DAVIS LANGDON

THE IMPACT OF THE 2012 OLYMPICS
Inflation and procurement

Report One | March 2006

EXECUTIVE SUMMARY

This report assesses the potential impact of workload associated with the 2012 Olympic Games on construction cost inflation and upon the procurement of projects in the UK during the period 2007 – 2012.

Davis Langdon's assessment is that...Olympics associated workload will add a further 1 to 2% to current inflation trends...equating to an average inflation rate of 6% from 2008 onwards.

In terms of overall workload, the Olympics represents 1.2 – 1.6% of new build construction output, which in isolation does not represent a substantial challenge to the industry. However, workload in other sectors, including civil engineering, retail and commercial offices will be on an upward curve in the run up to the Games, and as a result, there are likely to be inflationary and other pressures driven by the combined level of workload. In particular, the large number of high value projects that will emerge over the next five years will challenge the management capability of the industry.

Davis Langdon's assessment is that over the period 2007 – 2012, Olympics associated workload will add a further 1 – 2% to current inflation trends, equating to an average inflation rate of 6% from 2008 onwards.

Outside of London, we forecast that average inflation over the period will range 4.5% to 5.5%.

At this stage we anticipate that there are likely to be price spikes during late 2007/2008 and in 2010 as event-driven, private sector projects come on stream.

The effects of the Olympics will be felt beyond the impact of individual project costs. In particular, the risks that clients should be aware of include:

> The availability of high quality contractors' teams for major projects

> The potential for individual project failure given the constraints on management and labour resources

> The potential for a short-term break down of competitive conditions in the market, driven by contractors having temporarily secured sufficient workload in the run-up to 2012

> The risk that projects perceived to be unattractive by contractors will struggle to achieve either competitive or properly resourced bids.

> The risk of location specific cost hikes due to local concentrations of workload, requiring additional site management, increasing competition for labour, and complicating site logistics

In summary, we do not currently anticipate that the 2012 Games will result in industry-wide step changes to price levels, but that spikes may occur around a general inflation trend of 6% per annum. However, in order to secure successful outcomes, clients will need to take steps to ensure that their projects are packaged appropriately, or that long term commercial relationships are in place, to secure both competitive bids and high quality delivery teams.

In absolute terms, the size of the Olympic programme is not sufficient to drive an inflation step change in the run up to 2012.

The 2012 Olympics and UK construction capacity. The total value of construction set out in the UK Olympics bid book is £9.9 billion. This cost is at 2004 price levels and excludes inflation, which over the programme, is likely to add a further £1 billion to the costs of projects yet to be completed. As the design develops, these costs will be subject to refinement and potential upward pressure. However as the initial design stages of Aquatic Centre have demonstrated, the Government and the Olympics Delivery Authority are strongly focused upon delivering the project in line with stated cost, programme and quality targets.

From the point of the view of inflationary impact, the key issues to assess are the overall value of the programme relative to the capacity of the industry, the ability of the industry to accommodate growing output, the timing of the development programme and the impact of other major projects between now and 2012.

The value of the programme and industry capacity. Expressed at 2004 price levels, the total outstanding expenditure including inflation on Olympics 2012 is approximately £5billion. The bulk of this expenditure will occur during 2008-2011, and during this period, the annual addition to construction output is likely to range from £700million – £1.2 billion. Annual expenditure on the Olympics is therefore likely to be equivalent to 1.2 – 1.6 % of the total value of new work in the UK.

By way of comparison, expenditure on the £4.2 billion Heathrow Terminal 5 is totalling £500-700 million p.a., and has occurred with only a limited impact on tender prices. Of the anticipated £5 billion Olympics boost, only £2 billion is 'new' expenditure which has not previously been factored into long range work load and inflation forecasts.

