



Norfolk County Council
at your service

Council

Date: **Monday 28 October 2013**

Time: **10:00am**

Venue: **Council Chamber, County Hall, Norwich**

Supplementary Agenda 2

3. a) **Energy from Waste – Revised Project Plan**

To receive the following reports:

3 a (i) Energy from Waste – Updated Independent Report 1 attached **(Page B3)**

This updated QC's report replaces earlier advice set out in the previously published Supplementary Agenda for this meeting (namely pages A4-A22).

There are two new paragraphs at 60 and 61 of the attached document, and a final sentence in the renumbered paragraph 68 (paragraph 66 of the earlier version) which covers the Authority's liability for claims which have already accrued prior to termination.

Energy From Waste: Independent Report 3 attached **(Page B22)**

Valuation of Potential Compensation Scenarios

Energy From Waste: Independent Report 4

Please note that Report 4 referred to within the report from the Head of Law (Supplementary Agenda Page A4) will not now follow as the technical advisors have withdrawn. This report will be made available once new technical advisors have been appointed.

**For further details and general enquiries about this Agenda
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RE: THE WILLOWS POWER AND RECYCLING CENTRE

ADVICE

1. By a Contract dated 7th February 2012 the Norfolk County Council (“The Authority”) agreed with Willows Power and Recycling Limited (“the Contractor”) that the Contractor would build and operate for 25 years a power and recycling centre on an industrial site at Saddlebow, near King’s Lynn. The Authority was then a Conservative administration. In the local Government elections held on 2nd May 2013, the Conservatives lost their overall majority. The administration is now run by a Labour/Liberal Democrat coalition.
2. I am instructed that the decision to build and then operate a power and recycling centre was always controversial on political grounds.
3. At the meeting of the full council on 13th May 2013, Members requested that a report concerning the contractual penalty arising in the event of a withdrawal from the Contract be discussed at the next Cabinet Scrutiny Committee.

4. That Committee met on 4th June 2013. The Cabinet Scrutiny Committee discussed a report about the contractual penalties provided for in the event of the Council bringing an end to the Contract and considered a Briefing Note from the Head of Finance on the finance and funding implications of termination.
5. Consequent upon that meeting the Cabinet agreed to instruct Queen's Counsel:
 - (a) to consider the contractual powers to terminate the Contract and the contractual provisions concerning compensation for termination, and
 - (b) to conduct a review of the process of the manner in which the Contract was entered into.

In addition the Cabinet decided to obtain from an Accountant advice on the cost of the Authority of it extricating itself from the Contract.

6. I am instructed that there is urgency in the first part of my task, namely to consider the contractual provisions. That is because a Public Inquiry to consider the grant or refusal of planning permission ended on the 17th May 2013. The Inspector is expected to complete his report and submit it to the Department for Communities and Local Government in September 2013. It is possible, therefore, that the Minister's decision will be published in September. I have been instructed to provide this Advice by 20th September 2013.
7. In order to carry out the review of the process (see paragraph 5(b) above) I will need to see all relevant Committee papers, to have access to the relevant officers and to see the files of the Authority's legal advisers, Messrs Sharpe, Pritchard. In fact, I have seen a limited amount of the Authority paperwork but nothing else. I am not at

present in a position to carry out a review of the process. In any event, that should not be a matter which is hurried through. Councillor Kemp has sent a limited number of additional documents. One of them is a Member Briefing Note dated 24th July 2014, which consists of a draft revised Project Plan Process.

8. From that I understand that the Public Inquiry Process and its time requirements made it evident that the Contractor would not have planning permission by the contractual planning longstop date of 10th June 2013. Under the Contract provisions this led to the need to either request a draft revised Project Plan or to terminate the Contract for failure to obtain planning permission. On 31st January 2013 the Authority requested a draft revised Project Plan. That document was received on 30th April 2013. It can be agreed or rejected by the Authority on any date before 29th October 2013.
9. The critical issue for the new administration is the cost to the Authority of it extricating itself from the Contract. A further issue will be the source of the funds which will have to be paid to the Contractor. Additionally, it may be that the issue will arise as to the appropriateness of the use of public money for such a purpose. All of those matters are beyond my remit. My role is to consider the Contract and to identify the potential exit routes. I set out in full below the clauses which seem to me to be those which Officers and Members will need to consider.
10. Clause 10.5 provides:

“If this Contract is terminated for any reason prior to the Expiry Date:-

10.5.1 The Lease granted to the Contractor and any Underlease and/or any Sub-Underlease shall automatically and cease and determine with effect from the date of termination of this Contract (or, if not granted at the time, the obligation to grant the Lease)”

11. The effect of termination (for any reason) is thus that the Contractor loses its right to go onto and occupy the Site.

12. Clause 62 provides:

“62.1 Common Law Rights of the Contractor.

62.1.1 Without prejudice to any entitlement of the Contractor:

(a) to specific performance of any obligation under this Contract; or

(b) to injunctive relief;

The Contractor’s sole remedy in relation to matters for which an express right or remedy is stated in this Contract shall be that right or remedy and the Contractor shall have no additional right or remedy arising by common law, in equity, by statute or otherwise.”

13. Through that clause the Contractor’s claim for compensation or damages is limited to the formulae set out in the Contract wherever the Contract provides for an express right or remedy. The Contractor’s right to apply for specific performance or an injunction is unaffected.

