For information **FCRI(2008-09)5**

NOTE FOR FINANCE COMMITTEE

Application of Contract Price Fluctuation

PURPOSE

This paper informs Members of the Administration's decision that all government capital works contracts may incorporate contract price fluctuation provision regardless of the contract duration.

BACKGROUND

2. Driven by sharp and unexpected increase in the prices of major construction materials such as steel products and sand, the costs of construction works have been escalating since early 2007. The situation is reflected in the rising trend of labour and major construction material cost indices[1] in recent years as illustrated in Enclosure 1. The construction industry stakeholders have expressed grave concern about the situation, especially in regard to the financial difficulties confronting those small and medium enterprises, and have requested Government to review the current policy on contract price fluctuation adopted in capital works contracts.

Encl. 1

3. The contract price fluctuation system (CPFS) was first introduced in 1976 which allowed adjustment to contract payment in accordance with movements in the cost of labour and materials in government civil engineering contracts with contract duration exceeding 12 months. The system was subsequently extended to building contracts in 1977. In 1995, the threshold of the CPFS was raised from 12 months to 21 months in order to make greater use of fixed price contracts so as to achieve tighter budgetary control[2]. Currently, this policy is still being adopted, i.e. there is no provision for price adjustment for capital works contracts with duration of 21 months or less.

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[1] Index numbers of the costs of labour and materials used in public sector construction projects are published monthly by Census and Statistics Department.

[2] Finance Committee was informed of this policy via FCRI(94-95)45 in 1995.

CONTRACT PRICE FLUCTUATION SYSTEM

4. The objective of the CPFS is for risk sharing between Government as the employer and the contractor under capital works contracts. It is an equitable risk sharing mechanism as payments to the contractor can be adjusted either upward or downward (i.e. positive or negative payment) in response to changes in the material and labour costs. With contract price fluctuation provision, the contractor is aware at the time of tender that the contract will be subject to CPFS from the outset. This helps to remove the uncertainty of inflation and hence he can price his tender on the current market value of the works. As for Government, CPFS allows the government to pay for what should be paid, taking into account the prevailing inflation or deflation. Without CPF provision, contractors may build in additional premium in their bids for fixed price contracts under an inflationary environment.

5. An analysis of the public works contracts awarded between 2003 and 2007 indicates that for contracts with duration of 21 months or less, 66% were awarded to small and medium size contractors. Being less capable of mitigating the risks, these contractors are particularly exposed to inflationary risks and yet they are working mostly on contracts without contract price fluctuation provision. In a highly competitive market, it is possible that they may under-estimate inflation or be caught by sudden sharp increases in costs, which cause them financial difficulties, and affect their ability to fulfill their contractual commitments.

6. The 21-month threshold introduced in 1995 was against a background of high construction output with the Airport Core Programme works in full swing. Government's main concern at that time was to make greater use of fixed price contracts so as to improve budgetary control. With the use of the money-of-the-day (MOD) price adjustment methodology[3] introduced in 1995, and various subsequently developed management initiatives and measures introduced by Government over the past years to strengthen project financial management

Encl. 2 (some major initiatives are listed in Enclosure 2), the need to use fixed price contracts to ensure budgetary control is diminishing. On the other hand, incorporation of CPFS provision in all works contracts will help the small and medium size contractors to better cope with financial difficulties resulting from unpredictable inflation of construction cost.

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[3] Price adjustment factors derived from Government Economist's forecast of trend rate of change in the price deflator of public sector building and construction output will be used to convert the cash flow of project cost into MOD prices. The difference between the total of the MOD prices and the project cost will be the provision for price fluctuation adjustment to be included in the project estimate.

7. To uphold the principle of equitable risk sharing between Government and the contractor, the Administration has decided that all government capital works contracts may incorporate the CPFS provision regardless of the contract duration unless there are genuine practical problems such as for contracts involving predominate use of proprietary products/systems and there is no relevant cost indices for price fluctuation computation. This is supported by the Hong Kong Construction Association.

