



Greater Manchester Waste Disposal Authority

Recycling, Waste Management and Operations Committee

11th December 2012

Report of the Director of Contract Services

Life Cycle and Maintenance Costs

1. Purpose

- 1.1 To provide Members with background information on the accounting treatment of life cycle and maintenance costs and to set out the contractual arrangements for ensuring an appropriate level of expenditure is maintained by the Contractor.

2. Recommendation

2.1 Members are recommended to:-

- a) note the contractual provisions set out in section 5.0 of the report;
- b) endorse the proposals for additional resources to be allocated to the Contract Services section as set out in section 7 of the report;
- c) to require the Treasurer & Deputy Clerk to continue to lobby the Chartered Institute of Public Finance & Accountancy (CIPFA) and the auditors in this area in order to achieve an acceptable solution to the accounting issues; and
- d) request that the annual review of life cycle and maintenance costs is added to the Committee's work programme.

3. Executive Summary

- 3.1 Members of the Authority have sought reassurance that Viridor Laing (Greater Manchester) Limited (VLGM) is incurring appropriate levels of expenditure on life cycle and maintenance costs for the facilities.
- 3.2 Maintenance is the responsibility of VLGM under the Recycling & Waste Management Contract (the Contract) and they must have set plans for audit purposes. Failure to comply with these plans can lead to inspection rights for the Authority and could result in breach of Contract.
- 3.3 A review of the forecast spend against actual was undertaken for the first three years of the Contract. This demonstrated that Viridor Waste (Greater Manchester) Limited (VWGM) have incurred an additional £283k over this period above the forecast level, due to boiler tube and refractory failure at Raikes Lane Thermal Recovery Facility (TRF), Bolton.
- 3.4 It is proposed that additional resources, within existing budgets, be integrated into the Contract Services team specifically to monitor expenditure in this area. The outcomes of this exercise will be reported to the Committee on an annual basis.

4. Background

- 4.1 Members of the Audit Committee have recently discussed the technical accounting issue of the treatment of life cycle and maintenance costs relating to the Contract. This was further discussed at the meeting of the full Authority on 23rd November 2012, where Members also sought to understand how the Authority can be reassured that VLGM is actually incurring the forecast levels of life cycle and maintenance costs to ensure the facilities have the appropriate life span. The Authority delegated this issue to the Recycling, Waste Management and Operations (RWMO) Committee to review and monitor.
- 4.2 The Authority's auditors require all Private Finance Initiative (PFI) assets to be accounted for as part of the Authority's assets. International Financial Reporting Standard (IFRS) also requires us to consider what is spent on life cycle costs and the items of plant replaced would be removed and the depreciation of the various plant items adjusted accordingly. This exercise will become increasingly onerous and has limited added value.
- 4.3 Previously, this was not an issue as the sums involved were not material for accounting purposes. Now, with the new facilities coming on stream, in some years the total annual life cycle and maintenance costs could be over £12 million pounds. The difficulty for accounting treatment comes from the fact that these costs are built into the Unitary Charge. Also, the Authority does not control the facilities and can therefore not identify and account for which pieces of plant have actually been replaced. One way around this is to value the assets every year to get the right value for the assets. This may cost c.£50k per annum and is not cost effective. This whole issue is a technicality that affects PFI Contracts with a service element where the client authority has effectively passed the risk of maintenance to the contractor.
- 4.4 The Authority must comply with the requirements of IFRS, or would probably see its Accounting Statements qualified, so under current rules compliance is the only viable option. However, the Audit Committee recognised that this seems to be significant cost and effort, especially in these austere times, and in the absence of a "value for money" justification required that further lobbying of the appropriate bodies including CIPFA and the auditors, by the Treasurer and Deputy Clerk, to remove this requirement should be undertaken. It is recommended that the outcome of this lobbying is reported to the Performance, Policy and Resources (PPR) Committee.
- 4.5 Initial preparatory work has identified that whilst CIPFA could potentially disapply IFRS, they could only do so with support from Government because of its impact on the Whole of Government Accounts (WGA). This therefore requires careful handling and may take some time to resolve.
- 4.6 Whatever the outcome of that lobbying, an accounting solution needs to be found that is both practical in terms of information available and cost effectiveness and that complies as far as possible with the necessary accounting requirements and therefore meets the auditors' approval.

