

Report title: Future of the Mechanical Biological Treatment (MBT) Tovi Facility	
Report to: Place Services and Economic Growth Policy and Scrutiny Committee	
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Date: 30 June 2022	For: Discussion and identifying any follow-up scrutiny actions
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County Divisions affected: All Essex	

1. Introduction and Purpose

- 1.1 The purpose of this Report is to provide the Place Services and Economic Growth Policy and Scrutiny Committee with background information regarding the termination of the contract for the MBT Facility in Basildon and to outline the future plans for the MBT Facility.
- 1.2 Everyone's Essex sets out the Council's strategic purpose, including the aim of developing a high-quality environment as well as a net zero target objective in relation to greenhouse gas emissions. A review of past decisions and activities in relation to major waste contracts is important to ensure that learning is cemented in future waste management activities that support Everyone's Essex.

2. Action required

- 2.1 The Committee is asked to consider this report prior to the meeting planned for 30 June 2022.

3. Background

- 3.1 In 2007, Essex County Council (the "**Authority**") produced the Joint Municipal Waste Management Strategy (the "**Waste Strategy**") for Essex in collaboration with the county's twelve district and borough councils. The Waste Strategy was a 25-year plan for the management of waste across the county. Its core objective was to develop a sustainable waste-management solution that prioritised the reduction, re-use and recycling of waste and which minimised the amount of waste disposed through landfill. The Waste Strategy was also developed in order to comply with the Authority's legal obligations.
- 3.2 To deliver the objectives of the Waste Strategy, the Authority and Southend-on-Sea Borough Council ("**SBC**") prepared an Outline Business Case in July 2009 proposing the procurement of a mechanical and biological waste treatment ("**MBT**") plant in order to process the county's and SBC's residual waste (black bag) stream. The contract would be entered into pursuant to the government's private finance initiative ("**PFI**"). The Outline Business Case assumed that the project would be supported by Waste Infrastructure Credits ("**WICs**") of £100.9

million from the Department for Environment, Food & Rural Affairs (“**DEFRA**”). The funding provided by the WICs was critical to the viability of the project.

- 3.3 Following the requisite procurement process, on 31 May 2012, the Authority entered into a 25-year contract (the “**PFI Contract**”) with UBB Waste (Essex) Limited (the “**Contractor**”) for the design, construction, financing, commissioning, operation and maintenance of an MBT plant in Basildon to process the county and SBC’s residual waste (the “**Facility**”). All other separately collected waste (recycling, green waste and food waste) would continue to be processed elsewhere.
- 3.4 The Contractor is ultimately owned by Urbaser, S.A.U. (a Spanish company specialising in waste management) and Balfour Beatty Group Limited (an English company specialising in the construction) and was incorporated (as is entirely customary in PFI projects) as a ‘special purpose vehicle’ for the purposes of the project. The PFI Contract was a very detailed commercial contract with the main body of the contract running to 100 clauses and over 141 pages, but much of the detail was set out in 33 schedules. The PFI Contract was based on the standard form required under the PFI.
- 3.5 In conjunction with the funding of the Facility, the Contractor entered into an approximate £125,000,000 secured senior loan facilities agreement with a syndicate of banks, in addition to equity funding provided by the sponsors of the project (i.e. the shareholders in the Contractor).
- 3.6 The Facility was built and on 25 November 2014 it was independently certified as having passed the “Readiness Tests” which marked the end of the construction phase of the project. The Facility then entered the Commissioning Period and was required to pass certain “Acceptance Tests” (meeting contractual performance requirements in a number of different respects in terms of the treatment of waste) before the extended Planned Services Commencement Date of 12 July 2015. The facility never passed the Acceptance Tests either by such date or by the Acceptance Longstop Date of 12 January 2017. In fact, such were the issues with the facility that the Contractor could never undertake the required tests.
- 3.7 A major dispute between the parties arose as a consequence of this failure to meet the requisite tests within the required deadline and this resulted, ultimately, in proceedings in the High Court in London in May 2019. The parties also engaged in multiple dispute resolution procedures under the PFI Contract in relation to individual specific disputes. The High Court proceedings effectively resulted from the appeal of the first of these dispute resolution proceedings but addressed the overall issues relating to the Facility and the position of the parties under the PFI Contract. The Authority contended in the proceedings that the Contractor had failed to design and to construct the Facility so that it was capable of passing the Acceptance Tests, and that the Contractor’s failure either to pass the Acceptance Tests, or to attempt to do so by the Acceptance Longstop Date, was an event of default under the PFI Contract. In bringing the High Court proceedings, the Authority sought, amongst other relief, damages and a declaration that it was entitled to terminate the PFI Contract.

