

Supply Shortages are Here to Stay – Managing Cost Escalation under NZS 3910:2013

By Nick Gillies and Chanté Fourie

Over the past year, New Zealand has experienced a significant increase in the cost of construction, primarily from Covid-19 related disruptions. Supply chain constraints combined with booming domestic demand have resulted in surging costs for many building materials, including structural steel, GIB, framing, and timber. Skill and labour have become scarce too, with the flow of foreign workers grinding to a halt as borders remain heavily restricted.

These factors have culminated in a 5.8% increase in the cost of inputs for the construction sector in Q3 of 2021, compared to the same quarter in the previous year.¹ A reprieve from escalating costs seems unlikely, with a further 12% increase anticipated over the next 6 months.² In these circumstances, parties to new construction contracts will want to give more thought to managing (and allocating) price escalation risks.

This article outlines the main options available under NZS 3910:2013 (**NZS 3910**), as New Zealand's most used standard form construction contract. Namely: cost fluctuation; Provisional and Prime Cost Sums; and Cost reimbursement pricing.

Cost Fluctuation Provision

NZS 3910 has an under-utilised cost fluctuation formula (see clause 12.8 and Appendix A). This is an opt-in mechanism. That is to say, the parties must record in Schedule 1 (Special Conditions) whether they want to allow cost fluctuation adjustments and, if so, whether there should be any changes to the default formula in Appendix A.

If allowed, the default cost fluctuation formula entitles the Contractor to adjust the Contract Price by applying a seemingly daunting calculation. However, the calculation is not as complicated as

it might first appear. It uses the Labour Cost Index and Producer Price Index (available on Statistics New Zealand's [website](#)) as a measure of price increases between tender and the applicable quarter.

The default position is that 40% of the labour price increase and 60% of the materials price increase is recoverable. The calculated adjustment rate is then multiplied by the certified value of the works in the applicable quarter.

So, taking a simple example:

- If the Labour Cost Index has increased from 100 to 120, 8% cost fluctuation is recoverable on labour ($(0.4(120-100)/100)$);
- If the Producer Price Index has increased from 100 to 120, 12% cost fluctuation is recoverable on Materials;
- The combined cost fluctuation recovery rate is therefore 20% (ie $0.08 + 0.12$); so
- If the value of the applicable works was \$100,000, the amount claimable for cost fluctuation is \$20,000 ($\$100,000 \times 20\%$).

In our experience, most NZS 3910 contracts have not allowed any cost fluctuations. That decision is sometimes regretted by the Contractor when the works take substantially longer due to non-culpable delays, during which time prices can increase.

In the current environment, there is likely to be a stronger case for allowing cost fluctuations. If the default formula is adopted, the parties should consider whether a recoverability rate of 40% for labour cost increases and 60% for materials cost increases is acceptable in the circumstances. It is straightforward enough to specify other percentages, or another formula may be substituted altogether. Parties should also

¹ Statistics New Zealand, Business Price Indexes: September 2021 Quarter – Producers Price Index.

² EBOSS Q4 2021 Construction Supply Chain Update.





bear in mind that the default formula is based on industry wide indices as opposed to the actual cost experienced by the Contractor, which may produce a better or worse result. Further, these indices are only calculated quarterly, meaning that they might not be able to keep up with the current pace of price increases.

Provisional and Prime Cost Sums

Provisional Sums and Prime Cost Sums are discrete elements of, respectively, work and Materials that have only a provisional (or estimated) price when the contract is entered. The Engineer decides during the project whether this work is to be carried out or if the Materials are to be used (and the type to be selected). If instructed, the Contractor is paid, in summary:

- a. the work valued as if it were a Variation; or
- b. the net purchase price of the Materials plus a reasonable allowance for expenses and profit.

In other words, the provisional amount is effectively substituted with the valued or actual cost. The Principal therefore stands to bear (or benefit from) any price increases (or decreases) for such elements.

Provisional / Prime Cost Sums have traditionally been used for discrete parts of a project that are inherently difficult to price, as an exception to an otherwise lump sum contract. In the current environment, it may be appropriate to use them more widely to help better allocate or manage price risk.

Cost Reimbursement Pricing

If the risk of price change is considered too great or wide-ranging to be managed by cost fluctuations and/or Provisional / Prime Cost Sums, it may be appropriate to consider having a cost reimbursement contract.



NZS 3910 provides for three different types of contract: lump sum, measure and value, and cost reimbursement. Traditionally, most construction projects of any scale have been contracted on a lump sum basis because of the price certainty that it provides. However, this has become less viable (or accepted) for some projects in the current environment.

Under a cost reimbursement contract the Contractor is paid the Net Cost of the work carried out plus agreed allowances for overhead and profit. In this way, the price risk transfers to the Principal for the whole of the works. Practically speaking, this may now be the only way to secure a preferred or high-quality Contractor in some instances. However, there are advantages for Principals. It means the Principal is only paying for the work performed, while avoiding paying any risk premium that may otherwise be factored into a lump sum price. Contract administration and dispute risks associated with Variations are also likely to be minimised.

Finding the Balance

There is no single solution or one-size-fits-all for addressing price risk. The key message is for contracting parties to turn their minds to the issue and consider what type of pricing and/or combination of measures in NZS 3910 are most suited for each individual contract.

If you have any questions about how to manage cost fluctuation in your construction contract, contact the [Construction Team](#) or your usual contact at Hesketh Henry.

Disclaimer: The information contained in this article is current at the date of publishing and is of a general nature. It should be used as a guide only and not as a substitute for obtaining legal advice. Specific legal advice should be sought where required.

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Nick is a partner at Hesketh Henry, a sector-focused commercial law firm. He specialises in construction law and heads the firm's dedicated construction team. Nick acts on the full range of building and engineering disputes, as well as negotiating construction contracts and consultancy agreements. His experience includes eight years with a specialist UK construction firm, and he is individually recommended by Legal 500, Doyles Guide, and Chambers and Partners.



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Chanté assists in a range of civil matters within the Litigation and Dispute Resolution Team, including construction, insurance, and insolvency disputes. Her background is in insurance, having worked for a large New Zealand insurer prior to joining the firm. Chanté frequently assists in a variety of construction related matters including building remediation issues, liability claims against consultants, as well as time and money claims.

