Public Document Pack

CITY OF LONDON

# Projects Sub (Policy and Resources) Committee

**Date:** **MONDAY, 16 MARCH 2020**

**Time:** 11.00 am

**Venue:** **COMMITTEE ROOMS, 2ND FLOOR, WEST WING, GUILDHALL**

## SUPPLEMENTARY AGENDA

Items received too late for circulation in conjunction with the Agenda.

14. **ANY OTHER BUSINESS THAT THE CHAIRMAN CONSIDERS URGENT**

    a) **Dealing with Price Inflation for Construction Projects up to Gateway 5**
    Report of the Chamberlain.

    **For Decision**
    (Pages 1 – 8)

27. **ANY OTHER BUSINESS THAT THE CHAIRMAN CONSIDERS URGENT AND WHICH THE SUB-COMMITTEE AGREE SHOULD BE CONSIDERED WHILST THE PUBLIC ARE EXCLUDED**

    b) **Gateway 2 - Bridge House Estates 30-34 New Bridge Street Refurbishment**
    Report of the City Surveyor.

    **For Decision**
    (Pages 9 – 38)

**Enquiries:** **Alistair MacLellan**
**tel.no.: 020 7332 1416**
**alistair.maclellan@cityoflondon.gov.uk**

**John Barradell**
**Town Clerk and Chief Executive**

This page is intentionally left blank

| Committee(s) | Dated: |
|---|---|
| Projects Sub Committee | 16/03/20 |
| **Subject:**<br>Dealing with Price Inflation for Construction Projects up to Gateway 5 | **Public** |
| **Report of:**<br>The Chamberlain | **For Decision** |
| **Report author:**<br>John James, Chamberlain's Department | |


**Summary**

The purpose of this report is to consider the impact of price inflation on construction project costing and determine how this issue can best be tackled in gateway reports.

It is suggested that such project reports should clearly state, at each gateway, the price base of the estimated project cost included and be transparent on any inflation assumptions.

It is further suggested that costs for short term projects (defined as those projects which will reach the authority to start work stage, Gateway 5, within a year of the initial project proposal at Gateway 2 being agreed) should usually be shown at current prices. For longer term projects, estimated costs will still be shown at current prices but an inflation allowance held as a provision in the costed risk register, to be drawn down at Gateway 5 if required. For consistency a rate agreed by the Chamberlain/City Surveyor will be applied. This rate will be periodically reviewed.

For very long-term projects it is suggested that the provision should be held in the costed risk register (which may periodically need to be updated), based on advice from the external cost consultant, and drawn down as phases are completed.

It is too early to assess the long-term impact of Brexit on construction inflation, but in the very short term it appears that, together with UK political uncertainty, it is having an effect of depressing prices.

The suggested methodology set out in your report will be reviewed every two years.


**Recommendations**

Members are asked:

i. to note the contents of this report; and
ii. to agree the approach set out in paragraph 17 and in particular confirm reports should show clearly the price base of any estimated costs shown in the report and advise both the basis and the sum included in the costed risk register for any inflationary uplift.

iii. to note the inflation rate used will be set annually by the Chamberlain and the City Surveyor
iv. to note that the effectiveness of the arrangements set out in this report will be reviewed in a report to your committee every two years.

## Main Report

### Background

1. As a project progresses through the gateway process up to Gateway 5 (authority to start work) it has been observed in recent times that there has often been an increase in costs between stages attributed to 'construction inflation'.
2. Of course, there are numerous reasons for cost increases and some of the explanations identified by City Procurement for cost increases beyond the pre-tender estimate include:

   a) Reliance on inaccurate or incomplete cost data
   b) Employer generated scope change between outline business case (City Gateway 2) and full business case (City Gateway 5) – with associated implication for item a)
   c) Continued employer generated scope change in tendering period prior to full business case (City Gateway 5) with an associated implication for item a)
   d) Short notice to market and short tender return periods contributing to reduced opportunity for tenderers to engage supply chain on pricing
   e) No allowance for contingency (or optimism bias) for complex projects which are necessarily reliant on early contractor involvement/design contribution
   f) Seasonal trends in demand
   g) A tendency towards adversarial contracting and pushing risk (price et al) onto contractors
   h) Reliance on out of date cost data (beyond 12 months old) without inflationary adjustment

3. Nevertheless, the explanation of 'construction inflation' is one increasingly cited to explain cost increases. The purpose of this report is, therefore, to consider the best way to tackle the issue of inflation of project costs in reports up to Gateway 5, from which point costs will be based either on the contractor's tendered (usually fixed) price or on term contract rates (which are subject to price adjustment for inflation), depending on the nature of the project.