14. Further, Clause 62.5 provides:

“Save where stated to the contrary, the indemnities under this Contract shall not apply and (without prejudice to the Authority’s rights under Schedule 4 (Payment Mechanism) there shall be no right to claim damages for breach of this Contract, in tort or on any other basis whatsoever, to the extent that any loss claimed by either Party is for Indirect Losses. The Authority agrees that, notwithstanding the foregoing, any Losses of the Contractor arising under the Sub-Contracts as originally executed (or as amended in accordance with the terms of this Contract) which are not of themselves Indirect Losses shall not be excluded from such a claim by virtue of this clause.”

15. In Schedule 1 “Indirect Losses” are defined as,

“..... loss of profits, loss of use, loss of production, loss of business, loss of business opportunity, or any claim for consequential loss or for indirect loss of any nature, provided that notwithstanding the foregoing any loss of Unitary Charge or Third Party Income or any breakage costs incurred by the Contractor under any Third Party Waste Contracts and/or Off Take Contracts

meeting their requirements of Clause 51 (Off Take Contracts and Third Party Waste Contracts) shall not be excluded from any claim by reason of this definition.”

16. That clause, save in relation to losses arising under Sub-Contracts, reinforces clause 62.1.1. The Contractor’s remedies are limited to those defined in the relevant Contract clauses.

17. Clause 62.6 provides:

“Notwithstanding any other provision of this Contract, neither Party shall be entitled to recover compensation under this Contract or any Ancillary document or any other agreement in relation to the Project in respect of any loss that it has incurred (or any failure of the other Party) to the extent that it has already been compensated in respect of that loss or failure pursuant to this Contract, any Ancillary document or otherwise.”

18. The effect of that clause is to prohibit any form of double recovery.

19. Clause 62.11.1 provides:

“This Contract shall only terminate in accordance with the express provisions of this Contract.”

20. The provisions for termination pursuant to the provisions of the Contract available to the Authority through that clause are limited to those expressly set out in the Contract.

21. Clause 67 provides:

“Subject to Clause 67.1 (Rectification), if a Contractor Default has occurred and the Authority wishes to terminate the Contract it must serve a Termination Notice on the Contractor.”

22. A Contractor Default is defined in Schedule 1 by reference to one or more of 17 Events. It is unnecessary for me to consider those Events or their definition because there is no suggestion of which I am aware that a Contractor Default has occurred.

For the same reason it is unnecessary for me to consider the termination procedures to be brought into play on the ground of Contractor Default.

23. Clause 69 provides for termination on the ground of occurrence of a *Force Majeure* Event. A *Force Majeure* Event is defined in Schedule 1 as:

“the occurrence after the date of this Contract of:

(a) war, civil war, armed conflict or terrorism; or

(b) nuclear, chemical or biological contamination...”

24. I am aware of no suggestion that a *Force Majeure* Event has occurred. It is unnecessary for me to give any further consideration to Clause 69.

25. Clause 71 provides for termination on the ground of the Contractor having either breached its warranty (set out in Clause 71.1) that it has not committed a Prohibited Act or the commission of a Prohibited Act by the Contractor (Clause 71.2.2).

26. A Prohibited Act is defined in Schedule 1. Again, I do not set out the definition because I am aware of no suggestion that termination on the ground of breach of the warranty in Clause 71.1 or the commission of a Prohibited Act is available to our Client.

27. Clause 73.1 provides for termination by our Client voluntarily. The relevant Clauses are as follows:

“73.1 The Authority may terminate this Contract at any time on or before the Expiry Date by complying with its obligations under Clause 73.2 (Voluntary Termination by the Authority).

73.2 If the Authority wishes to terminate this Contract under this Clause 73 (Voluntary Termination by the Authority) it must give a notice to the Contractor stating:-

73.2.1 that the Authority is terminating this Contract under this Clause 73 (Voluntary Termination by the Authority);

73.2.2 that this Contract will terminate as soon as reasonably practicable and in any event no later than the date falling three (3) Months after the date of receipt of the Notice: and

73.2.3 whether the Authority has chosen to exercise its option under Clause 73.3 (Voluntary Termination by the Authority) below.

73.3 On termination, subject to Clauses 80.6 and 80.7 the Authority shall have the option to require the Contractor to transfer its rights, title and interest in and to the assets to the Authority or as directed by the Authority.

73.4 This Contract will terminate on the date falling no later than three (3) Months after the date of receipt of the Notice referred to in Clause 73.2 (Voluntary Termination by the Authority) above.”

28. As I read Clause 73, the Authority has an absolute discretion to terminate voluntarily the Contract at any time prior to the Expiry Date which is defined in Schedule 1 as the 31st March 2014. All that is required is for the Authority to service a Notice under Clause 73.2. The Contract will then terminate as soon as reasonably practicable but no later than 3 Months after date of receipt of the Notice by the Contractor.

29. If the Authority decides to act in that way the Contract provides for the payment of compensation by our Client to the Contractor. The relevant provisions are Part 2 of Schedule 17; see Clauses 66 and 74 of the Contract. I consider those provisions below.

30. Clause 98.1 of the Contract provides for the method of serving notices and details of the addressee. Notices served upon the Contractor must be simultaneously copied to WTI Holdco at a given address.
31. Clause 65 provides for termination on the ground of Authority Default. Authority Default is defined in Schedule 1 relevantly as:
- (a) a failure by the Authority to make payment of any amount of money or
 - (b) **“a breach by the Authority of its obligations under this Contract which substantially frustrates or renders it impossible for the Contractor to perform its obligations under this Contract for a continuous period of 2 months”.**
32. Compensation is payable on the ground of Authority Default. Compensation is calculated by reference to Part 2 of Schedule 17. Part 2 of Schedule 17 also provides after termination on voluntary termination by the Authority (see below and Clause 74 of the Contract).
33. Clause 75 is permissive of termination by the Authority on the ground of wilful breach by the Contractor of paragraph 2 of Schedule 16, the Re-financing Provisions. I am unaware of any suggestion that there has been any such breach. The Re-financing Provisions are set out in Schedule 16. It is unnecessary for me to give Clause 75 any further consideration.
34. There is an additional ground for termination which is not found in Part XII of the Contract. It is found in Schedule 26 **“Planning”**.

