Indexation of Pricing: Fluctuations

This guidance note explains how indexation and, more specifically, JCT fluctuations provisions and NEC Option X1, can be used to relieve pricing risks

- What are indexation provisions?
- How and when can fluctuation provisions be used?
- What are the fluctuation provisions in JCT?
- What are the indexation provisions in NEC standard forms?
- How can fluctuation provisions be incorporated into bespoke contracts?

ECA has a number of other key guidance notes dealing with pricing under construction and maintenance contracts which will also enable Members to consider how to share, spread and collaborate on risks in pricing allowing parties to move away from the fixed lump sum pricing

1. What are indexation (fluctuations) provisions?

Indexation clauses (or fluctuations as JCT refers to them), are contractual provisions that parties can incorporate into contracts. Their primary purpose is to provide a mechanism by which the contract price can be adjusted to take into account changes to the price of labour, materials or other costs that may be affected during the lifecycle of a construction or maintenance project.

As the name suggests, indexation provisions allow parties an opportunity to quantify fluctuating costs and as such are a useful tool for a Member that is a contractor or sub-contractor to have within its contractual arsenal.

They allows Members to combat the risk of being out of pocket for items that they may have initially priced at the time of tender, but which have subsequently fluctuated in costs due to inflation or other economic factors.

Without indexation/fluctuation provisions within the contract, a Member would be held to the price that they tendered at or entered into at the outset of the relationship, regardless of whether those prices subsequently rise or fall.

2. How and when can indexation provisions be used?

Members may not have previously come across indexation provisions in construction contracts since the 1980s, which is due to the fact that until relatively recently the UK had undergone a period of high economic stability including low and stable inflation, and also due to the fact that a most contracts are by default drafted to be pro-client/main contractor.

As such, indexation provisions are nearly always removed from construction contracts – although routinely used in FM/maintenance, framework, call-off and strategic alliancing contracts - as a client/main contractor seeks certainty of price, whereas conversely a Member should be seeking to increase its contractual flexibility in relation to price and concurrently decreasing its exposure to risk by incorporating indexation provisions that allow the contract sum to be adjusted in line with market conditions.

ECA wishes to identify and inform the engineering services sector and ECA Members' decisions on what represents 'fair, reasonable and good contractual practice'. ECA remains committed to fair and open competition and this document is not designed to in any way dictate what may be an appropriate risk allocation, or act as a substitute for ECA Members obtaining project and context specific legal advice and making their own commercial decisions.

The incorporation of indexation provisions is doubly important in the current economic climate, as without them Members may find themselves priced out of opportunities due to economic circumstances beyond their control, or else turn a commercially attractive opportunity into one in which they end up making a net loss.

Indexation (fluctuation) provisions can either be opted into under several standard forms of contracts, or they can be expressly drafted and incorporated into more bespoke contracts.

3. What are the fluctuation provisions in JCT

JCT refers to the mechanism for index linking the price or elements thereof, as the fluctuations provisions.

Under the JCT Standard Building Contract and Design and Build Contract suites, there are three options for fluctuation provisions:

- **Option A**: allows the contract sum to be adjusted in instances where the tax payable by a Member on materials or goods changes, or instances where; contributions, levies or taxes payable by a Member to its workers changes;
- **Option B**: allows the contract sum to be adjusted in instances where the market price of materials or goods changes, or in instances where the cost of labour changes;
- **Option C**: allows the contract sum to be adjusted in accordance with the JCT Formula Rules that offer formulae for different categories of work. For example, under the JCT Formula Rules for sub-contracts historically, the NEDO formulae was set up to measure inflation in for a based on baskets of good and/or labour within each sector. NEDO is now part of BCIS Price Adjustment Formulae Indices (https://bcis.co.uk/product/price-adjustment-formulae-indices-online-pafi-bcis/) which is operated by RICS Online . Members should remember that RPI is now obsolete and CPI was invented to reflect general societal inflation excluding the cost of borrowing. During 2022, the electrotechnical sector has seen inflation rapidly rise above 23%+, yet mainstream societal inflation under CPI has experience a much slower incline to 10%+.

It is also important to note that under the 2016 suite of JCT Standard Contract and Design & Build contract Option A is the only Option expressly stated within the contract schedules, but these contracts allow parties to incorporate Option B or Option C in its stead should they wish to do so.

Under these contracts if no fluctuation provision is chosen then Option A applies by default, so Members should always carefully check the contract to see whether the Employer/main contractor has deleted fluctuation provisions from the contract particulars or made a bespoke amendment under any schedule of amendments.

4. What are the indexation provisions in NEC?

NEC doesn't use the term fluctuations, it prefers to simply reference indexation.

Most pricing options under the NEC3 and NEC4 suite of contracts (excluding cost reimbursable and management contracts) allow for the price payable under the contract to be adjusted for inflation under Option X1. This gives Members the opportunity to incorporate into the contract data specific items that will be subject to adjustment and to identify the indices that is going to be used.

Option X1 gives parties a 'price adjustment factor' mechanism that applies the relevant formula using the latest data from the selected indices to the items that have been listed under the contract as adjustable for inflation.

5. How can indexation provisions be incorporated into bespoke contracts?

Depending on the size and complexity of the works, Members may find themselves engaged on projects where the construction contract is not based on an unamended JCT or NEC- often engagement is based upon a sub-contract which comprises either bespoke terms and conditions or a JCT or NEC that is so heavily amended that it no longer resembles the original standard form.

Such contractual arrangements are unlikely to cater for indexation provisions, and, before entering into these contracts, Members should consider incorporating indexation provisions if the Member is pricing for materials or labour during a particularly volatile inflationary period.

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In terms of how to incorporate indexation provisions into a bespoke contractual arrangement, we would recommend using wording derived from the JCT fluctuation Options and amending it to your requirements and then choosing a formula index that best captures the rise of inflation for priced items that require adjustment.

Members can consider the following boilerplate clause and amend it accordingly:

1. *The Sub-Contract Sum shall be deemed to have been calculated in accordance with clauses [x-x] and shall be subject to adjustment in the events specified below:*

    1.1 *If, in relation to any materials or goods used for the execution of the Sub-Contract Works (as identified in Schedule x), the cost of those materials or goods (as identified in Schedule x) increases or decreases from the tendered rate after the Sub-Contract Base Date, the difference between the amount the Sub-Contractor actually pays for those materials or goods and the amount the Sub-Contractor would have paid for those materials or goods had the cost not changed shall be paid to the Sub-Contractor.*

6. Summary

Members should give careful consideration to the particular formula index used to ensure it reflects the economic reality of inflationary prices- in the current climate a lot of indices are failing to keep up with the speed of rising inflation.

Members who are party to FM, framework, strategic alliancing and call-off contracts may have had the privilege of indexation clauses within agreements but are likely to have reaped limited benefit from indexation in 2022 given the breakneck speed of inflationary rises.

Indexation provisions clauses are one tool in a toolkit of options available to Members to mitigate costs and lessen their risk exposure, and we would advise Members to consider all options available to them at the pre-contractual stage and to speak with ECA should they require guidance.

As always, ECA's legal team are on hand to support Members with the drafting of indexation provisions into their contracts and to advise generally on the topic of indexation /fluctuations.

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