Available capacity – the national perspective. Whilst the size of Olympic expenditure is small relative to overall output, the capacity of the industry to absorb growth without triggering excessive inflation is a key to this analysis. Our construction industry is dynamic and, in current prices, the value of new build output has increased by nearly £20bn over the four years to the end of 2004. In real terms this represents an annual growth rate of 3.3%, significantly in excess of the long-term rate of 2.2%.

3.3% growth represents £1.9bn of extra construction per year at today's prices, demonstrating that, in the normal course of events, the additional construction output associated with the Olympics would be absorbed without significant disruption to markets and levels of tenders. Inflation since 2000 has ranged from between 3% to 7%, compared to a 30 year average of 5.3%. The current year-on-year rate is 4.0%, at the lower end of the range and below the long-term average, caused by a fall in output during 2005. This indicates that there is currently some headroom for increases in workload. Further evidence of available capacity can be found in data on regional performance set out overleaf.

On the basis of the quantity of work, available capacity and long term trends, we do not believe that the Olympic Games programme represents, in isolation, a major threat to inflation levels affecting general construction. Civil engineering and infrastructure work could be subject to more substantial inflationary pressures.

Available capacity in London and the South East. The London new build market was worth £8 billion per annum in 2004 with output in London and the South East totalling £16 billion in the same year. The projected annual Olympic-related spend of £700 million – £1.2 billion is equivalent to between 9-15% of London activity. However output in London is currently over £1 billion below levels recorded in 2002, which illustrates how much more volatile workload levels are at a regional level and how resources can be mobilised to deal with local demand without affecting price levels. However, the cyclical nature of regional workload suggests that there will be periods during the development programme when the Olympics will be competing head on for resources in a rising London market and short term local price fluctuations and resource pressures are likely to result.

For the General Contracting sector these effects will be mitigated by the relatively low proportion of general building work associated with the Olympics, totalling around £1.4 billion spread over seven years. This represents around 2% of London construction output. By contrast, the remaining £3.6 billion budget for Infrastructure and Civil Engineering represents 55% of the value of typical London infrastructure expenditure over the development period and represents a far more significant output spike.

Given that other major civils projects including the East London River Crossing and M25 road widening will be competing for resources with Olympics-related civil engineering and infrastructure projects such as the East London Line extension, costs of these works will be under the greatest pressure.

The timing of the Olympic development programme and other workload. The detailed design, procurement and construction programme will not be determined until the Games Programme manager is in place, but it is reasonable to anticipate that the impact of the games will be felt as early as 2007/2008, when procurement of infrastructure and long-lead in capital projects is likely to commence in earnest. This will probably coincide with major projects in London and the South-East in the office, retail, health and infrastructure sectors. In particular, the timing of lease fall-ins in the City and plans for a number of major retail-led regeneration projects mean that whilst overall output may not grow much faster than current trends, there will be a substantial number of projects chasing contractors' 'A' teams over the next 2-3 years. In addition to these projects, the coming of the Olympics will drive development in sectors related to tourism and culture.

The hotels sector will no doubt seek to increase capacity and there is also evidence that public sector bodies in the Arts and Leisure sectors will use the Olympics and its associated cultural programme as a lever to accelerate the completion of planned capital projects. Whilst most of these schemes will not be of a size to disrupt price levels, it is probable that some of these projects, notably high risk refurbishment or one-off cultural projects may struggle to attract competitive bids. Getting projects to market at the earliest opportunity may not help to obtain particularly competitive pricing but will be important in securing good quality project teams.

Impact of major projects between now and 2012. The issue with major projects is primarily one of whether workload is likely to be higher in the run-up to the Olympics. Workload in the South-East since 2000 has been characterised by a number of mega-projects including Heathrow T5, White City and Wembley Stadium. These projects, along with a substantial baseline public sector workload, have contributed to the buoyant market conditions and high levels of output referred to previously. Our assessment of prospects for major projects in the run – up to the Olympics is summarised in the table below, which shows that up to 2012, major project workload in the South-East, excluding the Olympics, is at a similar level to that experienced since 2000.