35. Paragraph 2.1.1 of Schedule 26 provides for an undertaking from the Contractor that it will use “All Reasonable Endeavours to obtain a Satisfactory Planning Permission and use Reasonable Endeavours to follow and meet the Key Due Dates”. Reasonable Endeavours are defined in paragraph 2.2 of Schedule 26. Paragraphs 2.1.3 – 2.1.7 of Schedule 23 sets out the procedure to be followed which allows the Authority to police and monitor the steps taken by the Contractor to comply with paragraph 2.1.1 of Schedule 26.
36. I had very little information on the planning history. I understand that the Contractor failed to get planning permission in the expected timeframe so as to give rise to the need for a revised project plan as mentioned in paragraph 3.3 of the Contract. From the document which I received from Councillor Kemp, mentioned in paragraph 7 above, I understand that the revised Project Plan was received on 30th April 2013.
37. Paragraph 3.3.7 of Schedule 26 provides that within 6 months of receipt the Authority may either accept it (3.3.7 (x) (sic)) or reject it (paragraph 3.3.7 (y) (sic)). Both (x) and (y) are mis-numbered and should be (a) and (b)). No response to the revised Project Plan by the Authority is deemed to be a rejection: (Clause 3.3.7 (y)).
38. The Authority has until 29th October 2013 to accept the revised Project Plan. If the decision of the Secretary of State on the Planning Permission is not received until after 30th October 2013 they will be deemed to have rejected the Revised Project Plans unless before that date it has been accepted.

39. Under paragraph 3.5 of Schedule 26 either Party may serve a written Notice specifying a wish to terminate any contract if there is a Planning Failure or if the Authority rejects or is deemed to have rejected the revised Project Plan. The Contract Period terminates 15 business days from the date of such Notice of Termination.
40. By paragraph 3.5.2 of Schedule 26, if it is agreed or determined that there has been a failure by the Contractor to use All Reasonable Endeavours the provisions for compensation shall not apply and the Authority shall not be liable to the Contractor for any compensation on termination. That is described as the sole remedy of the Authority in respect of a failure by the Contractor to use All Reasonable Endeavours.
41. Alternatively, if there has been no such failure, compensation is payable. By paragraph 3.5.1 of Schedule 26 the provisions of Clause 7 (Compensation on Termination for *Force Majeure*) shall apply as if such termination constituted a *Force Majeure* Event.
42. Compensation on termination for *Force Majeure* is calculated by reference to Part 5 of Schedule 17: see Clause 70.
43. One further route to termination is found within Schedule 27 of the Contract. In the event that the Contractor fails to obtain an Environmental Permit the Authority may serve a Notice of Termination: see paragraph 11 of Schedule 27. I understand that the Contractor has obtained such a permit. It is unnecessary for me to give Schedule 27 any further consideration.

44. Clause 90 provides that,

“Each Party shall and shall procure that any representative(s) appointed upon its behalf pursuant to this Contract shall act in good faith and deal in a timely and diligent manner in relation to the carrying out of any service, duty or obligation under this Contract and any Ancillary Document.”

45. That Clause might be relied upon for an argument that a decision to reject the Revised Project Plan should be taken in good faith and not, for example, because of the compensation payable on rejection of the revised Project Plan is less than where there has been Voluntary Termination.

46. Clause 101 provides that:

“The Contract and any non-contractual obligations arising out of or in connection with it shall be governed and construed in all respects in accordance with the Laws of England and Wales. Subject to Schedule 22 (Dispute Resolution Procedure) the Parties submit to the exclusive jurisdiction of the Courts of England and Wales.”

47. The Dispute Resolution Procedure in Schedule 22 provides for adjudication: see paragraph 3. That is subject to paragraph 12 which provides for referral of the dispute to the English Court within 20 business days of receipt of the Adjudicator’s decision in the case of a dispute *inter alia* in respect of compensation on termination for *Force Majeure* or compensation on Voluntary Termination by the Authority. Having regard to the express reference to the *Force Majeure* provision in paragraph 3.5 of Schedule 26, I expect paragraph 12 of Schedule 22 to be construed so that a dispute in respect of termination under paragraph 3.5 can also be referred to the English Court.

48. The provisions for payment of compensation on termination are within Schedule 17. Part 2 of Schedule 17 provides for the calculation of compensation following Authority Voluntary Termination under Clause 73.

49. Paragraph 1.1.2 provides that the Authority shall pay the Contractor the “Authority Default Termination Sum” in accordance with paragraph 4 (Method of Payment of Compensation on Termination) of Part 7 (General) of this Schedule 17 (Compensation on Termination).

