

23rd June 2008

REPORT BY DIRECTOR OF TECHNICAL SERVICES

SBc CONTRACTS TRADING OPERATION

1 Purpose of Report

- 1.1 To update the members of the Trading Operations Sub Committee on the 2007/08 financial year outturn of the SBc Contracts trading operation and an update on current issues for 2008/09.**

2 Matters Arising from previous Trading Sub Committee

- 2.1 There are no matters arising.

3 Background

- 3.1 SBc Contracts is the Council's only Significant Trading Organisation and performs a range of capital and revenue contracted and ad-hoc roads related maintenance and construction work for Network Roads, other SBC departments, other public sector bodies, and a wide range of external companies and private individuals.

4 Business Performance and Update

4.1 Workload:

There is a concern about the overall level of workload which will be available for SBc Contracts in 2008/09. The pressure on workload is arising from a combination of factors, namely:

- 4.1.1 Lack of trunk road work: The level of work we are receiving from BEAR remains very minimal compared with the volumes undertaken previously for AMEY. In 2007/08 we have undertaken only £401,000 of work for BEAR most of which arose from Winter Maintenance and emergency works. In 2006/07 we undertook over £3.6 million of work for the previous trunk road contract holder AMEY. Much of this work involved our surface dressing and surfacing teams and proved to have good profit margins. This effectively means that our trunk road workload has declined by almost 90% year on year with no indication that the position is likely to improve in 2008/09.
- 4.1.2 Roads Capital: The final level of roads client capital budget is not yet finalised but it looks likely to be lower than last year's. This coupled with the need to use much of the available revenue budget to address reactive and routine maintenance issues, is certain to create a shortage of surface dressing and surfacing work. This coupled with a complete lack of any kind of surfacing work emanating from the trunk road sector (see point 4.1.1) means that our dedicated equipment and skilled manpower resources used for this surfacing work will be heavily under-utilised. Options for re-deploying our surfacing manpower resources are likely to be very limited due to the

weakness in the external market (see point 4.1.3)

- 4.1.3 External market downturn: We are already seeing strong evidence of a significant downturn in the level of development activity in private sector construction projects. This is particularly so in the housing sector where we have been an active player for several years. Any downturn in the level of external work secured by SBc Contracts would be very unwelcome as it has been the prime source of profit margin over the past years. Evidence of the slowdown in activity can be seen in the recent actions taken by numerous housing developers across The Borders.
- The large Taylor-Wimpey development at Peebles, where we are a major sub contractor, has been split into two phases and the number of houses started scaled back from four per week to only one per week.
 - Taylor-Wimpey, the developer of the Hopefield site at Bonnyrigg in Mid-Lothian, has decided to delay indefinitely any work on that site due to the weak housing market conditions. This is particularly significant for SBc Contracts as we are understood to be the preferred bidder for the ground-works contract which would have been worth £2.6 million.
 - There appears to be no activity on the Barrett housing development in Clovenfords.
 - We understand that Persimmon are not undertaking any further new housing development work nationally until further notice.

Further evidence of the slowdown in the external market can be seen in Chart 1 which shows the 3-month rolling average value (£) of contracts won by SBc Contracts. Despite a good overall performance last year in winning external work, there has been a marked downturn in contracts won since November 07 and this points towards a likely downturn in external turnover for 2008/09.

- 4.1.4 High Schools Projects: The level of work available from the Borders PPP High School construction projects, where we are a major sub-contractor for Grahams, is now declining as two of these projects near completion. Our work at Berwickshire High School is expected to be completed by mid-July, and our work at the Eyemouth school site should be finished by the end of this calendar year. Finding replacement work for these projects is a key priority, but is likely to be challenging given the weak conditions prevailing within the external private sector construction market. This combination of adverse factors means that our income stream, although broadly based, is under pressure on all fronts during 2008/09.

4.2 **Budget :**

Budget targets for the 2008/09 surplus have increased from 2007/08 at a time when overall workload is in decline and margins are under pressure. This will make 2008/09 a very challenging year.

Considerable cost and profit margin pressure is also being exerted on the SBc Contracts business by the spiralling cost of fuel. As highlighted under point 4.2 of the Fleet Management report to this committee, the cost of all fuels has continued to increase relentlessly over the last year and particularly again over the last weeks. SBc Contracts is a particularly heavy user of DERV and Gas Oil.

In 2007/08 SBc Contracts used some 723,830 litres of DERV and some 210,758 litres of Gas Oil. A price rise of 1 penny per litre on these fuels therefore means an additional cost burden of £9.3k per annum for the business. Our 2008/09 plant & vehicle charge-out rates have been established based on the fuel price prevailing at the end of January. Since that time DERV has risen by **13** pence per litre and Gas Oil by **12** pence per litre, effectively creating an adverse fuel cost price movement of around £119,000 per annum at 2007/08 usage levels. The plant and vehicle rates are again in the process of being reviewed and will have to be further increased to take

account of these fuel price changes. This will translate into less work being undertaken on the ground for the available client budgets. The rising price trend also exposes SBc Contracts to higher costs on some major external contracts where plant rates are generally re-negotiated only annually or half-yearly.

4.3 **Review of 2007/08:**

- 4.3.1 Appendix 1 of this report contains the summarised financial outturn for SBc Contracts in 2007/08. Appendix 1 provides an analysis of the variance between the income and expenditure achieved and the Final Approved Budget for 2007/08.

The outcome and financial highlights have been analysed in more detail in the charts attached at Appendix 2 which will be the subject of a short presentation to the committee.