FINANCIAL IMPLICATION

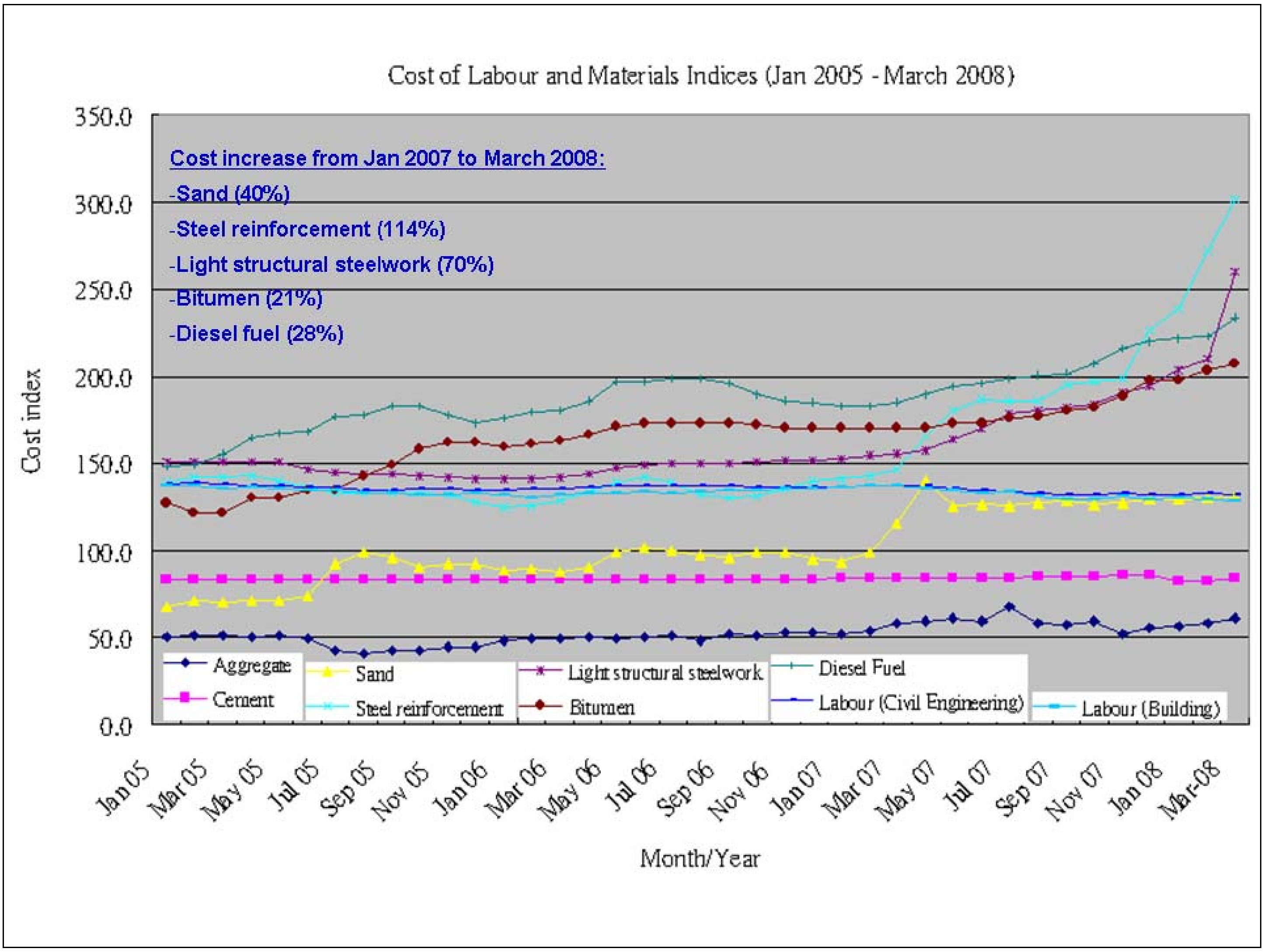
8. The implementation of the policy will not result in additional financial implication for the Government.

IMPLEMENTATION

9. With immediate effect, all capital works contracts may incorporate the Contract Price Fluctuation System provision regardless of the contract duration.

Development Bureau
July 2008

Enclosure 1 to FCRI(2008-09)5



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Financial Management Measures

Government has promulgated a number of measures to strengthen the project financial management system, including the following policies/measures to enhance budgetary control:-

(a) Estimating using risk analysis and implementation of systematic risk management to improve quality of estimation. This risk analysis approach is a formal decision-making technique that helps to identify and measure uncertainty. It is used to place a dollar value on the uncertainties identified in any construction project;

(b) Control of client-initiated changes on user and programme requirements of capital works is part of Government's continuous objective to, inter alia, contain the need for changes to user and programme requirements to those that are absolutely essential and necessary. This will prevent cost overrun due to client-initiated changes; and

(c) Various project management tools (e.g. cashflow forecast/monitoring and programme management etc.) and contract administration measures (e.g. variation and progress control etc.) adopted by works departments. Project Review Committee and Public Works Programme (PWP) Management Committee are set up in works departments to review project cost estimates, and to monitor expenditure on, and progress of PWP projects. Guidelines, delegation of authorities and procedure for approving variations and increase in contract sum in works contracts are also promulgated under departmental Technical Circulars.
