

LEGAL ADVICE NOTE

CAPITAL INVESTMENT IN THE RESIDUAL WASTE TREATMENT FACILITY: INITIAL SUBSIDY CONTROL ADVICE**1 INTRODUCTION AND BACKGROUND**

- 1.1 We are instructed by Milton Keynes City Council (the “**Authority**”) in respect of the Authority’s proposed capital investment in the Residual Waste Treatment Facility at Milton Keynes Waste Recovery Park (the “**Facility**”). The Facility is operated by Thalia Waste Management Limited (the “**Contractor**”).
- 1.2 We have been asked to provide an initial opinion on whether the proposed Authority investment and support complies with the UK’s prevailing subsidy control rules. These are set out in the Subsidy Control Act 2022 (the “**Act**”).
- 1.3 This advice note is produced by Sharpe Pritchard LLP pursuant to its terms and conditions with the Authority. It is based solely on the information provided and on the subsidy control regime in effect in England and Wales as of 4 January 2023.
- 1.4 We have considered the draft Memorandum of Understanding between the Authority and the Contractor (the “**MOU**”). The MOU remains subject to negotiation and clarification. From the MOU we understand the following:
 - 1.4.1 The Authority proposes supporting the Contractor by implementing a three-year rolling capital investment business plan/programme (the “**Investment**”). The Contractor will procure and install new and enhanced boilers, three-way value and sonic cleaning arrangements. The Council will then make the Investment.
 - 1.4.2 The Investment will only be made once the new boilers are accepted as being fully operational. The Contractor shall bear all costs until the point of acceptance.
 - 1.4.3 The Investment will not exceed £5,000,000 (five-million-pounds).
 - 1.4.4 External financial advisors will review the financial model. This will result in a review and change to the third-party income (“**TPI**”) mechanism. The TPI mechanism will allow the Contractor to recover the amount it would otherwise have been able to under the base case for the relevant year. Then the next tranche of TPI will go to the Council to allow it to recoup the Investment (or part thereof). Only then will TPI sharing in the original proportions occur. The revised TPI mechanism will not allow the Contractor to recover losses in prior financial years.
 - 1.4.5 The Contractor’s contractual termination liability limit and the Parent Company Guarantee will each be increased in a sum equivalent to the Investment.
 - 1.4.6 The normal provisions of the contract shall apply to the boilers meaning they revert to the Council at the end of the contract.
 - 1.4.7 The MOU will allow for some other support for the Contractor i.e., provision of storage – we understand this is small in scale and will actually not be related to the above transaction but rather a change in law made as a result of POPs changes in legislation.
- 1.5 We further understand that the Contractor is responsible for maintenance and repair of the boilers.

2 INITIAL SUBSIDY POSITION AND KEY NEXT STEPS

- 2.1 At this stage we cannot advise definitively on subsidy control matters. Rather we provide our initial view and key points for the structure. At this stage we see “no showstoppers” with the proposed structure.
- 2.2 We consider the transaction proposed in the MOU would likely constitute a subsidy. This is because it is an investment that improves the contractual position of the Contractor. Under the contract (without intervention) the Contractor would have to suffer the loss of income or fix the boilers at cost. However, we consider the Council may be able to make some arguments that there is not a subsidy.

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- 2.3 Even where there is a subsidy, we consider the Council could make an argument the subsidy is lawful.
- 2.4 There is more detailed analysis on the points in paragraphs 2.2 and 2.3 in what follows.
- 2.5 We propose that the Council makes and records the argument (a) that the transaction in the MOU is not a subsidy; and (b) in the alternative (even if it is a subsidy that it is a lawful one) – this will require completion of an assessment against the subsidy control principles and also notification on the register of subsidies.
- 2.6 We also propose that the following principles are adhered to:
 - 2.6.1 The Council assists us to make a case for market failure in respect of the failure of the boilers. This should be documented.
 - 2.6.2 The cap to the Council investment remains.
 - 2.6.3 The cap is expressed as £4,999,999. £5m is the threshold at which a subsidy can have to be referred to the Competition and Markets Authority. We consider it is preferable not to do this if possible.
 - 2.6.4 The Council should preserve the cap to limit its exposure and ensure it does not grant an unlawful unlimited subsidy.
 - 2.6.5 The Council does not refer to this as investment to safeguard the Contractor's financial wellbeing. This may make the subsidy unlawful.
 - 2.6.6 Once the variation is agreed the Council publish notice of it on the BEIS transparency register of subsidies. We can discuss this further if the Council is concerned about this.
 - 2.6.7 The Council ensures there is no reimbursement in the TPI mechanic for prior years financial losses.
 - 2.6.8 The Council separates this DoV (whether via annex or DoV) from the POPs change as the two are intellectually separate.
 - 2.6.9 There is no margin for the Contractor in the boiler installation.
 - 2.6.10 The Contractor to supply and install the boiler is procured.
 - 2.6.11 The Contractor should be required to maintain the boilers and return them in appropriate condition on expiry.
 - 2.6.12 The Council should consider the actual benefit to the Contractor i.e., how much of the boilers useful life is the Contractor getting the benefit of relative to its actual useful life.

