Open Report on behalf of Andy Gutherson, Executive Director - Place

Report to:	**Councillor R G Davies, Executive Councillor for Highways, Transport and I.T.**
Date:	**16 to 20 September 2022**
Subject:	**Highway Service - Inflation Options paper**
Decision Reference:	**I027901**
Key decision?	**Yes**

Summary:

This report outlines the risks to the Highway Service key delivery contracts as a result of rapidly rising inflation within the construction sector. In year inflation pressures are rising quicker than the mechanisms built into the original Highway Works, Professional Services and Traffic Signals term service contracts which is causing financial pressure at all levels within the supply chain. The report outlines the key risks that rapidly rising inflation is having within the construction sector and the potential impact on service delivery. The report outlines three potential options and recommends that the Executive Councillor for Highways, Transport and I.T approves "Do Something - Option 1".

Recommendation(s):

That the Executive Councillor for Highways Transport and IT:

(1) approves the implementation of the recommendation outlined in Option 1 to uplift the Price List rates within the Highway Works and Traffic Signals contracts from 1st August 2022 for work activities where Small Medium Enterprises are providing greater than 75% of the service.

(2) Delegates to the Executive Director - Place authority to implement this change and where necessary approve any documentation necessary to give effect to the above decision.

Alternatives Considered:	
1.	To not approve the recommended option and approve the "Do nothing" option which relies on the existing inflation mechanisms built into the original contracts.
2.	To not approve the recommended option and approve "Do Something - Option

	2" which uplifts the Price List rates from 1 August 2022 for all activities within the Highway Works, Professional Services and Traffic Signal contracts.

Reasons for Recommendation:

Rapidly increasing inflation pressure within the construction sector is currently outstripping the inflationary mechanisms built into the original contract and is causing real pressure on the contractors and supply chain working for Lincolnshire County Council. Based on the latest inflationary figures there remains a significant risk that SMEs working within the Highways Works and Traffic Signals contracts are struggling to deal with the pressures they are facing.

1. Background

The construction sector like most of the world is being impacted by rapidly rising inflation however the impacts within the Construction sector are above those experienced in wider society and is tracking higher than the Retail and Consumer Price Index. The key reasons behind this are:

- Skills shortages throughout all areas of the industry built up over several years are now being compounded by the aftereffects of COVID-19, making already hard to recruit positions extremely challenging. Even more so in the Highways maintenance sector where profit margins are low.

- The well-publicised shortage of Heavy Goods Vehicle (HGV) drivers has been felt within this sector as qualified drivers are able to take up positions in other sectors.

- Exaggerated inflationary pressure in comparison to other sectors due to the price of oil and gas which is having a direct impact on the work delivered by the service. This is as a result of high usage of these commodities both as fuel for transportation but also the heavy usage of products used which are derivatives from the oil and gas industry such as bitumen and tarmac. Fuel makes up a substantial proportion of the cost to produce and transport materials of this type making these products reactive to the global market.

- The other key area for inflationary pressure is in the purchase of metal and metal-based products such as electrical cable, street lighting columns, reinforcing bar for concrete and structural steel.

Lincolnshire County Council (LCC) has recognised the risk of inflation within each of its Highway maintenance contracts and has included a specific clause built to track inflation throughout the lifespan of the contract. It is worth noting that both the Highway Work (Balfour Beatty) and Traffic Signal (Colas) contracts are cost-based contracts where the contractor is paid the actual (Defined) cost of completing the work. The contracts have a set of prices which were tendered at the start of the contract and these prices are used to agree a target price for the work. At the end of the year the total of the costs is measured against the total of the targets to establish the pain or gain for the contract. If the targets are greater than the costs, the contract is in gain and the contractor is rewarded with a share of this gain. If the costs are greater than the target, the contract is in pain and the contractor pays LCC a share. The exposure for LCC is capped at maximum of five percent of total of the targets for the service as a whole. Specific inflation clauses are also built into the Professional Services Contract (WSP) but instead of target prices, people rates are adjusted and paid for depending on the time required to complete the task or activity.

The contract clauses cater for annual increase to the prices within the contract. The inflationary increase is measured using several indices which are published by the Building Cost Information Service (BCIS) and uses data gathered throughout the industry based on the reported costs of services. Lincolnshire County Council is also part of the data collection using the cost and price information gained through tendering projects. In order to implement the price increases into the contract, time is required to calculate the increase and apply these to the price list, then to upload the revised price list into LCC's works ordering system (Confirm) so that officers can use the revised prices to order their works. This means that inflation is measured in December and applied the following April. This system has been in place for over 10 years and has worked very successfully. However, given the current rapid inflation, particularly for the items already discussed, this system is being pressured.

