

**West of England Partnership
Joint Scrutiny Committee
12 September 2008**

PHASE 3 OF WASTE STRATEGY

Purpose of report

1. To consider further the Outline Business Case to DEFRA, including presentations on affordability and governance, and to give Scrutiny's views.

Background

2. The paper which was considered at the Joint Scrutiny Committee's meeting on 5 September is appended. The views expressed at that meeting will be summarised in the draft minutes which will be circulated to members in advance of this meeting if possible, or otherwise tabled.
3. PWC/Jacobs and officers will make presentations on the outcome of their further work. An additional meeting is proposed to consider the draft Outline Business Case.

Recommendation

4. That the Committee consider the further presentations and give Scrutiny's views.

Terry Wagstaff
Chief Executive
West of England Partnership
3.9.08

Agenda Item No 6

**West of England Joint Scrutiny Board
5th September 2008**

**Joint Waste Strategy
Phase 3 OBC Affordability Assessment
Key Assumptions**

Purpose of the Report:

To provide further information about the requirements of Section 8 of the OBC dealing with Cost, Budgets and Finance and how this aligns itself with the Affordability Assessment and to seek initial views.

At the 12th September 2008 Joint Scrutiny Board Meeting members will receive a further presentation and insight into the detailed modelling work and the outcomes and other aspects of the OBC.

An integral part of cost modelling is around the Key Assumptions taken forward.

Background

Members received a presentation and report in regard to the Outline Business Case (OBC), the Assessment of Costs and Affordability for waste treatment capacity under Phase 3 of the Joint Waste Strategy on 25th July 2008.

Members are reminded that the OBC comprises ten sections supported by Appendices. The sections are:

1. Executive summary
2. Background
3. Strategic waste management objectives
4. Procurement strategy and reference project
5. Risk management, risk allocation and contractual structures
6. Project team and governance
7. Sites, planning and design
8. Costs, budget and finance
9. Stakeholder communications
10. Timetable

For completeness, a copy of the Defra User's Guidance notes on how to fulfil the requirements of Section 8 is set out in Appendix A.

Costs of Reference Project using PFI

The OBC requires a shadow bid model to be developed in order to calculate the annual payment (Unitary Charge) payable to a contractor under the PFI contract

Inputs to the process include:

- Timing assumptions including construction, commissioning and operating start dates
- Cost and revenue assumptions including operating, capital and lifecycle costs
- Economic assumptions including financing rate and tax

Outputs from the process include:

- The overall contract cost for 25 years
- The Unitary Charge payable by the Partnership to the successful PFI Contractor

Budgets and Affordability Analysis

In order to determine the overall future budget costs and affordability envelope for the Partnership it is necessary to encompass the full scope of waste services within the Waste Strategy not just the PFI Reference Project following which it is necessary to have secured approval to the budgetary implications of the PFI procurement

Budgets:

- The need to 'approve' long term waste budgets for overall service e.g. to include budgets for service improvements
- The budget provides for the calculation of PFI credits based on 50% funding of capital

Affordability:

- Determination of the total cost of Phases 1, 2 and 3 set against current overall budgets
- This is described as the affordability envelope – a range of costs within which the full scope of the services will lie.
- The need to secure Member approval to meet future costs through clear evidence that members understand and have had sight of the full potential cost implications.

Key Assumptions

In order that members feel confident as to the outcome of the cost modelling of the OBC Reference Project and supporting waste services, it is proposed at this meeting to share with members the key assumptions which have been used to populate the cost model. These are set out in Appendix B.

Proposal

At this meeting the assumptions will be put into context, such as to allow further work to continue to refine the outcomes and to provide a greater degree of confidence as to the overall cost.

Extract from Defra Outline Business Case template for applications for PFI credits - Version 4.0 – May 2008

Section 8: Cost, budgets and finance

- **Introduction**

[User Guidance: This section should demonstrate the Authority has a good understanding of the cost of the procurement exercise itself, has demonstrated the preferred route represents value for money (using the HM Treasury's Value for Money Assessment Guidance) and has secured member approval to the affordability implications. It should show that the Authority has given due consideration to the interest of the project funders to ensure the project will be bankable.]

- **Procurement costs**

[UG: Set out the budgetary provision for internal resources, external consultancy support and any other expenditure required to complete the procurement. Provide details of the contractual arrangements employed to keep control over external advisory costs.]