50. The provisions are as follows:

“1.2 Subject to paragraphs 1.2.4 and 1.4 to 1.6 below, the Authority Default Termination Sum shall be an amount equal to the aggregate of without double-counting:

1.2.1 The Base Senior Debt Termination Amount;

1.2.2 The SDF Debt;

1.2.3 Redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of this Contract;

1.2.3A Any Sub-Contractor Breakage Costs pursuant to limb (A) of that definition;

1.2.3B Any Sub-Contractor Breakage Costs pursuant to limb (B) of that definition; and

1.2.4 An amount which when taken together with:

(a) Dividends (or other distributions) paid by the Contractor on its share capital on or before the Termination Date; and

(b) Interest paid and principal repaid by the Contractor under the Subordinated Financing Agreements other than in respect of Tranche A Subordinated Debt on or before the Termination Date;

taking into account the actual the actual timing of all such payments, gives a real internal rate of return on the share capital subscribed and amounts advanced under the Subordinated Financing Agreements (excluding the amount advanced for SDF repayment or on a conversion of SDF to Tranche AA Subordinated Debt (which shall be compensated pursuant to paragraph 1.2.2 above) and any payments made in respect of an Equity Cure) equal to the Base Case Equity IRR.”

51. Paragraph 1.4 of Part 2 Schedule 17 provides:

“1.4 If the Aggregate of the amounts referred to in paragraph 1.2.1, paragraph 1.2.2, paragraph 1.23(B) and paragraph 1.2.4 is less than the Revised Senior Debt Termination Amount, then the Authority Default Termination Sum shall be increased so that it is equal to the aggregate of the Revised Senior Debt Termination Amount and the amounts referred to in paragraphs 1.23 and 1.2.3A ... provided always that:-

1.4.1 The amount referred to in paragraph 1.2.3 and 1.2.3A shall only be paid to the extent that the Contractor has demonstrated to the reasonable satisfaction of the Authority that the amount will not be paid in payment (in whole or in part) of any distribution; and

1.4.2 If, at the time of termination, there are any Additional Permitted Borrowings outstanding, no Sub-Contractor Breakage Costs shall be paid in respect of any such sub-contract in circumstances where there is an event of default under such sub-contract which would entitle the Contractor to terminate such sub-contract.”

52. Paragraphs 1.5 and 1.6 contain provisions to protect the Authority if in particular circumstances, which I assume do not apply, the Contractor is at fault.

53. The Base Senior Debt Termination Amount is a defined term found within Part 1 of Schedule 17, as is the SDF Debt. Similarly the meaning of Sub-Contractor Breakage Costs is found in the same sections.

54. On the material which I have it is impossible to form any view on the amount of Compensation which would be payable on Authority Voluntary Termination. Accordingly I have not added to the length of this Advice by setting out the definitions in full. Those definitions will have to be considered by a forensic accountant.

55. If there is termination as a result of Planning Failure, that is to say either a failure to obtain Planning Permission or rejection or deemed rejection of the revised Project Plan under paragraph 3.5 of Schedule 26, in such circumstances the provisions of Clause 70 apply: see paragraph 41 above.

56. Paragraph 1.7 of Part 5 of Schedule 17 provides:

“If a force majeure termination occurs as a result of the operation of paragraph 3.5 of Schedule 26 (planning) then, provided the Contractor has used All Reasonable Endeavours in accordance with Schedule 26 (planning) the Force Majeure termination shall be auditable and evidenced costs against the following heads:-

**Bank arrangement fees
Bank commitment fees
EPC termination costs
Rolled-up interest
Bank Agency fees
Letter of credit costs
Bid and development costs
Hedge breakage....
Costs or receipts arising under any interest hedging arrangement.”**

57. Compensation under paragraph 1.7 is capped at £20.3 million in total save in respect of interest rate hedge, forex hedge breakage and Overhedging payments.

58. I suspect that much of that information is only in the knowledge of the Contractor. It will be necessary for an accountant to obtain such material from the Contractor with the supporting evidence so that an audit can be carried out.
59. By paragraph 4.1 of Part 7 of Schedule 17 payment of the Termination Sum is due 40 Business Days after the Notice date although there is provision for payment in Instalment (see paragraph 4.2).
60. The above consists of the possible routes to termination under the Contract and calculation of the compensation for termination. Additionally, the Authority will be liable for claims which have already accrued prior to termination. I do not know whether there are any such claims. But I note in the context of Planning in Schedule 26 that by paragraph 2.1 of that Schedule the Contractor undertakes to use All Reasonable Endeavours to obtain a Satisfactory Planning Permission. All Reasonable Endeavours is defined at paragraph 2.2 of that Schedule. The need to bring Proceedings in support of those Endeavours is dealt with at paragraph 2.4 of that Schedule.
61. By paragraph 2.6 of that Schedule it is provided that the Contractor will bear all costs relating to and arising from any Proceedings up to the Limit of the Appeal Contingency. That is defined in paragraph 1 of Schedule 26 as £50,000. Paragraph 2.6 also provides that in respect of “amounts reasonably, properly and prudently spent or contracted to be spent by the Contractor in excess of the Appeal Contingency in the proper and diligent conduct of the Proceedings” the Authority shall indemnify the Contractor for nine-tenths of the total spent. Paragraph 2.7 of the Schedule

provides for alternative ways in which the indemnity may be satisfied. I understand that approval of the evidence in support of the claim for “Excess Costs” was given earlier this year. Any such liability will be payable in addition to the Compensation due upon Termination.

