PRICING RISK

A CONTRACTOR'S VIEW

Presentation to

REAAA NZ CHAPTER ROADSHOW – SEPTEMBER 2008

By

Roading NZ Representatives

“Out of all the things that contractors have to achieve to survive and be successful, managing risk is the biggest challenge”

Types of Risk

- Contractual – programme, specifications, variations
- Financial – payment, cash-flow, penalties
- Operational – productivity, weather, resources, quality
- Organisational – skills, experience, technical support
- Legal Compliance – Health & Safety, Environmental, Resource Management Act
- Technical – performance of completed asset, geotechnical

Contractors ignore risk at their peril

How can contractors manage and mitigate risk?

- Risk assessment and analysis
- Risk modelling and simulation
- Improved decision making through more information or better knowledge
- Contingency planning
- Insurance

What is the impact of “risk” on price?

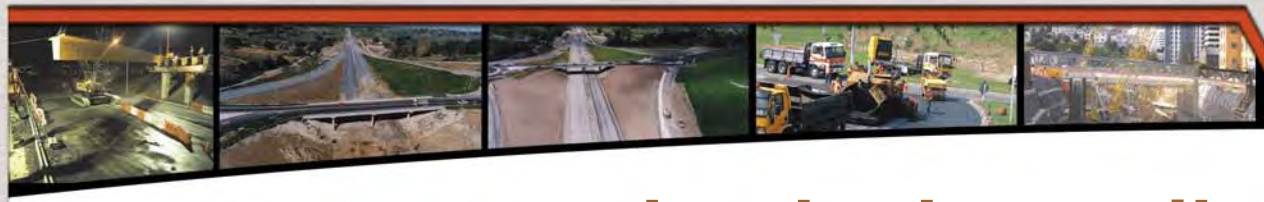
- In a contracting relationship it is often said that “the risk should lie where it is best managed”

  What does this mean?

- For some risks this is obvious:
  - Contractors – plant, labour and materials availability, productivity, technical compliance
  - Principal – main resource consents, unforeseen ground conditions and any unusual risks

- For other risks it is a lot less obvious – exchange

  rates, procurement, exceptional adverse weather



What is the reality?

- Contractors that identify contract risks will endeavour to mitigate where possible

- The cost of those mitigation measures or the cost of the unmitigated residual risk will be added to the price

- Contractors that fail to identify contract risks may be lucky enough to “get away with it” on occasions. However repeated failure to account for risk will lead to very poor contractual outcomes for contractors and clients.

What is the reality?

- Clients that have an ongoing relationship with a contractor or multiple contracts with the contracting industry will ultimately pay the price for contract risks

