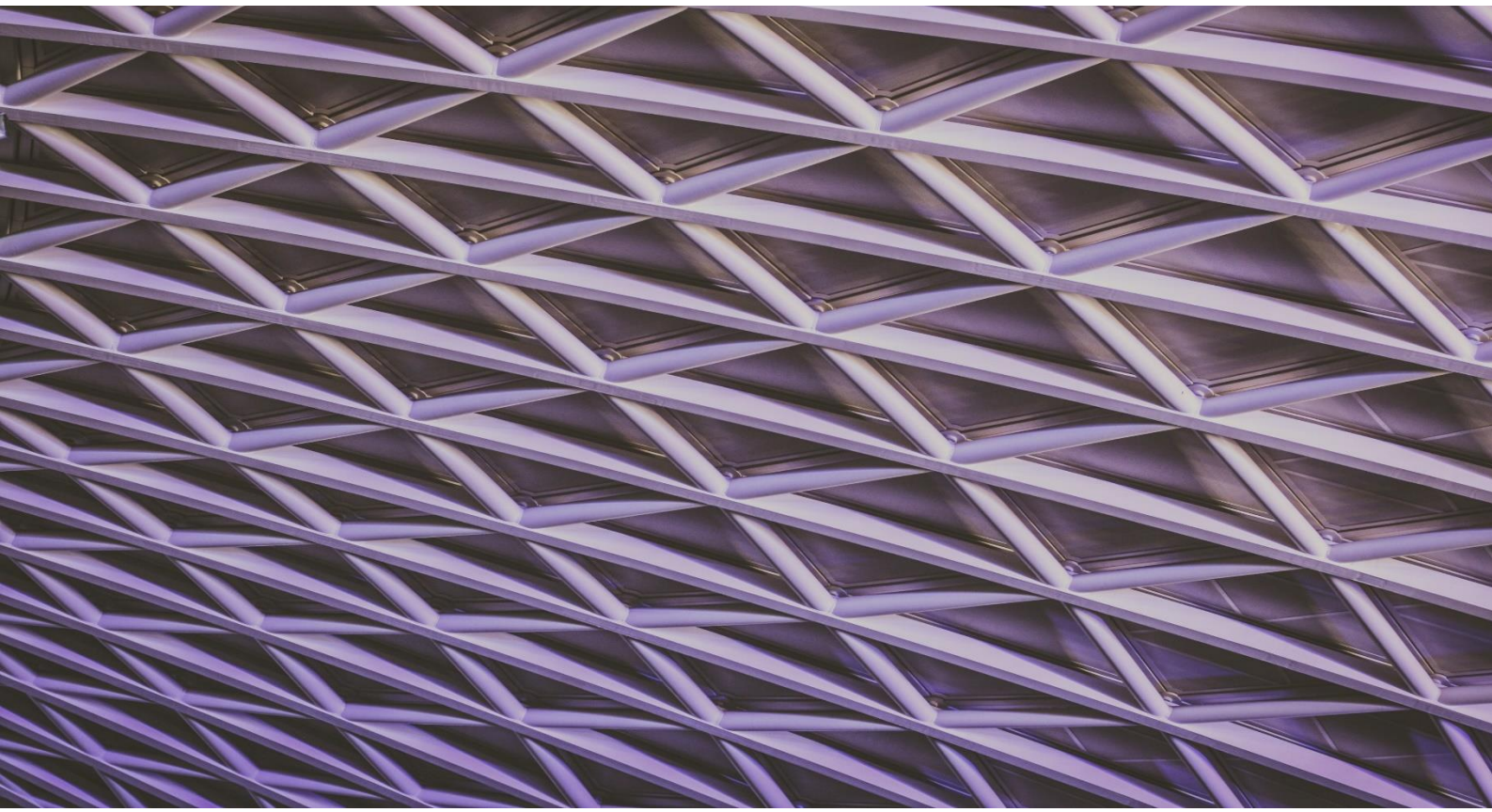
BCIS®

Mitigating Inflation Risks on Projects



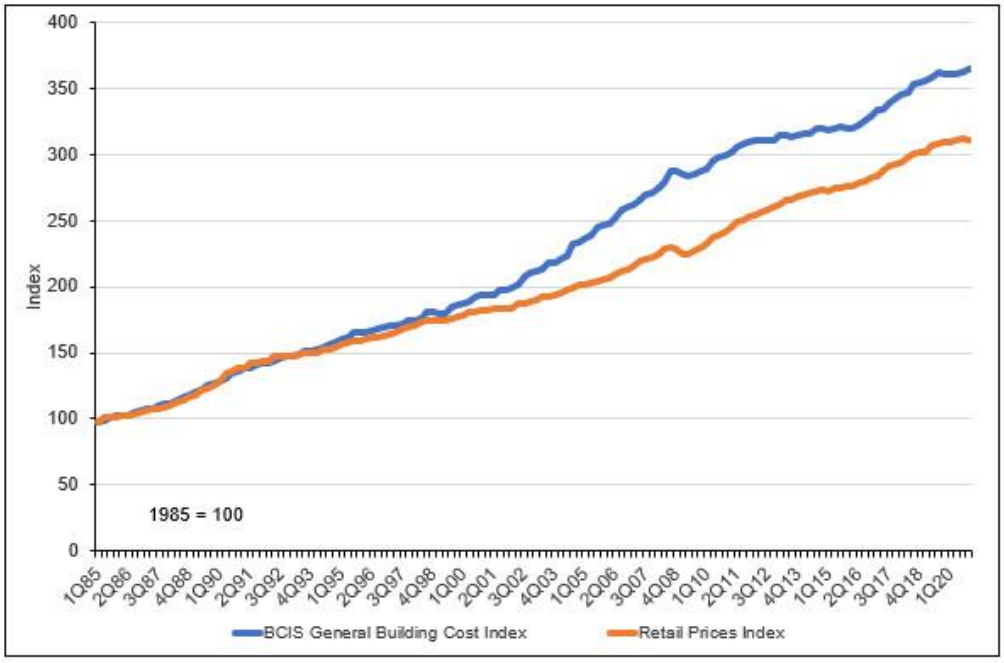
rics.org/bcis

Why Allow for Inflation

To ensure the best price on a contract, the risk for inflation should be taken by the party best able to manage it. Mitigating the inflation risk on projects should be considered during periods of high or uncertain inflation; on large projects; on long contracts; on complex projects. In those circumstances any underlying inflation caused by pressures from the wider economy and global markets probably cannot be borne by the contractor alone.

Some clients have adopted the practice of applying single, whole economy indices such as the Retail Price Index (RPI) to cover the inflation risk in a contract. However, construction projects will not inflate at the same level as the domestic consumables measured in the RPI, therefore contractors are likely to inflate their rates to cover the risk meaning that tendered rates could be higher. The chart below highlights the difference between building cost inflation and the RPI over the last thirty-five years.

CHART: BUILDING COSTS AND RETAIL PRICES



Source: BCIS & ONS

The use of non-construction indices creates a double risk to the contractor. The introduction of these risks will result either in a risk premium being built into the initial price or pressures on the contractor due to insufficient provision for inflation. The perception is that this practice does not subject funders and clients to any risk, however the reality is that the inflationary risk is undoubtedly being included by the supply chain in their base rates instead.

How to Allow for Inflation

Indexed linked inflation adjustment clauses provide a simple and transparent method of calculating and reimbursing fluctuations in the underlying costs on a project. They allow contractors to price and manage a contract knowing that they do not need to price in the risk of inflation. The most common method of allowing for inflation is through the use of indices. In the UK, the most frequently used indices are the price adjustment formulae indices (PAFI) prepared by BCIS.

The formulae method of inflation adjustment was introduced due to industry demand for a fast yet credible way of calculating and reimbursing fluctuations in costs. The method relies on resource cost indices for trades and individual resources. These can be weighted to represent the resources on a particular project so that the impact of inflation can be modelled. This allows the contractor to provide the best price in their tender and be confident that the inflation reimbursement will reflect their costs.

When the formulae method was introduced, the weightings of the indices were linked to items in the bill of quantities so that they were applied differently at each valuation. However, the alternative single index method has become standard practice so that the weightings of the indices are set, usually by the client, at the outset of the contract and applied to all payments.

Spending time choosing the right mix of indices, and discussing it with the contractors where there is early contractor involvement or competitive dialogue, will help in ensuring that the contractors are comfortable that they are protected from underlying inflation and so offer the best current price.

As the practice of using indices in inflation adjustment clauses has become standard, the choice of indices has proliferated. The point of the indexation is to match the indices as closely as possible to the work that is to be carried out. Therefore, using a general inflation index such as the Retail Prices Index (RPI) or applying a general construction index to specific sectors imposes a double risk for the contractor to account for both the risk of the inflation measured by the index and the risk of inflation in their actual costs.

