



Subject **Reseal Price Adjustment Index**

Circulation	All Road Controlling Authorities All Regional Councils Auckland Regional Transport Authority (ARTA) Department of Conservation Waitangi National Trust Board Office of the Auditor General New Zealand Contractors' Federation Roothing New Zealand New Zealand Road Markers' Federation New Zealand Association of Consulting Engineers (ACENZ) INGENIUM Local Government NZ	<i>for Action</i> <i>for Action</i> <i>for Action</i> <i>for Action</i> <i>for Action</i> <i>for information</i> <i>for information</i> <i>for information</i> <i>for information</i> <i>for information</i> <i>for information</i> <i>for information</i>
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Introduction

Land Transport NZ strongly advises all approved organisations to:

- review their current approach to the management of cost fluctuation risk in reseal contracts;
- ensure that all future contracts for reseal works (both single year and multiple year term contracts) include provision for price adjustment to account for cost fluctuations from the beginning of the contract; and
- review their use of the cost index for reseal work to ensure that it is being applied as intended¹.

This General Circular also revises advice given to approved organisations in August 2001 (Refer General Circular 01/07 *Reseal Price Adjustment Index*).

The current situation

The cost of bitumen was been relatively stable for several years prior to 2005 but since early 2005 it has risen significantly and has become prone to fluctuation. Attachment 1 shows how the Reseal

¹ Cost indices and their use are described in Appendix F to the Competitive Pricing Procedures (CPP) Manual Volume 1 – Physical Works and Professional Services.

Index² and the New Zealand dollar (NZD) value of Singapore HSFO 180 (high sulphur fuel oil) published by Platts Asia-Pacific have changed since September 2001. The NZD value of Singapore HSFO 180 is one of the factors used in calculating the Reseal Index.

An approved organisation that does not apply cost fluctuation adjustment to its reseal contracts (and passes cost fluctuation risk on to the contractor) may pay more for its reseal work as a result. Passing the risk of inflation on to the contractor gives the client more certainty regarding price, however, the approved organisation may pay a significant premium for that certainty. Approved organisations could find it informative to discuss with suppliers what that premium is likely to be.

In most situations best value for money will be obtained by applying cost fluctuation adjustment to all reseal contracts from the beginning of the contract.

Previous advice

General Circular 01/07 *Changes to the Reseal Price Adjustment Index* was issued by Transfund NZ in August 2001. The previous quarterly index was replaced by a monthly index based on Statistics NZ indices plus the NZD value of Singapore HSFO 180. The previous index had not adequately reflected changes in the cost of bitumen.

General Circular 01/07 stated that:

While still leaving it to the discretion of road controlling authorities to decide whether to allow price adjustment, we recommend the inclusion of the new price adjustment index in all future longer duration contracts. For single season (one year) contracts we suggest that use of the new index be considered.

New advice

This general circular withdraws that advice. We now **strongly advise** approved organisations to ensure that all future contracts for reseal works (both single year and multiple year term contracts) include provision for price adjustment to account for cost fluctuations from the beginning of the contract.

CPP manual requirements

Land Transport NZ's Competitive Pricing Procedures Manual Volume 1 – Physical Works and Professional Services (CPP manual) section 3.6 allows approved organisations to include in contracts a mechanism for contract price adjustment due to cost fluctuation. It does not demand contract price adjustment neither does it specify a particular method.

Appendix F *Transfund Price Adjustment Formula* within the CPP manual provides indices and sets out how these indices (including the reseal index) are to be used.

² This and other indices (and contract cost adjustment factors (CAFs)) are published on the Land Transport NZ website ([Funding manuals and procedures](http://www.landtransport.govt.nz/funding/manuals.html#cpp1)) – (<http://www.landtransport.govt.nz/funding/manuals.html#cpp1>)

The only restriction that the CPP manual places on contract price adjustment for cost fluctuation is a limit on financial assistance for approved organisations. Financial assistance paid will not exceed that calculated using one of the Land Transport NZ indices.

Applying indexation

Best practice risk management indicates that risks that a supplier cannot manage should not be passed to that supplier. In most instances inflation is such a risk. Allowing for cost fluctuation in contracts using the Land Transport NZ cost adjustment indices is the simplest and most practical way to manage inflation risk long term and ensure value for money for approved organisations.

Appendix F shows how to apply indexation. Cost adjustment factors (CAFs) for reseal contracts are published monthly on the Land Transport NZ website ([Funding manuals and procedures](http://www.landtransport.govt.nz/funding/manuals.html#cpp1)) – (<http://www.landtransport.govt.nz/funding/manuals.html#cpp1>). The amount payable under the contract for work undertaken in a particular month is multiplied by the appropriate CAF. It is important to use the correct CAF, taken from the row in the table corresponding to the month in which tenders closed and the column for the month in which the work was undertaken.

The fact that the CAF values for a particular month will not be published until up to five months after the month in which work was undertaken needs to be managed. If a monthly progress payment system is used, as prescribed in NZS3910 *Conditions of Contract for Building and Civil Engineering Construction*, then this delay in publication of CAF values is handled as specified in Appendix A *Cost Fluctuation Adjustment by Indexation*, clause A7. Where the CAF value applicable to a particular month has not yet been published, an interim payment should be made using the CAF for the most recent quarter for which a value is available.

Using CAF values in any other way is likely to result in random price adjustment that does not reflect the movement in costs since the work was priced, that is to say since tenders closed. It will also not give tenderers the confidence they need when preparing their tenders, i.e. that inflation risk will **not** be passed on to them. Tenderers need to be confident that inflation risk will be managed by the correct use of indexation.

A significant number of approved organisations have chosen in the past not to apply cost fluctuation adjustment to short term (single year) contracts or to the first year of longer term contracts. Due to the current uncertainty around the price of bitumen, significant cost changes can occur between the time that tenders close and when the contract works are completed even with a single year contract.

Managing contract cost increases

Where inflation increases the price of reseal work above that budgeted for, Land Transport NZ's first preference is for approved organisations to manage that increase within their block allocation for maintenance and renewal activities. This may require careful planning, and if necessary reducing the actual quantity of reseal procured.

Land Transport NZ will consider applications for additional funds to cover inflation where it is not practical to manage the increase within the block allocation as discussed above.

Where an approved organisation wishes to protect itself from an increase in its share of the cost of reseal work it may wish to consider purchasing a hedge arrangement to ensure that the cost of the local share is not affected by inflation. Banks and other financial institutions are prepared to take on cost fluctuation risk by entering into such an arrangement. Please note that the cost of purchasing a hedge is not currently eligible for financial assistance from Land Transport NZ.

Review of the current indexation formula

Land Transport NZ considers it timely to review the makeup of the current reseal index to ensure that it tracks the changes in the costs incurred by reseal contractors and that they can have confidence in it. We are also reviewing Land Transport NZ's policy around the management of inflation risk, which includes the current policy of not financially assisting the cost of purchasing a hedge arrangement.

This review will commence before the end of June 2008. Once complete we will advise approved organisations and their suppliers of the outcome, and if the index is revised we will also advise on the options available to approved organisations to ensure timely transition to the revised index.

Enquiries

For further information please contact Bernard Cuttance at Land Transport NZ's National Office by email bernie.cuttance@landtransport.govt.nz, or phone 04 931 8790.



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Attachment 1 to General Circular No 08/03

**Change in Reseal Index and the NZD value of Singapore HSFO 180
(published by Platts Asia-Pacific) since September 2001**

