

NOTE FOR PUBLIC WORKS SUBCOMMITTEE OF FINANCE COMMITTEE

Price Adjustment Factors

PURPOSE

The note announces the adoption of a new set of price adjustment factors for converting the cost of capital works projects funded by the Capital Works Reserve Fund from constant to money-of-the-day (MOD) prices.

SUMMARY

2. On a half-yearly basis, we update the Government's forecast of inflation for construction works and adjust the price adjustment factors we use in our funding requests for the Public Works Subcommittee and Finance Committee accordingly.

3. At the last update undertaken in October 1999, the forecast rate of increase in the prices of construction output was 2% for 1999, and a trend rate of increase of 5% per annum from 2000 to 2003.

4. These forecast figures have been updated as at end March 2000. The current forecasts are 0% for 2000 and a trend rate of increase of 4.5% per annum for the medium-term period 2000 to 2003. These forecasts and the corresponding price adjustment factors are adopted as from 1 April 2000.

ANALYSIS

5. Over the past five years 1995-1999, prices of construction output, as

/ measured

measured by the construction output price deflator⁽¹⁾, rose at an average annual rate of 7.0%. Please refer to the Enclosure for details.

6. With construction costs and tender prices both decelerating upon completion of the new airport and related projects and the downturn in the property market, the rate of increase in prices of construction output slowed down considerably in 1999, to only 2.1%.

7. Looking ahead into the near future when the construction sector will still be adjusting itself in the wake of the significant setback in 1998 and 1999, overall prices of construction output are expected to ease further to show virtually no change in 2000.

8. Beyond the short term, with work on the priority railway projects and the Disneyland theme park entering into their high periods of construction, the Public Housing Programme continuing apace, and private sector building activity picking up in tandem with the economic recovery, total workload of the construction sector can be expected to rise steadily to a much more hectic level over the medium-term period. This could lead to a progressive build-up of cost pressures on the construction sector. For 2000 to 2003, prices of construction output are thus projected to pick up to a trend rate of increase of around 4.5% per annum.

9. Many capital works projects have cashflows beyond 2003. Accordingly, beyond the medium term, we will apply, for the purpose of deriving an MOD estimate for public works projects, a forecast annual rate of increase of 6%, which is broadly the same as the trend rate of increase in the construction output price over the past 10 years.

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⁽¹⁾ The construction output price deflator purports to measure the average price change for building and civil engineering output, covering both the private and public sectors. It is essentially a weighted average increase in the tender price indices (TPI) compiled by the various Government departments and private quantity surveying firms, with the weights determined by the actual mix of projects in the period concerned. Over the past five years, the construction output price deflator rose at an average annual rate of 7%, as against 11% for both the public housing projects TPI and public sector building projects TPI, 6% for the civil engineering works index, 7% for the Levett and Bailey TPI, and 7% for the Davis Langdon and Seah TPI.

**Historical and projected rate of increase in
construction output volume, prices and costs (%)**

	Construction output price deflator	Volume of construction output	Construction labour and material cost	Public housing tender prices	Public sector buildings tender prices	Civil Engineering Works Index
1. Historical Rate						
1995	7.8	4.0	5.2	18.3	17.8	6.9
1996	7.3	8.7	6.8	11.4	14.4	7.8
1997	9.1	4.7	9.3	18.9	17.6	9.0
1998	8.7	-4.6	7.5	9.0	9.1	5.4
1999	2.1	-10.8	1.4	-3.3	-4.4	1.2
1995-99 Average	7.0	0.1	6.0	10.5	10.6	6.0
2. Projected Rate						
2000	0	6.3	-	-	-	-
2000-03 (4 years)	4.5	-	-	-	-	-