3 IS THE INVESTMENT A SUBSIDY?

- 3.1 If the Investment is not a subsidy, the subsidy control rules do not apply.
- 3.2 "Subsidy" is defined in Section 2 of the Act as:
 - “financial assistance which –*
 - (a) is given, directly or indirectly, from public resources by a public authority,*
 - (b) confers an economic advantage on one or more enterprises,*
 - (c) is specific, that is, is such that it benefits one or more enterprises over one or more other enterprises with respect to the production of goods or the provision of services, and*
 - (d) has, or is capable of having, an effect on –*
 - (i) competition or investment within the United Kingdom,*

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- (ii) *trade between the United Kingdom and a country or territory outside the United Kingdom, or*
- (iii) *investment as between the United Kingdom and a country or territory outside the United Kingdom.”*

3.3 We set out our initial thoughts with regard each limb of the definition below. Note that each limb must be satisfied for there to be a subsidy.

Financial assistance

3.4 Pursuant to s2(2), financial assistance may include:

- a) a direct transfer of funds;
- b) a contingent transfer of funds;
- c) the forgoing of revenue that is otherwise due;
- d) the provision of goods or services; and
- e) the purchase of goods or services.

3.5 The Authority reimbursing the Contractor for the cost of the boilers will involve a direct transfer of funds. As above, under the contract it would be the Contractor who would have to do this. As such the payment for the boilers is unquestionably financial assistance to the Contractor. The value of the financial assistance is a question to be determined as the value is not necessarily the full cost of the boilers. The contract only runs until 2033 and the boilers will have a useful life beyond this. The value of the financial assistance should be calculated in lines with principles of depreciation.

Given from public resources by a public authority

3.6 The Authority is a public authority, and the Investment will be drawn from public resources.

Confers an economic advantage

3.7 The [Statutory Guidance](#) provides that an economic advantage is conferred where:

“the benefit that an enterprise receives is provided on terms that are more favourable to the enterprise than terms that might reasonably have been expected to have been made available to the enterprise on the market.”

3.8 We consider that it is likely that the Investment confers an economic advantage on the Contractor but note that there are arguments for and against.

3.9 The argument against the conference of an economic advantage is that the Authority, through the Contractor, is purchasing goods (the boilers) at market rate. The Council is not paying any margin to Thalia. Further the Council will be the ultimate beneficial owner of the boilers on contract expiry. This argument supposes that the ultimate beneficiary of the goods is the Authority as:

- 3.9.1 the Authority owns the Facility and therefore has a financial interest in it;
- 3.9.2 the boilers are a crucial element of the Facility, without which the Facility cannot generate electricity (and therefore income) at the same volume; and
- 3.9.3 the Authority will continue to enjoy the benefit of the boilers following expiry of the contract.

Purchase of goods by the beneficiary of such goods at market rate does not confer an economic advantage and, as such, does not give rise to a subsidy.

3.10 However, ultimately, we do not find this persuasive. This is because *contractually* the beneficiary of the goods is the Contractor (as the Contractor is responsible for replacing the boilers and, as such, enjoys the benefit of the boilers as it can continue to perform its obligations under the PFI contract). If we analyse the procurement of the boilers from the Contractor’s position, the Contractor is receiving goods at zero cost (albeit there may be remuneration via the TPI mechanic) and gaining a benefit

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via third party income. It is also saving cost, offering little in return (simply the possibility of clawback). The open market would not offer this arrangement. The Authority purchasing goods in these circumstances when it is not itself the beneficiary of the goods is likely to give rise to a subsidy as it confers an economic advantage on the Contractor.