- 3.8 The Contractor denied any default and argued, in summary, that the Facility was capable of passing the Acceptance Tests, but for the Authority's failure to deliver waste of the required composition under the PFI Contract. It therefore argued that the Authority was in breach of the PFI Contract and the Contractor sought damages in excess of £77 million as well as declaratory and injunctive relief that would have shifted the entire costs of the defective design of the Facility to the Authority, and accordingly, to Essex taxpayers. The Contractor also alleged that the Authority and individual Council officers had failed to act in good faith, or to act honestly and reasonably in order to, effectively, engineer the ability to terminate the PFI Contract for convenience, and dressing this up as termination for contractor default. These, self-evidently, are serious allegations to have been made against the Authority and its Officers.
- 3.9 In view of the seriousness of the allegations made against it, and the failure to make any meaningful progress in settlement discussions (as to which see below), the Authority had little choice but to go forward and prosecute its case, and to defend itself against the allegations made against itself and its Officers.
- 3.10 The issues in the High Court proceedings were complex, and the main court hearing itself lasted 25 days. The decision was not issued until 18 June 2020, but in a damning judgment, Mr Justice Pepperall held in his decision that:

"Standing back from the trees, the shape of the wood can be clearly seen:

... The fundamental problem with this project was that UBB made a number of serious design errors:

a) Its density assumptions were based on little more than calculations on the back of the proverbial fag pack such that the biohalls were seriously undersized and incapable of processing the guaranteed tonnage of waste.

b) Its bid in respect of BMW reduction was inadequately researched, ambitious and set with a view to scoring well in the procurement exercise. It has not been achievable.

c) Its confidence that it could accept the composition risk and meet the performance guarantees notwithstanding significant variations in the waste proved to be misplaced

..."

- 3.11 The Judge made highly critical comments of the Contractor's case, and the evidence provided by a number of its witnesses and concluded that it was *"hopeless to suggest that the Authority was under a contractual obligation to agree fundamental changes to the contract and the Acceptance Tests in order to keep the project on track"*. UBB failed on all of its claims except for a relatively minor issue unrelated to the main dispute (regarding the Authority stopping deliveries for a short period of time during when it believed there may have been an asbestos issue with the processing of material at the Facility). The Judge noted that doubt was cast on the integrity of the Contractor's lead witness, and that *"this attitude to commercial integrity ... was part of a widespread culture*

within UBB.” The Contractor had concealed the density issue with the Facility, and had not designed it “with reasonable skill and care”. In summary “UBB therefore designed and built a facility that simply could not pass the Acceptance Tests.”

3.12 The Judge granted declaratory relief to the Authority declaring that the Contractor failed, in breach of contract, to achieve Service Commencement by the Acceptance Longstop Date under the contract, that the Contractor was not entitled to operate certain modifications it had made to the Facility, and which would therefore make it impossible for the terms of the PFI Contract ever to be met, and that the Authority was entitled to terminate the PFI Contract for Contractor Default. In addition, the Authority was awarded damages in the amount of £9,038,428 to the end of February 2019 and continuing losses thereafter at £99,563 per month. On the asbestos issue, the Contractor was granted compensation of £745,234.

