TENDER PRICE **FORECAST**

for 4th Quarter 2023 is...

3.00%

Annual UK Average

◀▶ compared to 3.00% Annual UK Avg. in Q3 2023

The UK construction industry continues to grapple with uncertain demand, high construction and financing costs, as well as skilled labour shortages. The good news is that some stubborn material pressures are now receding, and tender price inflation looks set to reduce in 2024 and beyond. But with 'higher for longer' interest rates, there are challenges to viability in the immediate future.

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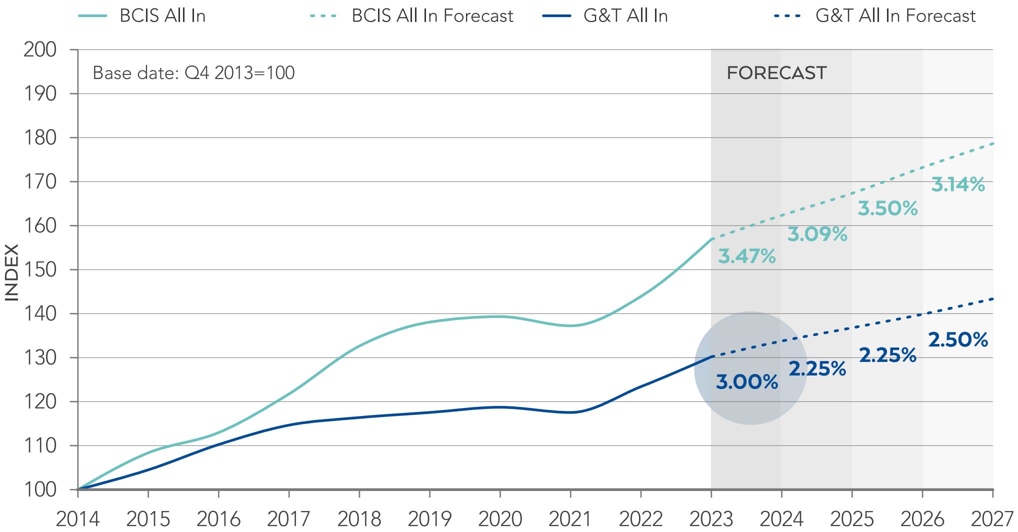
TENDER PRICE ANNUAL PERCENTAGE CHANGE Q4 2023

%	2023		2024		2025		2026	
Regional forecasts	**Now**	**Last***	**Now**	**Last***	**Now**	**Last***	**Now**	**Last***
Greater London	3.25	3.25	2.25	2.25	2.50	2.50	2.50	2.50
South East	3.25	3.25	2.25	2.25	2.50	2.50	2.50	2.50
South West	2.50	2.75	2.25	2.25	2.00	2.25	2.25	2.25
East (Anglia)	3.25	3.25	2.50	2.50	2.50	2.50	2.50	2.50
Midlands	3.00	3.25	2.00	2.25	2.00	2.00	2.25	2.50
Wales	2.50	2.75	2.25	2.50	2.50	2.50	2.50	2.50
Yorks & Humber	2.00	2.00	2.00	2.00	2.50	2.00	2.50	2.00
North West	2.00	2.00	2.00	1.75	2.50	1.75	2.50	1.75
North East	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
Scotland	3.00	3.00	2.50	2.25	2.50	2.25	2.25	2.25
Northern Ireland	3.00	3.00	2.25	2.25	2.00	2.00	2.50	2.50
UK Average	**3.00**	**3.00**	**2.25**	**2.25**	**2.25**	**2.25**	**2.50**	**2.50**

Last* **3Q 2023**

Our forward forecasts show annual tender price inflation (Jan-Dec)

TENDER PRICE TREND 'ALL UK TPI'



HOW DO WE REACH OUR TENDER PRICE FORECAST?

We conduct a detailed industry survey and consider factors including...

INPUT COSTS

- ▲ 5.7% — BCIS Labour Cost Index, Aug 2022 - Aug 2023 (High Cost Driver)
- ▼ -7.2% — BCIS Plant Cost Index, Aug 2022 - Aug 2023 (Low Cost Driver)
- ▲ 1.4% — BCIS M&E Cost Index, Aug 2022 - Aug 2023 (Medium Cost Driver)
- ▼ -28.6% — Fabricated Structural Steel, Jul 2022 - Jul 2023 (Medium Cost Driver)
- ▼ -27.2% — Concrete Reinforcing Bars (Steel), Jul 2022 - Jul 2023 (Medium Cost Driver)
- ▼ -23.5% — Imported Sawn or Planed Wood, Jul 2022 - Jul 2023 (Low Cost Driver)
- ▲ 20.5% — Ready Mixed Concrete, Jul 2022 - Jul 2023 (Low Cost Driver)
- ▲ 6.9% — Oil Prices (Brent Crude), Oct 2022 - Oct 2023 (Low Cost Driver)

KEY
Input to tender price movement of a typical project has a range of contributory impacts from:
● *High Cost Driver* ● *Medium Cost Driver* ● *Low Cost Driver*

MACRO ECONOMICS

Unless otherwise indicated, figures show percentage change over 12 months

- ▲ 0.6% — UK GDP Annual Growth Rate, Q2 2022 – Q2 2023
- ▲ 6.7% — CPI August 2023, 12-month rate
- ▲ 9.1% — RPI August 2023, 12-month rate
- ▲ 5.25% — UK Base Interest Rate, October 2023
- ▲ 4.3% — UK Unemployment Rate, May 2023 - Jul 2023
- ▲ 8.5% — UK Wage Growth, Average Weekly Earnings (Total Pay), Y-on-Y three-month average to Jul 2023
- ▲ 4.9% — UK Construction Wage Growth, Average Weekly Earnings (Total Pay), Y-on-Y three-month average to Jul 2023

Our advice is to review each project on its own merits. This forecast publication must be treated as a guide only, being that it is based on averages of various types and sizes of projects across a region, ascertained through our latest market research.

GT

Our Tender Price Inflation report looks at the movement of prices in tenders for construction contracts in the UK. The report examines a number of contributing factors and is further informed by our market survey responses and contractor consultations. This forward forecast illustrates our view of annual tender price inflation from January to December 2023 and beyond.

OUR FORECASTS

The UK construction industry continues to grapple with uncertain demand, high construction and financing costs, as well as skilled labour shortages - a potential storm that is increasing financial pressure.

These pressures may pose viability challenges in the immediate future and exacerbate the recent trend of rising construction insolvencies – the effects of which are being increasingly felt up and down the supply chain. Any reduction in capacity could exacerbate the current inflationary pressures and pricing of risk offsetting the reduced demand. While smaller specialist contractors and subcontractors are evidently being hit the hardest, larger main contractors are also not immune. Recent high-profile collapses from the likes of Buckingham Group and M&E specialist contractor Michael J Lonsdale illustrate how financial pressures and their knock-on effects are impacting all.