62. I have set out above the relevant clauses in relation to the termination of the Contract and calculation under the Contract of compensation for termination. However, if the agreed sum, (that is the sum calculated by reference to the Contract) is a penalty it will not be enforced by the courts. It is sometimes a matter of some difficulty to determine whether agreed damages, are in the particular circumstances of the case, penalties or liquidated damages, but the principles are well established. The onus of showing that a clause is a penalty clause lies upon the party who is sued upon it.
63. *“The classic form of penalty clause is one which provides that upon breach of a primary obligation under the contract a secondary obligation shall arise on the part of the party in breach which does not represent a genuine pre-estimate of any loss likely to be sustained by him as the result of the breach of primary obligation but is substantially in excess of that sum”*: Lord Diplock in **Scandinavian Trading v Flota** [1983] 2 AC 694 at 702.
64. *“The essence of a penalty clause is a payment of money stipulated as in terrorem of the offending party: the essence of liquidated damages is a genuine covenanted pre-estimate of damage”*: Lord Dunedin in **Dunlop v New Garage** [1915 AC 79 at 86. Thus the test is whether as a matter of construction the predominant contractual

function of the provision is to deter a party from breaking the contract or to compensate the innocent party for the breach.

65. The comparison to be drawn is between the stipulated sum and the range of losses that it could reasonable be anticipated that the sum would have to cover at the time the Contract was made.
66. In **Philips Hong Kong v AG of Hong Kong** [1993] 61 BLR 41 a calculation based partly on a formula applied to the total value of the contract was held to be a perfectly sensible approach in a situation where it would be obvious that substantial loss would be suffered in the event of delay but what the loss would be would be virtually impossible to calculate precisely in advance.
67. Prima facie, the loss suffered by the Contractor on termination by the Authority will be loss of the profit it would have made had the Contract lasted full term plus any irrecoverable expenditure not caught up in the loss of profit calculation. The Forensic Accountant will have to advise on whether the sum payable under the Contract is disproportionately excessive and on whether it was feasible to provide for a formulaic calculation of that sum at date of entry in to the Contract. It would be helpful to have full details of the negotiations, if any, concerning the contractual formulae.

Summary

68. In practice there are two alternative routes to Termination. The first is voluntary termination by the Authority under Clauses 73 and 74. The second is in relation to planning under Schedule 26. Both have onerous compensation clauses, the full scale of which I am not in a position to determine. It may be that the argument summarised in paragraph 60 -65 above will be of assistance to dilute the effect of the contractual compensation provisions. Additionally the Authority will remain liable to satisfy any claims which have already accrued.

69. Those who instruct me should consider with the Authority the content of this Advice. There is an urgent need to quantify the Compensation Provisions so that an informed view can be taken. I would be delighted to assist the accountant in consideration of the meaning of the compensation provisions.

15th September 2013

JONATHAN ACTON DAVIS QC

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- 2013 -

**Re: THE WILLOWS POWER AND
RECYCLING CENTRE**

ADVICE

Willows Power and Recycling Centre

Valuation of potential compensation scenarios

Report to Norfolk
County Council

22 October 2013

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Use of this document

This document has been prepared only for Norfolk County Council and solely for the purpose and on the terms agreed with Norfolk County Council. We accept no liability (including for negligence) to anyone else in connection with this document.

1. *Introduction and background*

Introduction

- 1.1 PricewaterhouseCoopers LLP (“PwC” or “we”) has been appointed by Norfolk County Council (“NCC” or the “Authority”) to carry out an independent forensic calculation of the termination compensation that may be payable by NCC in respect of the Willows Power and Recycling centre (the “Facility”). You have asked us to prepare a summary of the scope of our work and findings, which we have done in this document. This document has been prepared only for NCC and solely for the purpose and on the terms agreed in the engagement letter. We understand that a copy of this document is to be placed on the NCC’s website. For the avoidance of doubt, we accept no liability or responsibility (including for negligence) to anyone else in connection with this document, including those who may access it on the NCC’s website.

Background

- 1.2 We understand that in March 2011, NCC’s Cabinet agreed to award a 25 year service contract to Cory Wheelabrator, a consortium of Cory Environmental Ltd and Wheelabrator Technologies Inc, (the “Consortium” or the “Contractor”) to build and operate the Facility.
- 1.3 We understand that NCC entered into a contract with the Consortium for the construction and operation of the Facility on 7 February 2012 (the “Contract”). This was after completion of a procurement process but prior to the granting of a planning permission. In July 2012, the Environment Agency granted an Environmental Permit to allow the proposed Facility to operate.
- 1.4 On 30 August 2012, the Secretary of State for Communities wrote to NCC to inform NCC that he had decided to ‘call in’ the planning application for the Facility. A planning inquiry commenced on 26 February 2013 and closed on 17 May 2013. We understand from the NCC that the Planning Inspector reached her conclusions in September 2013, and that a decision is expected to be made by the Secretary of State on or before 14 January 2014.
- 1.5 On 10 June 2013, the NCC Cabinet, following the recommendation of the Cabinet Scrutiny Committee, agreed to commission Queen’s Counsel Jonathan Acton Davis QC (the “QC”) to advise on a number of matters including the possible routes available to NCC under the Contract by which the Contract could be terminated and the implications of each of those routes on the compensation payable by NCC to the Contractor.
- 1.6 In conjunction with the engagement of the QC, the NCC Cabinet also agreed to commission a financial advisor to “...provide bespoke costings for each penalty scenario in the Contract”. In accordance with this decision, the NCC appointed PwC to carry out an independent forensic calculation of the compensation amounts payable.

