

Item No. 10.	Classification: Open	Date: 5 February 2024	Decision Taker: Audit, Governance and Standards Committee
Report title:		Southwark Construction - Retrospective contract variations	
Ward(s) or groups affected:		Camberwell Green, Peckham Rye, East Walworth Ward, Old Kent Road, North Bermondsey, Rotherhithe, Newington.	
From:		Managing Director, Southwark Construction	

RECOMMENDATIONS

1. That the Audit, Governance and Standards Committee note that the current governance process that is in place is not wholly aligned to the construction routes being undertaken nor are they aligned to the current construction contracts which are the overriding legal context to which the council (the employer) needs to adhere to with the Contractor. Thus the Audit, Governance and Standards Committee note that Southwark Construction has sought to exercise contract standing orders clause 6.7 to confirm additional costs, following their initial approvals as per the relevant JCT building contract, so as not to unduly delay the works on site and risk incurring additional costs as a result.
2. That the Audit, Governance and Standards Committee note the actions taken by the Southwark Construction as set out in paragraphs 20-22 to review and enhance the operational and governance arrangements for new build projects to mitigate against the risk of incurring additional unforeseen costs within their building programme in the future.
3. That the Audit, Governance and Standards Committee note that Southwark Construction will move to a centrally managed contingency fund that covers all programme schemes, or sectional part thereof, such that localised spend is prevented and, instead, a more stringent route to managing contingency spend is established. This is likely to incorporate higher levels of control whereby the Managing Director of Southwark Construction will need to satisfy themselves that any additional call for expenditure has been thoroughly checked and tested with a view to cost prevention and only when that has been exhausted that a recommendation for use of the global contingency may be passed to the Strategic Director for final approvals. An expenditure monitoring tool will be established accordingly.

BACKGROUND INFORMATION

4. As part of the Council's strategy to deliver 11,000 new homes by 2043, Southwark entered into JCT Design and Build Contracts to deliver on the Corporate Delivery Plan target to achieve 2,500 new homes on site by May 2022, one of the most ambitious programmes of any local authority.
5. Since August 2018 this has meant there have been between 30-50 live schemes on site at any given time and a total investment programme of £1,792m over 15 years to seek to meet local housing need. To date the programme has delivered 1,516 homes, which includes 1,401 social rent homes and 115 intermediate rent, benefited from £254.8m grant funding as well significant investment in wider community benefits.
6. The procurement of contractors to deliver new homes adheres to the council governance procedures through gateways and approvals in line with the Housing Scheme of Management. In addition, the programme has a range of monitoring and programme governance to ensure effective management. This report is required to comply with CSO 6.7.1 in relation to retrospective approvals whereby an approval to a contract variation was not sought at the time and has an estimated value of more than £100,000.
7. This report sets out the circumstances and manner in which the decision was taken and sets out a number of considerations for the purpose of obtaining guidance to inform future decision making. In summary, the reasons for contract variations sought retrospectively are;
 - a. Within JCT contracts once it has been determined that a variation is not the contractor's liability i.e. a 'relevant matter', the contractor will be entitled to make a loss and expense claim under the JCT contract for any delays and costs incurred, which is in addition to the cost of the change. Any loss and expense claim will include preliminary costs, including overheads and inflation which are charged on a weekly basis.
 - b. Prior approval of a variation would necessitate stopping works on the live sites, pending approval. This would have incurred further delays, costs and potential compensation claims from the contractor (a worked example is noted in paragraph 13).
8. The majority of schemes within the programme started on site within a 2-3 year period, thus a number of contract variations have occurred within a similar timeframe as schemes experience some similar issues during broadly the same period which is the reason for a cluster of 13 Gateway 3 reports documented in Table 1, either approved or pending approval. In each instance the following has

been undertaken prior to taking forward a Gateway 3;

- a. Check and challenge between council and professional services; all variation requests received from the contractor are thoroughly reviewed by the quantity surveyor/employers agent and a further review is then carried out by the project delivery team. Once the Strategic Lead is satisfied that the cost is a legitimate variation, a change management form is completed by the project manager for approval by the Strategic Lead or the Managing Director of Southwark Construction in accordance with the Scheme of Management.
- b. There have been a number of instances across schemes in the programme where variations have been reviewed, reduced and/or refused. Table 1 highlights schemes within the report where variations have been reviewed, reduced and/or refused.

