

SURREY COUNTY COUNCIL

CABINET

DATE: 2 FEBRUARY 2016

**REPORT OF: JOHN FUREY, CABINET MEMBER FOR HIGHWAYS,
TRANSPORT AND FLOODING**

**LEAD OFFICER: JASON RUSSELL, ASSISTANT DIRECTOR HIGHWAYS AND
TRANSPORT**

SUBJECT: KIER CONTRACT EXTENSION AND VARIATION



SUMMARY OF ISSUE:

Surrey County Council's Highways and Transport core maintenance contract is with Kier. The contract was set up in 2011 for an initial term of 6 years with options to extend by up to 4 years by means of 2 plus 2 year extensions. The initial term of the contract will terminate in April 2017.

This paper outlines the recommendation to Cabinet to approve a decision to extend the contract with Kier to its full term 31 March 2021.

RECOMMENDATIONS:

It is recommended that:

1. Cabinet approves the contract extension commitments and associated contract modifications agreed with Kier and approves the extension of the highway maintenance contract to its full term - 31 March 2021, and
2. Highways and Transport develop proposals to accommodate the increased revenue cost within the budget from 2017/18, in line with paragraph 24 of this report.

REASON FOR RECOMMENDATIONS:

Extending the Kier contract to its full term is the optimum commercial option at the current time. A value for money and market analysis exercise demonstrates that the current contract price is competitive and remains below Retail Price Index (RPIX) and tender price inflation. Although there is a revenue cost increase, extending the contract is the best value for the council. It is performing well, extending it will bring social and other benefits and the alternative carries significant financial and performance risks.

The option of retendering the contract has been considered as part of the decision making process but there is strong evidence to suggest that this is likely to result in a significant cost increase to Surrey in the current market. Increasing demand in a consolidated highway and construction sector fuelled by major infrastructure projects like HS2 and Crossrail (TFL), alongside a £50bn investment through Highways England in the strategic road network, has created a supplier led market which is enabling large contractors to command higher profit levels. The value for money analysis has also taken into account the additional cost to Surrey of re-procuring and mobilising a new highways contract, which would be around £1.2m - £1.8m.

Surrey has worked with Kier to develop an extension agreement for the remainder of the contract which delivers greater strategic alignment, value for money and improved services for residents. This includes an increase in the safety defect lump sums, to reflect the actual cost of this service, and the introduction of an annual cap on defects. The increased costs and transfer of risk will be balanced by an equivalent reduction in the costs of Capital schemes so that the economic balance of the contract is not altered. In addition, Kier will be providing additional social value through a number of initiatives, which are detailed in this report.

All these commitments will be enshrined in the Kier contract extension agreement. Although there is no significant change to the scope of the contract, there are a number of formal modifications required to the contract to deliver the commitments agreed.

DETAILS

Contract background

1. Surrey County Council's Highways and Transport core maintenance contract is with Kier. The contract was originally awarded to May Gurney but was transferred to Kier following their acquisition of May Gurney in July 2013. The contract was set up for an initial term of 6 years with options to extend by up to 4 years by means of 2 plus 2 year extensions. The initial term of the contract will terminate in April 2017.
2. The recommendation to extend the contract to its full term has been informed by an assessment of; whether the contractual criteria for extension have been satisfied; whether Kier are able to meet the future requirements of the service; whether the Kier contract has delivered value for money to date; and the alternative options in the current market conditions.

Contract scope and criteria

3. There are five contractual extension criteria which need to be satisfied. These cover overall programme delivery, contract price stability, performance against

standards, user and customer feedback. A comprehensive assessment of all the criteria was undertaken and scrutinised through the contract management governance arrangements, which included representation from the Council's Procurement and Finance service. All five criteria were met.

4. In order to assess whether the Kier contract is able to meet the service's future requirements a contract scope review was undertaken. The review was informed by the contract features required to deliver Highway and Transport's new five year strategic business plan for 2016-2021 and Kier's vision for the remainder of the contract.

Kier contract extension commitments

5. The contract scope review established that although there were no fundamental changes to the contract scope, there were opportunities to improve the commercial, business and strategic relationship with Kier as part of the extension agreement. As a result Kier have agreed to incorporate a number of operational and strategic contractual commitments.
6. The operational commitments will improve value for money in the delivery of planned works, while ensuring that Kier deliver Surrey Highways and Transport's strategic goals and improve the overall efficiency and effectiveness of the contract. These commitments include the implementation of a new joint procurement strategy and intelligence based procurement department for all capital works which will create future saving opportunities for Surrey through the supply chain. The strategic commitments agreed with Kier are longer term programmes and expected to deliver approximately £5m in capital savings to Surrey Highways and Transport over the remainder of the contract. They will create tangible social benefit and economic growth to local communities and include:
 - The development and implementation of a new integrated business operating model to deliver efficiencies via process, systems and organisational improvements.
 - The development of a business case with the Department of Education and Surrey to open a new regional construction academy to support the regional skills shortage.
 - The operation of a social educational enterprise "Eduprise" organisation to support pre apprentice traineeships and aid young people not in education, employment or training (NEETs) to gain local employment.
 - The retendering of all existing sub contracts for planned capital works on an open book basis. In order to improve the quality and level of customer service provided by sub contractors a new performance regime will also be introduced.
7. A new contract performance management framework, aligned to the delivery of the Council's corporate goals of well being, resident experience and economic prosperity goals will be introduced to ensure the contract extension benefits are realised.