Scope of work

- 1.7 We have been instructed to perform an independent forensic analysis to calculate the amount of compensation that may be payable to the Contractor under the following scenarios:
- i. **Scenario 1** – the compensation payable if NCC opts for a voluntary termination of the Contract (“Scenario 1 – Voluntary termination” or “Scenario 1”); and
 - ii. **Scenario 2** – the compensation payable if the NCC terminates the Contract due to failure to obtain planning permission (“Scenario 2 – Failure to obtain planning permission” or “Scenario 2”).
- 1.8 We have also been instructed to consider as part of our work how the estimated compensation payable under the scenarios above compares to a general compensation for loss of profits plus irrecoverable expenditure wasted by the Contractor, to the extent these can be calculated (“Lost profits and wasted expenditure”).
- 1.9 The question of what compensation may be payable to the Contractor upon termination of the Contract requires both a legal and financial analysis. This report is not intended to address any of the legal considerations of terminating the Contract or the legal interpretation of Contract clauses relevant to the compensation payable. To the extent that our report touches on points of law it should not be taken as expressing an opinion on any matters of law, but rather our understanding based on discussions with NCC and the QC. While we have considered the amount of compensation payable from an accounting perspective we have not considered issues of liability. These matters are outside the scope of our work.
- 1.10 In this document we summarise our calculation of the potential compensation payable by the NCC under each of the above scenarios, based on information made available to us to date. We have not been provided with all the information that is relevant for the purposes of our analysis. Therefore, where applicable, we have estimated relevant amounts based on information that has been made available to us. Such estimates may change were we to be provided with all the relevant information necessary to quantify the compensation amount payable.
- 1.11 Our calculations in this document also include estimated amounts which relate to costs or profits that would crystallise in the future. As with any exercise of this nature, an estimate of such future costs and profits can usually be made based on available information and using relevant methodologies. However, there is no guarantee that the amounts thus calculated will be consistent with how the Contractor may calculate the compensation they deem is payable to them under the Contract. Further, the Contractor may claim for other types of losses (including consequential losses), which may not have been possible for us to identify in the course of our work.
- 1.12 We also draw your attention to the limitations of the scope of our work set out on the final page of this document.

Sources of information

- 1.13 We have been provided with the following key documents which we have reviewed in preparing this report:
- i. The Contract dated 7 February 2012;
 - ii. Schedule 17 of the Contract – Compensation on Termination;
 - iii. Schedule 26 of the Contract – Planning;
 - iv. Schedule 34 of the Contract – Financial Close Financial Model;
 - v. Audited financial statements of the Contractor for the year ended 31 December 2012 (including comparatives for the 9 month period ended 31 December 2011);
 - vi. Correspondence from the Contractor to NCC in relation to hedging break costs dated 9 May 2013 and 13 September 2013;
 - vii. Correspondence from the Contractor to NCC in relation to estimated planning inquiry costs dated 25 September 2013; and
 - viii. QC's advice dated 15 September 2013.
- 1.14 A full list of the documents relied upon in the preparation of this document is set out in Appendix 1 of our full report.
- 1.15 The following additional documents were requested from the Contractor, but have not been provided to us as at the date of this report:
- i. Financing facilities drawn down, finance fees incurred to date and anticipated early repayment charges;
 - ii. Current Bank Balances;
 - iii. Contractor's Financial Information including details of material, labour, planning/development and other costs incurred;
 - iv. Contractor's capital and other cost commitments;
 - v. Details of redundancy payments of employees of the Contractor in the event of termination; and
 - vi. Details of costs incurred in respect of sub-contractors and estimated sub-contractor break costs.

2. *Executive Summary*

Introduction

- 2.1 In accordance with our instructions, we have sought to calculate the compensation payable by the NCC to the Contractor under the following two scenarios:
- i. **Scenario 1** – the compensation payable if NCC opts for a voluntary termination of the Contract (“Scenario 1 – Voluntary termination” or “Scenario 1”); and
 - ii. **Scenario 2** – the compensation payable if NCC terminates the Contract on the basis of failure to obtain planning permission (“Scenario 2 – Failure to obtain planning permission” or “Scenario 2”).
- 2.2 These scenarios are based on the QC’s advice as to possible routes available to NCC to terminate the Contract, as well as seeking clarification from the NCC’s legal advisors as regards the possible interpretation of the relevant compensation clauses in the Contract.
- 2.3 We understand that, if compensation payable under Scenarios 1 or 2 is disproportionately excessive relative to the loss suffered by the Contractor on termination of the Contract, then the compensation payable under Scenarios 1 or 2 (as applicable) may be deemed to be a penalty and therefore not be enforceable by the courts¹. Therefore, we have also been instructed to consider how the compensation payable under Scenarios 1 and 2 compares to a general compensation for loss of profits and irrecoverable expenditure of the Contractor.
- 2.4 The question of what compensation may be payable to the Contractor upon termination of the Contract requires both a legal and financial analysis. This report is not intended to address any of the legal considerations of terminating the Contract or the legal interpretation of Contract clauses relevant to the compensation payable. To the extent that our report touches on points of law it should not be taken as expressing an opinion on any matters of law, but rather our understanding based on discussions with NCC (including its legal advisors and the QC). Where, based on such discussions, we understand that the Contractor may apply a different interpretation of the compensation clauses in the Contract, we have commented on the potential impact such alternative interpretation may have on the estimated compensation payable.
- 2.5 We have not been able to calculate precisely the amount of compensation payable under Scenarios 1 and 2 because:

¹ See paragraphs 60 to 65 of Exhibit 1.

(a) most of the information we needed to calculate amounts payable under the Contract has not been provided by the Contractor²; and

(b) some of the amounts that fall to be included do not crystallise until the actual termination date or later (e.g. hedging termination costs).