Anticipated Projected Project Workload in London and the South East (Major schemes only)

Period 2000-2007	Value (£ billion)	Period 2000-2012	Value (£ billion)
Heathrow T5	4.2	Heathrow East	1.5
CTRL ph2	3.5	City Office Towers	1.2
White City	0.7	London PFI Hospitals	2.0
Wembley Stadium	0.7	Kings Cross	0.7
Arsenal Stadium	0.3	Stratford City	2.0
		Thames Gateway Residential (London only)	1.0
		Retail Regeneration schemes in Stevenage, Bracknell, Croydon etc	1.0
Total	£9.4 billion	Total	£9.4 billion

This analysis supports the following conclusions:-

Tender price inflation will be in excess of the long-term trend, but is not anticipated to reach the high levels experienced in the run-up to the millennium or during the 1980s development boom.

Competition for good quality teams will be a key issue for clients.

There is likely to be sufficient large-scale, well packaged work to potentially make it difficult to procure the more complex and high risk projects.

In addition to a healthy workload in the South-East there are a number of large schemes in the regions including large hospitals in Edinburgh, Birmingham and Manchester, together with major retail projects in Birmingham, Leicester, Nottingham, Sheffield and other regional centres. With workload in the regions presently at high levels – particularly in the South-West, North West and Yorkshire and Humberside this means that there is likely to be a sufficient workload in the regions to keep regionally based subcontractors and labourers busy in their core local markets, further increasing pressure on the London market directly affected by the Olympics.

There will also be further Olympics development outside of London related to the provision of training camps and the enhancement of tourism facilities.

Davis Langdon's Spring 2006 Olympics Tender Price Forecast is that the average inflation trend will increase to 6.0% during the run-up to the Olympics commencing in 2007.

The initial impact of the Games programme on inflation in 2007/2008 could be substantial, particularly with benign levels of inflation of 4.1% currently forecast for 2006. The initial increase in inflation could be even sharper if spend on the first Olympics phases is combined with a rapid recovery in commercial and infrastructure workload.

Our forecast is currently for a straight line 6% increase per annum. Once a programme has been established it will be possible to forecast in more detail the timing of peaks and troughs. At this stage we anticipate that there are likely to be price spikes during 2008 and in 2010 as event-driven, private sector projects come on stream. Beyond 2007, no detailed economic forecasts have been published for this period and the index represents a broad trend in inflation rather than an assessment based on known workload.

Due to the healthy levels of workload that are expected to be seen in the regions, we anticipate that tender price inflation outside of London will be generally in the range of 4.5% to 5.5%, albeit that localised hot spots may occur over the period, as they have in locations such as Manchester and Liverpool over the past few years.