Given the current pressures acting out in the market, it is unsurprising that new construction activity has softened, especially compared to 2022, which was an exceptionally strong year for UK construction growth. Some projects, driven by development appraisals and debt finance, are finding it difficult to proceed and commit to construction from a viability perspective. However, with interest rates looking like they may have now peaked and materials cost inflation softening, these stalled projects may become unstuck.

While the emerging picture may be one of declining construction activity overall, certain sectors remain robust, giving rise to a two-speed market. Commercial fit-out and refurbishment, life sciences and biotechnology, data centres, and even the industrial sector, continue to benefit from strong demand. However, weakness in the residential sector (which accounts for around 22% of total construction output in the UK) is acting as a significant drag on overall growth, and in 2023 the Construction Products Association expect the sector will make an outsized contribution to its forecasted 7% contraction in total output this year.

Softer client demand and reducing material prices have been balanced against rising labour costs in our latest set of forecasts. Our UK weighted average TPI forecast remains at 3.00%, but minor adjustments have been made to some UK regions. Our forecasts for 2024 (2.25%), 2025 (2.25%) and 2026 (2.5%) also remain unchanged from our previous (Q3 2023) TPI report.

All forecasts in this report take account of all sectors and project sizes as a statistical average, indicating an overall trend in pricing levels. It should be remembered that individual projects may experience tender pricing above or below the published average rate, reflecting the project specific components and conditions.

THE ECONOMY

A slowing UK economy and an unexpected dip in headline inflation in August has warranted the first pause in a cycle of interest rate rises going back to December 2021, according to the Bank of England.

The Monetary Policy Committee **(MPC)** held to its message that further monetary policy tightening would be necessary if there was evidence of more persistent inflationary pressures and repeated guidance that monetary policy would be "sufficiently restrictive for sufficiently long" to get inflation back to its 2% target from 6.7% in August. However, for many, 5.25% now marks the peak of the rate raising cycle.

One pressure the MPC intends to monitor closely moving forward is the UK labour market. Although there are some indications of it loosening (ie rising unemployment rates and falling vacancies), the labour market remains relatively tight. High wage growth across the economy has resulted in continued resilience in demand, feeding into domestic inflationary pressures. Further rapid wage growth could therefore indicate more persistent inflationary pressure, so the MPC will be keeping a keen eye on wage movements when setting the bank rate.

Recent upward pressure on energy and oil pricing due to uncertainty in the Middle East conflict and continued war in Ukraine will also be monitored closely by the bank, as these have the potential to further stoke inflation.

GDP grew by 0.2% in Q2 2023, but this is unlikely to change the current subdued growth outlook. The Bank of England expects the UK economy to remain near stagnation for the next two years as a result of the battle against inflation. The impact of past increases in the bank rate is expected to increasingly weaken demand, pushing the economy into a state of excess supply (or 'economic slack').

Despite making some progress in the battle against inflation, the UK is forecast to have the highest inflation rate among G7 nations, averaging 7.2% over 2023. However, there are also reasons to be hopeful. UK inflation will average 2.9% next year, according to OECD forecasts. It also transpires that after a recent ONS data revision, the UK was in fact among the fastest in the G7 to recover from the pandemic, with the IMF now suggesting that the UK will grow faster than Germany, France and Italy in the long term. Furthermore, consumer confidence has climbed to its highest point since January 2022, supported by strong wage growth and easing inflation. The same trends also helped retail sales rebound in August.

Of course, the UK construction industry is impacted by more than just consumer confidence and interest rates. Government spending is a key driver of activity with the National Infrastructure Programme stimulating growth and shoring up the UK economy. Although the infrastructure sector is sustaining its output growth momentum, the pipeline is susceptible to shifts in Government policy and its overarching strategy to reduce spending and long-term debt, particularly heading into a general election. Infrastructure new orders have been on a downward trend in recent quarters as the Government scales back and reschedules projects, cooling the pipelines of work and disrupting order books in the rail and road sectors especially. However, the water, aviation and energy sectors appear buoyant as we approach the start of the new asset management plan period (or 'AMP8').

CONSTRUCTION OUTPUT AND NEW ORDERS

While contracting 0.5% in value terms in July 2023, UK construction output remained 8.4% above the five-year monthly average figure and 6.8% higher than before the pandemic hit in February 2020.

Monthly construction output has yo-yoed between modest growth and contraction in 2023, painting a far more unsettled picture compared to last year. While total output has now grown for seven consecutive quarters, the rate of growth is evidently easing. However, at the sector level, the picture is not as clear cut. While some sectors face real challenges, others have seen future pipeline opportunities grow as demand remains strong.

In July, the decrease in monthly output came solely from a 1.3% fall in repair and maintenance work, with new work increasing 0.1% on the month. Acting as a drag on both new work, repair and maintenance work was the continued slowdown in the private housing sector. Private new housing output was 12.1% lower on an annual basis in July – the biggest year-on-year contraction of all the construction sectors. Conversely, infrastructure, public new work and, to some extent, private commercial output growth has been robust.

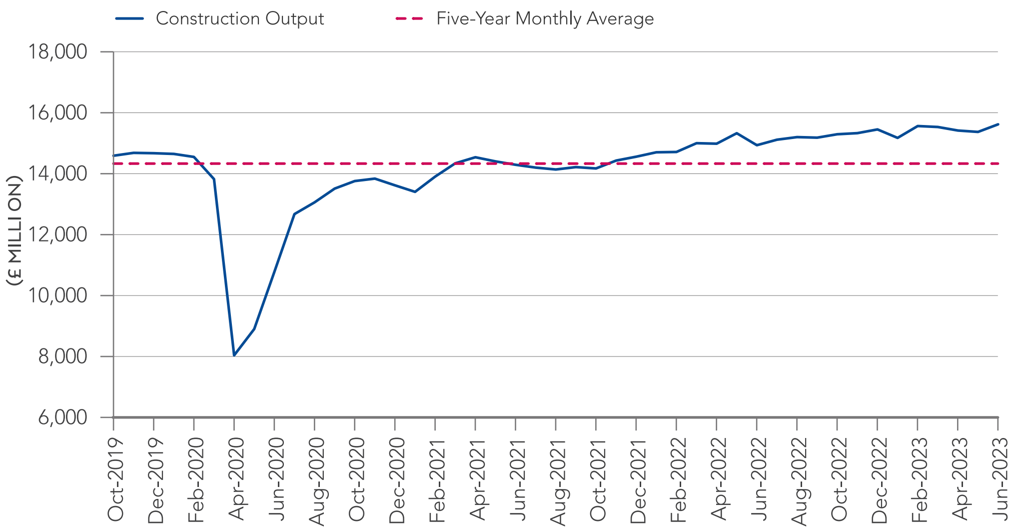
Anecdotal evidence suggests heavy rainfall in July led to delays in planned work as the housing market also continued to slow down amid high interest rates and plummeting demand. Although interest rates show signs of stabilising and the rate of construction cost inflation is easing, the industry as a whole remains very volatile with the picture changing from month to month.