CONSULTATION

8. Consultation was undertaken with internal stakeholders including Legal, Finance and Procurement.
9. Consultation on the decision was also undertaken with councillors via a Highways and Transport Member Reference Group. The group completed an extensive review of the Kier contract which looked at overall delivery, performance and communication with customers and Members. The group's findings are captured in their report to the Economic Prosperity, Environment and Highways Board on the 10 December 2015. The Member report concluded that although there are areas for improvement, overall Kier have demonstrated value for money and their commitment to the partnership. Examples of this include:
 - The successful delivery of the capital road maintenance programme Project Horizon to a high quality and standard.
 - The development and implementation of the new Works Manager IT system which delivers operational efficiencies including improvements to scheduling via route optimisation tools.
 - The implementation of a new safety defect process which operates on a 'milk round' basis, meaning defects are identified and repaired more quickly and efficiently through team integration.

The Group support a decision to extend the contract to its full term, subject to the inclusion of contractual conditions to address the issues identified. All these conditions are covered in the operational and strategic commitments agreed with Kier.

RISK MANAGEMENT AND IMPLICATIONS:

10. As part of the contract extension officers have agreed new liability clause for the repair of road safety defects. This is to reflect the increasing threat of flooding and severe weather and to better define the cost impact. Under the revised conditions, Kier will now be responsible for repairing all road defects to an annual capped volume of 52,500, with SCC agreeing to repair a further 20,000 defects through a targeted capital investment programme, which will be funded within the existing Highways and Transport capital programme. The details of the capital programme will be reflected in the new Asset Management Strategy which is expected to go to Cabinet for approval in Spring 2016.
11. The revised conditions thus enable Surrey Highways to permanently repair approximately 72,500 defects per year. Based upon historical analysis this represents the anticipated annual amount of road defects for an "average" year (April to March). However, there is a risk that this annual volume would be exceeded in times of severe flooding or snow. Using data from previous severe flooding this could increase annual defects to approximately 100,000 for that specific year and a corresponding increase in staff/traffic management costs. The revised contract conditions makes it explicit that this direct cost of severe weather and repairing a potential additional 30,000 defects is an SCC risk, which previous experience suggests could result in an additional expenditure of up to £5m depending on the severity of the weather event. In the past Central

Government have provided some emergency financial assistance, following severe weather events but this cannot be guaranteed going forward.

12. This risk amount is aligned to the additional expenditure SCC has previously incurred to mitigate impact of severe weather on the road network. For example, in 2012/13 the council invested £5m from reserves to recover from severe snow and a further £5m (part funded from Central Government) was invested in 2013/14 to mitigate the impacts of severe flooding. However, the new capped liability removes any ambiguity between SCC and Kier and makes it explicit on when the cost risk transfers from Kier to SCC.
13. Following discussions with finance officers, it has been agreed that it be recognised as a financial risk rather than built into Medium Term Financial Plan because it is not possible to predict the frequency or severity of a severe weather event, and instead the council's budget should represent a "typical" year. In addition to manage this risk better the service will also introduce a new safety defect strategy aimed at reducing the number of defects over the remainder of the contract to enable a lower revenue funding requirement from 2021. This will be done via preventative capital and jet patching programmes to improve the overall condition of the network.
14. Whilst going out to market with Kier to retender existing subcontracts creates saving and value for money opportunities, there is risk that this might lead to increased costs in some contracts. This risk will be managed via the implementation of a shared procurement strategy which will include a joint procurement team comprising Kier and Surrey staff working collaboratively to achieve cost savings. Kier Group is a large construction and services organisation and brings substantial procurement capability to Surrey. The joint procurement strategy will be based on developing longer term programmes; this will enable the Council to leverage Kier's wider contracts and position in the market to gain more competitive discounts, applying the same procurement principles used in the Council's 5 year capital road investment programme, Project Horizon.
15. There are potentially further financial and reputational risks to the Council if the service does not extend the Kier contract to its full term. Surrey Highways and Transport terminated its previous contracts with Ringway and Carillion early. The service has made good progress improving its reputation in the sector over the last few years. However, early termination of another major highway maintenance contract is likely to have a negative impact on Surrey's reputation as a client organisation and this could increase contract prices.