The same applies to the practice of main contractors applying an all trades index to a specific subcontractor. Applying an inappropriate index or indices will never achieve the desired effect of attracting the best prices.

BCIS HAS SIX RULES FOR CHOOSING AN APPROPRIATE INDEX:

1. Be clear about what you want to measure and how you want to apply it.
2. Choose an index that is measuring the costs that most closely match what you want to measure.
3. If you are using an index linking something in a contract or agreement, be clear that it meets your needs, particularly in respect of:
    - the frequency of the publication (monthly, quarterly, annual) and
    - the updating and revisions policy.
4. Understand the inputs to the index and the calculation methodology.
5. Read the notes and definitions.
6. Never choose an index because of its past performance.

PRICE ADJUSTMENT FORMULAE INDICES (PAFI)

Where a client or funder wishes to take on or share the risk of inflation over the period of the contract; the contract sum, target cost, capital funding allowance, etc. will be linked to and adjusted by an index. The Price Adjustment Formulae Indices have been designed for this purpose. The indices are intended to represent the underlying inflationary pressures, not the actual costs on a particular project. However, the range of indices is intended to allow those underlying inflationary pressures to represent the resources being used on a project. This method has become the standard approach with the contract identifying the indices to be used and their weighting and this is applied in each valuation.

The indices represent the movement in factory gate prices and nationally agreed wage awards and are for national (UK) application. They are not intended to represent the effect of market pressures, national or local, on prices from subcontractors, merchants, factors, etc. The management of these is the commercial concern of the contractor.

The indices are available at BCIS online as four series:

- building
- specialist engineering
- civil engineering and
- highways maintenance.

Implementing Index Linked Inflation Clauses

Index linked inflation clauses can be used on all types of procurement but will be applied differently depending on the contract:

- On design and build and traditional lump sum contracts, the agreed tender price will be adjusted for inflation in valuations for stage payments.
- On target cost contracts, the target cost is adjusted for inflation.
- On framework and term contracts, the value of the individual contracts is adjusted.

ISSUES TO CONSIDER WHEN IMPLEMENTING INDEXATION:

1. Define clearly the work that is subject to review in line with the index.
2. Ensure that the mix of indices represents the work being undertaken. The indices selected will affect the price change recorded and should be chosen carefully to best represent the work subject to indexation and the intention of the parties.
3. Ensure that the reference to the chosen indices is clear and unambiguous. The indexation clause of a contract should identify the indices selected by its complete title, index number and any identifying codes.
4. Check the availability and frequency of the index.
5. State the base date for the updating.
6. State the frequency of price adjustment. The indexation clause should specify whether price adjustments are to be made at fixed intervals (such as monthly, quarterly, bi-annually, or annually), at stages or at the beginning or end of the contract.
7. Specify the date the price adjustment calculations are to be made and what index is to be used. This is normally the latest version of the index available on the date specified.

8. Be clear on how to deal with the changing status of the indices, e.g. provisional, firm, etc. Some contracts allow for the inflation to be recalculated later when provisional indices become firm. For simplicity, some do not.
9. State how to implement revisions to the index, changes to the index base date, discontinuation, etc. With the PAFI, revisions are rare, and the indices will continue to be calculated on superseded series. When series are discontinued, advice is given on the use of newer series to continue the discontinued series through to the end of a contract.
10. Define the method for calculating the inflation adjustment. The normal method is to calculate the percentage change from the base date for each index and multiply it by the weighting in the contract to give an overall percentage change.
11. Define the number of decimal places to be used in the calculation.

BCIS Consultancy

BCIS Consultancy can provide you with bespoke advice regarding mitigating inflationary risk in project delivery, including selecting the most appropriate indices to cover the inflationary risk and the practical implementation of inflation clauses in contracts.

For more information about BCIS Consultancy visit Rics.org/consultancy or please contact us at consultancy@rics.org if you would like to discuss your requirements

BCIS®

For the past 60 years, we have been collecting, collating, analysing, modelling and interpreting cost information.

With the Building Cost Information Service (BCIS), we make that information easily accessible through our online applications, data licensing and publications. We also provide consultancy and research support to clients from both the public and private sector

BCIS
Parliament Square
LONDON
SW1P 3AD

t: +44 (0)24 7686 8502
e: contactbcis@rics.org

rics.org/bcis