The Construction Products Association **(CPA)** downgraded its overall forecast for output growth in its Summer 2023 report, from -6.4% to -7% in 2023, before recovering slowly in 2024 with growth of just 0.7%. The drags on output growth mentioned in the latest set of forecasts include persistent inflation, hindering the UK economy and its growth prospects, interest rates staying higher for longer, higher borrowing and financing costs harming prospects for new construction activity (particularly housebuilding) and client investment plans.

Although technically indicating a recession for the industry in 2023, it's worth remembering that the forecasted contraction follows a record year of output growth and that 2023 output volumes will still be broadly on par with 2021 volumes. As reflected in ONS data, the CPA's downgraded 2023 forecast is primarily due to sharp falls in activity in the two largest construction sectors: private new housing and private housing repair, maintenance and improvement **(RM&I)**.

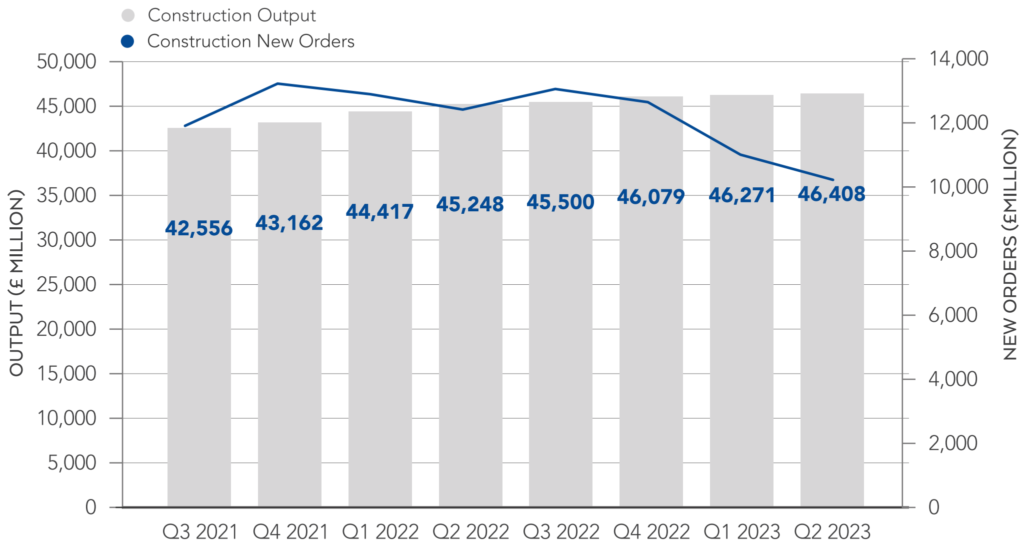
CONSTRUCTION OUTPUT: ALL WORK

Seasonally adjusted



Source: *ONS*

UK CONSTRUCTION: NEW ORDERS (ALL NEW WORK) V OUTPUT (ALL WORK)



Source: *ONS*

New order growth – a measure of the value and volume of new orders received by main contractors – dropped significantly in Q2 2023, contracting by 7% and falling well below the five-year quarterly average. Excluding the pandemic period in 2020, new orders in the second quarter of the year fell to their lowest level since Q2 2012.

With slowing new work volumes putting contractor pipelines under increasing pressure, output growth in 2024 will likely be muted.

G&T TPI SURVEY FEEDBACK

Workload

Until recently, workloads have been sustained by a busy period of strong market activity, but as construction costs continued to rise and higher financing costs became more restrictive, an increasing proportion of schemes have been put on hold.

Despite evidence of an overall slowdown in construction activity, sentiment over future workload growth is mixed. This is a potential reflection of the broad mix of project types and sectors being monitored. Workloads within the more active sectors (eg commercial office, life sciences and healthcare) were reported as being 'steady', with most expecting workloads over the next 12 months to either remain the same or grow between 0-5%. Conversely, there is a greater sense of pessimism regarding future workloads in sectors where construction activity is presently stagnating or falling (eg residential, hotel, leisure and hospitality). As major projects in these sectors reach practical completion, many cautioned there is little of significant size on the immediate horizon to replace them.

Many respondents noted that workload volumes at the early planning stages of development remain robust. However, the pausing of these schemes prior to the construction stage (due to viability concerns and cost pressures making schemes unworkable) have prompted concerns about the conversion rate of these opportunities.

Getting past feasibility appears to be less of an issue in the commercial office sector. The strong pipeline across the sector has been supported by a pick-up in new enquiries and a greater appetite to commit to these schemes. Clients remain keen to refurbish their space to appeal to tenants/end-users. The carbon agenda remains a key driver of activity in this space and as leases expire across developers' portfolios, many will seek to reduce operational carbon emissions across their portfolio through numerous plant replacement projects.

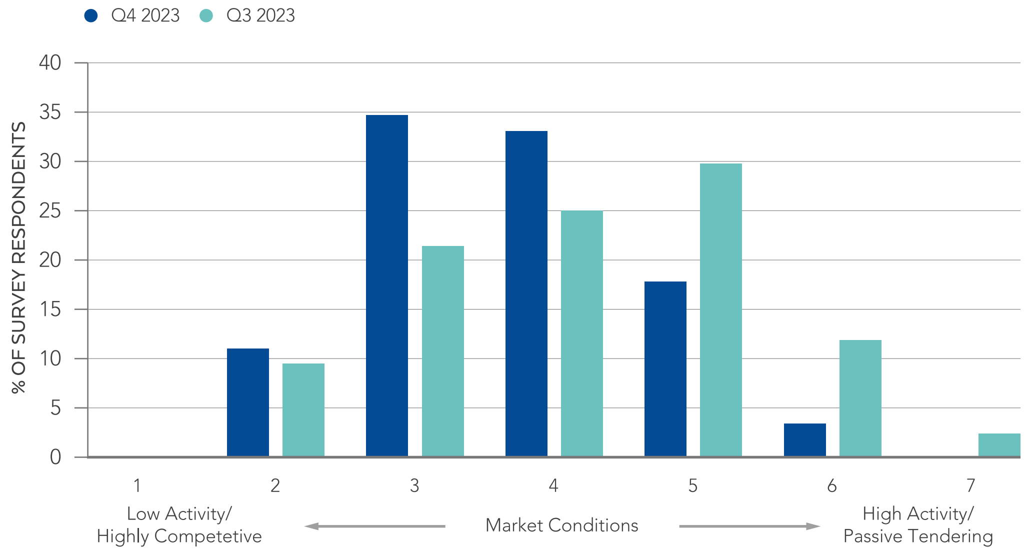
In the residential sector, numerous schemes have stopped following interest rate-driven drops in demand and pressures caused by the introduction of the second staircase rule (for new buildings above the 18-metre height threshold). Schemes are pausing as they are redesigned, adding cost and reducing development value due to the loss of saleable space.

