# **Managing contract price reviews – Goods and services procurement guide**

## Background

The Victorian Government Purchasing Board (VGPB) recognises the important role contract managers have in ensuring the procurement of goods and services not only improves government service delivery, but also delivers value for money over the life of the contract. To achieve this, procurers should fully consider the cost drivers which impact the goods or services’ overall costs, before determining the appropriate price index applicable to a contractual arrangement. Contract managers should fully understand the cost drivers to assess the validity of a price increase or decrease.

The Consumer Price Index (CPI) is widely used within government contracts as a basis for calculating price increases during the term of a contract. This is likely due to its easy comprehension and seminal status as a price indicator, relative lack of volatility and ease of application when calculating and verifying price movement.

However, the CPI, by nature, may not always be the most appropriate measure for calculating price changes: CPI measures price movement in a wide range of consumer goods and services, most of which are not applicable for the types of goods and services procured by the Victorian government. Alternative indices and other approaches for measuring cost changes are available and should be considered when negotiating contracts. Furthermore, contract managers should also determine if an annual price change is warranted at all.

The intent of this document is to assist contract managers to make an informed decision when deciding on an appropriate price indicator for the life of the contract.

### Challenge the assumption that prices increase every year

Each year, the price of goods and services fluctuates depending on the type. However, not all goods and services increase in price: the price of a particular item may remain the same or decrease in price. Implementing a fixed annual price increase should be assessed on a case‑by‑case basis, rather than applied as a default price indicator

Price review mechanisms, to some extent, ignore the supplier’s ability to increase their margins over time through increases in efficiency and/or innovation. Consider the price review from the supplier’s perspective. Are they:

* mitigating risk for cost movements that are outside of their control?
* trying to recoup money ‘lost’ in the early years of a contract, as a result of bidding low?

Contract managers should aim to recognise genuine price increase requests that are attempting to maintain a supplier’s profit margin.

## Considerations

Two factors need to be considered when including a price review mechanism in a contractual arrangement:

* the cost drivers; and
* the contract term.

### Case study 1

A print supplier providing printing of a weekly journal for a period of three years submitted a substantial price increase for the third year of the contract. The supplier requested the price increase on the basis of increases in electricity costs (which had changed in the market place by a similar amount.) However, by understanding the proportion represented by the cost of electricity in the supplier’s overall costs, the contract manager was able to reduce the price increase to a much smaller and appropriate amount.

### Case study 2

A department established a contract for the provision of ICT services for a period of 5 years with the option to extend for a further 2 plus 2 years. The contract included the provision of hardware, software and IT services. A price review mechanism utilising both a Producer Price Index and a Labour Price Index was applied to applicable components of the contract. This was designed to provide a more relevant and appropriate price review mechanism. The contract also required the supplier to provide justification, with evidence, to support a request for a price increase.

## Understanding the cost

Before considering an appropriate price review mechanism, it is important to understand the main influences, or drivers, on the cost. This will help determine the most appropriate mechanism to manage cost increases and help determine which cost components are ‘controllable’ by the supplier and which components are ‘uncontrollable’. There is some strong support for the notion that ‘controllable’ components should remain fixed during the term of the contract or are at least forecastable. It is also important to understand the relative proportion of each component to gauge its impact on price changes. This understanding of cost drivers and their impacts can help influence the procurement process and the contract (including the term).

The use of fixed pricing within contracts can also be considered as a means of avoiding price increases during the term of the contract. However, if prices reduce during the term of the contract, the benefits of these decreases will be missed.

The choice of price review mechanism ultimately requires careful consideration of what is being procured.

## Determining the contract term

The proposed contract term needs to be considered carefully as it can drive the need for a price review.

Longer contract terms are considered prudent in certain circumstances (e.g. where transition to a new supplier is considered costly or risky, or where the supplier is required to make significant investments in order to deliver the goods or services), but the increased duration may necessitate the need for regular price reviews. In highly competitive markets, shorter contracts should be considered in order to leverage competition as frequently as possible. Consideration should also be given for a period of time in which the supplier is prepared to fix their pricing, as it may cause a reduction in savings.