An example of the indices monitored within the Highway Works contract are included within the table below and show the movement since the start of the contract in April 2020 (Year 1) to the current rates in April 2022 (Year 3) and the monthly movement so far in year to date:

% change	Prelims	Routine, Cyclic and Time Charge Works	Renewals and Construction Works	Professional Services	Machine Surfacing	Hand Surfacing/Patching	Surface Dressing	Road Markings	Street Lighting	Vehicle Maintenance	Columns
Year 1	1.14%	1.85%	0.91%	0.06%	-1.84%	-0.32%	-1.68%	-1.41%	0.38%	1.34%	0.91%
Year 2	1.08%	1.25%	0.91%	2.62%	0.00%	0.25%	-2.17%	0.78%	2.21%	1.99%	0.91%
Year 3	4.87%	5.36%	8.58%	3.36%	5.72%	5.71%	10.98%	5.22%	6.13%	4.48%	56.39%
Apr-22	9.35%	9.80%	17.03%	8.14%	17.14%	14.91%	26.68%	10.54%	10.33%	7.66%	98.03%
May-22	11.53%	11.13%	19.51%	13.19%	18.88%	16.65%	28.60%	13.45%	12.11%	9.06%	95.56%
Jun-22	12.67%	12.29%	20.98%	13.45%	19.89%	17.88%	31.88%	15.46%	13.07%	10.30%	93.78%

Table 1 – BCIS indices Categories – Highway Works Contract

As can be seen in Table 1, significant pressures can be seen after the Year 3 annual uplift by the level of movement in the monthly indices data. Monthly rises in April, May, and June of on average 3% mean that the annual prices set within the contract are moving away from the actual cost to deliver the service. Whilst the indices are rising in this way, pressure is being felt by the Contractors and Consultants delivering the service, often these are Small Medium Enterprises (SME) based locally within Lincolnshire.

2. Options

Do Nothing

An annual uplift mechanism within the contract already exists to deal with the impact of what would be considered as normal inflation without putting excessive pressure on either LCC or the Contractors and Consultants working within the contracts. If the Do-Nothing option was taken forward the indices would be uplifted based on the December 2022 figures and would apply to all works instructed from April 2023.

The major risk of a Do Nothing' option is that elements of the supply chain fail completely or can no longer work for LCC as the prices are too low. LCC have some insulation in that the responsibility lies with the contractor to manage their supply chain and LCC is only contracted to the Tier 1 supplier. LCC has also included a contract clause which requires that any supply chain contract mirrors the main contract as closely as possible, a back-to-back arrangement, ensuring that the inflation mechanism in the main contract, is repeated throughout the supply chain. However, as previously described the current conditions are causing such rapid change in the market that the annual uplift approach is not keeping up with the pressures faced within the construction sector. This is compounded by the payment basis of many of the smaller subcontracts where a pain/gain mechanism isn't appropriate and so these subcontracts, whilst back to back on the inflationary clauses, are paid on a price only basis meaning the inflation is directly affecting their income. The further risk of this option is that as the supply chain is made up of much smaller companies, they have no wider resilience to these increases. LCC is the main source of income and so the risk of failure is currently high. These suppliers are often locally based and so failures or changes in working patterns could have significant impacts on the local job market and would carry a large reputational impact for LCC.

Do nothing – Financial Implications

The cost to implement this option would be £0 however if one of the Tier 1 or supply chain partners were to go into administration there would be significant disruption to service delivery and LCC may see a jump in prices from the replacement contractor/consultant in the current market conditions.

Do Something – Option 1

There is an option for LCC to apply a mid-year uplift from 1 August 2022 to selected areas of the contracts that target the SMEs working for the Tier 1 providers and which would target the most acutely affected providers.

As the Professional Services contract does not involve the use of sub-contractors that contract would not be covered by this option which would be limited to the Highways Works and Traffic Signals contracts,

The majority of sub-contractors working on those contracts are classed as SMEs given either staff headcount or turnover and these are largely working within the Highway Works Contract. To target support to where it is most needed, SMEs delivering above 75%

of each individual work activity have been identified within the main contractor price list as those who are most at risk and are facing the full impact of the current inflation.