Table 1 – Examples of reviewed variations on schemes			
Variation Description	Initial variation from contractor	Proposed amount varied following the review	Reduction
Loss and expense as a result of delays and variations	£3,057,843	£2,243,589	£814,254
Ground contamination	£1,500,000	£1,309,596	£190,404
Additional design and construction	£2,300,000	£1,519,908	£780,092
Loss and expense as a result of delays and variations	£796,878	£166,211	£630,667
Loss and expense as a result of delays and variations	£360,000	160,000	£200,000
Total	£8,014,721	£5,399,304	£2,615,417

- c. Where a GW3 report is required, (for sums over the allocated contingency allowance) supplementary advice is obtained from finance, procurement and legal. Where necessary, cabinet approval has been sought for budget variations in advance of Gateway 3 reports, to ensure projects remain in budget.

9. The schemes in Table 2, are GW3 reports that are approved or pending retrospective approval via the GW3 governance requirements. Those schemes noted as 'pending' are currently in draft and in the GW3 process. The schemes are collated within this report for ease of reference.

Table 2 – Approved and pending retrospective approval reports via the GW3 governance requirements.				
Date Approved OR Forward Plan date	Scheme	Reason for variation	Estimated value of GW3 retrospective contract variation	Summary of variation
Dec 2023 <i>Approved</i>	Rye Hill Estate	Site remediation	£661,790	Utility cable discovered on site. Ground investigations and routine topographical surveys had been carried out prior to planning and tendering. There was no wayleave agreement which covered the impacted area. This resulted in a loss and expense claim of £2.2m due to diversion requirements. This variation is executed via a deed of variation.
Nov 2023 <i>Approved</i>	Lomond Grove	Site remediation	£956,116	Site investigations identified chrysotile asbestos material on site. Remediation action was required which resulted in a £1.3m uplift in the contract. An industry standard pre-works survey did not identify the material or estimate volumes of the asbestos material later discovered.
Jan 2024 <i>Pending</i>	Goschen Estate	Site remediation	£1,089,651	Includes extensive remediation works required to dispose of below-ground asbestos discovered outside of those identified in the phase once surveyed at a cost of £940,333. Other scheme variations totaling £1m
Jan 2024 <i>Pending</i>	Albion & Renforth Street	Building Safety requirements	£2,887,002	Specification upgrades to accommodate the council's latest standards including electrical works and evacuation lifts. A large proportion of the variation is due to electrical works with a variation of £2.3m.
Feb 2024 <i>Pending</i>	Ledbury Estate (Development RIBA 3+/4A Architect Appointment)	Building Safety requirements	£1,396,893	In October 2022 cabinet approved a revised total budget of £212m for the Ledbury Estate redevelopment. Whilst the proposals for the Ledbury Estate achieved planning approval prior to 23 December 2022 it was considered, in consultation with the (formerly titled) Cabinet Member for Council Homes and Homelessness, that there was still an opportunity to ensure the tower on