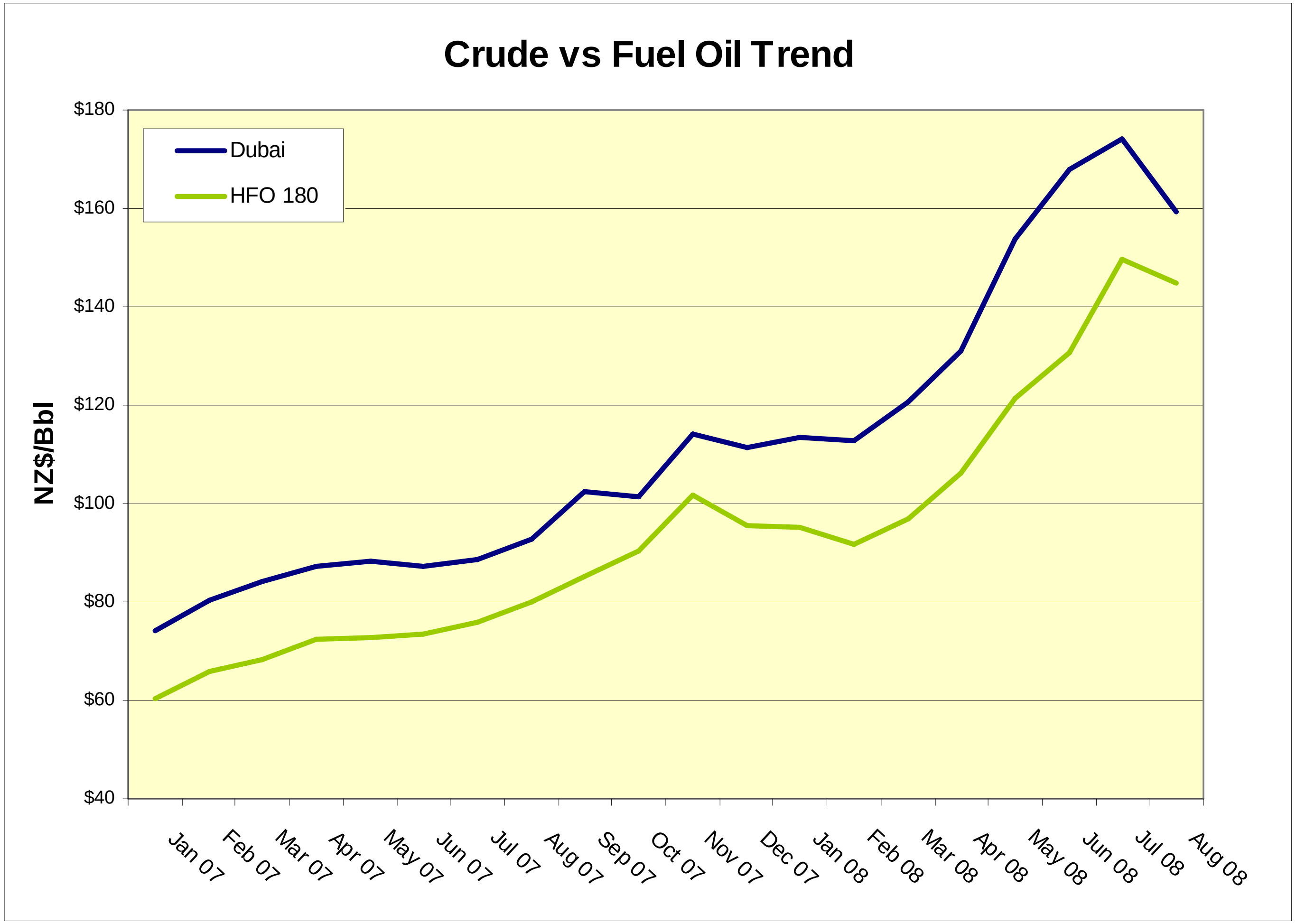
- Ideally these clients will pay a fair price for their project, and they will receive a quality job, completed on time

- Unfortunately, if the risks allocated to the contractor have been unreasonable, then the outcome maybe less than desirable for both the client and contractor