3.13 In a subsequent ruling, the Judge also ordered that UBB pay 95% of the Authority’s legal costs, such costs to be assessed on an indemnity basis. The 5% deduction was to account for costs in considering the asbestos issue, but no discount was to apply looking forward where the Authority’s recovery was 100%. In the costs judgement it was noted that indemnity costs are appropriate only where the conduct of the paying party is unreasonable “to a high degree”, and Mr Justice Pepperall noted:

“I am pleased to say that the making of allegations of commercially unacceptable conduct without any proper evidential foundation – as happened in this case – is “out of the norm”. In my judgment, it is important that it should remain so and that parties realise that they cannot make unjustifiable allegations of a lack of good faith with impunity. While I do not equate the allegations in this case with fraud, I nevertheless conclude that UBB’s conduct in making widespread allegations of a lack of good faith against the Authority and its officers without any proper foundation was “out of the norm” and, of itself, justifies an order for costs on the indemnity basis.”

3.14 He also noted:

3.15 *“In my judgment, UBB’s counterclaim can properly be described as speculative, weak, opportunistic and thin. I infer that its determined prosecution by UBB combined with its unfounded allegations of a lack of good faith were designed to bring commercial and political pressure to bear on the Authority not to press its own claims to trial. Such conduct was “out of the norm” and, of itself, justifies an order for costs on the indemnity basis.”*

3.16 The Contractor then sought permission to appeal on 28 separate grounds, but Mr Justice Pepperall refused to grant consent on each such ground. Even then the Contractor sought leave to appeal in the Court of Appeal on 8 grounds, but the Rt. Hon. Lord Justice Coulson refused permission, noting in multiple instances that the argument raised by the Contractor had “no realistic prospect of success”, or that it was “untenable”, or “unarguable”. He also noted the “unchallenged findings by the judge that UBB were in breach of contract”. At this point, the Contractor’s legal remedies were exhausted.

- 3.17 The Authority had been left with little or no choice but to proceed with the High Court proceedings given it was evident to the Authority that the Contractor was in breach of the PFI Contract, had made fundamental design errors in the design of the Facility (for which it was solely responsible for designing), and had built a facility which, as the proceedings determined, was simply incapable of meeting the performance standards required under the PFI Contract. It was also necessary to defend against the attempt to shift blame and costs for these errors and breaches to the Authority itself, and to defend against the entirely unfounded allegations made about the conduct of the Authority and its Officers, which Mr Justice Pepperall determined were unjustifiable and resulted in a costs award on an indemnity basis being made against the Contractor.
- 3.18 Notwithstanding this, prior to the commencement of the High Court proceedings, the Authority, its Officers and advisers engaged in almost continuous discussions with the Contractor, its banks, sponsors and advisers with a view to resolving the dispute. These discussions were conducted on a without prejudice basis, but unfortunately no solution could be found which did not shift risk and significant liability for the issues at the Facility to the Authority. In any event, it was obvious that the Facility could not meet the performance requirements of the PFI Contract, and thereby deliver on its contributions to the Waste Strategy. The impact on the continuing availability of the WICs from DEFRA (which could, at DEFRA's discretion, be removed if the project did not remain in line with the approved Final Business Case) also had to be considered.
- 3.19 Likewise, the Authority considered whether, technically, the Facility could be put into a position where it could meet the requirements of the PFI Contract, but no viable technical, commercial or legally deliverable solution was feasible. Equally, no alternative solutions were possible in terms of providing a value for money solution for an alternative use of the Facility (and which, in any event, would not deliver on the objectives of the Waste Strategy while retaining DEFRA's support).
- 3.20 The Authority considered a wide range of alternative waste related uses with input from external technical advisors including: waste transfer, waste composting, lower performing MBT, and materials sorting; together with a range of non-waste commercial uses such as open storage and covered storage. No solution could be found which would satisfy a value for money analysis, with significant fixed overheads such as national non-domestic rates and uncertain environmental pollution risks rendering the options unviable. Potential alternative commercial uses for the Facility were assessed with input from external property advisors, all of which entailed very significant demolition or modification costs for the Authority that could not be confidently recovered through the increased rental income or otherwise.
- 3.21 The Contractor entered into administrative receivership on 27 July 2020, the day before the Court's deadline for the Contractor to pay the damages award. The Contractor accordingly defaulted on both the payment of damages and costs due the following day.
- 3.22 It is important to note that the Contractor is a special purpose vehicle incorporated solely for the purpose of implementing the project under the PFI Contract. Also,

