Guidance Note - Updated Approach to Cost Escalation in Waka Kotahi Physical Works Tenders

ENTERPRISE PROCUREMENT

NOVEMBER 2021

1. PURPOSE OF THIS GUIDANCE NOTE

This Guidance Note provides guidance to Waka Kotahi project managers and Tender Evaluation Teams on how to apply Waka Kotahi escalation indexes to manage current cost volatility resulting from COVID-19 supply chain impacts.

While availability of some materials is also an issue, this is manifesting in materials pricing or should be managed via other responses (for example advance ordering). The focus of this Guidance Note is therefore on materials cost escalation.

This guidance is aimed at Capital Infrastructure (construction) only and excludes Maintenance and Operations.

The measures set out in this Guidance Note are a response to the current market conditions and are intended to be reviewed regularly against prevailing market conditions.

2. BACKGROUND

The COVID-19 pandemic has caused strong disruption to markets domestically and globally for key inputs used in capital delivery of Waka Kotahi infrastructure. The resulting materials price escalation and price uncertainty are directly impacting our estimated and realised project costs.

The increased cost of delivering new infrastructure in the medium-term (18-24 months) has direct implications for contingency allowances and contingency and project budget management.

Price uncertainty for input materials is impacting contractors' ability to commit to firm tender prices, presenting potentially unmanageable commercial risk for our contractors that was not present pre-COVID-19. This could result in inefficient pricing and potentially reduce competition at the tender box.

Previously, materials suppliers would provide fixed pricing terms (at least until the contract had been awarded) and escalation rates were relatively predictable. Under current market conditions, tenderers are exposed to price change between tender submission and contract award and between contract award and order placement. There is a duration mismatch between the time tenderers are required to hold committed prices and the time that materials suppliers will commit to firm prices. Additionally, attempting to predict forward cost escalation has increasingly become a gamble for tenderers. The risk is particularly prevalent where design is not finalised at time of contract. It is less of a challenge for construct-only contracts where materials requirements are known and contractors can place orders soon after contract award.

Elements of our existing tender process and contract escalation policy are not designed for these market conditions and require a different approach. This approach, which is explained in this Guidance Note, includes the following interim measures:

- Allowing escalation (cost fluctuations) to be paid from commencement of the contract period.
- Identifying high risk materials, and if appropriate, treat their supply as a provisional sum.

3. HOW ARE COST FLUCTUATIONS USUALLY MANAGED IN WAKA KOTAHI CONTRACTS?

The Waka Kotahi guidance on contract price adjustment generally is set out in the document *Contract price adjustment for cost fluctuations: infrastructure contracts*.

Currently, the following is applicable specifically to Waka Kotahi capital works (improvement) contracts.

One of two indexes are used

Either the *Waka Kotahi structures index (costs excluding bitumen)* or the *Waka Kotahi construction other than structures index (costs excluding bitumen) are used*. For some contracts both indexes will be used in combination. The *structures index* has a stronger weighting on steel prices. The choice of index depends on the cost proportions in the specific project.

The 'Adjuster' does the calculations

The contractor sets up a contract file in the Adjuster, which is the Waka Kotahi online tool that calculates contract price adjustments for cost fluctuation. Every month the total value of work completed to the end of the month, plus the total volume of bitumen applied to the end of the month, are entered in the Adjuster. It then calculates the total cost fluctuation adjustment to date for inclusion in the contractor's monthly claim.

We begin indexing after 12 months

Contract price adjustments currently begin from 12 months after contract commencement for costs other than bitumen. We apply contract price adjustments for bitumen from contract commencement.

Where is the contract detail found?

Almost all Waka Kotahi capital works contract documents are prepared in accordance with SM031 which includes standard conditions of contract (CoC). The CoC for a traditional contract include Schedule 17 - 'Cost fluctuations' – refer pages 60 & 61. For a design and construct (D&C) contract or an early contractor involvement (ECI) contract the CoC include Schedule 18 - 'Cost fluctuations'.

Note that the above links to SM031 and the standard conditions of contract will take you to the latest versions. **SM031 was last updated in August 2021 and included changes to Schedule 17 and Schedule 18.** A significant number of current contracts are therefore not expected to be using the latest CoC. The specific terms of these contracts should be referred to.

There are differences according to the delivery model

Alliance contracts have their own bespoke provisions for cost fluctuations. Minor works contracts do not generally include cost fluctuation provisions.

4. HOW IS COST ESCALATION TO BE MANAGED DURING CURRENT MARKET CONDITIONS?

All project managers responsible and Tender Evaluation Teams (TETs) involved in new tenders and in-flight procurement processes need to be familiar with the following guidance and adopt it as appropriate – and do so until further notice.

These changes are intended to lower tender prices by transferring unquantifiable escalation risk to Waka Kotahi, rather than have the risk priced into the tender.