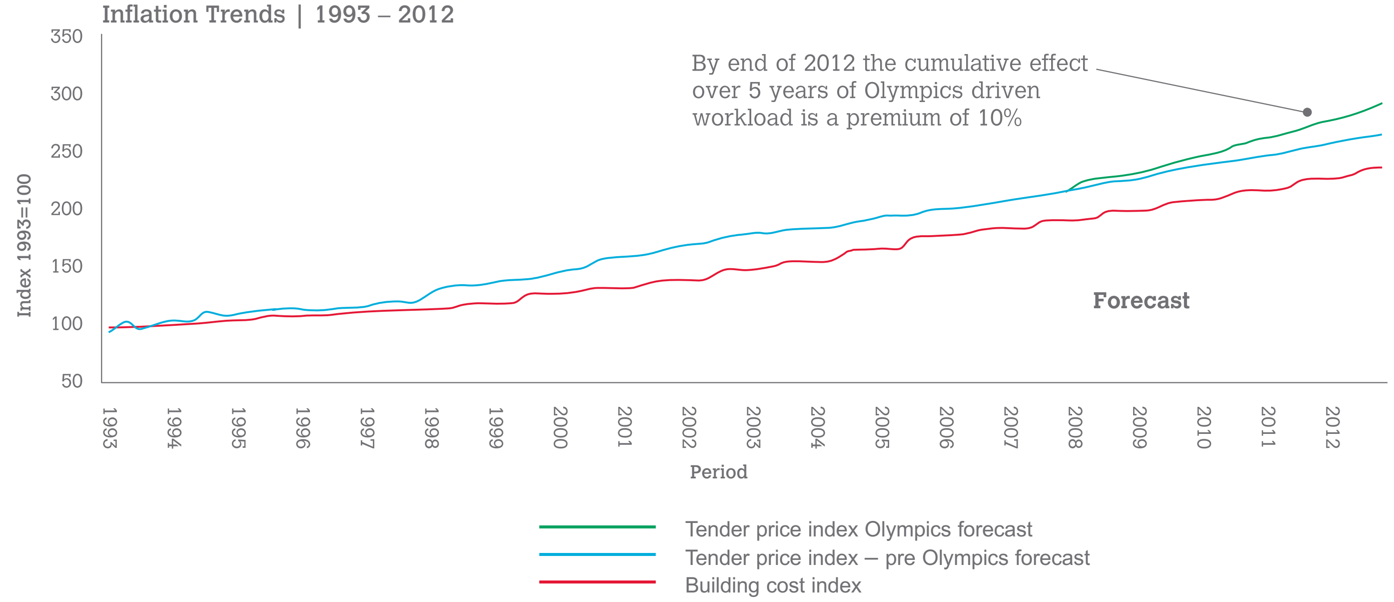
Long term tender price forecasts from Davis Langdon and BCIS are set out below together with a graph illustrating the long term tender price inflation trend.

Long-term tender price forecasts | Year on year change at 1st Quarter

	2005	2006	2007	2008	2009	2010
Davis Langdon (1 Q 06)	4.3%	4.1%	4.8%	6.1%	5.9%	6.1%
BCIS (August 05)	4.7%	5.4%	6.0%	6.4%	6.0%	n/a

Source – Davis Langdon, BCIS 5 Year Forecast 2005

Inflation Trends | 1993 – 2012



It should be noted that Davis Langdon's forecast relates to the London market, whereas BCIS forecast mean UK tender price inflation. Furthermore, until more detailed programmes for the works are known, it is difficult to assess the timing and scale of the impact of the Olympics and associated workload.

The key assumptions on which our forecast is based include:

> Output. Static or falling new build output in 2005/2006, followed by growth of 3-3.5% driven by infrastructure and private/public non-residential construction.

> Availability of resources following the completion of major projects in the South East including T5 and CTRL.

> That no major oil price shock occurs.

> The number of major projects undertaken in the South East in parallel with the Olympics will not represent a significant increase in current resource requirement. Effectively T5, CTRL, White City and Wembley will be replaced but not exceeded by future work at Heathrow, Stratford City, Barts and London Hospital, Thames Gateway etc. and that the Olympics will represent the prime source of increased demand. This assumption needs to be carefully monitored if other major projects begin to emerge.

> That construction of CrossRail will not proceed ahead of the Olympics.

Problems with the achievement of real competition between contractors large enough to take on major projects could affect the London and South East market in the run up to the Olympics.

Competitive pressure. In the current London market there have been recent instances where contractors with relatively full order books have chosen to submit bids on the basis of substantially increased margins. These bids have had a significant impact upon project budgets. This trend is partly a result of agglomeration of contractors in the major projects market, where there are not enough contractors to ensure that all tenderers are competing fully on each bid they submit.

Similar pressures could result in additional problems in connection with ensuring competitive bids from the supply chain in 2nd stage tender procurement.

The concentration of a number of very large projects in single locations is further source of potential price pressure. In addition to increased inflation, other cost drivers in these instances will include more complex site management, disruption to access and logistics caused by pressure on the local infrastructure, together with some potential for additional upward pressure on labour costs between competing sites.