4. In this context, building projects tend to be let on the basis of fixed price lump sum contracts, whereas highways/ civil engineering works may employ term contracts such as the Highways Repair and Maintenance Term Contract, where the schedule of rates are subject to agreed indices which should make price and scope changes much easier to identify. The provision for any inflationary increase, envisaged under the contract, should be agreed with the Chamberlain, and this sum included in the risk register.

**Current Position**

5. In the past, price inflation has been relatively low and therefore has had a marginal effect on project costing. Occasionally some projects have seen significant increases attributed to this issue with prices at Gateway 5 received well above the sums estimated for the project. Certainly, it should not be assumed construction inflation will remain relatively low forever and so it would seem sensible to put a methodology in place to deal with the issue.

6. It is important from an early stage to get project option costing right for three principal reasons:

    a. Need to reflect the full project cost when planning/agreeing projects to confirm affordability. This is particularly important for schemes funded from cash limited funds (e.g. S106, Designated Sales Pool etc.). A key issue being the question of affordability which must be addressed before the project can proceed. A reasonable allowance for inflation is therefore important but unrealistically large inflation provisions are not desirable as they tie up funds that could be used for other projects.

    b. Need to ensure that best estimate of project cost is included for those projects subject to investment appraisal. This is particularly important for works on investment properties as the scale of works, or indeed whether the project goes ahead at all, will be determined by the anticipated financial return.

    c. Need to provide consistent data for capital forecasting purposes. There is a need to ensure consistency in inflation assumptions used on project costing that feed into the City's capital expenditure forecasts. This is a particular problem for projects spanning a number of years.

**Evidence of Tender Price/ Construction Cost Inflation**

7. Depending on the nature of the contract to be employed for a project (e.g. fixed price lump sum, re-measurement term contract subject to adjustment for inflation), consideration needs to be given as to whether the focus should be on either tender price inflation or general construction cost inflation. This is because movement in tender price or general construction cost inflation may not move together eg in a tight market tender prices may fall, even though construction cost inflation is rising, as contractors absorb the construction cost inflation to effectively 'buy in' work. For City projects tender price inflation is the key measure.

8. Current indices of tender price inflation suggest that it is running at 2% per annum for 2019/20 and that this will continue for 2020/21. This forecast for construction inflation is anticipated to rise to 4% per annum towards the end of 2021 rising to 5% per annum from the end of 2022.

9. Tender prices and margins on construction works have seen increases in London and the City over the previous years.  Current construction market indicators

show these increases are not generally being driven by rising costs, as the cost of materials (generally) and labour remained relatively stable with a small number of exceptions in the material market place. It is the strength of demand for construction work and the ability for contractors and sub-contractors to fill their order books without having to offer cut-throat prices which are increasing profit margins, particularly for those projects that contractors are not particularly keen on winning. The combined effect will push up tender prices above the level of general inflation.

10. The indices will include any effect that Brexit uncertainty has had to date in depressing prices. However, the latest market commentary notes that due to current UK political uncertainty, the UK construction industry has seen in August the sharpest fall in new work for over ten years. Previous experience has suggested that should work for major projects slow down this can have a knock-on effect for more minor project's costs, as larger contractors compete for work on smaller projects whilst they wait for the market for major construction projects to recover. So, it is possible in the short term tender prices may be depressed further.

11. At this stage it is too difficult, however, to predict the Brexit effect for the longer term.

12. At Gateway 5, for most building contracts, the tender price accepted is fixed (as we usually employ fixed price construction contracts) so should not be subject to further inflation increases. The price bid by the contractor, of course, will not be transparent for the inflation sum built in, but assuming this has been accepted through a competitive process the issue becomes a moot point. For highways/ civil engineering works procured using a term contract, the prices current at Gateway 5 may be subject to a price fluctuation adjustment (usually based on published indices) depending on the timescale of the project.

**Value for Money**

13. By including sums for potential inflationary increases there is always a concern that should these sums not be required they will nevertheless be spent on 'would be nice' items not essential to deliver the project. Holding such sums in the costed risk register and then only drawing sums down once work had be tendered will mitigate this risk, particularly if it is understood any unused sums will be automatically returned to the centre and not available as funding for additional works.