4.1. New tenders planned

For new tenders planned:

1. All new contracts should include appropriate allowance for cost fluctuation adjustment.
2. You should identify in the procurement plan any high-risk materials that may need special treatment in relation to escalation.
3. Amend clause 4 in Schedule 17 (or 18) of the SM031 standard conditions of contract in the RFT to the shortened form as follows.
   The current clause 4 reads:

   > "*Cost Fluctuation provisions shall be applied from the commencement of the contract period except that for months 1 to 12 of the contract period CI shall be deemed = $Nil*."

   Amend to the new shortened clause with strikeout as follows:

   > "*Cost Fluctuation provisions shall be applied from the commencement of the contract period~~. except that for months 1 to 12 of the contract period CI shall be deemed = $Nil.~~*"

   This change is intended to lower tender prices by transferring this early escalation risk to Waka Kotahi, rather than the risk being priced into the tender.

The above change, to allow cost fluctuations from contract commencement, is a temporary measure to address current market conditions. It has been advised through a Technical Advice Note (TAN) and temporary changes have been made to SM031. This change is to be applied to all tenders in the market today and all future RFT documents until further notice.

The project manager must ensure that the RFT has been compiled based on the latest version of SM031 (August 2021), the most appropriate index(es) have been nominated in Schedule 17 (or 18) and the value of 'p' reflects the proportion of total cost in the specific project other than bitumen.

Care needs to be taken to ensure that the tender interactive process draws out any issues. It is better to know about these early so that an appropriate response can be considered (if needed), rather than to find them as tender tags after tender submission or have them emerge during contract delivery.

4.2. Active tenders in the market today

The following three actions should be immediately taken by Tender Evaluation Teams (TETs) to update the approach to escalation management in their tender process and procurement and contract documents.

ACTION 1:

- **Issue a Notice to Tenderers: Escalation commences from Tender Submission**

Each TET is asked to issue a Notice to Tenderers (NTT) to amend clause 4 in Schedule 17 (or 18) in the RFT (from SM031). The current clause 4 should read as follows:

> "*Cost Fluctuation provisions shall be applied from the commencement of the contract period except that for months 1 to 12 of the contract period CI shall be deemed = $Nil*."

New clause to strikeout as follows:

> "*Cost Fluctuation provisions shall be applied from the commencement of the contract period~~. except that for months 1 to 12 of the contract period CI shall be deemed = $Nil.~~*"

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ACTION 2:

- **Verify Contract Details**

The TET is asked to review the following contract details:

  - Check that the latest version (August 2021) of Schedule 17 (or 18) has been used in the CoC. If not, then the detail of the version adopted will need to be checked for any material differences when compared to the latest version and corrected.
  - Check that Schedule 17 (or 18) has nominated the most suitable index (or indexes) at clause 3 plus a value for 'p' that reflects the proportion of total cost in the specific project other than bitumen.

ACTION 3:

- **Identify High Risk Materials and Consider Treating them Separately in the Tender**

Using the interactive process, the TET should engage with all potential tenderers to understand any concerns they may have regarding volatility in material prices or other similar issues that could lead to tenderers not submitting, including tags to address issues or increasing their tender prices to cover real or perceived risks.

Once identified, the TET may decide to isolate specific materials for special treatment, such as via provisional sums or prime cost sums - advised through an NTT.

As an example - for some steel products, steel suppliers will not honour a price offer from tender close date through to the expected date of contract award. The price that a tenderer must use in their tender is thus unknown. Alternative ways to address such an issue need to be explored with tenderers. Use of provisional sums (or prime cost sums) may be appropriate. Following the steel example – schedule of prices (SoP) items covering steel supply could be made provisional sum line items:

- The TET would nominate a Provisional Sum (or Prime Cost for materials only) amount to be included in the tender price.
- Tenderers must submit, as part of the Non-Price submission, methodology and supporting quotes for how the provisional sum line item will be procured and managed. This is expected to include a breakdown of the calculation of all relevant overheads, labour, equipment, materials, subcontract, finance and other costs and margins of the contractor and its subcontractors in a clear and transparent manner.
- The methodology for managing the Provisional Sum will be evaluated focusing on how the contractor will address material price risk to ensure value for money and security of supply.
- The Provisional Sum line item will be managed separately and excluded from cost fluctuation calculations.

    This may include significant steel structures, bridge bearings, bespoke manufactured items or long lead high cost items identified by the designer.

Before making changes to the commercial arrangements set out in the RFT you must consult with the procurement team – email procurement@nzta.govt.nz.

4.3. Existing Contracts

Where indexation is being applied to a contract the index will adjust for the higher escalation environment. For example, for the September 2021 quarter the *Waka Kotahi Structures Index (costs excluding bitumen)* (as published on the Waka Kotahi Open data portal) showed an annual quarterly increase of 3.71%. This compares to the typical quarterly increase of around 0.5%. This mechanism is understood in the market and will provide contractors with additional compensation to cover current rates of inflation.

Contractors are required to deliver according to the terms of the contracts they have entered into. The standard Waka Kotahi processes for managing claims against the contract continue to apply.

5. ONGOING SUPPORT

For additional support please reach out to a member of the procurement team directly or at procurement@nzta.govt.nz.