Stratford itself could be vulnerable to this pressure, and the likelihood of further price hikes will become clearer as the scope and programme of co-located projects is firmed up.

Project delivery risk. In addition to the risk of cost inflation, clients should also recognise that constraints on the availability of management and other key resources could lead to problems on projects once they get on-site.

Clients may not be able to secure the quality of bid and team that they would expect in the run up to the Games. The effects of this could be long-term in relation to the quality of construction secured but may also affect construction costs and programme. Poor bids may be more qualified than usual and lower quality teams may also be less able to respond to delay and disruption on projects and thereafter to mitigate and agree the cost impact of such problems. In the run-up to 2012, clients proceeding with projects with unfamiliar teams should review their capabilities carefully to ensure that the appropriate level of skill and experience is in place.

PROCUREMENT IMPLICATIONS OF THE OLYMPICS

The run-up to the 2012 Olympic games will be accompanied by a large number of event driven projects at all levels of the market. Clients with small, low profile or high risk schemes need to ensure that their projects are appropriately set up to secure competitive prices and good quality contractors.

Workload. We believe that the 2012 Olympic Games will result in the acceleration or initiation of a wide range of projects from both the private and public sectors. This will affect all levels of the market as the projects will not be limited to the headline schemes. Our expectation is that the initiators of smaller, low profile schemes may struggle to secure interest and competitive prices in a buoyant market place.

Resources. The foregoing analysis examining the relative size and impact of the Olympics suggests that the projects are not large enough in themselves to result in a noticeable impact on labour and materials availability. Experience of Heathrow T5 is valuable in this respect, in that the volumes of building materials such as steel and concrete have been exceptional, (80,000 tonnes of steel, 150,000 tonnes of rebar, 1.5million m^3 of insitu concrete) but have not compensated for falling demand elsewhere in the region.

However, there are some commentators, the Engineering Construction Industry Association (ECIA) for example, who are forecasting that any skills shortage will be more severe than previously forecast due to growing international competition for labour and the slow replacement of an ageing UK workforce. ECIA's particular concern is the widespread replacement of power generating plant with future global investment in oil and gas projects estimated to be worth more than £3,500 billion over the next 25 years.

A further area of risk that needs to be considered is wage agreements for operatives. Some sabre rattling has commenced from the construction unions and there is likely to be a concerted effort to get a London-wide deal at an enhanced rate, similar to that which has applied to the T5 Project. Given the level of self-employment and widespread use of European labour, this may not succeed. However, premium wages at the top sites may have a knock-on effect on sites elsewhere.

We anticipate that the major resource constraint will relate to management skills. A key issue will be the degree to which the management core from major projects such as T5 is lost to other projects ahead of the Games. Mace for example is planning to expand its role in the road and rail sectors to utilise expertise derived from Heathrow.

The 2012 Olympics do not represent a huge increase in construction output. We believe that price increases will be contained within 1-2% of previously forecast levels. Average annual inflation will reach 6% in 2008.

CONCLUSION

The industry has demonstrated the ability to absorb and deliver a range of major projects including T5, Wembley Stadium and CRTL. This evidence indicates that there is enough available capacity in the region to deliver the Olympics without significant market disruption. At this stage we can find no evidence to suggest that available capacity will be overloaded by general contracting work associated with the Olympics.

However, workload demands for Civils projects associated with the games are large relative to typical workload and capacity in London and the South East – this could be an area of risk.

One aspect of controlling inflation during the construction phase of the Olympics will be in making projects attractive in terms of size and duration, profile and risk, Complex, one-off or high risk projects could struggle to attract competitive bids and as a result localised tender price inflation may result during the run-up to the games.

If you would like to discuss the details of this report further, please contact Simon Rawlinson or Peter Fordham of Davis Langdon's Cost Research Team.

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