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Procurement Advisory Note

PAN 01/21

Construction Material Costs during Pandemic Recovery

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PROCUREMENT ADVISORY NOTE

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INTRODUCTION

With the emergence of the Covid-19 pandemic in 2019/20, businesses globally were encouraged to adhere to their national government restrictions to reduce transmission and spread of the disease. Many countries adopted national lockdown strategies which led businesses to close unless they could continue to work safely.

As the disease became better understood, restrictive measures were gradually eased in line with the rise and fall of infection rates and some businesses were able to continue operations either in part or in full subject to safe social distancing requirements.

The impact of these measures has led to a reduction in the supply of raw materials to the manufacturing sector for production of everyday consumables which are often taken for granted.

Many countries are investing in national infrastructure projects as a means of delivering economic recovery. There has also been a reported increase in spending on home improvements as a result of increased home working and restrictions on foreign travel. These have led to an increased global demand for building materials which, coupled with reduced production since the outset of the pandemic, is now leading to shortages and delays in the availability of some building materials and increased prices as a result of the impact of supply and demand.

Construction materials currently affected include: raw materials and products reliant upon raw materials such as steel, timber, cement, plasterboard, metal and UPVC piping. Additionally, a shortage of electronic components is having an impact on the availability of some electronics systems.

Although typical increases are in the range 10-25%, some material prices have reportedly increased by 40% in recent months. The combination of product shortages, delivery delays and escalating costs for some products is impacting on project delivery.

Where contractors could not have anticipated the current delays or price pressures and allowed for them in their tender and programme there is a risk that this could lead to late completion and/or ultimately contractor failure.

Likewise, the escalating prices will impact on contracting authorities' budgets going forward.

It is not known how long it will take for raw material suppliers and the manufacturing sector to return to optimum output; to match demand; or for markets to stabilise.

Where Departments are aware that market volatility, delays in the supply of materials and/or price increases are impacting on the delivery of construction contracts that are necessary to support public services, they should consider the following actions.

ACTIONS

When considering these actions, a Department should seek the advice of its Centre of Procurement Expertise (CoPE).

1. MANAGING DELAYS DUE TO MATERIAL SUPPLY ISSUES

1.1 Existing Contracts

Where a contractor can provide compelling evidence on an open book basis that it has experienced a significant delay in the supply of a construction material that impacts on the completion date or a Key Performance Indicator (KPI), the Department and the contractor should work together in a spirit of mutual trust and cooperation to identify suitable alternative materials or agree an acceptable change to the completion date or KPI.

Departments should consider early warnings of delay in the contract, and consider waiving or delay exercising the authority's rights and/or remedies (for example, to claim delay damages). In these circumstances, contract change control procedures should be used to keep records of any changes made and the rationale for each decision.

1.2 Future Contracts

Departments should work with the design team to review material availability and estimated delivery times during the design stage to aid development of a realistic works programme. Where significant lead-in times have an adverse impact on the projected critical path, alternative materials or an extension of the works programme should be considered.

Whilst responsibility for the works programme rests with the contractor, lead-in times for specific materials for which there is no alternative, should be clearly identified as a risk to the contract. Before allocating responsibility for such risks, the contracting authority should consider how they may impact future tender prices and the successful delivery of the contract.

2. MANAGING THE IMPACT OF VOLATILE MATERIAL PRICES

2.1 Existing Construction Works and Maintenance Contracts

It is reasonable to expect contractors to absorb price fluctuations within moderate tolerances as prices for materials will change regularly depending on the level of supply and demand within markets.

There are various NEC contract pricing options including priced contracts (Options A and B), target contracts (Options C and D) and cost reimbursable contracts (Option E). The effect of an increase in the cost of materials will depend on the pricing option - the impact on a priced contract will be quite different from a target contract with a pain/gain share in relation to any increased costs. In addition, the impact of the change will depend upon the Secondary Optional clauses and any Z clauses. For example, the contract may already include an adjustment for inflation if Option X1 (Price Adjustment for Inflation) applies.

Notwithstanding the presence or absence of an existing contractual clause to deal with price adjustment for inflation, where the contractor provides compelling evidence, on an open book basis, that clearly demonstrates that the impact of inflation is higher on specific element(s) of the contract than that which a diligent contractor could reasonably have anticipated, then the Department should consider applying a Net Price Adjustment for inflation to impacted element(s) of the Price. This is a temporary measure and will be reviewed at the end of September 2021 to assess the effectiveness.

Where a contract does not include a mechanism for price adjustment for inflation, then the Net Price Adjustment is the 'extra over' amount between actual inflation and that which a diligent contractor ought to have anticipated and included for within its tender for that specific element.

Where a contract already includes a mechanism for price adjustment for inflation, then the Net Price Adjustment is the extra over amount between actual inflation and that which a diligent contractor ought to have anticipated and included for in its tender for that specific element less that payable under the contractual mechanism for price adjustment for inflation.

The Net Price Adjustment may be calculated by comparing the index forecast for that element(s) at the closing date of tender submissions with the actual index outturn data, with the difference being applied to the sum allowed for by the supplier for that element(s) in its original tender as evidenced on an open book basis. The selected index, shall be appropriate for the specific contract element(s).

All sums payable as a result of a Net Price Adjustment shall be the defined cost i.e. not subject to any mark up for profit, overhead or other fee.

2.2 Future Construction Works and Maintenance Contracts

Departments should take cognisance of increasing prices when setting budgets for future projects.

Discussions on the availability of materials should be started at an early stage and if issues with material availability are anticipated, they should be planned for within the project programme and budget.

Departments should ensure that the evaluation and award stage of procurements are completed quickly to avoid unnecessary delays.

It will be difficult for contractors to hold tendered prices open for acceptance for long periods after the tender submission date. Departments should therefore include a price adjustment for inflation mechanism in works and maintenance contracts (e.g. NEC Option X1) with a base date set to the tender return date.

An appropriate Price index should be selected for the particular type of contract.

3. TRANSPARENCY

Departments and suppliers must work collaboratively to ensure there is transparency surrounding any Net Price Adjustment payments. Suppliers in receipt of public funds on this basis must agree to operate on an open book basis. This means they must make available to the Department their original tender build up and any data from ledgers, cash-flow forecasts, balance sheets, and profit and loss accounts, as required and requested to demonstrate the impact of inflation. For example, this might include evidence that relevant sums have been passed on to the supply chain as quickly as possible.

Departments must keep records of decisions and agreements made, and ensure suppliers maintain records to enable future audits to be undertaken.

Suppliers should not expect to make profits on payments received as a result of a Net Price Adjustment payment.

Suppliers are expected to operate with integrity and should be made aware that, in cases where they are found to be taking undue advantage, or failing in their duty to act transparently and with integrity, Departments will take action to recover payments made.

Further, any supplier found to have acted fraudulently may be excluded from future public contracts on grave professional misconduct grounds.

4. FURTHER INFORMATION

Any queries on this advice note should be addressed to:

Procurement Policy Branch

Construction and Procurement Delivery

2nd Floor East

Clare House

303 Airport Road West

Belfast, BT3 9ED

Phone: 028 9081 6233

Email: procure.policy@finance-ni.gov.uk