Indexation Guidance & Information

Indices estimate changes to the price levels over a given period – often year-on-year, but are often more frequent as well (e.g. monthly). This guidance is not definitive, but is a recommended starting point for deciding the most appropriate measures of indexation to apply to contracts and payment mechanisms.

To understand the impact of different rates of inflation on costs, please visit: [The Indexation Tool](https://defcalc.apps.alpha.mojanalytics.xyz/) for an interactive application that allows for easy comparison between various rates of inflation. Note that the official source(s) for high-level inflation forecasts are the OBR, and the ONS for detailed historical inflation.

# Recommendations

Indexation should reflect the relevant cost category. Contracts are complex and it is always not viable to breakdown costs to a granular detail. Common approaches are:

* **General Costs**. Consumer Price Index (**CPI**) is the default index which should be used if no other relevant index can be identified. Note that there are a number of secondary indices that breakdown costs further if necessary (e.g. for Food, Transport, or Energy).
* **General Costs, incl. housing.** Consumer Price Index, including Housing1 (**CPIH**) is the default index which should be used for general costs which include housing related costs, such as mortgage interest and rental payments.
* **Staff Costs**. Average Weekly Earnings (**AWE**) is the recommended index for inflating staff costs. Note that there are a number of secondary indices that breakdown costs further (e.g. Private Sector, Construction, or Services).
* **Building Maintenance Costs**. Building Maintenance Index (**BMI**) is the recommended index for inflating maintenance costs. This includes materials, health and cleaning costs, and is strongly influenced by AWE.
* **IT/Digital Costs**. If applicable, it is recommended to use appropriate variations of CPI and/or AWE.

There are several indices that are not recommended; their use is strongly discouraged. These are:

* Retail Price Index (**RPI**), and **RPIX**, are no longer an official UK Statistics, as of 2013. It has been replaced by CPI.
* **GDP Deflator** is relatively volatile as it is impacted by changes in economic output (i.e. what an economy produces). It does not accurately reflect the change in prices within contracts and excludes all imported goods and services in its price level.

Note that indexation may not always be appropriate for every contract. There are circumstances, such as with short term contracts, when it may be preferable to not include indexation.

It is worth noting that HMT aim to settle the Spending Review for departmental budgets using GDP Deflators. As such there may be a difference between actual rates of inflation and those funded centrally by HMT; this may lead to cost pressures if contract indexation is greater than GDP deflators (or vice versa).

# Comparisons

**CPI and CPIH are relatively low and stable indices**, which do not fluctuate significantly over time unless there are significant unforeseen economic shocks to the whole economy.

**AWE and BMI tend to fluctuate more, and trend higher than CPI** and CPIH except for during periods of economic downturn (i.e. recessions). This means that, in general, costs linked to these indices rise faster than those linked to CPI and CPIH.

**GDP Deflators** tend to trend closely to CPI – albeit often slightly higher - but diverge largely during economic downturns when output is less consistent. They **are more volatile than CPI** and **do not accurately reflect the contract costs** for the service provision that contractors are legally bound to provide.

# Detailed Indices

Retail Price Index (RPI)

RPI is a general price index. *RPI is no longer a UK national statistic; its use is not recommended.*

There are several commonly used derivatives of RPI:

* RPI (CHAW) – Overall index. This is the primary category; all others are subcategories.
* RPI (CHBG) – RPI, excluding fuel and energy costs.
* RPI (CHAZ) – RPI, excluding housing costs.
* RPI (CHMK) – RPI, excluding mortgage interest payments. *This is known as RPIX.*

Consumer Price Index (CPI)

CPI is the general price index used in official UK publications. It includes goods and services bought by consumers. It does not include housing costs. *It is the recommend default index.*

There are several commonly used and recommended derivatives of CPI:

* CPI (D7BT) – Overall index. *This is the recommended default if no other suitable/specific alternative indices are available or realistic.*
* CPI (D7BZ) – CPI, including health related costs only.
* CPI (D7BU) – CPI, including food (and non-alcoholic beverage) costs only.
* CPI (D7CQ) – CPI, including transport costs only.
* CPI (DK9T) – CPI, including energy costs only.
* CPI (D7C3) – CPI, including communication costs only.
* CPIH (L522) – Overall CPI index, also including housing costs.

Average Weekly Earnings (AWE).

AWE is the price index for work-related income and earnings used in official UK publications. There are several differing versions of this, which include/exclude different earnings. *It is recommended to use the total earnings (inclusive of overtime and bonuses) unless there is justification to use a different measure.*

There are several commonly used and recommended derivatives of AWE:

* AWE (K54U) – AWE, whole economy total earnings.
* AWE (K54V) – AWE, private sector total earnings only. *For outsourcing, this is the recommended index of labour-related costs.*
* AWE (K54W) – AWE, public sector total earnings only.

Buildings and Maintenance Index (BMI)

BMI is a privately sourced index, produced by the Royal Institution of Chartered Surveyors’ (RICS) Building Cost Information Service (BCIS). *It is recommended to use the overall (all-in) index for any costs related to building maintenance.*

There are several derivatives of BMI:

* All-In – inclusive of all derivatives. *This is the recommend index for BMI related costs.*
* Health Service – health related maintenance costs only.
* Local Authorities – local authorities’ maintenance costs only.
* Private Sector – private sector maintenance costs only.
* Materials – materials used in building maintenance costs only.
* Cleaning – cleaning of buildings/maintenance costs only.

## Construction Output Prices (OPI)

OPI is a construction related index, produced by the ONS. *It is recommended to use if a project is related to building and construction.*

There are several derivatives of OPI:

* New Work – OPI, new building projects only.
* Repair & Maintenance – OPI, repair and maintenance of existing projects only.

GDP Deflator

GDP Deflator is an index published by HM Treasury (HMT). It is used to convert nominal prices into real prices. It is not recommended to use as an index for contractual inflation/payment mechanisms as it is unlikely to reflect actual contractual expenditure. This is because it relates to changes in output, as well as changes in price levels, and is therefore inherently more volatile. It also excludes imports from its calculations, and includes government expenditure, which may not be appropriate for outsourced contractual expenditure.

## CPI vs GDP Deflator Comparison Example

**Example:** *Tea is imported into the UK from abroad. Tea harvests suffer dramatically, and the supply of tea/tea leaves falls. As a result, the cost of tea increases.*

* CPI will reflect the change in price, as this is what consumers will have to pay.
* GDP Deflators will reflect the change in the supply of tea and the change in price. Depending on the magnitude of these changes, GDP deflator could increase or almost entirely exclude the impact of the price change on tea (if total domestic demand fell to near-zero).
* Therefore, if a contract was required to use/provide a certain level of tea, inflating the prices with GDP deflators would not accurately represent the increase in prices that will be paid by suppliers.

*Note that the opposite would also hold true. If the supply of tea increased significantly, and the price fell, CPI would reflect this with a lower and consistent rate of inflation whereas GDP deflators could increase or decrease depending on the magnitude of the price fall (i.e. if price fell, but demand remain unchanged, GDP deflators would fall negative).*