## Types of price indicators

### Consumer price index

Consumer price index (CPI) is the key measure of inflation in Australia and measures the average change over time in the prices paid by households for a fixed basket of goods and services. Its purpose is to provide a general measure of inflation for Australian households. Each quarter, the Australian Bureau of Statistics (ABS) obtains over 100 000 prices that are used as a representative range of goods and services that Australian households acquire. The changes in price of these goods are combined with actual expenditure data of Australian households to calculate the overall price change in the quarter.

Because it is a general measure, the CPI could be considered to lack precision when being applied to specific cost drivers.

Access the [Australian Bureau of Statistics website](http://www.abs.gov.au).

### Producer price indexs

Several producer price indexes (PPIs) are published by the ABS. These include a set of indexes relating to specific industries (selected manufacturing, construction, mining and service industries), which may be more representative of the goods and/or services being contracted.

PPIs can be utilised as either output measures (measuring changes in the prices of goods and/or services sold by the specific industry) or input measures (measuring changes in the prices of goods and/or services purchased by the specific industry).

### Labour price index

The Labour price index (LPI) measures annual changes in the price of labour in the Australian labour market. Specific indexes are published quarterly for combinations of State/Territory, sector (public/private) and broad industry groups. This index may be appropriate where labour costs make up a significant proportion of contract prices.

If possible, an agreed ceiling rate can be applied to a specific index, which creates an upper limit to protect parties from unforeseen spikes in the specific index. This is particularly useful when applying indexes which can be more volatile than the CPI. It may also be useful to develop a weighted combination of price indexes where there are two or more main cost drivers

## Evidence‑based request

Suppliers can be requested to provide written evidence for the basis of their price increase request, such as increases in their cost inputs (e.g. utilities, wages or fuel). These requests can then be reviewed by the contract manager and approved, negotiated or rejected as appropriate. This method could be considered to be the most rigorous and evidence‑based process and is best managed with a sufficient understanding of cost drivers, proportion of elements and how these elements are managed by the supplier. Adequate pre‑planning, understanding and knowledge of the products and services being acquired will help avoid protracted negotiations and re‑work as a consequence of any price change request.

## Other considerations

Each contract should be considered on a case‑by‑case basis when determining the most appropriate price review method. However, the following factors should also be taken into account:

* volatility of the price index – what impact will this volatility have on pricing and, in turn, budgeting?;
* time and resources available – some price review mechanisms are time, data and labour intensive to validate and administer;
* ease of negotiation – some price review mechanisms can be problematic to either include in a contract or require ongoing negotiations to agree on a price increase; and
* capability of procurement practitioners to undertake financial and data analysis, complex contract negotiations and robust contract management, supported by an efficient contract management system.

Irrespective of the measure or approach adopted, the following factors should be considered for inclusion in a contract (if the price is not fixed): clearly identify the selected index and its source;

* clearly establish the base price and the starting point of the price index;
* clearly state the frequency of the price review;
* clearly define the formula by which the price adjustments will be calculated;
* clearly state the process and timing for the formal price adjustment requests to be made by the supplier;
* allow for re‑named, varied or discontinued price indexes; and
* ideally, price reviews should allow for negative price movements.

Best practice in contract management should include a request for sufficient evidence or justification from the supplier when a price change is proposed. This information then becomes the basis for a better understanding of the cost drivers.

All price increases, once reviewed, should be approved by the contract manager before becoming effective.

## Using this guide

This guide accompanies the [goods and services supply policies](https://buyingfor.vic.gov.au/goods-services-supply-policies). There are 5 supplies policies:

* Governance policy
* Complexity and capability assessment policy
* Market analysis and review policy
* Market approach policy
* Contract management and disclosure policy

This guide supports the [Contract management and contract disclosure policy](https://buyingfor.vic.gov.au/contract-management-and-contract-disclosure-goods-and-services-policy).

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