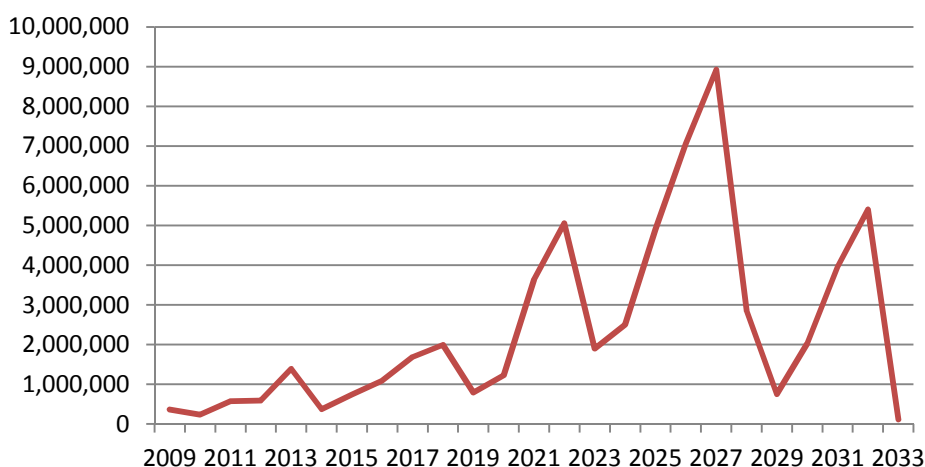
5. The Contractual Position

- 5.1 Under the Contract the responsibility for maintenance of facilities rests with VLGM. Included in the financial model are annual costs for planned maintenance and life cycle replacement. The planned maintenance costs are fixed and subject to annual inflation at Retail Price Index excluding mortgage interest payments (RPIx). These can be extracted from the financial model (at April 2009) prices as follows:
- 5.2 Annual Maintenance Cost (£)

	£
Materials Recovery Facility (MRF)	128,714
In-Vessel Composting (IVC)	412,586
Mechanical Biological Treatment (MBT)	2,942,116
Green Waste Shredding Facility (GWSF)	33,239
Household Waste Recycling Centre (HWRC)	378,005
Transfer Loading Station (TLS)	251,430
Thermal Recovery Facility (TRF)	724,174

- 5.3 The life cycle costs are variable reflecting the different technologies and different replacement cycles. The graph below sets out the annual life cycle costs for all facilities as extracted from the financial model. These are at April 2009 prices and will also be subject to annual inflation using RPIx.

Life Cycle Costs (£s)



- 5.4 Both of these items are included in the fixed cost element of the Unitary Charge payable by the Authority and as such there is no significant variation in payment.
- 5.5 Essentially, the Authority is liable for paying these fixed sums for maintenance and life cycle costs and in a given year the Contractor may spend more or it may spend less. From a commercial perspective there will always be a temptation to spend less in these areas and make additional profit, so from the Authority perspective, it must ensure that appropriate expenditure is incurred by VLGM.
- 5.6 Maintenance is covered under the Contract via Clause 23. At a headline level this requires the Contractor to maintain the facilities such that they are continuously available to meet the requirements of the Output Specification, are maintained to achieve their full working life and are handed back to the Authority at expiry in an appropriate working condition.
- 5.7 Clause 23 requires the Contractor to produce detailed maintenance plans for each facility setting out the planned maintenance required. These are updated annually and the Contractor is required to comply with the maintenance plan.
- 5.8 The maintenance plan and compliance with it is detailed in the VLGM annual report required under the Contract and this gives a facility by facility account of maintenance undertaken.
- 5.9 Clause 23.9 of the Contract requires VLGM to maintain a sinking fund for maintenance and life cycle costs which VLGM has to ensure VWGM use solely for this purpose. This

sinking fund is effectively the sums specified previously in paragraph 5.2.

- 5.10 If the Authority believes that the Contractor is in breach of any of its obligations under Clause 23, the Authority has a right to undertake a survey using a third party assessor. This cannot be undertaken more frequently than every two years for any one facility. If the survey shows the Contractor has not complied with Clause 23 then a Notice is issued by the Authority specifying works to be undertaken and a time frame for completion and any such works would be at the Contractors' expense. If the Contractor does not comply with the Notice it would then be in breach of Contract.
- 5.11 The Contract also requires that at the end of the 25 years the assets are sufficiently maintained to prolong life (as set out in Clause 23 - Maintenance). In simple terms the usual test applied is so that they run for a further five years. Against that background in late year 22 the Authority will need to make sure it assesses the condition of facilities, and thus any defects can be rectified as part of the 2032 final "spike" in lifecycle costs. The process to effect this is set out in Clause 6. The Contract diary provides a suitable reminder note.
- 5.12 It should also be noted that whilst, in theory, the contractor may wish to delay larger life cycle spend, they could as a result, be faced with facilities being unavailable which in turn would lead to the imposition of unavailability charges.

6. Authority Monitoring Activity

- 6.1 In light of the potential for reduced spend on lifecycle costs, a review of the financial model was undertaken in 2011/12. This showed that in the early years of the Contract life cycle replacement costs are only incurred at the TRF. Longley Lane MRF, Sharston and Chichester Street IVC, Rochdale start to undergo some life cycle replacement in 2015/16 and this commences at the MBT plants in 2016/17. Given the staggered handover dates of each facility, this means that each facility has a different profile in relation to life cycle costs.
- 6.2 At the end of 2011/12, VLGW were requested to provide a breakdown of life cycle cost expenditure on Raikes Lane TRF, Bolton against forecast and for this to be on an open book basis supported by invoices. The spend profile demonstrated was:

	<u>2009/10</u>	<u>2010/11</u>	<u>2011/12</u>
Forecast life cycle spend (£)	123,720	463,950	474,260
Actual life cycle spend (£)	123,720	695,260	526,057

The variance in 2010/11 relates to the requirement to repair and replace cracked boiler tubes that were discovered in the annual shutdown. In 2011/12 the variance is down to a major refurbishment and replacement of the refractory lining of the furnace.

