority believes that there is value for money justification<sup>17</sup> for an adjustment to any termination trigger DEFRA will consider whether it is willing to seek derogation approval from HMT/PUK for such adjustment on a project specific basis. In addition to the overall value for money justification any proposal to DEFRA on this issue is unlikely to be acceptable unless:
- i) adjustment is clearly requested as part of the original bid submission and the Authority seeks derogation approval during evaluation of tenders;
  - ii) the scale of any proposed adjustment to any termination trigger is pre-determined and in any event no more than 5% of the original performance target. This assumes that the parties can not agree an acceptable termination trigger at the outset because of differing views on the performance ability of the asset;
  - iii) the adjustment does not apply where the performance targets in the Contract have not been met as a consequence of performance by the Contractor or where the Contractor has not attempted to rectify the issues giving rise to poor performance; and
  - iv) any adjustment to the termination trigger is only available for a New Contract entered into following Step-in by the Senior Lenders. If following adjustment to any termination trigger the value of the Contract is greater than the amount outstanding to the Senior Lenders such excess shall be paid to the Authority.

It is important that the Authority should contact DEFRA or PUK at an early stage in considering issues around the relaxation of performance targets. As for the derogations set out in Sections 6.3.7 and 6.3.8 above it is considered that the relevance of any derogation on this issue to waste projects that include new technologies will be time limited.

6.5.3 Depending on the performance history of the solution proposed, some funders may not feel comfortable with the performance requirements under the payment mechanism and would require the Authority to agree to amend such performance requirements in the event that any Contractor, despite efforts to rectify the issue giving rise to poor performance, fails to meet the required performance level.

6.5.4 It is not appropriate to relax performance requirements under the payment mechanism. In contrast to the position concerning termination triggers, where the performance requirements under the payment mechanism can not be met be-

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<sup>17</sup> Authorities should be mindful that any proposal to relax performance targets may affect the balance sheet treatment of the project.

cause of technical limitations of the assets any prospective tenderer for the defaulted project should be able to reflect deductions for performance failure that will be made under the payment mechanism into the proposed tender price.

# 7 Deferred Capital Expenditure

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## 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 after 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 – these 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; and
- 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 be completed, 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.

7.1.5 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. It is important to note that, as 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. This is relevant to projects with short or long periods of deferred construction.

## 7.2 Short deferral period

- 7.2.1 This Section considers the situation where the Key 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 a procurement or during the course of a procurement the Authority should take measures to reduce the period of deferred construction as follows:
- a) the Authority should 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<sup>18</sup>. 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 for a period of time, 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 may be fixed by the bidder in its bid or be subject to adjustment post-financial close. The Authority and its financial adviser should specify its requirement relating to interest rate fixing adjustment in the tender documents 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.

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<sup>18</sup> 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.

### **7.3 Long deferral period**

- 7.3.1 This Section considers the scenario where one or more Key Facilities are only required to be built after a significant period, for example, 5 years or more after the Contract signature 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 appropriate on value for money grounds 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 that are to be constructed so far in the future (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 Authority 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. Any certainty of funding commitment provided by the bidder (e.g. availability of any corporate guarantee) should be recognised in the Authority's bid evaluation; and
  - 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 the incumbent funders only provide funding for phase 1 of the Project or as for Contractor Default with phase 1 limited ring-fencing (see Section 6 and the Appendix) if the incumbent funders have provided a conditional commitment for funding the whole Project. This will help incentivise equity to

procure appropriately priced funding; and

- 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)

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### 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)<sup>19</sup>, 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<sup>20</sup>.
- 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)<sup>21</sup>. 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? Authorities should also bear in mind that the use of Landfill Allowances also precludes the sale of those allowances. The ability to sell Landfill Allowances may be of significant value to the Authority.
- 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;
  - 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; and
  - c) The size of the potential liability that may arise if LATS risk crystallises may jeopardise shareholder returns.
- 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 lack experience in managing this activity. The passing of such risk to the Contractor will also give rise to bankability issues. It does not, therefore, represent value for

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<sup>19</sup> 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.

<sup>20</sup> The separate issue of allocation of Landfill Tax risk is dealt with in the 4Ps Pack.

<sup>21</sup> Further details concerning the Landfill Allowance banking and borrowing mechanism may be found at <http://defraweb/environment/waste/localauth/practice-guidance/pdf/infosheet09.pdf>

money for the Authority to pass LATS Risk in its entirety to Contractors.

## **8.2 Recommended approach**

- 8.2.1 LATS Risk may materialise 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, borrow or use its allocation of Landfill Allowances<sup>22</sup> 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<sup>23</sup>. If however 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 amount deducted 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 that have not been provided. This is especially important in an integrated waste 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<sup>24</sup>.
- 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 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.

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<sup>22</sup> Welsh Authorities do not currently have the ability to trade Landfill Allowances.

<sup>23</sup> 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.

<sup>24</sup> 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.

- 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 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 does not constitute 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 insurance; and
  - 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; any such carry forward should however only be payable after current senior debt service but before junior debt and equity; and
    - setting a cap on the amount claim that is carried forward. 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

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### 9.1 Introduction

The new Insurance Guidance published by HM Treasury on 23<sup>rd</sup> December 2005 (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. Additions or reductions in the type and scope of Required Insurance (as set out in the revised Chapter 24) are not treated as derogations and such revisions will not, therefore, require DEFRA/HMT approval.

### 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 funders 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, for 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 period 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. Only the sum insured for the Contractor's interest which corresponds to the unavoidable fixed costs (a definition for which is included in Annex 5 of the revised insurance guidance) may be treated as an element of Required Insurance. Unavoidable fixed costs include senior debt service.

# 10 Patents and Drawings

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## 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.

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

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This Appendix is intended to provide an illustration of the regime set out in Section 6.3.9 (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.

Definitions:

**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.

**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" as referred to in Step 1)	£65m	£25m	£5m	£19m
Expert determination of the value of Phase 2 of the Contract (if X is less than £27m) ("Y" as referred to in Step 3)	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)