2.6 We have therefore estimated compensation amounts based on information available to us and by making certain assumptions, which we have set out in detail in our full report. It is highly likely that the actual compensation payable will be different from the amounts we have estimated (and could be either higher or lower). Furthermore, there is no guarantee that the amounts we have calculated will be consistent with how the Contractor may calculate the compensation they deem is payable to them under the Contract. The Contractor may apply a different interpretation of the contractual terms in any claim for compensation that it submits and may claim for other types of losses (including, for example, consequential losses), which may not have been possible for us to identify in the course of our work. The estimates we have calculated should be understood as providing an indication of the order of magnitude of the compensation payable under Scenarios 1 and 2, as well as which of these two alternative termination routes is likely to be more costly for NCC, rather than providing a “worst case” estimate of the compensation that may be payable.

2.7 For the purposes of our report we have assumed a termination date of 30 October 2013. Should the termination date be different the estimated compensation amounts would change.

Compensation payable under Scenario 1

2.8 In the event of voluntary termination of the Contract by the NCC, we understand that the Contractor is entitled to receive compensation for the following³:

- i. repayment of any outstanding senior debt and secured debt amounts as at the date of termination;
- ii. the costs of terminating certain debt and hedging arrangements that the Contractor has entered into, or drawn down, as at the date of termination;
- iii. the Contractor’s redundancy costs in respect of its employees;
- iv. the cost to the Contractor of terminating any sub-contracts that it has entered into as at the date of termination; and
- v. a specified rate of return on certain amounts that the Contractor has invested in the project.

² This information has been requested but the Contractor has not provided it on the basis that it is commercially sensitive and that they are not required to provide it at this stage.

³ Summary of costs contained within Exhibit 1, QC’s advice, paragraph 50.

- 2.9 We estimate that the compensation payable under Scenario 1 would be **£28.0 million**. This estimate is based on the assumption that under point v. above, the Contractor is entitled to obtain a return only on the amounts actually invested in the project to date. The Contractor may seek to apply a different interpretation to the calculation of the return on investment to be included within the compensation payable under Scenario 1. For example, the Contractor may interpret the Contract as entitling them to compensation for the return on all the amounts that the Contractor would have invested over the life of the Contract. Such an interpretation would result in a significantly higher overall compensation under Scenario 1. Whilst we cannot estimate with certainty what this amount may be, our best estimate at present is that it would be in excess of **£100 million**⁴. It is expected that any claim from the contractor for these losses over the life of the contract would need to consider the question of mitigation and to the extent that non-performance of this contract allows the contractor to earn some return elsewhere that should be off-set. It is not possible for us to comment further on this.
- 2.10 The compensation estimates above include an amount of £1.0 million in respect of breakage costs⁵. Actual break costs will likely be different (and may be higher) to this amount depending on the actual progress of the sub-contractor services and the costs that have actually been incurred or committed to the date of termination.
- 2.11 The compensation estimates above also include £4.4 million in respect of the cost of terminating hedging arrangements, which is based on an estimate as at 9 September 2013⁶. The cost of terminating hedging arrangements may fluctuate significantly over time. By way of illustration, the Contractor's estimate of the cost of terminating its hedging costs at 30 April 2013 was around £12 million. The actual cost (or profit⁷) generated when hedging contracts are terminated will depend on factors such as applicable interest rates and foreign exchange rates at the date of termination and cannot be estimated with any degree of accuracy at this stage. As the cost of terminating hedging arrangements is included in the compensation payable under both Scenarios 1 and 2, it should not impact the analysis of which termination route is less costly.

⁴ Being the estimated compensation in respect of items i. to iv. set out at paragraph 2.8, where compensation for the return on investment is calculated on the total amount expected to be invested by the Contractor over the life of the contract, as set out in the Financial Close model.

⁵ This represents the amount provided by the Contractor within the Financial Close model, in respect of sub-contract breakage costs in the event on planning failure.

⁶ Being the latest estimate made available by the Contractor as at the date of this report.

⁷ Should termination of hedging arrangements result in a profit to the Contractor, rather than a cost, such profit would be deductible from the compensation payable under both Scenarios 1 and 2.

Compensation payable under Scenario 2

- 2.12 The Contract states that in the case of termination due to the failure to obtain planning permission, the Contractor is entitled to receive compensation for the following “*auditable and evidenced*” costs⁸:
- i. Bank arrangement, agency and commitment fees;
 - ii. Rolled up interest;
 - iii. Letter of credit costs;
 - iv. The cost to the Contractor of terminating any engineering, procurement and construction (“EPC”) sub-contracts that it has entered into as at the date of termination;
 - v. the Contractor’s bid and development costs that the Contractor has incurred up to the date of termination; and
 - vi. the costs of terminating any debt and hedging arrangements that the Contractor has entered into, or drawn down, as at the date of termination.
- 2.13 The compensation payable in respect of items i. to v. above (the “capped cost categories”) is capped at £20.3 million under the terms of the Contract. Compensation for hedging costs (item vi.) is not capped. We understand that costs incurred by the Contractor which do not fall to be included within the categories i. to vi. above would not be included in the compensation payable under Scenario 2.
- 2.14 We estimate that the cost incurred by the Contractor in respect of the capped cost categories as at 30 October 2013 is likely to be equal to or higher than the cap of £20.3 million. Taking into account the estimated cost of terminating the Contractor’s hedging arrangements (of £4.4 million), we estimate the compensation payable under Scenario 2 to be around **£24.7 million**.
- 2.15 Whilst the degree of reliance that can be placed on these estimated compensation amounts for Scenarios 1 and 2 is limited (due to the limitations noted at paragraphs 2.4 to 2.6), it is reasonable to conclude that the compensation payable under Scenario 1 will be higher than that under Scenario 2 because:
- a. Scenario 2 limits the types of costs that the contractor can be compensated for⁹ and imposes a requirement for such costs to be “*auditable and evidenced*”; Scenario 1 does not include these limitations;
 - b. Scenario 2 does not include any return on amounts invested by the Contractor, whereas Scenario 1 does; and
 - c. Scenario 2 caps the compensation payable for costs other than costs of terminating hedging contracts, whereas Scenario 1 does not contain a cap.