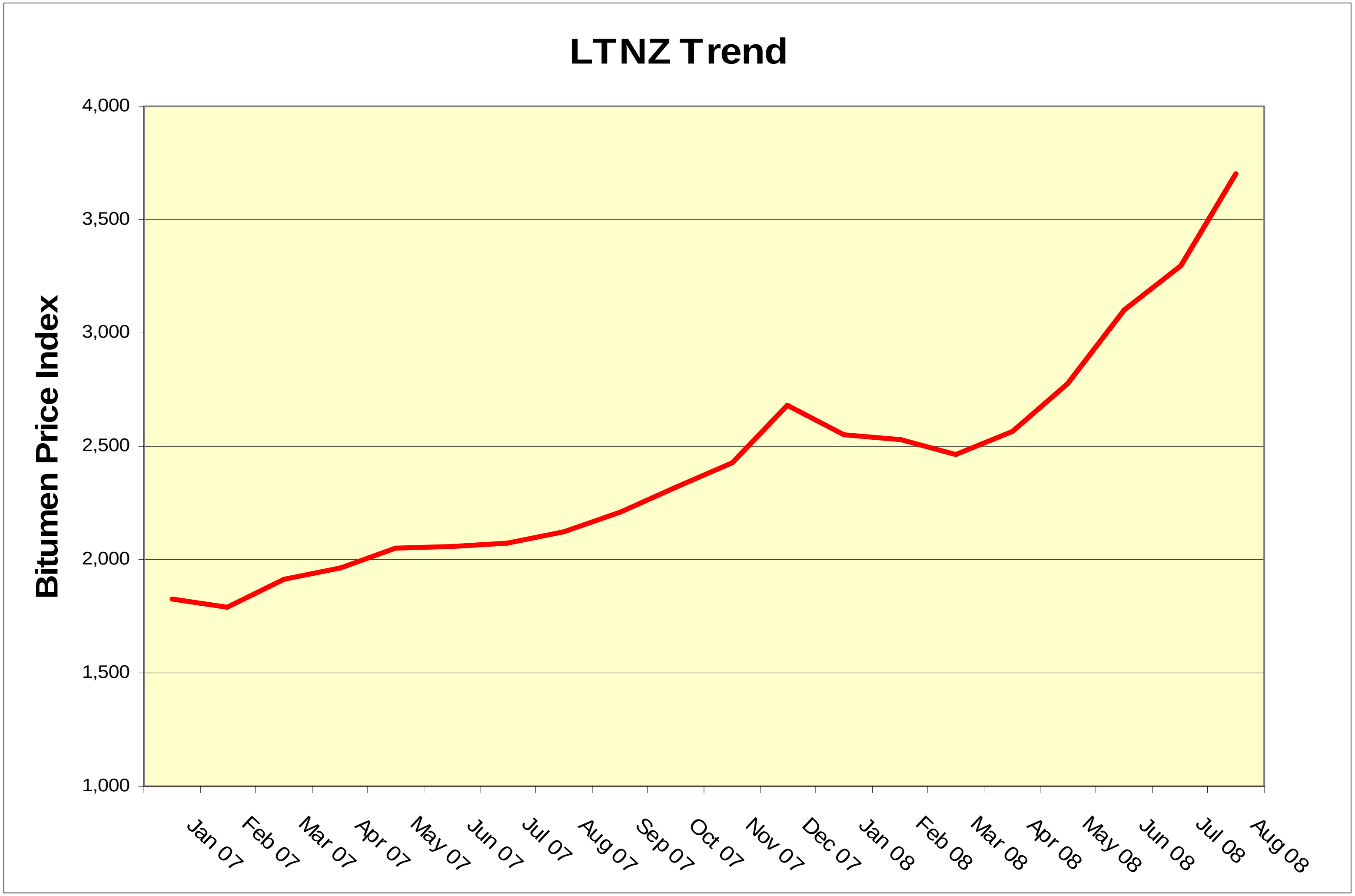
Current hot risk topics

- Cost of bitumen
  - NZ contractors cannot effectively manage the risk of cost fluctuations in bitumen
  - Unprecedented international volatility
  - Some hedging options but size of contracts and timing detract from benefit
  - Bitumen index has been a worthwhile tool to reduce contractor risk but it must relate to bitumen volume used

How do we index the cost of bitumen?



What’s happened to the price of bitumen?



Other current hot risk topics

- Cost of Steel
  - Increased by 75 - 100% in last 12 months
  - Resulting cost of steel fabrications +20%
  - Resulting cost of reinforced concrete +12% -14%

- Cost of Fuel
  - Up to 100% increase in the last 12 months
  - This has increased bulk earthworks rates by 16%
  - Recent decrease but still volatile

Other significant risk topics - examples

- Geotechnical
  - Clients want to shift unforeseen ground conditions to contractors – our crystal ball is no better than the client's/consultant's!

- Technical
  - e.g. recent Energy sector tender, client required contractor to cover guaranteed performance of novated turbine supplier – contractor declined to bid because those risks were too high

Other significant risk topics - examples

- Planning and Consenting
  - A contractor took on the risk of consenting an alternative design for a large design-build Water Treatment Plant - but never again!
    - Landowner issues
    - Legal issues
    - Compensation claims
    - Time (12 months)
    - Cost

Other significant risk topics - examples

- Contractual
  - A client sought to procure a large roading project with all the risks of relocation and restoration of a large number of Heritage buildings plus physical security of the site on the contractor
  - The industry declined to tender
  - The client subsequently agreed to accept a cost plus basis for the identified risk elements (~$7m)

Conclusion

- Contractors have to cover risks when pricing if they are to survive and succeed
- Contractors are risk managers and manage risks every day in their normal business
- Risks should be assigned to the party that is best able to manage those risks – whether that is the contractor or the client.
- Clients will ultimately pay a premium for risk if they expect the contractor to carry inappropriate or unmanageable risks
- Appropriate risk allocation will minimise any risk premiums

Conclusion (cont'd)

- Clients that regularly engage contractors to supply bitumen products (and other price volatile commodities) need to reduce the contractor's risk by using the bitumen index or similar to pay current costs

- This will reduce the unmanageable risk that contractors face, and minimise the prices clients pay over the long term

- Clients and consultants need to have considered and resolved the allocation of risk issues prior to compiling the RFT

Thank you