Commercial principles on escalation risk for infrastructure projects

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Background

In recent decades, the low inflationary environment has enabled escalation risk to be borne and managed by the contractors on NSW Government construction projects. That is, the contractors accepted the risk of potential price changes on construction inputs for the duration of the contract, except in circumstances specified in the construction contract.

However, recently the price of some essential inputs for constructions projects have experienced elevated levels of inflationary pressure and price volatility due to the disruptions in the global supply chain resulting from COVID-19 and the conflict in Ukraine. A growing number of contractors have advised that they are reluctant or unable to offer fixed contract prices on specific inputs given the current price volatility and uncertainty.

Current challenge

- In the current inflationary environment contractors may not be able to accept escalation risk on all construction project inputs/goods for fixed price lump sum contracts, or may seek to manage those risks by charging higher than necessary prices or seeking costly and inefficient contract variations.

Principles

- **Value for Money:** The overarching consideration for government procurement is ensuring the best value for money outcome in the procurement of goods, services, and construction.
- **Efficient Risk Allocation:** Risk should be allocated to the party best placed to manage that risk. Where appropriate, this may involve risk sharing the price of specific construction inputs/goods expected to be susceptible to high escalation (excluding labour).
- **Effective Contract Design:** Contracts should be designed to allow for changes in scope or timing to be made in response to material and unanticipated cost escalation.
- **Effective Collaboration:** All parties should work collaboratively and proactively to minimise and mitigate the impact of cost escalation on the project.

Application

The commercial principles apply:

- From the 1 September 2022 and will be reviewed in June 2024.
- To construction projects of all values, excluding public private partnerships, unsolicited proposals and professional services contracts.
- Grant-funded construction projects may adopt these principles to support the delivery of projects within budget.
- On a project specific basis.

- In conjunction with NSW Procurement policies, NSW Government COVID-19 Commercial Guidelines issued on 6 March 2022, NSW Government Commercial Principles and NSW Procurement Board Directions.

The commercial principles do not apply to supply chain delays and disruptions due to COVID-19. Agencies should refer to the NSW Government COVID-19 Commercial Guidelines in this regard.

Guidance for agencies to respond to the current challenge in accordance with the Principles

1. **Projects in pre-procurement and procurement**

   a) **Engage** with industry as early as possible to identify and understand the potential impact of escalation risks and mitigation strategies for the project. For example, agencies may engage industry to provide advice on the sourcing of materials, design choices, constructability and opportunities for innovation.

   b) Consider the timing of when to **commence** new procurements for projects reliant on inputs that are subject to high escalation risk, particularly where project costs are uncertain.

   c) Consider staging projects to ensure the flexibility to **defer** project scope where costs are uncertain and volatile, accounting for the potential consequential cost and other impacts of doing so.

   d) Facilitate **flexible** design and **broader** technical specifications **early** in the design process so that contractors can suggest alternative materials that are less likely to be impacted by escalation risk.

   e) Consider where market risks arise, for example foreign exchange, commodity and interest rate risks and **engage with NSW Treasury Corporation** for support in managing market exposures in line with NSW Treasury *Financial Risk Management Policy* (TPP21-14).

   f) Use pre-tender value engineering to identify **pre-agreed variations** to reduce scope that can be exercised under the contract during delivery if necessary due to budget pressure.

   g) Require reasonable **tender validity periods** from tenderers that account for the impact that cost volatility may have on a tenderer's ability to provide firm pricing.

   h) Request tenderers or respondents to expression of interest to:

      - identify the **specific inputs/goods** required for the project that are expected to be subject to high escalation risk and the relevant benchmark unit costs (excluding labour).

      - **price** pre-agreed variations that can be included in the contract.

   i) Conduct **due diligence** on the nature of escalation risk identified by tenderers.

   j) As part of the agency's value for money consideration, **assess** as part of the tender evaluation, each tenderer's:

- approach to mitigating cost escalation risk(including hedging strategies, and early ordering of key materials)
- optimisation of design (where appropriate).
- pricing of pre-agreed variations and rights of the client to exercise those options.
- willingness and process to pass on contractual relief to flow through the relevant supply chain.
- willingness to accept quantity risk, schedule risk and escalation risk other than for inputs/goods expected to be impacted by extreme cost escalation.

k) Facilitate timely procurement **decisions** to better allow tenderers to hold prices for the period of decision making.

l) Where escalation risk on a specific input/good is demonstrated to pose a material risk, agencies should consider applying a **'rise and fall'** contractual mechanism so that the government price for the relevant input increases or decreases based on an agreed index. The 'rise and fall' provision should be based on:

- **Risk sharing** - the costs and benefits are to be shared on a 'pain share, gain share' basis that incentivises both parties to actively manage escalation risk.
- **Transparency** - the processes required to quantify the impact of cost escalation on a specific input/good and determine whether the impact is sufficient to justify a 'rise and fall' mechanism, are to be transparent, easily verifiable, and supported by open book practices where appropriate.
- **Clarity** – thresholds in price movements which trigger price adjustments, and upper levels of liability for contractors where appropriate.
- **Objectivity** - based upon independently verifiable published indices (e.g. Australian Bureau of Statistics), or a percentage change on a transparent and reliable benchmark or open book process.
- **Timeliness** - periodic adjustments to the price of inputs (that relate only to unfinished works) based on movements to indices.
- **Implementation** - Practical administration of the regime by the parties.
- **Dispute minimisation and issues resolution** - designed to minimise the scope for disputes and resolve issues efficiently.

m) Consider the impact of variations that may result in extensions of time on from rise and fall arrangements in the contract.

n) Determine, on a case by case basis, if and how the rise and fall mechanism will operate where a contractor causes a delay, noting that contractors are generally responsible for costs associated with delays under their control.

2. For projects in advanced stages of procurement as at 31 August 2022

Where Agencies are awaiting bids, evaluating tenders, or soon to award a contract, Agencies should seek to introduce as many of the measures outlined above as practicable if it is clear that shortlisted tenderers may not bid or may seek to introduce mechanisms to allow changes to contract sums to account for movements in input prices. Those efforts will be most successful while there is still a competitive process underway with more than one bidder, and certainly prior to contract award.

3. Projects in delivery as at 31 August 2022

Projects in delivery should be managed in accordance with existing contractual terms.

4. All projects

a) **Model** escalation risks for specific construction inputs/goods as required by the *NSW Government Cost Control Framework* to appropriately quantify a project's retained escalation risk provision.
b) **Assess** claims (wholly or partially) and pay contractors progressively as claims are verified.

Reporting

a) Clusters must report to Infrastructure NSW (**INSW**) on overall risk exposures and retained contingencies as required by the *NSW Government Cost Control Framework.*

b) Agencies must provide INSW with monthly updates on any Tier 1 projects (as defined under the *Infrastructure Investor Assurance Framework*) in procurement where the agency expects the State to accept escalation risk on specific inputs. This will inform INSW's semi-annual review of the principles.