- **Cost of the reference project using private finance**

[UG: Detail the results of the (shadow bid) modelling performed to calculate the Unitary Charge arising from the Reference Project. Identify all input assumptions including the assumptions made regarding the sources and cost of finance. Authorities should note that it is an essential requirement that they provide a full, unprotected copy of the shadow bid model for the Reference Project with the OBC submission to WIDP. This will be made available to Partnerships UK to assist in their preparation of their report to PRG.]

- **Value for Money (VFM) assessment**

Overall

[UG: the OBC should summarise the results of a Stage 2 – Project Level Assessment of VFM as set out in HM Treasury's Value for Money Assessment Guidance (November 2006). This includes a qualitative and a quantitative assessment and replaces the previous requirement to construct a Public Sector Comparator (PSC).]

Qualitative assessment

[UG: Detail comprehensive qualitative assessment of the Reference Project based on HM Treasury's Value for money Assessment Guidance. Authorities should ensure that this section of the OBC fully addresses Defra's criterion No. 7 and PRG's Criterion No. 7.]

Quantitative assessment

[UG: Demonstrate how quantifiable costs and benefits of using PFI as a procurement route are likely to compare with conventional procurement using the generic spreadsheet as provided in HM Treasury's value for money assessment guidance document. See www.hm-treasury.gov.uk/media/4/4/vfm_assessmentguidance061006opt.pdf. Authorities should note that they will need to provide a copy of the VFM model to WIDP with the OBC submission.]

Key input assumptions

[UG: Provide Project input assumptions and descriptions and for non hardwired inputs and an explanation of reasoning behind assumptions with special emphasis on the inputs for Optimism Bias.]

Indicative results

[UG: Summarise the key outputs from the HM Treasury spreadsheet including the comparison of the Net Present Cost (NPC) of the Conventional Procurement approach with the NPC of the PFI approach.]

Sensitivity analysis

[UG: Demonstration of Indifference Points to show the level of change required in the value of individual inputs to erode the difference between the cost of the conventional procurement approach and the cost of the PFI option (expressed in Net Present Value (NPV) terms). Generally demonstrate robustness by varying key inputs and testing several scenarios.]

Conclusion

[UG: Summarise the outcome of the assessment in terms of viability, desirability and achievability and provide a conclusion as to the VFM of using private finance as a funding source.]

- **Affordability analysis**

Projected budgets

[UG: Set out approved long term waste budgets with a view to demonstrating that members have understood and approved the annual budget implications of procuring the PFI contract. Contrast the projected level of expenditure to historic annual waste management budgets for at least the 3 full financial years prior to the date of the OBC.

Please note that revenue projections from the sale of any LATS allowances, any non-guaranteed income from the sale of recyclables and the shadow cost of carbon should not be included in the affordability calculation.]

Details of calculation of PFI credits

[UG: Calculation of the PFI credit and Revenue Support Grant adopting the method of calculation set out in Appendix E.]

Sinking fund

[UG: Please provide an annual analysis of the nominal cost of the PFI contract plus all other expenditure on waste disposal matched against projected annual waste management budgets (the full analysis to be provided in one of the appendices).]

Sensitivity analysis

[UG: Details of sensitivity analysis performed on the shadow bid model (stress testing capital expenditure or operating costs) to demonstrate impact on affordability over contract period.]

Member approval of affordability

[UG: Defra and ultimately PRG require clear and unambiguous evidence that the decision making body of each relevant local authority is committed to meeting its share of the cost of the PFI project over the lifetime of the contract. The OBC should also provide evidence that the relevant decision making body has understood there is significant uncertainty involved in the cost estimates at the OBC stage and that the risk that costs change lies with the Authority. The latter point should be addressed by making members aware of the budgetary impacts if key input assumptions are varied. The range should be derived by sensitivity analysis involving downside scenarios.

We accept that any sign-up is ultimately valid at the given time that it is produced and that changes in circumstance will affect this. However, it is an essential building block in the case for PFI support and its importance cannot be overstated as it demonstrates the necessary political commitment to meeting the not inconsiderable long term costs of procuring residual waste treatment infrastructure. Authorities should note that where there is a material change to the affordability position after the submission of the OBC to WIDP (whether as a result of the WIDP evaluation or otherwise) they will be required to provide sign off of the new position by the relevant decision-making body prior to the PRG review.