Stalled projects could come back online if interest rates peak, the economic climate begins to improve, and construction cost inflation continues to soften. In the interim, strong retrofit activity and repurposing of existing assets will present opportunities and help support workloads.

Market Conditions

Those surveyed suggest that the true impact of interest rate hikes will become evident through more competetive tender pricing in 2024 and beyond, as tender opportunities fall and material costs plateau. Labour cost inflation will steady but remain a key underlying factor in overall tender price inflation.

PERCEPTION OF MARKET CONDITIONS OVER THE NEXT SIX MONTHS (LONDON)



In our Q4 survey, there was yet another shift in the perception of future market conditions. Greater proportions of respondents expect lower market activity and greater tendering competition over the next six months.

Anecdotal evidence to support this shift in market conditions included:

- Main contractors changing their focus to different markets/sectors (eg Resi-led main contractors seeking work in growth sectors due to a lack of new projects coming forward).
- Some clients cutting back investment plans due to a combination of high interest rates, changing building regulations and high land values – all putting pressure on scheme viability.
- Increased frequency of schemes being delayed, reconfigured or not materialising.
- As gaps in order books emerge, contractors are becoming more proactive in seeking work and responsive to invitations to tender.
- Enhanced due diligence on schemes.
- Growing number of contractors are restructuring their businesses to improve efficiencies in anticipation of a slowdown.
- As construction starts to slump, there is growing concern about the risk of insolvencies as firms take additional measures to mitigate against failures.

However, market conditions differ widely from sector to sector. Many contractors working in several key sectors continue to benefit from full order books and high workloads, allowing them to maintain a degree of selectivity on tenders. In the more active sectors, Tier 1 contractors are struggling to service projects well from a pre-construction basis and are reporting difficulties securing competitive tenders from their supply chain, often blaming a lack of labour resource. As such, there is a two-speed market emerging, as certain sectors weather the economic pressures better than others.

INPUT COSTS

Key inflationary and deflationary pressures

Despite the UK construction sector seeing a significant easing in input cost inflation this year, some elements of inflation continue to work through the system.

Higher interest rates, softer energy and material prices, combined with a normalisation of demand conditions and certain regulatory hurdles have conspired to slow the overall rate of tender price inflation in 2023. Labour (which can account for around 40% of the cost of a commercial office scheme) has been the clear driver of inflation this year. The BCIS' cost indices suggests that labour costs will rise by 6.8% in 2023, more than offsetting softer material price inflation and falling plant costs.

With UK consumer price inflation set to fall back to around 2.7% in 2024 (based on an average of independent forecasts), this should theoretically take some pressure off labour cost inflation. The dynamic interaction between prices and wages is that if workers see and expect prices to rise, they demand higher wages so that their real (inflation adjusted) wages are constant. With raw and building materials generally levelling off (and in some cases, falling significantly), on the current trajectory, construction input inflation should return to more typical, long-term average levels next year. This is demonstrated in the BCIS' General Building Cost Index, which after rising 8.7% in 2022, is set to fall towards a more typical annual rate of 3.2% in both 2023 and 2024.

However, softer input cost inflation is unlikely to fully compensate for higher interest rate costs. New order growth will likely remain weak until there are clearer signs that borrowing costs are falling and clients are more confident about the direction of travel across the wider economy. Once there is greater clarity regarding these two market-influencing factors, recently stalled projects could be green-lit and a wave new work unleashed.

Material Costs

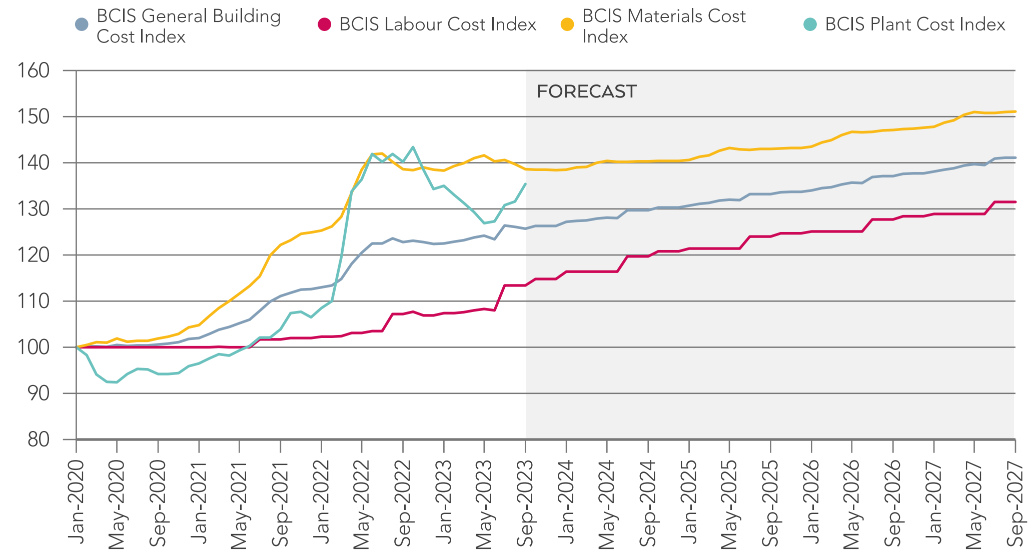
The supply costs for many of the major material elements in the UK construction sector have come off considerably this year. Structural steel, rebar and imported timber have all experienced strong deflationary trends since mid-2022, resulting in the BCIS' 'All Work' material price index (a basket of goods that tracks price movements for construction materials) to experience its first annual contraction since September 2020.

Although still elevated by historical measures, according to July's data, material prices were on average 4% lower than they were one year ago. The welcome and positive trend has been led by falling wholesale energy prices, oversupply issues at stockists (following a reversal of the supply-side squeeze during the pandemic) and normalising demand.

However, prices for some product categories (eg insulating materials, concrete/cement and electrical materials) are still rising.

