County Council

29 September 2022

The Impact of Inflation on the Capital Programme

Recommendations

That Council:

1. Sets aside £15m of the Capital Investment Fund to create an Inflation Contingency Fund to manage the impact of inflation on the approved capital programme; and

2. Delegates authority to make allocations from the Fund to the Strategic Director for Resources, in consultation with the Portfolio Holder for Finance and Property in accordance with the proposals in paragraph 2.9.

1. Purpose of the Report

1.1. Building and highway construction and maintenance industries continue to exhibit strong evidence of instability on the back of the EU Exit and the Covid pandemic, compounded locally by the impact of HS2, with the consequence that inflation indices have been increasing over the last two years. This has fed through into cost pressures for the Authority and the on-going war in Ukraine is having a significant impact on top of these existing challenges, affecting the availability and cost of critical materials such as steel, iron and timber. Oil and gas prices have also risen rapidly and remain unstable. Bituminous products, i.e. asphalts etc., are being heavily impacted and materials that require intensive energy input, such as, bricks, plastics and ceramics are expected to continue to rise as are the costs of transportation due to rising fuel prices. The latest overall construction material price index stood at 26.4% for June 2022 (published 3 August).

1.2. With these current high levels of inflation there are now a number of projects across the capital programme that are identifying a need for additional funding to allow the schemes to continue through to completion.

1.3. The purpose of this report is to seek approval of an approach to the management of these requests that supports efficient and timely decision-making.

2. Approach to the Funding of Inflationary Uplifts on the Capital Programme

2.1. The statutory basis of capital spending in local authorities requires that capital spend is not incurred and contracts are not entered into unless full funding of the estimated total cost of a scheme is in place. It is accepted that on occasion the cost of a capital scheme may change at various stages in a project, for example, once tenders are received or if unplanned work becomes necessary. The Council's financial rules and regulations allow for this circumstance and set out how Services seek approval for a budget variation before entering into any commitment which will cause the total project cost to exceed the budget approved. This requires Member approval of any increase in the total cost of a scheme, with the route to achieving this depending on the source of additional funding.

2.2. Members approved additional inflation allocations to assist in retaining the 'buying power' of the maintenance allocations that formed part of the 2022/23 Medium Term financial Strategy approved in February 2022. However, no additional funding was allocated for the impact of inflation on approved investment projects. Initial work with Services has identified 47 schemes in the approved capital programme where it is likely schemes will need additional funding approved to deliver the projects in full, with an average cost uplift in the region of 18%.

2.3. Due diligence is on-going with Services to firm up the estimated inflationary uplifts covering:

- Evidence the cost increase is due to inflation and not to other changes to the scheme such as changes to the scope, planning/building guidelines or the tender specification;
- The extent to which the additional cost can be absorbed through value engineering, reducing the scope of the scheme or working closely with contractors to anticipate and where possible manage price and delivery pressures in the supply chain;
- The availability of alternative funding sources to fund the cost increases; and
- An analysis of the residual risks being covered by scheme contingencies and the extent to which any of the contingency can be made available to offset the inflationary uplift needed.

2.4. This work is expected to bring the estimated inflationary impact down, but it will not remove the need to identify additional resources to complete schemes that are currently part way through construction or where, despite the increased cost, it is agreed the scheme needs to be completed to the original timeframe. There is a real risk, if a timely way forward is not identified, that delays will simply increase the inflationary pressures and delivery challenges further. It is therefore prudent to earmark contingency funding to efficiently manage the current difficult situation and underwrite the cost of inflation on individual schemes where it cannot be met from approved budgets.

2.5. Since 2018/19 the Capital Investment Fund (CIF) (or rather the Council borrowing that resources CIF) has been the source of funding required to deliver the Council's ambitions for investment in Warwickshire's infrastructure, once all other funding options have been explored. Subject to the benefits from any of the mitigating work set out above, CIF is also the only available source of funding for an inflationary uplift contingency. There is an opportunity cost to using CIF to fund the impact of inflation on investments in the approved capital programme as it will reduce the funding available to invest in other projects that support the Council's priorities and ambitions.

2.6. The current approval processes for variations to the capital programme mean that each individual request for an allocation from CIF to meet the cost of inflation will require a separate Cabinet report as well as a review of an updated business case by the CIF Technical Evaluation Panel. (If the amount being requested is over £2m then the Cabinet report will lead to a recommendation to full Council).