- 6.3 The review demonstrated that planned life cycle replacements on Raikes Lane TRF, Bolton have been undertaken and also unscheduled replacements have been made at VWGM cost. Where a major part replacement has been made ahead of schedule, this will mean that the forecast life cycle profile for the plant will change as that particular piece of plant will not need to be changed again as quickly. It is this reprofiling that will require ongoing monitoring and assessment by the Authority. It is therefore intended to undertake a similar review on an annual basis at year end to track actual spend against forecast and compliance with Clause 23. In 2012/13 the forecast spend on Raikes Lane TRF, Bolton is £1.278m, thereby demonstrating the need to continue to review this on an annual basis.

7. Future Authority Activity

- 7.1 Monitoring of maintenance and life cycle cost spending is a specialist area that requires engineering knowledge to analyse and interpret the information presented by VLG and VWGM. In recognition of this requirement, and as part of a wider review of spend, it is proposed to integrate additional resources into the Contract Services Team specifically to fulfil this role. Those resources will, however, be funded within existing approved budgets.
- 7.2 Once the sale of the landfill sites is concluded there will be four staff retained for the purposes of managing the retained landfill sites. It is proposed that this team will be transferred to the Contract Services directorate and the Engineering Manager will report directly to the Director of Contract Services under these proposals. Around 50% of the time of the Engineering Manager role will be dedicated to the construction, maintenance and engineering aspects of the Contract. This will include the following key tasks:-
- ensuring facilities are operated in accordance with operation and maintenance manuals;
 - verifying planned maintenance has been carried out;
 - tracking downtime and unplanned maintenance;
 - reviewing expenditure on maintenance and compliance with maintenance plans;
 - tracking life cycle cost expenditure against forecast;
 - monitoring facility condition.

On the basis the landfill sale is concluded on 17th December 2012, it is proposed that the full integration of this team will be from 1st April 2013 with a phased handover in the interim period.

- 7.3 In a similar way, VLG has also restructured its construction team to reflect the changing emphasis of construction management moving into the operational phase of the Contract. A claims review steering group has been established that consists of external legal and technical advisors specifically to manage any Costain related claims over the next 12 months. This frees the construction team to focus on acceptance and commissioning tests, clearing snags and defects and also to commence monitoring of life cycle and maintenance expenditure. This restructure has resulted in the removal of the Construction Manager post which VLG believe is appropriate at this time, given the additional specific resources to manage claims. The financial model shows a phased reduction in VLG staffing from 2012/13. Looking further ahead, it is likely that VLG will maintain a number of the project engineer posts in the long term to continue to manage this element of the Contract.

8. Consultation

- 8.1 The accounting treatment of life cycle costs has been discussed with Members of the Audit Committee and the wider issue of monitoring actual expenditure was discussed at the full meeting of the Authority on 23rd November 2012. It is recommended that the annual review of actual life cycle expenditure is added to the work programme of the RWMO Committee.

9. Risk Assessment

9.1 Resources

The additional resources required for effective monitoring of life cycle and maintenance expenditure proposed are set out in paragraph 7.2. Provision has been

made in the budget and the Medium Term Financial Plan for this in the event that this structure is implemented.

9.2 Human Resources

If implemented, the transfer of the four Landfill and Environmental Management Team members to Contract Services will be carried out in accordance with the Authority's policies.

9.3 Environmental & Health Safety

Maintaining assets in accordance with operation and maintenance manuals will facilitate compliance with emission limits, maximise the opportunities for diversion from landfill and contribute towards a safe working environment.

9.4 Assets & IT

The measures set out in this report will prolong asset life in accordance with the Contract requirements.

10. Comments of the Solicitor

10.1 Legal issues are addressed in the main body of the report (CB).

11. Comments of the Deputy Treasurer

11.1 As the life cycle costs are built into the unitary charge payable under the terms of the Contract there are no direct financial implications associated with this report.

11.2 The review and monitoring of the life cycle costs and maintenance programme will provide reassurance that the Authority is receiving value for money in this area.

11.3 Achievement of an acceptable solution to the technical accounting issues is essential if the Authority is to avoid a potential qualification to its audited accounts in future years. (AJB)

12. Corporate Plan Reference Number

12.1 1.1 Successful Contract Delivery and Development and 2.1 Managing Money

David Taylor
Director of Contract Services

The following is a list of the background papers on which this report is based in accordance with the requirements of Section 100D(1) of the Local Government Act 1972. It does not include documents which would disclose exempt or confidential information, as defined by that Act.

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