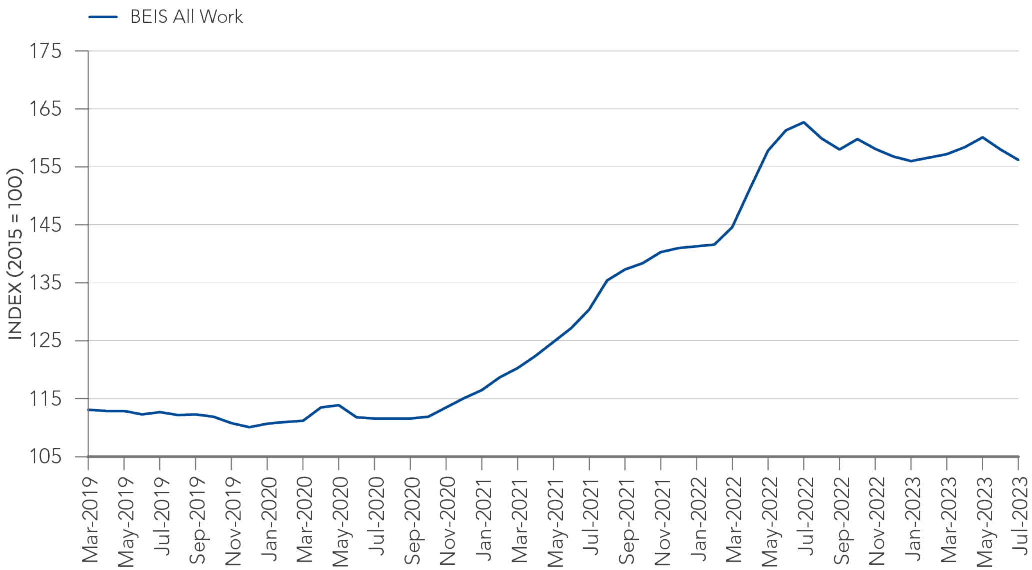
As one of the key elements of the construction industry's purchase of inputs, falling material prices is positive news for overall construction costs, but there is still a wide range of inflationary rates across the basket of tracked materials.

BCIS INPUT COSTS



Source: *BCIS*

BEIS: 'ALL WORK' CONSTRUCTION MATERIAL PRICES INDEX, UK



Source: *BEIS*

Ready-mixed concrete is a stand-out example, with prices having increased by more than 20% in the year to July 2023. Upward price pressure in this instance stems from the lingering effects of historically high energy costs, the rising cost of aggregates and higher labour and equipment costs required for batching, mixing and transportation to site. It is expected that lower wholesale energy prices will eventually filter through the supply chain, putting further downward pressure on prices. However, supporting prices will be higher demand for low-carbon variants of concrete which, due to the additional steps and materials involved in its production, has a cost premium to standard cement.

Meanwhile, the cost of heavy materials such as steel, bricks and timber have fallen in response to the slowdown in the new-build sector (in contrast to the buoyancy of refurbishment and energy-efficiency retrofit work). Manufacturers have experienced a significant drop in sales for products that are typically used at the earlier stages of construction. Steel manufacturers like British Steel have tried to stymie the trend of falling prices by announcing price increases (eg British Steel's £30/t hike on structural sections in July) but these increases have generally not stuck. Stocks remain high compared to current demand, maintaining downward pressure on prices for the time being. However, once the current oversupply issues have eased, prices may start to rise once again.

With material price inflation becoming less volatile and more predictable, price fixing has become less of an issue and some contractors are showing increased willingness to fix for longer periods.

The ongoing war in Ukraine and, to a certain extent, the recent conflict in the Middle East, will continue to impact manufacturers of energy intensive products. With the UK's energy supply far from secure, many have therefore hedged their energy contracts into 2024. However, by insulating themselves against global energy shocks, the cost of manufacturing these products will remain elevated compared to the levels seen before the outbreak of the war in Ukraine. A weaker pound is another factor that is likely maintain price pressure on imported construction materials and components. Sterling's current weakness is undeniably a concern, not least because international commodities priced in dollars – including oil – place additional cost pressures on UK businesses and consumers at a time of already high inflation.

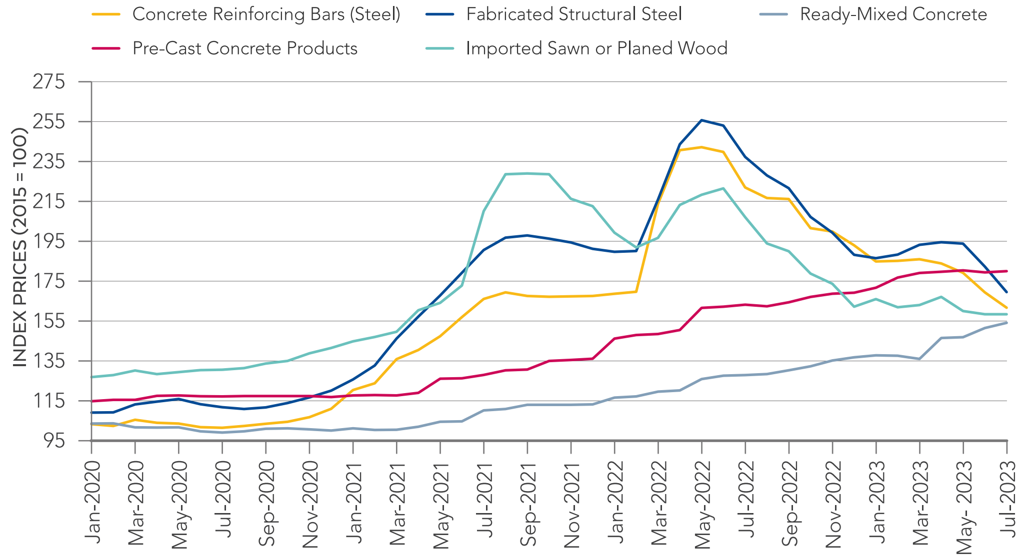
Overall, the levelling off in material prices should be seen as a positive. Manufacturing input costs and factory gate prices have fallen over the past year and, although it may take time, softening production costs should flow into the wider economy. However, there are a variety of factors that could disrupt the current trajectory, ranging from further energy price spikes to changing demand conditions in China.

Labour

Labour supply issues continue to be a major challenge for the construction industry. Although the industry's labour challenges may be tempered in the short-term by slowing new order growth and softer demand, demographic and structural issues will continue to put upward pressure on wages in the longer-term.