- 4.3.2 SBc Contracts expanded its turnover by over 23% in 2007/08 to reach its highest ever level of £29.73 million (see Chart 2). This exceeded the final approved budget by £2.4 million due to higher than expected workload in the final quarter for SBC capital works and work from external bodies. The additional turnover was achieved with only a 1.4% increase in average employee numbers compared to the previous year. This contributed again to another increase in the value of sales per direct employee which rose by 21% to £140,246 per person (See chart 3).
- 4.3.3 Total income was £2.44 million higher than the final approved budget. This was due to a very strong final quarter with additional turnover being generated from SBC capital works and work for external bodies. The additional work undertaken in the final quarter also resulted in additional costs of £2.44 million relative to the final approved budget with most of the increase due to higher direct materials and sub-contractor costs. SBc Contracts generated 435,417 chargeable labour hours in 2007/08. This was an increase of 5.7% on the previous year. Whenever possible, SBc takes opportunities to sub-contract elements of its workload to local companies. This not only helps the local economy but also enhances our surplus potential; it is the main reason why our revenue has continued to increase at a faster rate than our chargeable man hours. Strong efforts continue to be made to achieve growth through a combination of higher efficiency and appropriate sub-contracting. This can clearly be seen when viewing the changes in turnover against changes in direct manpower as shown in Chart 4.
- 4.3.4 A key measure used by an increasing number of businesses to measure their effectiveness and to benchmark performance is "Added Value per Person". This can be a particularly important measure for an organisation like SBc Contracts which has the dual objective of profit generation (from external clients) and to offer best value (to internal clients) and where profitability (surplus) alone does not therefore give an accurate indication of overall performance. Many organisations are recording their added value rating and aim to improve this value by increasing turnover, improving efficiency and productivity and reducing material costs. SBc has shown a consistent improvement in the added value per direct worker (see chart 5). In 2007/08 this value increased again to reach £63,298. This is an increase of almost 6% on the previous year and forms part of an improving long-term trend. This value compares very favourably with much larger private sector construction contractors
- 4.3.5 The main sources of income in 2007/08 arising from council work across the Borders was, winter maintenance £1,230,428, surfacing dressing of roads £911,550, general lighting maintenance £309,464, grass cutting £241,922 Oxnam Road, Jedburgh £220,215. In total in 2007/08, SBc Contracts performed 1,523 jobs (capital and revenue) for SBC council with an average value of £9,465.
- 4.3.6 The main sources of income in 2007/08 arising from external clients was, Graham Construction £1,990,289, David Wilson Homes Ltd £1,916,715, Graham HQ £1,629,928 Kenmore Homes Ltd £1,176,115 and Tweed Homes £1,104,610.

In total in 2007/08 SBc Contracts performed 853 non SBC council jobs with an average value of £18,369.

4.4 Resources & Operational Issues:

Our construction waste re-cycling facility at Langlee is now fully operational and expected to make an increasing environmental contribution this financial year by re-cycling, and re-using a range of construction project waste materials which would otherwise have gone to landfill.

Plans are also being actively considered for developing a small scale concrete production facility at Langlee which will also help to use some the recycled aggregates being produced there. Such a facility would cut down travel costs for SBc Contracts vehicles and other private contractors who presently have to travel to Kelso to pick-up relatively small quantities of ready mixed concrete.

4.5 Staffing:

Current staffing levels will need to be very carefully monitored in view of the internal and external work availability pressures. With limited availability of roads capital funding and the minimal trunk road workload, both of which would normally generate work for our surface dressing and surfacing squads, we will be facing a significant under recovery on our surfacing plant and an under utilisation of the skilled labour team dedicated to surfacing type work. The downturn in the external construction market means that re-deployment to alternative external construction projects is not a viable option at this time.

SBc Contracts currently has 214 manual workers in place against a budgeted establishment figure of 228.

4.6 Training :

The installation of our deep manhole unit and pipe section for confined space training at the Langlee site is now complete and in use.

4.7 Health and Safety :

No issues to report at this time.

5 Financial Implications

5.1 There are no financial implications directly associated with this report, except as reported above.

6 Consultation

6.1 The Heads of Corporate Finance, Financial Administration, Corporate Administration, and Legal Services have been consulted and their comments have been incorporated into the report.

7 Equality

7.1 There are no equality issues directly associated with this report.

7.2 There are no rural proofing issues directly associated with this report.

8 Environment

8.1 There are no environmental issues directly associated with this report.

9 Risk Commentary

9.1 There is a risk that SBc Contracts will be unable to meet its 2008/09 budgeted surplus target. A range of mitigating measures as outlined under point 10.1 are currently under

consideration.

10 Future Activities

- 10.1 Management efforts are being directed at reviewing a range of measures to help offset the effects of the downturn in workload described under point 4.1 of this report. This will include measures such as reducing overtime, scaling back on sub-contracting, reviewing overhead expenditure, possible disposal of surplus equipment, and developing additional complimentary income streams from areas such as construction waste re-cycling, external training etc.

11 Summary

- 11.1 SBc Contracts generated a surplus of £292k in 2007/08. A turnover of £29.7 m was also recorded which was the highest ever produced.
- 11.2 In addition to the surplus generated, SBc Contracts also contributed significantly to the local economy by sub-contracting a variety of work worth £6.33 million to a wide range of mostly local businesses.
- 11.3 There is a concern about the overall level of workload which will be available for SBc Contracts in 2008/09. There is a risk that SBc Contracts will be unable to meet its 2008/09 budgeted surplus.

12 Recommendations

12.1 I recommend that the Group:

- (a) **Notes the contents of this report.**
- (b) **Approve the outturn as the final position for the SBc Trading Organisation in 2007-08.**

Approved by

Name	Designation	Signature
Callum Hay	Director of Technical Services	[insert signature]

Author(s)

Name	Designation
Kenny Hastings	SBc Contracts Manager

Background Papers:

ADD AS APPROPRIATE

Previous Minute Reference: