

The use of Haylett in a low inflation environment

by Dirk De Vynck
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One of the outstanding features of the new South Africa and the ANC-led government is its stable macro-economic policies, with lower inflation being one of the biggest beneficiaries. This begs the question if the Haylett index is still needed since it was implemented with the intention of compensating contractors for cost fluctuations in times of high inflation.

Background and objective

The Contract Price Adjustment Provisions (CPAP) — colloquially referred to as the Haylett formula or index — was introduced in 1976 as a formula method of compensation, reimbursing contractors for price fluctuations in labour costs, material prices, plant and equipment, and fuel. This was necessitated by high inflation, around 15% in 1976.

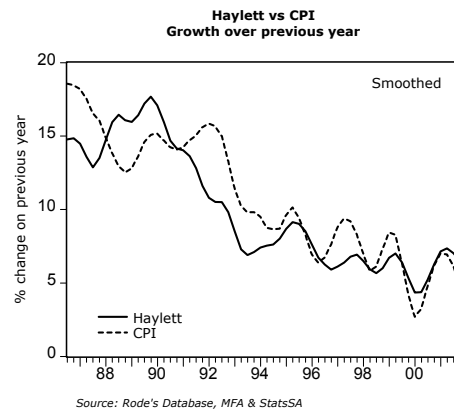
According to the Joint Building Contracts Committee — which took over responsibility for the CPAP in 1994 from the Building Industry Advisory Council — the purpose of the formula adjustment provisions was to provide for the needs of contractors who require a clear-cut, agreed escalation recovery formula method to avoid dissension and disputes with employers and subcontractors. A workable formula method of contract price adjustment would also simplify accounting procedures and generally provide for acceptable reimbursement.

The Haylett index reflects price changes as closely as possible within the philosophy of an index-based system. Note that the proportions and indices applied are indicative of average price movements and do not represent any particular contract.

Current use

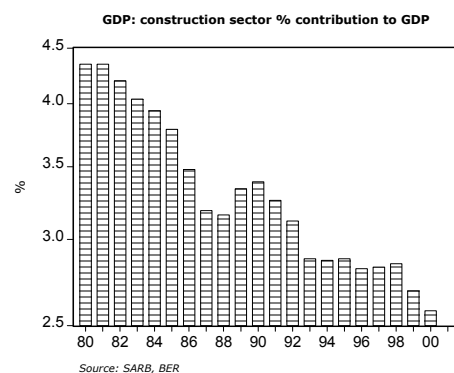
According to Arnold Bestbier, quantity surveyor with DV Boland Consulting based in Paarl, little use is still made of the Haylett index, especially in the private sector. The reason for this is that most building projects are completed within a year, which in the present low-inflation environment does not necessitate the use of Haylett. He says most of these contracts are negotiated on a fixed-price, fixed-term tender-price basis. Nevertheless, in the days of double-digit inflation the Haylett was used even in contracts lasting shorter than one year. In the case of building contracts lasting longer than one year, Bestbier says an adjustment like Haylett may still be required.

The accompanying graph clearly shows how the Haylett has come down, in line with lower inflation. Also note the greater stability in Haylett from about 1996 compared to consumer inflation.



According to Linley Wiener, of DV Cape Consulting in Cape Town, most of the contracts shorter than one year that they have been involved in over the last five years, have been done on a fixed-price, fixed-term basis. Furthermore, Wiener says the trend in the building industry has shifted from fewer, bigger contracts to more, smaller contracts. This, in itself, has led to shorter contract periods, placing less emphasis on the use of Haylett. The average size of a building contract was about R13 million in the early 1990s, R7,5 million five years ago and is about R3,5 million at present. The accompanying graph clearly shows how the dearth of building activity and the general, smaller contracts have negatively impacted on the construction sector's contribution to the country's GDP — from about 4,4% in 1980 to around 2,6% in 2000.

However, Dr. Johan Snyman of Medium-Term Forecasting Associates (MFA), says use of the Haylett is still required for building contracts done on behalf of the public sector. This is due to entrenched procedures that have to be followed. However, Bestbier and Wiener contend that in many cases government work of shorter than six months does not require the use of Haylett.



Snyman warns that if inflation stays on its current, relatively low levels, government could review its policy on the use of Haylett, which could eventually lead to the possible scrapping of the index. Other than a slight increase in the forecast for the Haylett in 2002, brought about mainly by the increased rand cost of imported plant and equipment, MFA has forecast the year-on-year change in the Haylett to stay below 6% until 2006.

Another area of concern mentioned by the users of the Haylett, has to do with the calculations in adjusting for Haylett. The formula provides for a constant of 85% whereby the work value is adjusted. This assumes a 15% (100%-85%) non-adjustable element to eliminate any escalation on profits. Some industry participants say that because of the decline in the work volumes and subsequent lower profit margins, this non-adjustable element is no longer relevant, thus in a way penalizing the contractor for profits not really earned.

Conclusion

The diminishing use of Haylett results from a combination of the shorter duration of the average building contract and the dearth of building-construction work. Where before most building contracts were subject to the Haylett, the present situation only warrants it if the contract lasts longer than one year. However, this only applies to private work. In most cases Haylett is still required when doing work for government. Furthermore, South Africa's stable macro-economic policies lend themselves to more stable inflation rates, which simplify the prediction of future price fluctuations in building input costs. The case for this, of course, is strengthened by government's use of inflation targeting. Thus, although longer contracts still warrant the use of Haylett, a continuation of South Africa's stable macro-economic path could eventually see the disappearance of the index. ■