The mid-year uplift would be completed by using the same contractual mechanism and indices as the annual uplift. It is worth noting that the rapid increase in inflation means that the indices will still be lagging, but LCC will be sharing the impact with the supply chain partners who would still be responsible for any inflation pressure until the next annual rate change in April 2023. By only uplifting those areas where the pressure is most acute, protection can be offered for some key supply chain partners, who are generally on a price only contract, whilst limiting the effect on an already challenged LCC budget. It is worth stating however, with fuel costs providing such a large portion of the work, which is delivered, this option would effectively ignore the issue being felt by the main contractors / consultants across the contracts and only protect the most vulnerable supply chain partners. A further complexity is that within the Highway Works Contract the supply chain is so varied that often a single SME supplier is involved in several service areas, meaning there may be an uplift on some of their works and not others.

The level of service from SMEs working within LCC is high and the loss of any of these firms would be significant in terms of Lincolnshire's economic impact but also quality of the ongoing Highway Service. Replacement to SMEs, whether via alternative SMEs or direct delivery would likely take several months to transition to a new provider and is likely to result with employees seeking opportunities away from the Highway maintenance sector.

Option 1 – Financial Implications

If these specific items were uplifted from August 2022, it is estimated that LCC would lift the total of the target prices for the two relevant contracts by £964,000 for the remaining 8 months of the financial year.

If this approach were adopted the Highway service would have an in-year budget pressure of £964,000 and the level of Highway related activity will need to be managed within the total funding available.

<u>Do Something Option – 2</u>

The remaining option is to provide a mid-year uplift to all of the Highway Maintenance Contracts (Highway Works, Traffic Signals and Professional Services). This would ensure the whole supply chain feels the benefit of the increased prices and prevents any anomalies in how the increase is distributed. This would clearly have a larger impact on LCC budget but would send a strong message to the supply chain that we are sharing the impact of the current inflation. This would ensure that the supply chain and service is protected and eliminates any reputational damage.

The level of service from the term service contracts Key Performance Indicators and contract specific performance indicators is good and the loss of any of these firms would be significant in terms of economic impact and the quality of the ongoing Highway Service. Replacement of the main Contractors or Consultants would be a major activity and is likely to hamper service delivery for several months as the service transitions to a new provider. The option to step in and directly manage the overarching contract exists but the skills to deliver a direct labour organisation of this scale would be challenging.

Option 2 – Financial Implications

Highway Works – If all of the Price list items were uplifted from August 2022 it is estimated that LCC would lift the total of the target prices by £1,296,000 for the remaining 8 months of the financial year.

Traffic Signals – If all of the Price list items were uplifted from August 2022 it is estimated that LCC would lift the total of the target prices by £46,000 for the remaining 8 months of the financial year.

Professional Services – If all of the Price list items were uplifted from August 2022 it is estimated that LCC would lift the total of the prices by £170,000 for the remaining 8 months of the financial year.

If this approach were adopted the Highway service would have an in-year budget pressure of £1,511,000 and the level of Highway related activity will need to be managed within the total funding available.

The proposal in this Report will not involve any variation to the contracts. Although the Council would be accelerating an inflationary increase the indexation provisions in the contracts will remain unchanged and continue to apply to determine the price list for future years of the contract.
It is envisaged that the proposals within the report would be affected by the Council issuing an instruction under the contracts and in accordance with their terms. That instruction would include instructions issued to the tier 1 contractors to ensure that the benefit of the accelerated indexation is passed onto the SMEs who are the intended beneficiaries the proposals.

4. Legal Issues:

Equality Act 2010

Under section 149 of the Equality Act 2010, the Council must, in the exercise of its functions, have due regard to the need to:

- Eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act.

- Advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it.

- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

The relevant protected characteristics are age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex; and sexual orientation.

Having due regard to the need to advance equality of opportunity involves having due regard, in particular, to the need to:

- Remove or minimise disadvantages suffered by persons who share a relevant protected characteristic that are connected to that characteristic.
- Take steps to meet the needs of persons who share a relevant protected characteristic that are different from the needs of persons who do not share it.
- Encourage persons who share a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionately low.

The steps involved in meeting the needs of disabled persons that are different from the needs of persons who are not disabled include, in particular, steps to take account of disabled persons' disabilities.

