



Department of

Finance

An Roinn

Airgeadais

Better Business Cases NI Supplementary Guidance

Dealing with the Impact of Inflation in Business Cases

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1 Introduction

High general inflation coupled with particularly high real terms inflation in certain sectors presents challenges for appraising and delivering programmes and projects. Not adequately accounting for inflation in Business Case submissions can lead to issues of affordability and potential breaches of approval conditions/tolerances.

Inflation presents a non-systemic external risk to programmes and projects. With high inflation there is a risk the estimates and projections in Business Cases will undershoot realities and it is important this is mitigated as far as possible. It follows that any Business Case submitted to support expenditure approval should include the latest estimates and projections of costs and benefits taking account of advice on appropriate inflation factors.

As outlined in HM Treasury's [Guide to developing business cases for projects and programmes](#), the “five case model” is applicable to policies, strategies, programmes and projects and comprises of five key dimensions:

- the Strategic Case;
- the Economic Case;
- the Commercial Case;
- the Financial Case; and
- the Management Case.

This supplementary guidance focusses on the Economic, Commercial and Financial Cases. However, it may be necessary to reflect the inflationary environment in the other cases too, for example, in the Management Case there may be delivery targets impacted by high inflation and it may be necessary to include management structures to ensure ongoing review of costs for larger and longer term projects where costs could have the potential to escalate significantly during delivery.

2 The Economic Case

2.1 Input Figures

Net Present Social Value/Cost (NPSV/C) assessments using the Green Book discount rate should exclude the effects of general inflation and be based on 'real relative prices' as opposed to current or nominal prices. Consequently, appraisers may have to adjust inputs to put them onto a common price base. GDP deflators are generally used to make these adjustments unless there is evidence to the contrary. Where certain cost or benefit items' prices are not following/are not predicted to follow the trend of general prices in the economy, i.e. they are changing or are expected to change relative to general prices, their differential with general price changes should be reflected in the appraisal. This involves further adjustments to these items to reflect the understanding that they are/will be changing at a differential rate to general or other items' prices over time so that the same price base is reflected as far as possible in all input values. These assumptions should be transparently set out in the Business Case.

In larger cases it may be appropriate to seek advice from procurement experts who have experience of recent tender prices for particular costs. For example, DoF Construction Procurement Delivery (CPD) use the Building Cost Information Service (BCIS) All-in Tender Price Index, which is a recognised industry standard that provides cost and price data for the UK construction industry¹. There may be specific sources of information depending on the sector/area the case relates to and your CoPE² or Departmental Economists may be able to assist with identifying these.

¹ The BCIS All-in TPI is published by the Royal Institution of Chartered Surveyors and is a national index, which is subject to change dependent upon collated data, and is updated quarterly.

² Centre of Procurement Expertise.

2.2 Risk and Uncertainty

In times of abnormal inflation particularly in sectors relevant to the project, the appraiser should consider whether it would be prudent to make any further adjustment to seek to reflect *residual* risk regarding inflation in the specific sector(s). This should only be done after best attempts have been made to account for real inflation as robustly as possible in the input figures. Particular spending areas may have specific approaches to accounting for this risk, and Departmental Economists can advise on these. However, in the absence of more specific approaches, a general approach to monetising this residual risk impact within the NPSV/C calculation would be to make an adjustment for Optimism Bias (OB). In the absence of robust evidence bases the majority of OB adjustments use the MMD calculator approach³.

If seeking to include residual sector-specific inflation risk within the overall OB adjustment percentage, care must be taken to avoid double-counting and introducing a perverse aspect into the assessment. If the MMD calculator⁴ is being used then general the risk area to include it in would be “External Influences – Economic” if using the ‘Building Projects’ or ‘Civil Engineering’ calculators, accompanied by an explanation for its inclusion⁵. The extent of mitigation should reflect the robustness or status of the projection sources used and attempts already made at accounting for inflation in the input figures.

It would be advisable also in Business Cases where inflation is considered an important risk to apply a specific sensitivity test to options’ NPSV/Cs to test their robustness in both NPSV/C absolute and ranking terms to particular inflation scenarios/ranges. This could be useful later in deciding whether, or the extent to which, to re-open the Economic Case if a particular inflation outcome occurs that falls within the range tested and breaks an approvals tolerance.

³ This builds up an overall adjustment percentage to apply to an input through the appraiser making mitigation adjustments to key causes of cost and time over-runs, which have different weights within the overall percentage calculation.

⁴ [Additional Business Case Templates | Department of Finance \(finance-ni.gov.uk\)](#)

⁵ For a standard building project where all other potential risks in the calculator remain of relevance, this carries a weighting of 11% against the overall OB adjustment meaning it can contribute up to 3 percentage points to the overall OB adjustment percentage. The contribution of this factor to the overall OB percentage adjustment for non-standard building projects is up to 7 percentage points, and for civil engineering projects between 2 and 3 percentage points. However, best endeavors to account for inflation in the base inputs mentioned above would imply some mitigation against this specific risk area in the calculator may be appropriate. The ‘Equipment – Outsourcing’ OB calculator does not assign a weighting against this risk factor.

3 The Commercial Case

The purpose of the commercial case is to set out the procurement arrangements for the project's key outputs and activities. Such arrangements should reflect the approach to prices/charging anticipated in any contractual arrangements, and be consistent with the Financial Case. Procurement experts can advise on these aspects.

4 The Financial Case

The purpose of the Financial Case is to demonstrate the affordability and funding of the preferred option, including the support of stakeholders and customers, as required. Unlike the Economic Case, which seeks to remove the impact of general inflation in preparing input costs and benefits for assessment, the Finance Case must express the costs (and cash releasing benefits/receipts if relevant) of the preferred option in nominal prices.

If real price increases (i.e. over and above general inflation) have been properly accounted for in the Economic Case assessment, then the exercise of converting to nominal prices initially should be relatively straightforward in the Financial Case (since the figures from the Economic Case will already have accounted for relative price change differences across the cost inputs).

However, in a dynamic inflation environment it may be prudent also to consider a financial contingency measure on top of any adjustments made in the Economic Case. In this context it is important to note that an OB adjustment is not the same as a financial contingency. Care would be needed to avoid double-counting and any contingency should only be accepted on the basis it is not allocated to the project unless and until needed and only then for the reasons stated in the contingency justification. However, where justified it is reasonable to include it in the approval envelope⁶

⁶ HMT Green Book states (para 6.83): 'Contingency is an allowance in the financial dimension of the business case to cover residual risks. It consists of...the remaining optimism bias adjustment (that is, the original optimism bias adjustment minus the risks that have been prevented)...the value of any remaining risk that has not been prevented.'

5 Summary

- In the Economic Case, seek to account for sector-specific inflation in estimating and projecting costs and benefits and their timing for use in NPSV/Cs so that real inflation is properly accounted for and all inputs are appropriately adjusted to a common price base.
- Subsequently, *only if considered necessary*, seek to account for undershooting inflation (i.e. inflation risk) in the NPSV/C assessment through an OB adjustment to the relevant items, being careful not to double count;
- If relevant, undertake sensitivity tests on the options covering a range of inflation scenarios;
- In the Commercial Case, reflect the approach to prices/charging anticipated in any contractual arrangements; and
- Consider in the Financial Case whether a financial contingency should be included for inflation-related expenditure on top of any adjustments made in the Economic Case.