Is specific

3.11 We consider that the Investment is specific as it benefits the Contractor over other enterprises.

Has or is capable of having an effect on competition, investment or trade

3.12 We consider that the Investment is capable of having an effect on competition within the UK. This is generally a low threshold.

Our initial view

3.13 On the basis of the above analysis, we consider at this initial stage that the Investment has a medium-high risk of being classed as a subsidy in the event of challenge (50-70%). Albeit we do consider there are arguments the Council could make that a subsidy does not arise we do not consider they would be likely to be successful.

4 IF THE INVESTMENT IS A SUBSIDY, IS IT UNLAWFUL?

4.1 Even if, in the event of challenge, the Investment is deemed to be a subsidy, that does not necessarily mean it is unlawful. The subsidy control regime allows for the award of lawful subsidies. A subsidy is lawful unless it falls under one of the categories of prohibited subsidies or if it fails to comply with the subsidy control principles.

Prohibited subsidies

4.2 The list of automatically unlawful subsidies is set out in Annex 1. Note in particular that subsidies granted to rescue an ailing or insolvent enterprise are automatically unlawful, unless certain conditions are met¹. The MOU states that the Authority is supporting the Contractor because of its "acute financial issues". This is not helpful from a subsidy control compliance perspective. We are also not sure this is the correct analysis and would advise this should be rephrased. The issue is not the contractor's insolvency but an issue arising with a challenging technology that could not be procured. The Council is making this investment to secure its investment.

4.3 We do not consider the automatically unlawful categories of subsidies further for the purposes of this initial advice nor is it obvious any other of the categories apply.

Subsidy control principles

4.4 The subsidy control principles are set out in Annex 2. A subsidy must comply with the principles to be lawful. We would require assistance from the Council to document a case that the subsidy was compliant.

4.5 We note the following in support of compliance with the principles:

4.5.1 There is a potentially arguable market failure in respect of the technology as technology failure in respect of this type of plant is not unique to the Facility and could not have been reasonably foreseen.

4.5.2 The Contractor is purchasing the boilers at market rate and as such the subsidy is proportionate and limited to what is necessary.

4.5.3 We understand that there is no liquid market for alternative contractors taking over the Facility and, as such, there are no less distortive means of remedying the market failure.

¹ Section 19 of the Act.

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- 4.5.4 The Contractor will not fund the purchase itself and would sooner terminate the PFI contract. This would have a material adverse impact on the Council.
- 4.5.5 The positive effects of the subsidy are considerable: if the Contractor terminates the PFI contract, the Authority will be left owning the inefficient and defective Facility. The Authority may be forced to spend more public money on alternative solutions. The positive effects likely outweigh the relatively modest negative effects arising from this negligible subsidy.
- 4.5.6 There is a potential clawback mechanism through which the Authority could recover the totality of the Investment.

5 CONCLUSION

- 5.1 Our initial review identifies potential risk from a subsidy control perspective. We have set out initial options for the Authority above but note that none of the options entirely de-risk the position.
- 5.2 We require further information to advise fully. We also await the finalised MOU and will need to reconsider our position at that stage but hopefully the principles set out above will assist.
- 5.3 If the Authority has any queries in respect of this advice or if we can advise further, please contact Steve Gummer (sgummer@sharpepritchard.co.uk).

Sharpe Pritchard LLP

11 January 2023

ANNEX 1: AUTOMATICALLY UNLAWFUL SUBSIDIES

The Act prohibits certain categories of subsidies. If the Investment falls within one such category, it is automatically unlawful. There are no workarounds or defences to the following categories of subsidies:

- unlimited state guarantees;
- subsidies contingent upon export performance relating to goods or services;
- subsidies contingent on the use of domestically produced goods or services;
- subsidies requiring relocation of all or part of a beneficiary's existing economic activities where such relocation would not occur in the absence of the subsidy; and
- subsidies granted to rescue an ailing or insolvent enterprise, unless certain conditions are met.

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ANNEX 2: SUBSIDY CONTROL PRINCIPLES

Principle A: Subsidies should pursue a specific policy objective in order to remedy an identified market failure or address an equity rationale (such as local or regional disadvantage, social difficulties or distributional concerns).