Financial and Value for Money Implications

16. A comprehensive value for money assessment and market research analysis demonstrates that the current contract price is competitive and remains below RPIX and tender price inflation. Increasing demand in a consolidated highway and construction sector has created a supplier led market creating the potential for large contractors to command higher profit levels. The Government's £50bn spending plans for the strategic road network, between 2015 and 2021 along with national infrastructure projects like Crossrail and HS2 are contributing to driving up industry costs. Forecast analysis indicates that tender pricing will continue to increase and accelerate above RPIX from 2015 -2021. Therefore, retendering the contract in the current market climate is likely to result in significant cost increase to Surrey.

17. The value for money assessment also needs to consider the costs of re procuring and mobilising a new highways contract, which previous experience suggests would be expected to be between £1.2m - £1.8m.
18. Remaining with the Kier contract is therefore considered to be the optimum commercial option at the current time.
19. The proposed contract extension includes a number of adjustments to costs and risks:
 - Increased revenue lump sum payments for activities including safety defect repairs, accident & emergencies, and winter maintenance to more accurately reflect the actual cost of routine maintenance
 - Kier's liability to repair safety defects would be capped at 52,500 defects, transferring volume risk to SCC. As outlined in paragraph 14 this could equate to an additional cost of up to £5m depending upon impact of any severe weather event
 - Reductions to overhead payments across revenue and capital works
20. These changes are not expected to result in any significant change to the overall contract cost. However the contract adjustments would result in a transfer of costs between revenue and capital, with a corresponding reduction in the cost of capital equal to an increase in revenue budget of approximately £2.2m resulting in a cost neutral financial position. The capital savings will be reinvested to help relieve revenue pressures.
21. As outlined in paragraph 8, the revised contract agreement and move to longer term programmes also enables Surrey Highways to realise further opportunity to secure further savings in the capital investment programme of approximately £5m.
22. Additional income and/or savings will be required from 2017/18 in order to offset the additional revenue cost associated with the proposed extension. A number of savings options are currently being considered, and the intention is that the increased revenue costs will be managed within the service's budget.

Section 151 – Officer Commentary

23. The value for money assessment which supports the decision to extend the Kier highway maintenance contract included a review of contract costs and an analysis of inflation and tender prices within the wider construction market, and concluded that to date the contract has provided value to the council. The alternative option of retendering the contract would expose the council to risks associated with higher market inflationary pressures, and also to procurement and contract mobilisation costs.
24. The financial impacts of proceeding with the contract extension are outlined in the body of the report and summarised in the report. Although overall costs are expected to remain broadly balanced, costs would be rebalanced across contract activities leading to an increased revenue cost estimated at £2.2m, offset by a reduced capital cost, which will need to be accommodated within existing budgets. In addition the proposed extension introduces changes to the allocation of risk, including the introduction of a limit to the number of safety

defects that will be treated before additional cost is incurred, as detailed in paragraphs 10 to 12.

Legal Implications – Monitoring Officer

25. The Council is subject to public procurement law and cannot vary a contract so that it becomes substantially different to that which was the subject of the original invitation to tender. If a contract becomes so materially different to the original so that the initial award would have encouraged or allowed other bidders to be considered for the award, or might have resulted in a different result, then that would amount to a breach of EU procurement law. The Public Contracts Regulations 2015 (PCRs 2015) which came into force in February 2015 codified much of the case law in this area.
26. There are always risks attached to modifying or varying of a contract where the changes proposed do not fit neatly within the modifications allowed by the PCRs 2015. The Council has considered the modifications proposed, including the increase in value over the period of the Contract, in the light of the provisions of the PCRs 2015. From the careful consideration and analysis undertaken by the Council and with the benefit of assistance from external legal advisers, the Council considers that the contract award outcome would have been the same if those changes had been notified to the marketplace when the original OJEU notice was published, with the contract awarded to the same contractor. Nevertheless to mitigate the risk of a challenge to the modifications proposed in the contract extension, the Council published a voluntary ex ante transparency (VEAT) notice in OJEU on the 26 December 2015. If Cabinet approves the extension of the contract with the modifications proposed, the Council will only affect the extension after the requisite time for a challenge has elapsed to mitigate the risk of the contract extension being declared ineffective.

Equalities and Diversity

27. A full Equality Impact Assessment was undertaken as part of the original procurement exercise. As there are no significant changes to the contract scope and the contract extension modifications do not negatively impact residents or staff it has been determined that a further Equality Impact Assessment is not required.

WHAT HAPPENS NEXT:

28. Subject to Cabinet approval the contract extension agreement will be executed by the end of June 2016. The decision to extend the contract with Kier to its full term including the changes and implications will be formally communicated to all Members by the Assistant Director for Highways and Transport.

Contact Officer:

Jason Russell, Assistant Director, Highways and Transport, Tel: 020 8541 7395

Consulted:

Highways & Transport Member Reference Group

Background Papers

Highways & Transport Member Reference Group Report to Economic Prosperity,
Environment & Highways Board - December 2015

Procurement Services – Contract Modification Analysis report - December 2015

Core Group- Kier contract extension report - 9 November 2015