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				the Phase 1 site, in excess of 30m m (block A2), complies with the new two stair core requirement. This formed part of the increase in cost alongside an increase in the main works contract due to inflation. This required a variation of £1.3m for the architect appointment.
Feb 2024 <i>Pending</i>	Flaxyard	Site remediation Building safety requirements	£2,827,254	Service diversions and specification uplifts for supplies, Highways works under s38/s278 and Party Wall works. Variation of contract sum £2,827,254.
Feb 2024 <i>Pending</i>	Manor Place and Braganza	Building safety requirements	£160,169	Variations are due to the delayed period between the previous Gateway 3 report and the start on site. This led to the council requiring security and re-design costs including uplift in windows and sprinkler systems £160,169.
Feb 2024 <i>Pending</i>	Rutley Close	Building safety requirements	£498,251	Additional scheme costs due to uplifts to meet updated fire safety requirements. Loss and expense related to building control delays. Variation of £498,251
Feb 2024 <i>Pending</i>	Haddonfied	Site remediation Building safety requirements	£1,044,996	A series of variations requires including repositioning of the building from the gas main, additional lift maintenance rooms on the roof as per our updated employer's requirement, soil remediation works and additional surface and foul water drainage resulting in a variation sum of £1,044,996.
March 2024 <i>Pending</i>	Meeting House Lane	Site remediation	£809,103	District heating additional pipework from new valve location. Redesign to the combined heat and power. Delays to the UKPN lease agreement retrospective approval of £809,103
March 2024 <i>Pending</i>	Comber House Drying Rooms	Building safety requirements	£1,178,852	A number of items were required to ensure Building Control compliance such as additional installation of Automatic Opening Vents, fire compartmentation walls, sterile ceiling installation and sprinklers.

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Date Approved OR Forward Plan date	Scheme	Reason for variation	Estimated value of GW3 retrospective contract variation	Summary of variation
March 2024 <i>Pending</i>	Henslowe Bessano and Underhill	Party wall requirements	£462,813	Variations related to receipt of necessary permissions and approvals beyond the contractors control, delays in the implementation and agreement of party wall awards and delays linked to boundary wall requirements
March 2024 <i>Pending</i>	Hidden Homes (Bew Court, Grosvenor and Whaddon)	Site remediation Building safety requirements	£262,458	Hidden homes variations as a result of asbestos contamination remediation, insulation and ventilation required and enhanced building safety requirements.

KEY ISSUES FOR CONSIDERATION

10. To meet the council's Corporate Delivery Plan objectives of 2500 new homes the implementation of the council's programme at significant scale and pace is a significant achievement. However, as with all programmes there are lessons learnt, some of which are relevant to this report as it has led to Southwark Construction needing to utilize the retrospective approval route to ensure contractual obligations are met, delivery programmes and associated targets remain deliverable and additional costs to the council are mitigated. The demanding pace at which projects were required to get projects up and running has been a contributing factor.
11. Changes and variations are extremely common in construction projects. As noted in Table 2 a number of schemes in the programme have required variations due to modification of design, quality or quantity or remediation works. For clarity, local variations and adjustments would routinely be funded by way of the scheme contingency fund whereas additional works would be funded by way of additional funding secured via a GW3 submission. The GW3s also include loss and expense claims which are a direct result of the required variations, which all contribute to an increase in the total contract variation sum. Alongside this the typical contingency provision for schemes is around 5%, this is relatively low for construction projects and when faced with unforeseen site specific issues as well as legislative changes and wider economic challenges in the market the level of contingency has been insufficient to be able to manage the changes within the original budget envelope.
12. The time required to undertake the governance process is a key factor in the need to utilise the retrospective approval route, to avoid even further costs accumulating. The current governance approval process requires around 10 weeks from identifying the anticipated variation to obtaining approval for the variation.
13. This is illustrated in Table 3 below which shows the minimum lead in time for governance milestones to be met, for variations over £100,000. It is worth noting that this timeframe does not reflect the time needed for clarifications required through usual check and challenge (both internally and with contractors and professional services) and assumes availability and capacity of all key commentators and decisions makers, including timings of relevant Boards are in perfect alignment.