Evidence

Acceptable evidence of sign-up would include both minutes of cabinet/members meetings at which the approval was given as well as a copy of a report to members clearly setting out the position. What we would not consider acceptable is merely reference to the OBC where the information can be found. Defra and PRG require, for the avoidance of any doubt, clear evidence that members have had sight of the full potential cost implications rather than merely having had sight of the OBC. For Joint Waste Disposal Authorities where the cost of the PFI project will be passed onto the Constituent Borough or District Councils through the levy the members of the JWDA should provide the primary affordability sign off but in addition letters

should be provided from each Borough and District Council. These should refer explicitly to the impact on that Councils budgets and be signed by the Leader of the Council, the Chief Executive and the Chief Financial Officer of the Council]

The following are the key components that need to be drawn out of the OBC into the report to members to satisfy our concerns.

Key components of members report

- Total global cost of the reference project in comparison to the “business as usual” option.
- Underlying impact of the total cost of the reference project to any constituent partner Authorities (not WCAs). This will cover the total nominal cost by year. The analysis can be curtailed as costs level out but should include the cumulative total over the duration of the contract.
- The impact of sensitivity analysis against the key sensitivities for the project should be separately highlighted (for example high Capital Construction Costs, Higher Operation Running Costs, Lower Recycling income). Comparison to “business as usual” would be helpful.

This final point clearly highlights the affordability envelope. That being the highest and lowest possible costs to the authority as a result of the sensitivity testing.

The text below taken from a recent successful PFI application illustrates what would provide WIDP and PRG with the degree of comfort being sought, if presented in conjunction with a suitable report to members:

“That the level of financial support required to meet the affordability gap for the Waste Management PFI Project, as outlined in Appendix 1 to the report [to members], be approved.”

The report to members set out a summary recommendation:

“Approves that the Council proceed with the PFI procurement on the basis of a £[]m to £[]m affordability range and confirm it is committed to meet this affordability gap.”

This recommendation was supported by clearly quantifying the affordability position in comparison to the do nothing/do minimum scenario as described above as well the key sensitivities that have been applied to derive the “worst case” which represents the top end of the affordability envelope. An explanation of affordability was also included.

Project teams are advised to share draft reports and wording of recommendations to members with their Transactor and WIDP scrutiny team in advance in order to confirm their suitability

[UG : Authorities should ensure that this section of the OBC fully addresses PRG’s criterion No. 1.]

- **The authority’s LATS strategy**

[UG: Outline the Authority’s intentions in relation to the trading of Landfill Allowances. Please note that any income stream anticipated from the disposal of Landfill Allowances should not be included in the affordability analysis.]

- **Budgets**

[UG: Provide clear evidence that members are aware of and have approved the budgetary implications of the PFI procurement such that there is no “affordability gap” between the cost of the project and the resources available to meet that cost. The absence of an overall affordability gap should be demonstrated by providing the relevant figures for each year of the project in the format below.

	Year 1	Year 2	Year 3	Year 4		Year 25
	£'000	£'000	£ '000	£ '000		£ '000
Unitary Charge						
Other Costs						
Total Costs						
Revenue Support Grant (RSG) from PFI Credit						
Projected Budgets						
Total Budget						
Affordability Gap						

OBC – Key assumptions

1. Tonnages arising : *feeds into affordability assessment. Source – Jacobs/UAs.*
2. Residual tonnages, after increases in recycling : *feeds into affordability assessment – Source – Jacobs/UAs.*
3. Cost of recycling initiatives : *feeds into affordability assessment. Source – UAs.*
4. Cost per tonne of phase 2 : *feeds into affordability assessment (cost of ph.2). Source – soft market testing.*
5. Cost per tonne of phase 4 : *feeds into affordability assessment (cost of ph.4). Source – BCC landfill contracts.*
6. Capital cost of phase 3 plant : *feeds into reference project costing. Source – Jacobs. Note that bidders may propose larger plants to meet other demand.*
7. Financial implications of CHP : *feeds into reference project costing. Source – Jacobs. Note sensitivity re: cost and sale of electricity.*
8. Cost of borrowing : *feeds into reference project costing. Source – Defra (and PWC advice re: sensitivities).*
9. Value of PFI credits : *feeds into reference project costing. Source – Defra model.*
10. Inflation : *feeds into all expenditure and budget streams. Source – PWC/officer assumptions.*
11. Landfill tax : *feeds into affordability assessment. Source : officer estimate.*
12. Cost of LATS permits : *feeds into the 'planned service improvement only' model. Source – officer estimate.*
13. UA budgets : *relevant to affordability assessment. Source : UAs.*