**Options**

14. There are two options to address inflation provisions:

    1. Current Prices: Cost all projects at current prices and include where appropriate an allowance for inflation in the costed risk register to be drawn down at Gateway 5. The advantages of this are transparency and simplicity. Under prevailing conditions for most short-term projects current and outturn prices are the same.

2. Outturn Prices: Cost all projects at outturn prices and only included any further provision in the costed risk register for inflation if there are further uncertainties (which need to be justified)

15. Which ever option is chosen it is proposed that for consistency the City Surveyor in conjunction with the Chamberlain will set a rate to be generally used except in the case of very large or long term projects when the advice of the external cost consultant will be sought.

**Proposal**

16. Option 1 above is the favoured option and the following changes are therefore suggested:

a. Construction project costs quoted in gateway or other reports should always show the price base used for clarity (e.g. current prices at April 2020). Any inflation assumptions should also be clearly set out in the report both in terms of the basis and the sum included.

b. The price base used for Gateways 1-4 (inclusive) for all schemes should be current prices. Depending on the duration of the project the following should be applied as follows:

Short Term Projects - defined as those that are anticipated to reach authority to start work stage (Gateway 5) within a year of the initial project proposal (Gateway 2) being agreed. Price base should be at current prices and there should generally not be a need to include an inflation provision in the costed risk register. If there is a case for including inflation in the risk register this should be agreed with the Chamberlain and the report author should confirm that inflation has been considered when completing the costing and advise the basis/sum that has been included.

Longer Term Projects - defined as those that are anticipated to reach authority to start work stage (Gateway 5) more than one year from the initial project proposal (Gateway 2) being agreed. Price base again should be at current prices but a sum should be included in the costed risk register to allow for inflation. The report should clearly state the basis and the amount included for inflation (which for most projects should be the rate set by the City Surveyor/Chamberlain). If the inflationary uplift cannot be readily assessed across the period a further provision for inflationary uplift may also be held in the costed risk register to provide for any potential shortfall, but the report will need to be clear on this point and this is subject to agreement by the Chamberlain . Where practical a sensitivity analysis should be prepared to clarify the impact of varying rates of inflation on the proposals. This is considered essential for projects subject to investment appraisal or funded from cash limited funds.

Very Long Term Projects - defined as those that will be delivered in phases over a longer period, via a series of tenders. An example would be the Central Criminal Court Plant Replacement Works which stretches over a 10 year period. Special arrangements would need to be made for allowing for inflation for the overall project and it may be preferable to show costs at current prices with an allowance for inflation made in the costed risk register. This provision could then be drawn down as contracts are let and prices crystallise. As such projects are delivered in phases this may prove the most practical way of tackling the problem. The report should state the basis of the inclusion of the inflation assumptions, the amount allowed, and how the issue is to be monitored/controlled across the life of the project. Advice on the inflation sum to be included should be sought from the external cost consultant and agreed with Chamberlain.

17. It is further suggested that reports should clearly show the price base and detail of any inflation assumptions. Some suggested wording for inclusion in project reports is detailed in Appendix 1

**Beyond Gateway 5**

18. Gateway 5 onwards the price base for both short and long term projects should always be at estimated outturn prices e.g. fixed price tendered sum or, for term contracts, an allowance for estimated inflation should be included in the risk register. Only for very long-term projects will there need to be special arrangements which, for transparency, should be clearly set out in the report.

**Conclusion**

19. The above paper sets out ideas on how construction inflation could be dealt with in the costing of projects and Member's views are sought on the suggestions made.

**Appendices**
Appendix 1 - Suggested wording on price base for inclusion in reports

Mr John James
Chamberlain's Department

T: 020 7332 1532
E: john.james@cityoflondon.gov.uk

**APPENDIX 1**

**Suggested Wording for Inclusion in Construction Gateway Reports Concerning the Price Base Used**

It is suggested that the following wording be included:

*"The project cost included in this report are shown at current prices (Month/Year price base). As a consequence, no uplift has been included for inflation.*

If a longer term project please add :

*but a provision of x% which equates to £x has been included in the costed risk register."*

If a further sum is to be added to the costed risk register, then the following wording should be added:

*"An additional provision of £x has been included in the costed risk register to cover uncertainties around the inflation assumptions due to [please specify]. This amounts to £x or an extra uplift of £x%"*

This page is intentionally left blank

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

This page is intentionally left blank