Milestone	Minimum number of weeks
Confirmation of required variation and drafting of GW3 report	1
Review from Senior Project Manager/Strategic Lead	1

Review from Southwark Construction Programme Office and Managing Director	1
Circulation for comments from finance, legal and procurement	1
Reporting to DCRB	1
Reporting to CCRB	1
Amendments following CCRB	1
Lead Member Briefing	1
Concurrent from finance, legal and procurement	1
Notice of publication and approval	1
Total	10 weeks

14. A worked example of the financial implications is as follows, based on a contract value of £6m. The weekly contractor prelims with overheads and cost around £12,000 per week. A 10-week delay of a decision over £100k could result in the additional cost of £120,000 per variation (if this variation is on a critical path on the programme). As noted, a GW3 approval of a variation to the contract (CSO 6.6) is required for all variations with an estimated contract value over £100,000.
15. The majority of the schemes in the programme achieved planning approval a number of years ago and since then, there have been a series of changes in building regulations and fire safety guidance. This has resulted in the council being required to amend specifications and designs to meet the new or enhanced requirements.
16. Southwark Construction takes all necessary steps to ensure due diligence and best practice. In the two most recent audits in relation to the new build programme monitoring and cost controls conducted by the council's external and internal auditors, Grant Thornton and BDO respectively, both audits concluded that there were no material recommendations for improvements.
17. Further to all the considerations already outlined, schemes within the programme have started on site during a period of high inflation, increased construction costs, material and labour shortages and other factors compounded by the Covid-19 pandemic. The impact of COVID-19 was that schemes were limited in labour on site and as a result all programmes were extended in time. This meant additional costs by way of overheads and preliminaries (equipment, labour, and materials).

KEY ACTIONS

18. The GW3 approvals noted in this report are a result of a number of internal and external factors that have been outlined and the rationale for the retrospective mechanism illustrated. The overall value of variations is significant, however should be considered in the context of the overall level of investment and the relatively short timeframe in which the council has successfully initiated and implemented its direct delivery function.

19. Southwark Construction has taken, or is in the process of taking, the following key actions;

20. Review of contingency provisions and associated governance process

- a. It is recognised that the governance process is established to work across the council, however the process that is in place is not wholly aligned to the construction routes being undertaken nor are they aligned to the current construction contracts which are the overriding legal context to which the council (the employer) needs to adhere to with the contractor. This, on occasion, may become more complex as the council is reliant upon independently appointed representatives (Employers Agents) whom will seek to interrogate applications for payment and duly certificate those agreed payments at which point the payment becomes due.
- b. With the increase in build costs, inflation, enhanced building regulations and building safety requirements it has been identified that the contingency provision provided to manage the contracts within this report requires further review. It is proposed that Southwark Construction will move to a centrally managed contingency fund that covers all programme schemes, or sectional part thereof, such that localised spend is prevented and, instead, a more stringent route to managing contingency spend is established. This is likely to incorporate higher levels of control whereby the Managing Director of Southwark Construction will need to satisfy themselves that any additional call for expenditure has been thoroughly checked and tested with a view to cost prevention and only when that has been exhausted that a recommendation for use of the global contingency may be passed to the Strategic Director for final approvals. An expenditure monitoring tool will be established accordingly.
- c. For future schemes, contingency of between 12% - 15% of the contract sum will be considered on a scheme-by-scheme basis to provide a more realistic cover for unforeseen events, thus reducing the need for a contract variation approval. This will also help to mitigate the risk of the council over committing resources and borrowing capacity to the programme.
- d. Whilst the current £100k threshold for the procurement and governance process is understandably a sizeable value, in the context of capital schemes this could be reviewed alongside alternative assurance measures that could enable a more streamlined approval route which seeks to avoid the need for retrospective approvals being required to such a degree.
- e. There are schemes in programme (mostly on site and nearing completion) which are not covered in this report but may also be at risk of cost increases for

the same sort of issues and reasons mentioned in this report. As such the timescales involved in adhering to due process may present additional costs pressures to scheme and in which case the retrospective approach mechanism may be utilised.