as entirely standard in relation to PFI financing arrangements, the Authority was required, very simply, to subordinate its claims against the Contractor to those of the banks providing finance to the project. This was done pursuant to an agreement called the “Direct Agreement” entered into by the Authority at the time the senior credit facilities for the project were entered into.

- 3.23 Given that the Contractor was a special purpose vehicle and insolvent, and given the Authority was an unsecured creditor of the Contractor, with its claims subordinated to the claims of the senior lenders (the administrative receivers of the Contractor were acting on behalf of the interests of the secured creditors), there was no realistic way in which the Authority would be able to recover the damages and costs directly from the Contractor.
- 3.24 In relation to costs, the Authority therefore began preparation to bring a third-party costs claim against both the sponsors of the project and the banks. This was on the basis that they directed the Contractor’s litigation strategy, and funded it through the proceedings. Faced with this potential claim, the project sponsors agreed to a settlement and to pay the Authority £13,450,000, being the substantial portion of the Authority’s costs claim. The Authority also exercised its set-off rights under the Contract to set-off an amount of £961,654.49 that it owed the Contractor pursuant to a commissioning invoice for waste that had been processed at the Facility.
- 3.25 Practically speaking, the Facility was, from the time the Contractor entered into administrative receivership, mothballed, but the Contract would remain in place until the Authority decided to exercise its right to terminate, which the Authority was not bound to exercise (it could do so entirely at its discretion).
- 3.26 However, in accordance with the standard terms for PFI contracts, even when the contract is terminated for contractor default, there is a complex assessment of the valuation of the facility, which could result in the Authority having to pay compensation on termination to the Contractor. While counterintuitive, the purpose of this structure is to provide credit support for the secured lenders who, even if their borrower (i.e. the Contractor) is in default, still need to be repaid. But, this would mean that, having forced the Authority into proceedings to protect the Authority’s interests, and with a judgment firmly in the Authority’s favour, the Authority could end up having to make a substantial payment to the defaulting Contractor. Even then, the Authority would be assuming ownership of a failed facility, with all of the potential ensuing liabilities, including exposure to environmental liabilities which could not be quantified.
- 3.27 Faced with the fact that the Authority was not going to terminate, and thereby no compensation on termination would be paid, the secured lenders agreed to enter into an arrangement whereby the debt related to the project was sold to a sponsor entity at a very significant discount. The secured lenders thereby suffered a significant loss on their investment.
- 3.28 At the same time the sponsors had to incur significant further liability in order to fund the purchase of the debt from the banks. This was all done at no cost to the Authority. Any settlement discussions, going forward, would be directly between the sponsors and the Authority.