In the currently tight labour market, availability issues are intersecting with cost-of-living pressures, pushing earnings in the sector higher. According to ONS data, average weekly earnings in UK construction were 4.9% higher in July 2023 compared to a year ago (on a three-month average basis). This far exceeds the long-term average annual growth trend of 3.1%. However, as the ONS data captures all types of roles within the

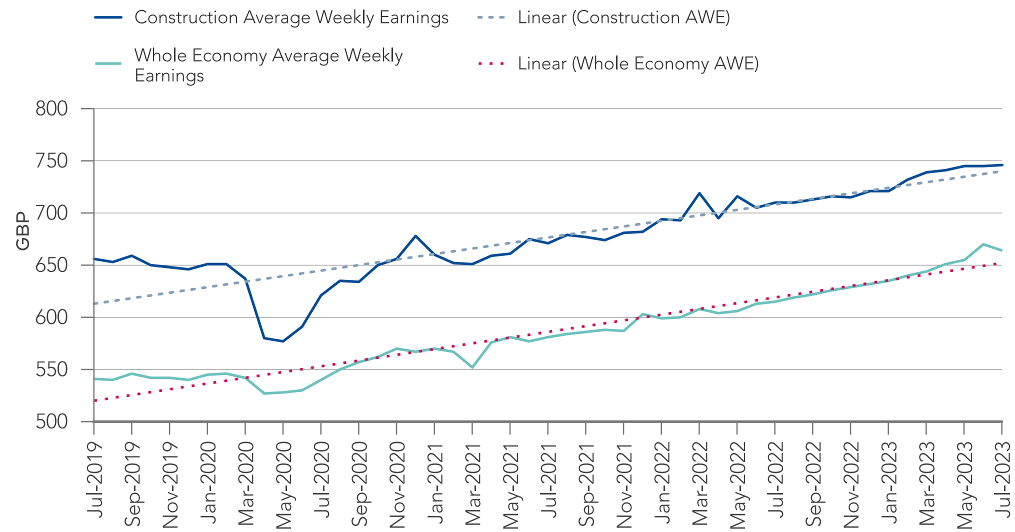
BEIS: PRICE INDICES OF CONSTRUCTION MATERIALS (UK)



Source: BEIS

AVERAGE WEEKLY EARNINGS (UK CONSTRUCTION)

Seasonally adjusted



Source: ONS

industry, this is likely to mask larger rises for certain specialist trades working on site. For example, employers and unions on the Construction Industry Joint Council (CIJC) have concluded their negotiations and agreed an 8% rise in the general operative rate for site workers from 10th July 2023. The CIJC also agreed a two-stage increase for all other rates, amounting to a compound rise of 7.59%. Approximately 500,000 workers are affected by the agreement, which pushes their annual wage growth above the current rate of inflation in the wider economy (which was 6.7% in the 12 months to August 2023).

Rising labour costs are essentially a consequence of demand exceeding supply. Shortages in recent years have been exacerbated by strong workloads, the impact of Brexit on European labour supply and growing working-age inactivity rates. Other dynamics pushing wages higher include resource poaching and staff retention costs. In light of these pressures, labour remains on track to be the main input cost driver in 2023 and into 2024.

Estimates by the Construction Industry Training Board (CITB) suggest that the UK construction sector will need an additional 225,000 workers by 2027 to meet projected domestic demand. While this estimate might not have factored in the current drop in demand for construction work, the task of acquiring such a substantial workforce is bound to be challenging.

The number of vacancies in UK construction has dropped in recent months, falling from their 20-year record high of almost 50,000 job openings in the middle of 2022. Construction vacancies in the June-August 2023 period of this year fell to 37,000, but this is still well above the 10-year average for vacancies (c.28,000). Falling vacancies have almost certainly been a consequence of easing construction output growth and uncertainly over future workloads and pipelines.

Despite an easing in the number of advertised vacancies, sourcing for several roles (professional and site-based) remains a challenge. While the Government recently accepted recommendations from the Migration Advisory Committee to add additional roles to the 'shortage occupation list' (including bricklayers and masons, roofers, carpenters and joiners as well as plasterers), contractors continue to report difficulties recruiting skilled labour for many of these occupations.

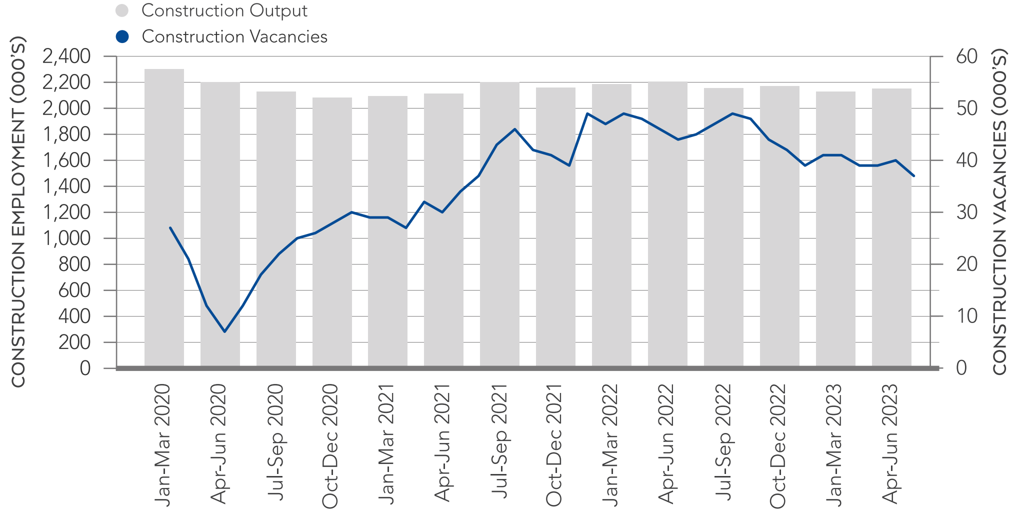
On-costs

In 'percentage-of-total-project-cost' terms, around 30-40% of those surveyed reported that project preliminaries costs had risen in Q3 2023. The rest noted no change over the period. Those that did report increasing preliminaries costs explained this was being driven by higher wages for staff and skilled management. Rising plant operational costs were also flagged as a reason for higher preliminaries.

Conversely, overheads and profit (OH&P) remained broadly consistent, with the majority of those surveyed (between 50-60%, depending on the project value) suggesting there has been no movement over the past three months. In one instance, a respondent anecdotally noted that on one project, the same contractor placed two bids on the project 12 months apart. While their preliminaries allocation has increased, OH&P remained unchanged from the original bid.