2.7. Rather than having to prepare a series of reports on a scheme-by-scheme basis, and to avoid the capacity implications of a series of business cases having to be updated and reassessed, Council is recommended to approve setting aside a part of the CIF in an Inflation Contingency Fund to fund inflationary uplifts on investment schemes in the approved capital programme.

2.8. Any allocation from CIF to meet the inflationary uplift needed will reduce the funding available for the Council's investment priorities that will drive the delivery of the Council Plan and the Levelling Up strategy. Therefore, any process for making additional inflation allocations to individual schemes needs to be rigorous and confirm that the benefits expected from the scheme remain a priority for the organisation.

2.9. To ensure this, if the creation of an Inflation Contingency Fund is supported, the approach to approving an allocation from the Fund to an individual scheme would operate as follows:

1) Services complete a request for additional funding to meet the impact of inflation on schemes in the capital programme currently underway.

2) The request goes through a due diligence process, as set out in paragraph 2.3, and co-ordinated by Finance.

3) For those schemes where the need for an inflationary uplift can be evidenced a summary report is submitted to the Strategic Director for Resources, as the Authority's Section 151 officer, for approval and with the delegated authority to add the additional funding for the scheme to the capital programme, following consultation with the Portfolio Holder for Finance and Property, or for referral back to Cabinet for a decision. All allocations from the Fund in excess of £1m will automatically be referred back to Cabinet for approval or onward recommendation to Council if an uplift of more than £2m is required.

4) Monthly monitoring reports to Corporate Board and the quarterly reports to Cabinet will provide an update on the decisions made.

5) Any funding set aside in the Inflation Contingency Fund not needed to provide for the impact inflationary uplifts on the approved capital programme is returned to CIF for allocation to future priority schemes.

2.10. To ensure the best use of Council resources there will be two exemptions for access to the Fund. These are:

- Schemes in the approved capital programme where works contracts have yet to be agreed. Before being eligible to access the Fund such schemes will go through a precursor screening to review whether the risks, such as service, financial or reputational, are such that the Authority still wishes the scheme to proceed despite the increase in funding required. These reviews will be led by the Strategic Director for Resources in conjunction with the Chief Executive, Leader and Portfolio Holder; and
- Any increase in scheme costs not due to inflation.

Any scheme not meeting the requirements for access to the Inflation Contingency Fund will be considered as part of the wider prioritisation of the use of CIF resources as part of the 2023/24 MTFS refresh.

3. Level of the Allocation to the Inflation Contingency Fund

3.1. The most difficult judgement in determining the level of the CIF set aside to meet the inflationary uplift on the approved capital programme is to ensure it is sufficient without reducing the remaining CIF unnecessarily. The initial work on the impact of inflation on the capital programme identified a potential ask of an 18% uplift. Work to date suggests that once cost uplifts not related to inflation or where alternative funding is available e.g. education capital grant, the inflation only element is more likely to be in the region of £15m to £20m. It is therefore recommended that, at this stage, an allocation of £15m is approved.

3.2. Recognising the use needs to be time-limited as it only relates to schemes already approved and underway, any change to this figure (upwards or downwards) will be considered as part of the 2023/24 MTFS refresh to be approved by Council in February 2023 and, if still required, be reviewed at least annually thereafter.

4. Financial Implications

4.1. The current level of the unallocated CIF is £116.3m. The use of £15m of this funding to meet the cost of inflation on the approved capital programme that cannot be mitigated or resourced from elsewhere would reduce the remaining CIF by 13% to £101.3m.

4.2. This allocation is affordable within the Medium Term Financial Strategy (MTFS). A consequence of reducing the unallocated CIF is that a greater degree of prioritisation will be required as to which new schemes are affordable and provide the most effective use of the Council's scarce capital resources.

4.3. Work on the development of a pipeline of capital investment schemes aligned to the Areas of Focus in the Council Plan and the approved Delivery Plan is currently underway as part of the preparation for the 2023/24 MTFS Refresh.

5. Environmental Implications

5.1. There are no direct environmental implications as a result of this report.

6. Background Papers

6.1. None

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Elected Members have not been consulted in the preparation of this report.