<u>Price increases and the NEC3 ECC contract</u>

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Introduction

Recent pressures in the availability of materials and skilled labour combined with the recovery in demand following the gradual easing of lockdown restrictions, have led to a rapid increase in construction cost, a major component of which is materials' prices. According to some views, this phenomenon has been building up since September 2020; nonetheless, the impact is now obvious with contractors and clients forced to adapt their contract and procurement strategies in order to deal with it and be prepared for future price spikes.

Most commonly used contract forms such as the NEC3 ECC and JCT include provisions dealing with inflation and price increases, the former through the secondary Option X1 and the latter under the Fluctuations Provision (Schedule 7), if selected to apply.

We examine the price adjustment mechanism in the NEC3 ECC contract below.

NEC3 ECC secondary Option X1: Price adjustment for inflation

This option is used with main Options A, B, C and D which are lump sum (A, B) and target contracts (C, D) with activity schedule (A, C) or bill of quantities (B, D) respectively (Options E and F - cost reimbursable and management contracts - already provide for costs of inflation under the Defined Cost payment mechanism).

If X1 is not selected in the contract, the *Contractor* undertakes <u>all</u> inflationary risk in the lump sum Options A and B and <u>shared</u> risk in the target cost Options C and D. <u>However, this refers to the original scope of works and does not extend to the cost impact assessed for compensation events with certain exceptions as regards the rates in Contract Data</u>.

If X1 is selected, the *Employer* undertakes the risk of inflation with the exception of the non-adjustable proportion of the *works* and the application of the *Contractor's* share (in Options C and D); in Contract Data part one, the contract provides for:

- the *base date* for indices (this would be a date before the tender submission);
- the publisher of the indices; and
- the proportions of the *works* linked to indices and used to calculate the Price Adjustment Factor (PAF); the total of these proportions should be 1.00 (or 100%) and they include a non-adjustable proportion which represents the *Contractor's* risk in inflation. That proportion also affects the payment of compensation events, i.e. the *Contractor* cannot recover the non-adjustable portion of the cost increase between the compensation event assessment date and payment date, in the same way it cannot recover the non-adjustable portion of the cost increase in the originally tendered works at the time of payment.

In clause X1.1 the PAF is calculated as the <u>total of</u>:

The products of each of the proportions (as stated above) multiplied by (L-B)/B,

whereas,

B is the latest available index before the *base date* or the Base Date Index; and

L is the latest available index before the date of assessment or the Latest Index.

Calculation of price adjustment (if X1 is selected)

Clauses X1.4 and X1.5 provide for the price adjustment calculation on each assessment date respectively as follows:

<u>For Options A and B</u>

Price adjustment included in the amount due = [The change in the Price for Work Done to Date (PWDD) multiplied by the PAF which applies at the assessment date] **+** [price adjustment amount included in the previous assessment] **+** [corrections arising from changes in the indices used in previous assessments]

<u>For Options C and D</u>

Price adjustment added to the total of the Prices[1] = [The change in the Price for Work Done to Date (PWDD) multiplied by (PAF/(1+PAF) where PAF is the Price Adjustment Factor which applies at the assessment date] **+** [corrections arising from changes in the indices used in previous assessments]

Calculation of price adjustment for compensation events (Defined Cost)

<u>If X1 is selected (clause X1.3 applies)</u>

Defined Cost **=** (Defined Cost current at the date of the assessment) / (1 + PAF of the last assessment of the amount due)[2] **+** (Defined Cost at *base date* levels for amounts calculated from rates stated in Contract Data part two for employees and Equipment).

<u>If X1 is not selected</u>

The Defined Cost is calculated using current costs <u>but</u> *base date* costs when using rates stated in Contract Data part two for the Shorter Schedule of Cost Components (SSCC) in Options A and B, and the Schedule of Cost Components (SCC) in Options C and D.

Conclusion

The NEC3 ECC contract, when secondary Option X1 is selected, sets out the way price adjustments should be calculated for both the originally tendered works and any compensation events, whereby the risk (with the exception of the non-adjustable proportion and the application of the *Contractor's* share in Options C and D) is carried by the *Employer*.

When X1 is not selected, it is important for contractors to allow for inflation risk in the rates stated in Contract Data as these would remain unchanged (at *base date* levels) when assessing compensation events; contrary to the remainder of the assessment of Defined Cost which should incorporate current (at the date of the assessment) costs.

For assistance in related matters, you can contact us at info@pronea.co.uk

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[1]: Adjustment for inflation in target cost contracts is added to the total of the Prices for Option C or to the Total of the Prices for Option D so as to calculate the *Contractor's* share of the difference between the total of the Prices (or Total of the Prices) and the PWDD; PWDD = Defined Cost + Fee, whereas Defined Cost refers to current cost at the time of the assessment and includes the inflation accrued since the *base date*.

[2]: In this way the current Defined Cost, and consequently the change to the Prices, is reduced to the *base date* level, so that when the assessment of the amount due is made, the adjustment will be calculated as set out in clauses X1.4 or X1.5 (depending on the Option).