Having due regard to the need to foster good relations between persons who share a relevant protected characteristic and persons who do not share it involves having due regard, in particular, to the need to tackle prejudice, and promote understanding.

Compliance with the duties in section 149 may involve treating some persons more favourably than others.

The duty cannot be delegated and must be discharged by the decision-maker. To discharge the statutory duty the decision-maker must analyse all the relevant material with the specific statutory obligations in mind. If a risk of adverse impact is identified consideration must be given to measures to avoid that impact as part of the decision-making process.

The Equality Act has been taken into account. The discussion and options progressed as a result of this paper are not anticipated (positively or negatively) to impact people with a protected characteristic when compared with people who do not share that characteristic.

Joint Strategic Needs Assessment (JSNA) and the Joint Health and Wellbeing Strategy (JHWS)

The Council must have regard to the Joint Strategic Needs Assessment (JSNA) and the Joint Health and Wellbeing Strategy (JHWS) in coming to a decision.

The discussion and options progressed as a result of this paper are not anticipated (positively or negatively) to impact the JSNA and JHWS.

Crime and Disorder

Under section 17 of the Crime and Disorder Act 1998, the Council must exercise its various functions with due regard to the likely effect of the exercise of those functions on, and the need to do all that it reasonably can to prevent crime and disorder in its area (including anti-social and other behaviour adversely affecting the local environment), the misuse of drugs, alcohol and other substances in its area and re-offending in its area.

The duties under section 17 of the Crime and Disorder Act 1988 have been considered and it is deemed that the options and discussion within this paper will have no direct impact.

5. Conclusion

Rapidly increasing inflation pressure within the construction sector is currently outstripping the inflationary mechanisms built into the original contract and is causing real pressure on the contractors and supply chain working for Lincolnshire County Council. Based on the latest inflationary figures there remains a significant risk that SMEs working within the Highways Works and Traffic Signals contract are struggling to deal with the pressures they are facing.

The decision to pursue any of the options set out in this Report is a significant one given the challenges that are also faced by Local Government as additional funds from Central Government remain unlikely. However, the cost to replace those at risk is real and service continuity plays a significant factor when delivering essential services of this type.

Based on the information contained within this report, the recommendation is to target support at those areas of the contract where SMEs are most at risk of failure working under the Highways Works and Traffic Signals contracts and proceed with Do Something – Option 1 proposal.

To implement Do Something option 1, an in-year rate increase from the 1st August 2022 could be implemented either within the Highways works ordering software “Confirm” by adjusting the rates or working out the change in prices and adding the additional value to the jobs at a later date. Both approaches have positives and negatives, but the overriding objective would be to support the parties most at risk. For this reason, consultation with those parties on the easiest and quickest way will be carried out.

If Do Something - Option 1 is selected, appropriate steps will be taken to ensure that the Highway Works provider, Balfour Beatty and the Traffic Signals provider Colas pass on the full price increases to those areas of the contact that are reliant on SMEs. The approach would also be communicated directly with those SMEs where this option has been selected.

The Executive Councillor is requested to consider whether to approve the recommendation as set out within this report.

6. Legal Comments:

The Council has the power to make the adjustments proposed.

The decision is consistent with the Policy framework and within the remit of the Executive Councillor.

7. Resource Comments:

Accepting the recommendation within this report, will support the SME's working within the Highways Works Contracts to mitigate against a risk of failure and recognise current inflationary pressures.

The recommendation will increase the cost of these works, and the service will look to programme their activity within the total resources available to them, from their approved budget and available reserves. The corporate contingency is also available to support in year unplanned cost pressures if necessary.

8. Consultation

a) Has Local Member Been Consulted?

N/A

b) Has Executive Councillor Been Consulted?

Yes, the Executive Councillor for Highways, Transport and I.T. has been consulted.

c) Scrutiny Comments

The report will be considered by the Highways and Transport Scrutiny Committee at its meeting on 12 September 2022. Any comments from the Committee will be presented to the Executive Councillor for Highways, Transport, and IT.

d) Risks and Impact Analysis

See main body of this paper.

9. Background Papers

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

This report was written by Jonathan Evans, Head of Highways Client and Contractual Management Services, and Tom Gifford, Client and Contract Manager, who can be contacted by email at Jonathan.evans@lincolnshire.gov.uk and Tom.Gifford@lincolnshire.gov.uk.

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