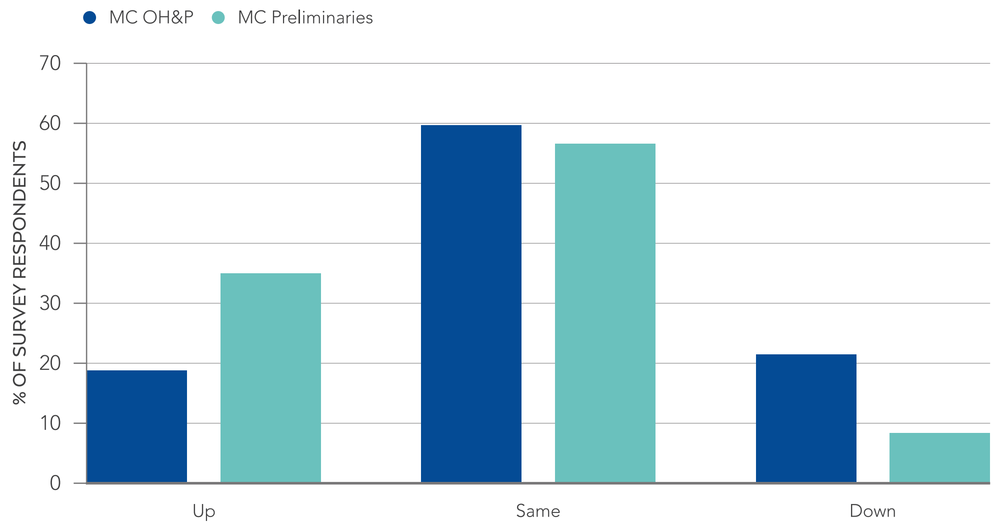
Over the next 12 months, many commentators suspect contractors will have to compete more heavily on price and will therefore lower their returns and controllable costs to secure work. Increased levels of tendering competitiveness will naturally drive a review but with the current labour pressures, preliminaries costs are unlikely to come down significantly.

VACANCIES IN UK CONSTRUCTION (SA) V CONSTRUCTION EMPLOYMENT (NON SA)

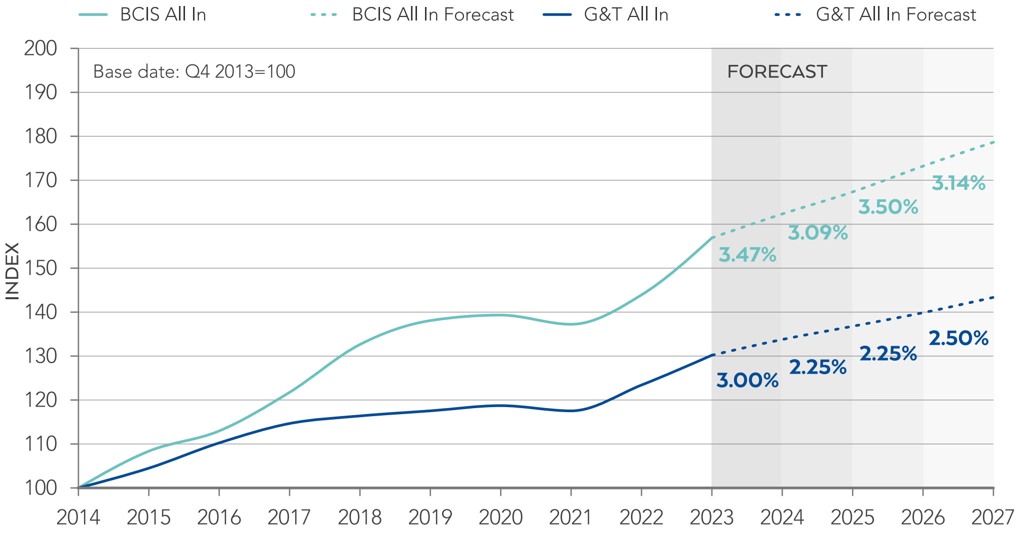


Source: *ONS*

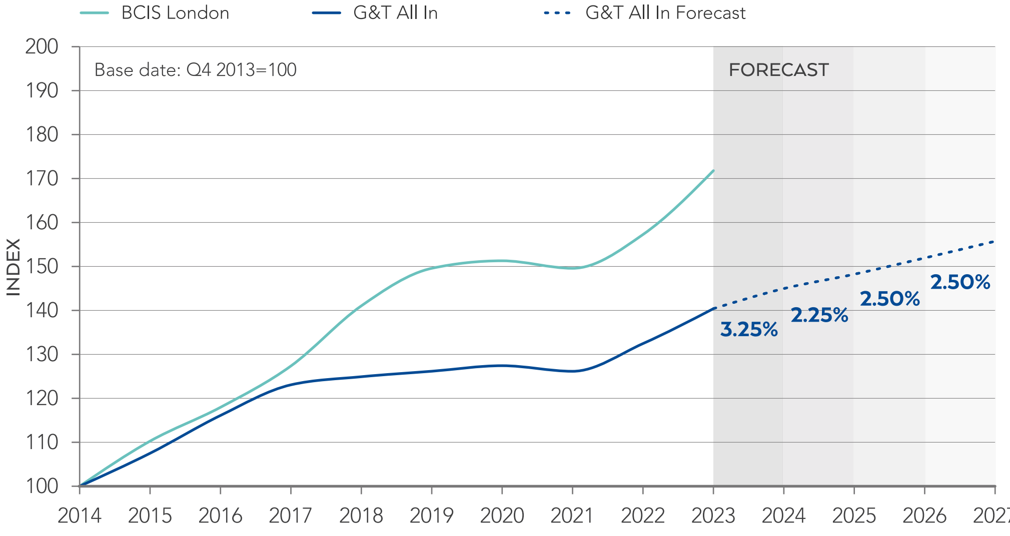
INFLATIONARY PREDICTION FOR MAIN CONTRACTOR OH&P AND PRELIMINARIES OVER THE NEXT 12 MONTHS



TENDER PRICE TREND 'ALL UK TPI'



TENDER PRICE TREND 'LONDON TPI'



TENDER PRICE ANNUAL PERCENTAGE CHANGE Q3 2023

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Wales	2.50	2.75	2.25	2.50	2.50	2.50	2.50	2.50
Yorks & Humber	2.00	2.00	2.00	2.00	2.50	2.00	2.50	2.00
North West	2.00	2.00	2.00	1.75	2.50	1.75	2.50	1.75
North East	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
Scotland	3.00	3.00	2.50	2.25	2.50	2.25	2.25	2.25
Northern Ireland	3.00	3.00	2.25	2.25	2.00	2.00	2.50	2.50
UK Average (weighted)	**3.00**	**3.00**	**2.25**	**2.25**	**2.25**	**2.25**	**2.50**	**2.50**

Last* **3Q 2023**

COMPARISON OF PUBLISHED FORECASTS FOR TENDER PRICE CHANGE

G&T UK AVER.	**BCIS** UK AVER.	**G&T** LONDON	**AECOM** UK	**ARCADIS** LONDON	
Q4 2023	Sep 2023	Q4 2023	Q3 2023	Autumn 2023	
% CHANGE					
3.00	3.47	3.25	4.30	2.00	**2023**
2.25	3.09	2.25	3.30	1.00 - 2.00	**2024**
2.25	3.50	2.50	N/A	3.00 - 4.00	**2025**
2.50	3.14	2.50	N/A	4.00	**2026**
N/A	3.51	N/A	N/A	4.00	**2027**

Note: Arcadis' TPI figures are for its 'London Building Construction TPI' series.
Aecom's baseine forecasts are from Q3 2023 to Q3 2024 and Q3 2024 to Q3 2025

Our advice is to review each project on its own merits. This forecast publication must be treated as a guide only, being that it is based on averages of various types and sizes of projects across a region, ascertained through our latest market research. The quality, both of design and desired end product, procurement route (particularly ownership and transfer risk), delivery timescales, complexity of design and desire of contractors to tender should be carefully considered in project specific estimates and their outturn cost. Suitable allowances should be made for project specific designs, site conditions and local market conditions, which should be reviewed regularly with your Gardiner & Theobald team to determine the appropriate base cost.