⁸ See Exhibit 1, QC’s advice, paragraph 56.

⁹ For example, Scenario 2 does not include any compensation in respect of employee redundancy costs or subcontractor termination costs other than for the EPC subcontractor.

Consideration of the Contractor's loss of profits and wasted expenditure

- 2.16 Prima facie, the loss suffered by the Contractor on termination by the Authority would be loss of the profit the Contractor would have made had the Contract lasted full term plus any irrecoverable expenditure not included within the loss of profit calculation¹⁰.
- 2.17 We understand that the commercial aspects of the Contract were envisaged to operate in such a way as to guarantee the Contractor a certain rate of return (IRR) on the amount invested in the Facility. The inclusion in the contract of a specified IRR may be interpreted as setting an expectation of the return that the contractor would expect to generate during the life of the contract. The original base case model prepared by the Contractor and which forms part of the Contract estimated that the Contractor would receive a return in excess of **£90 million**¹¹ over the life of the Contract, based on the IRR set in the contract. That amount is likely to be the basis of a general loss of profit claim. To this amount would be added any additional lost profits¹², irrecoverable costs and any consequential losses that the Contractor may be entitled to. It is expected that any claim from the contractor for these losses would need to consider the question of mitigation and to the extent that non-performance of this contract allows the contractor to earn some return elsewhere that should be off-set. It is not possible for us to comment further on this.
- 2.18 We do not have sufficient information to quantify all these potential heads of claim. However, in the context of assessing whether estimated compensation under Scenarios 1 and 2 is likely to be disproportionately excessive relative to a general lost profits and irrecoverable expenditure claim we note the following. It is highly unlikely that the Contractor's compensation payable under Scenario 2 would be disproportionately excessive relative to the Contractor's loss of profits and irrecoverable expenditure. How a general loss of profit and irrecoverable expenditure claim would compare to the compensation payable under Scenario 1 depends to a large extent on the prevailing interpretation of the amount of return on investment that the Contractor is entitled to under Scenario 1. However, on the basis that a general loss of profits and wasted costs claim is to compensate the Contractor for the lost profits and any wasted costs as a result of the contract termination, it would seem unlikely that such a general claim would be lower than Compensation under Scenario 1 in the contract.

¹⁰ Exhibit 1, paragraph 65.

¹¹ The discounted present value of the return on the Contractor's share capital subscribed and return on Subordinated Financing (which we understand relate to the loans provided by the Contractor or sponsors) over the entire Contract period.

¹² For example, we understand that the Contractor may have sold spare capacity at the plant to third parties and generated other auxiliary revenue from third parties, in addition to the return envisaged under the Contract with NCC. In addition, we understand that if the financing facilities of the Contractor were renegotiated onto more favourable terms during the life of the Contract, further profits would be made from the resultant cost savings.

Other matters

- 2.19 We understand that the NCC is required to pay a contribution to the Contractor's planning inquiry costs (this is regardless of whether the Contract is terminated). We understand that the NCC would currently be required to pay around £1.5 million to the Contractor in respect of planning inquiry costs incurred to date¹³.
- 2.20 Whilst Scenarios 1 and 2 do not include specific compensation for planning inquiry costs, it is possible that they indirectly compensate the Contractor for those costs. For example, if planning inquiry costs were financed by the Contractor using senior or secured debt that remains outstanding at termination, Scenario 1 would indirectly compensate the Contractor for these costs since all outstanding senior and secured debt is included within the compensation payable. In Scenario 2, it is possible that the capped cost categories included within the compensation amount include some or all of the Contractor's planning inquiry costs.
- 2.21 We have not been provided with sufficient information to assess whether planning inquiry costs are captured in our estimates in respect of either Scenario 1 or Scenario 2. We understand that the Contract states that there should be no double counting of amounts paid to the Contractor. Therefore, any final assessment of the compensation payable ought to include whether the Contractor has already been compensated for planning inquiry costs outside of the compensation mechanisms envisaged under Scenarios 1 and 2.

¹³ Exhibit 2 provides for total planning inquiry costs estimate of £1.69 million of which we understand from NCC management that NCC may be liable for approximately £1.5 million.

Limitations to the scope of this report

We have not carried out anything in the nature of an audit nor, except where otherwise stated, have we subjected the financial or other information contained in this report to checking or verification procedures. Accordingly, we assume no responsibility and make no representations with respect to the accuracy or completeness of the information in this report, except where otherwise stated.

The scope of our work was limited to a review of documentary evidence made available to us. As set out in this report, we have not been provided with all documentation required to complete our agreed scope of work. We highlight in this report where this is the case. In such instances, we have estimated amounts payable based on the information that was made available and, where relevant, highlighted in the report any gaps or incomplete estimates.

This report sets out our calculation of the potential compensation payable by the NCC under the relevant scenarios. Due to the time constraints in our work, this report has not considered all areas which might be relevant. We have identified those areas which came to our attention where we consider further investigation may be required.

We cannot guarantee that we have had sight of all relevant documentation or information that may be in existence and therefore cannot comment on the completeness of the documentation or information made available to us. Where we are aware of documentation (or information) which has not been provided to us, we have highlighted this in our report. Any documentation or information brought to our attention subsequent to the date of this report may require us to adjust and qualify our report accordingly.