- 3.29 The Authority subsequently commenced further High Court proceedings seeking declarations that, following the sponsors' purchase of the debt, an effective repayment of the senior secured debt had occurred, and this would then enable the Authority to take direct action (unrestricted by the subordination provided for in the Direct Agreement, as mentioned above) against the sponsor entity that acted as the construction contractor for the Facility for its design and build errors, and also potentially against the sponsor parent companies as guarantors of the Contractor obligations. The claim would be for the amount of the awarded damages under the previous High Court proceedings (i.e. £9,038,428, plus interest).
- 3.30 Immediately after these proceedings were commenced, the sponsors sought further engagement on a settlement of the dispute. The starting condition imposed by the Authority, and accepted by the sponsors, was that, notwithstanding the terms of the PFI Contract, no compensation on termination would be paid. This also has to be considered in the context of the senior lenders suffering significant losses, and the sponsors incurring significant liabilities in making the discounted purchase of the debt.
- 3.31 The key question for the Authority was whether the Facility should be handed back to the Authority, or whether it should be demolished, and a vacant site handed back (clean from any environmental exposure) to the Authority. Despite significant technical analysis, no commercially viable alternative use for the Facility could be identified. If the Facility were handed back, the Authority would be assuming responsibility for a mothballed plant which did not meet its specifications, and could never meet the required performance standards, and the Authority would become responsible for all costs of maintenance and all ongoing risks and liabilities associated with taking control (including environmental exposure). There was a high degree of certainty that the Authority would have to demolish the Facility, and incur costs in the region of around £11,000,000 in so doing (albeit this would depend significantly on whether material environmental issues were discovered during demolition – the Authority was already aware of a number of potential concerns, including with the drainage system). A handback of the Facility would also involve a protracted and difficult negotiation (with material costs) with complicated legal issues to be determined, for example, establishing what warranties as to condition would need to be provided by the sponsors (knowing the Facility did not meet its specifications in any event).
- 3.32 The Authority determined that a demolition option would largely mitigate all of these risks, and result in the best value for money outcome for the Authority. Accordingly, the Authority entered into final settlement discussions with the sponsors on the basis that, notwithstanding the terms of the PFI Contract, no compensation on termination would be paid, the facility must be demolished subject to stringent environmental requirements, and all works must be undertaken at the sole cost of the sponsors and the Contractor. The Authority's environmental and technical consultants would monitor the works and would be required to certify compliance in order for handback of the vacant site to be completed. In addition, the sponsors would have to provide an unlimited guarantee and indemnity of performance, and which would continue to apply for

three years post-handback in case any latent environmental defects were discovered. The PFI Contract would be amended to define these conditions of handback, applicable on termination of the PFI Contract, and upon handback (i.e. after satisfactory completion of all works), the PFI Contract would be terminated. Each party would release all claims against the other parties, and in the case of the Authority, this would mean releasing the Contractor from the obligation to pay the damages (which the Authority would likely never be able to recover from the Contractor given that it was insolvent). In conjunction with this, the sponsors lost their entire equity investment in the project, they incurred significant additional liabilities in the discounted purchase of the debt, they have assumed all liability for the demolition of the Facility and meeting all conditions of handback, they have provided an unlimited guarantee and indemnity, and paid over £13,000,000 in settling the Authority's costs of the High Court proceedings. The banks also suffered a material loss on the discounted transfer of the debt to the sponsors (and all remaining outstanding debt was written off).

- 3.33 As a consequence of the settlement, the Authority would avoid the costs and uncertainties associated with future litigation (which could be substantial), it would not assume responsibility and liability for a defective Facility, and the potential for unquantifiable environmental liabilities, and the Authority would have flexibility in respect of its future waste strategy and in terms of the use of the site going forward. The long-running dispute would finally be brought to an end. All liabilities associated with the settlement terms would be for the Contractor's account, while the Authority would have the comfort of the continuing sponsor guarantee and indemnity for a further three years post-termination of the PFI Contract. The settlement agreement was entered into based on these principles on 21 April 2022.
- 3.34 The demolition of the Facility will commence shortly, and the Contractor has given an estimate that it will be completed in approximately 18 months. Following demolition of the Facility and satisfaction by the Contractor of stringent environmental clean-up requirements, the site will be handed back to the Authority for future use.
- 3.35 Due to the Facility (that was required to treat Essex's residual waste for the next 25 years) not being available, it is clear that a new waste strategy for the county is required. The Authority has begun the substantial process of working with the districts and borough councils to decide options for treating, not only its residual waste, but all the recycling, food and green waste streams. The new strategy will ensure that councils can respond to the Environment Act and support the work of the Essex Climate Action Commission. In due course, a full public consultation will take place on the recommendations that emerge from the work with the district councils.

4. Next Steps

Monitor the demolition of the facility by UBB and the subsequent environmental clean-up activities.

5. Appendices

None.