Water sector

WILL THE RISING TIDE OF CAPITAL DELIVERY LIFT ALL BOATS?

Water companies are facing intense public scrutiny and supply chain challenges in both cost and availability. Against this backdrop, the task to deliver record capital programmes for AMP8 (regulatory period for English and Welsh water companies covering 2025-2030) becomes even more acute. Whether water companies can rise to the challenge will require careful navigation to satisfy all stakeholders.

SECTOR OUTLOOK AND SCALE OF DELIVERY

The water sector in England and Wales is experiencing a tough time. Calls for increased investment, cries that our rivers are hazardous to public health and attacks that those in positions of authority are not up to the task have grown into a wave of public and political opinion demanding change.

Few contest the cause of the current situation, historic under-investment leading to aging infrastructure and high gearing means money is used to service debts and is diverted away from upgrading the network, leading to poor performance.

The weighted average gearing across all UK water companies is currently 68.5%, while their combined debt levels are over £61bn[1]. Over 50% of this debt is index linked and while customer bills are also tied to inflation, which can offset this problem, sustained high inflation results in more money being diverted to service debt. However, another issue is that bills may not rise as fast as debt, causing liquidity problems as witnessed with Thames Water earlier this year.

The overall size of the AMP8 obligations is dependent on finalised public sector regulation and price setting approvals. It is widely anticipated that the next regulatory asset management period – AMP8 will be on an unprecedented scale with some estimations that the capital expenditure could be twice that of AMP7.

In addition to the Capital Programmes, RAPID (Regulators' Alliance for Progressing Infrastructure Development) is also pushing forward 14 Strategic Resource Options[2] schemes valued at £13bn (2020-21 price base) with construction of these starting mid-late AMP8.

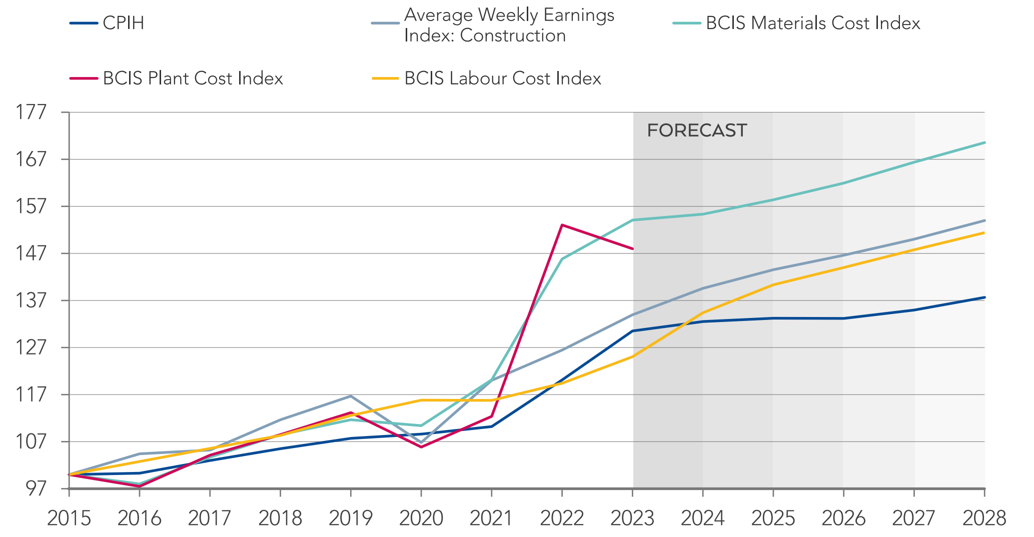
PRICE FLUCTUATIONS

As has been widely reported and experienced, significant inflation has affected all sectors. While water companies can increase customer bills in line with inflation, the regulatory mechanism for this is through CPIH. However, actual prices for construction costs have seen increases far in excess of the CPIH measure. Between 2015 (ie the beginning of AMP6) and 2023, CPIH inflation measured 31%, yet materials (typically accounting for 40-50% of overall project costs) have increase by 54%. Over the same period, labour (which accounts for 40-50% of overall costs) has only seen an increase of 25%. However, looking forward to mid AMP8, current forecasts show all cost elements will significantly outstrip CPIH inflation. This further exacerbates the challenge to deliver significantly larger portfolios.

SO HOW CAN THE WATER SECTOR SUCCESSFULLY DELIVER THE INCREASED OUTPUTS OF AMP8 WITH A SHRINKING SUPPLY CHAIN?

The imperative mitigations might include strengthening the supply chain (retaining incumbents, re-engaging former suppliers, attracting new entrants etc) and smoothing the demand (working to avoid pinch-points through planning and innovative procurement). This includes having open, clear and consistent communication with the supply chain, sharing

RELATIVE MOVEMENTS OF INFLATION INDICES FROM THE START OF AMP6



1 https://www.ofwat.gov.uk/wp-content/uploads/2022/12/MFR_2021-22.pdf
2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873100/National_Framework_for_water_resources_summary.pdf

prospective procurement pipelines and a commitment to ensure that risk is apportioned to the party that is best placed to manage it. This enables effective commercial relationships and sets the right foundation to undertake strategic supply chain management.

ACQUIRING BENEFITS THROUGH SUPPLY CHAIN MANAGEMENT

Water companies can approach this unilaterally, with individual clients engaging the market directly and competing for resource. However, this strategy perpetuates the status quo of trying to 'beat the market', putting stress on the supply chain and other fellow clients in the sector. Rarely does the first-to-market buyer succeed in retaining a suppliers' A-team due to the pressures on contractors to secure turnover and seek better margins offered by latecomer buyers. These latecomer buyers, however, are themselves unable to negotiate or impose low rates in a constrained market.

Instead, water companies can leverage their buying power through collaboration and co-operation. By strategically planning their demand and procurements, they can make capital investment more efficient for investors and shareholders while delivering the benefits demanded by society. Simple acts such as providing pipeline visibility and giving certainty of opportunity can also help grow the resilience of the supply network.

CONCLUSION

The water sector is constantly under intense pressure to perform, and it appears that the challenge is set to grow in future AMPs. While there is potential capacity within the industry – be that in professional services, construction firms or the education system that replenishes the workforce – there is evidence that people are turning their back on the water sector. The question is, how can client organisations rekindle the fire and reignite the appetite for people and organisations to engage with the sector?