Principle B: Subsidies should be proportionate to their specific policy objective and limited to what is necessary to achieve it.

Principle C: Subsidies should be designed to bring about a change of economic behaviour of the beneficiary. That change, in relation to a subsidy, should be conducive to achieving its specific policy objective, and something that would not happen without the subsidy.

Principle D: Subsidies should not normally compensate for the costs the beneficiary would have funded in the absence of any subsidy.

Principle E: Subsidies should be an appropriate policy instrument for achieving their specific policy objective and that objective cannot be achieved through other, less distortive, means.

Principle F: Subsidies should be designed to achieve their specific policy objective while minimising any negative effects on competition and investment within the United Kingdom.

Principle G: Subsidies' beneficial effects (in terms of achieving their specific policy objective) should outweigh any negative effects, including in particular negative effects on competition and investment within the United Kingdom, and international trade and investment.

The Energy and Environment Principles will also need to be considered. These are as follows:

Aim of subsidies in relation to energy and environment

A Subsidies in relation to energy and environment shall be aimed at and incentivise the beneficiary in—

- (a) delivering a secure, affordable and sustainable energy system and a well-functioning and competitive energy market, or
- (b) increasing the level of environmental protection compared to the level that would be achieved in the absence of the subsidy.

Subsidies not to relieve beneficiary from liabilities as a polluter

B Subsidies in relation to energy and environment shall not relieve the beneficiary from liabilities arising from its responsibilities as a polluter under the law of England and Wales, Scotland or Northern Ireland.

Subsidies for electricity generation adequacy, renewable energy or cogeneration

C (1) Subsidies for electricity generation adequacy, renewable energy or cogeneration—

- (a) shall not undermine the ability of the United Kingdom to meet its obligations under Article 304 of the Trade and Cooperation Agreement (provisions relating to wholesale electricity and gas markets),
- (b) shall not unnecessarily affect the efficient use of electricity interconnectors provided for under Article 311 of the Trade and Cooperation Agreement (efficient use of electricity interconnectors), and

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(c) shall be determined by means of a transparent, non-discriminatory and effective competitive process.

(2) But a non-competitive process may be used to determine a subsidy for renewable energy or cogeneration if appropriate measures are put in place to prevent overcompensation and—

(a) the potential market supply is insufficient to ensure a competitive process,

(b) the eligible capacity is unlikely to have a material effect on any of the following—

(i) competition or investment within the United Kingdom,

(ii) trade between the United Kingdom and any country or territory outside the United Kingdom, and

(iii) investment as between the United Kingdom and any country or territory outside the United Kingdom, or

(c) the subsidy is given for a demonstration project.

(3) Sub-paragraph (1)(c) is without prejudice to Article 304(3) of the Trade and Co-operation Agreement (capacity mechanisms in electricity markets).

(4) In this paragraph and paragraph D, “subsidy for electricity generation adequacy” means a subsidy that provides an incentive for a capacity provider to be available in times of expected system stress.

D Subsidies for electricity generation adequacy may be limited to installations not exceeding specified CO₂ emission limits.

E Subsidies for renewable energy or cogeneration shall not affect beneficiaries’ obligations or opportunities to participate in electricity markets.

Subsidies in the form of partial exemptions from energy-related taxes and levies

F (1) Subsidies in the form of partial exemptions from energy-related taxes and levies in favour of energy-intensive users shall not exceed the total amount of the tax or levy concerned.

(2) “Levy” does not include network charges.

Subsidies in the form of compensation for increases in electricity costs

G Subsidies in the form of compensation for electricity-intensive users given in the event of an increase in electricity costs resulting from climate policy instruments shall be restricted to sectors at significant risk of carbon leakage due to the cost increase.

Subsidies for the decarbonisation of emissions linked to industrial activities

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H Subsidies for the decarbonisation of emissions linked to industrial activities in the United Kingdom shall—

(a) achieve an overall reduction in greenhouse gas emissions, and

(b) reduce the emissions directly resulting from the industrial activities.

Subsidies for improvements of the energy efficiency of industrial activities

I Subsidies for improvements of the energy efficiency of industrial activities in the United Kingdom shall improve energy efficiency by reducing energy consumption, either directly or per unit of production.