21. Applying lessons learnt

- a. Increased pre-tender site investigations: It has been identified that a large a large proportion of the additional costs for contamination etc. has been a result of the industry standard site investigations. The new programme accounts for an enhanced approach to intrusive surveys that are being carried out to identify and mitigate site risk. This includes the instruction of phase two intrusive surveys.
- b. Increased use of two-stage tenders. Two-stage tenders which include a pre-construction services agreement (PSCA). Enables Southwark and contractors to limit any site and design risk before entering into the main contract. This was utilized on Bells and Lindley and Sceaux Gardens which were recently paused due to budget pressures, the two-stage tender approach enabled the council to withdraw from progressing to main works.

22. Contract management

- a. Southwark Construction will continue to robustly monitor budget management and cash flow and project and programme level. Southwark Construction uses PAMWIN, an industry standard financial monitor software as a tool to oversee project performance. Should it be identified that a large proportion of the contingency is required to be drawn, this will be flagged as part of the risk monitoring in the monthly project reviews.
- b. To support this an enhanced training programme is being developed for all staff of Southwark Construction on effective contract management and working with employers agents. This includes contract dispute resolution.
- c. Robust and clear guidance on governance procedures were also developed last year by the Southwark Construction Programme Management Office, with clear guidelines of when decisions are required, forward planning and key decision dates, all which aims to support wider improved governance reporting.

Summary

23. Officers within Southwark Construction have discussed and agreed on the actions and conclusions, as set out above.

Policy framework implications

24. There are no policy implications arising from this report

Community, equalities (including socio-economic) and health impacts

Community impact statement

25. This report is not considered to contain proposals that would have a significant impact on any particular community or group

Climate change implications

26. There are no climate change implications arising from this report

Resource implications

27. There are no resource implications arising from this report

Legal implications

28. There are no legal implications arising from this report

Financial implications

29. As noted in paragraph 8 of this report

Consultation

30. There has been no consultation on this report

SUPPLEMENTARY ADVICE FROM OTHER OFFICERS

Assistant Chief Executive (Governance and Assurance)

31. Contract Standing Order (CSO) 6.7 requires that in the event of an activity being commenced other than in compliance with CSOs, it may be necessary to seek approvals retrospectively, and in such case the procedures in relation to the gateway report (in this case – the gateway 3 variations reports) should be followed as soon as possible. In addition, where the decision relates to a variation/s with an estimated value of over £100,000 a report should be presented to CCRB and to the audit, governance and standards committee, setting out the circumstances and manner in which those decisions were taken, for the purposes of obtaining guidance to inform future decision making.

32. Paragraph 9 set out those retrospective decisions made/to be made in relation to a number of the New Homes projects, and the key actions (set out in paragraphs 20-22) which Southwark Construction have taken or is in the process of implementing to avoid future retrospective approvals.

Head of Procurement

33. The report has been reviewed and commented on by the Procurement Advice Team.

34. Contract Standing Orders set out the actions that are required that in the event of an activity being commenced other than in compliance with CSOs but it may be necessary to seek approvals retrospectively, and in such case the procedures in relation to the gateway reports (gateway 3 variations reports in this case) should be followed as soon as possible, together with reporting to boards such as CCRB.

35. Processes and arrangements for managing construction spend and processes, whilst adhering to the council's governance requirements are possible with some process accommodations that support timescale and planning, in addition to regular and timely engagement, as is noted in paragraphs 18-22 of the report on the actions being taken or planned as part of this planning to avoid the need and any future retrospective approvals.

BACKGROUND DOCUMENTS

Background Papers	Held At	Contact
None		

APPENDICES

No.	Title
Appendix 1	GW3 Contract Variation Rye Hill Estate
Appendix 2	GW3 Contract Variation Lomond Grove

AUDIT TRAIL

Lead Officer	Stuart Davis	
Report Author	Nannette Sakyi	
Version	Final	
Dated	18 December 2023	
Key Decision?	No	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	Comments Sought	Comments Included
Assistant Chief Executive, Governance and Assurance	Yes	Yes
Strategic Director of Finance	Yes	No
Procurement Advice Team	Yes	Yes
Cabinet Member	Yes	Yes
Date final report sent to Constitutional Team		24 January 2024