MANAGING PRICE INFLATION

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BUILDUK
Leading the Construction Industry

WHAT IS THE ISSUE?

The construction industry has had a lot to contend with in recent years to mitigate the effects of Brexit, COVID-19 and the ongoing war in Ukraine and is now facing further inflationary pressures in the wake of the imposition of global tariffs by the US Government.

The effect of those tariffs is yet to play out but uncertainty is affecting markets used to global supply chains. As such, inflation is likely to be with the industry for some time to come and businesses across the supply chain will need to find ways to manage the risks of cost escalation over the life of a project that are fair and proportionate to all parties, which may require a re-allocation of risk in existing and future contracts.

> Regardless of the provisions of the contract, if cost inflation is seriously impacting the project or one or more of the parties, then all parties should work together to find a way to manage it.

WHAT IS A FLUCTUATIONS CLAUSE?

A fluctuations clause is a contractual term allowing the price of a construction contract to be adjusted to reflect changes in the law, the cost of materials and/or the cost of labour during the contract period.

Events in recent years have caused price volatility not seen since the 1970s, particularly of key construction inputs such as energy, steel and timber, and businesses are increasingly seeking to include fluctuation provisions in their contracts, which increase the Contract Sum in accordance with objectively measured price rises.

With the imposition of tariffs expected to result in further volatility, there are a range of fluctuations clauses in standard form contracts and which ones are adopted needs to be considered carefully in relation to the overall project and duration. For example, certain fluctuation provisions may be more appropriate for projects of a longer duration or for particular materials that are subject to high price volatility.

WHERE CAN I FIND FLUCTUATIONS CLAUSES IN STANDARD FORM CONTRACTS?

In JCT 2024 contracts, there are three fluctuations options to choose from to cover different types of price increases.

- **Option A** covers contributions, levy and tax fluctuations (essentially statutory changes)
- **Option B** covers labour and materials cost and tax fluctuations
- **Option C** is a formula, which adjusts prices, using cost indices produced by the RICS.

These fluctuations clauses can be incorporated by reference in the Contract Particulars. Alternatively, the parties can specify their own cost adjustment provisions by identifying the document(s) in which they are contained and including them as Contract Documents.

The Contract Conditions include the operative clauses in the payment provisions of each contract which are essentially additions to the interim payments. Option A is the only Option now included in the JCT contracts themselves, whilst Options B and C are available on the JCT website.

In NEC4 contracts, there are three groups of options in relation to price inflation.

- Under **Options A** and **B**, there is a lump sum for the works and the supplying party carries the cost risk, including inflation, save for Compensation Events that can allow for more time or money, or risks allocated under the terms of the contract.
- Under **Options C** and **D**, the parties agree a target price for the works and respective shares of savings (where the works come in under budget) or overrun (where the price is exceeded) – otherwise known as pain/gain sharing. The proportions are agreed within the contract and do not have to be a 50/50 split.
- Under **Options E** (cost reimbursable contract) and **F** (management contract), the parties agree levels of overheads and profits and the client pays the agreed overheads and profits, plus the actual cost of the works, so in effect, the client carries the risk on costs, including inflation. However, under Option F, risk allocation can be varied using the options chosen in the specific sub-contract.

Fluctuations are dealt with in Secondary Option X1. Where this is used, the details needed for calculating the adjustment need to be set out in the Contract/Subcontract Data.

IF NEGOTIATING A CONTRACT, HOW CAN INFLATION BE DEALT WITH?

The starting point is whether the proposed terms and conditions allow for any price increases and if not, the parties should consider how it can be best addressed in relation to all the circumstances of the project.

If the works are being procured by way of a **standard form contract** and it is agreed that the contract's fluctuation provisions apply, then this must be made clear by making an entry in the Contract Particulars/Contract Data and in any schedule of amendments to the contract that the fluctuation clauses are being used.

Attention must also be paid to the date inserted into the contract for the "Base Date" from which any fluctuation provisions will apply:

- In **JCT contracts**, the Contract Sum is deemed to have been calculated at the agreed Base Date. The Base Date is usually stated to be the date of the tender or priced offer, which means that the risk of inflation between the tender and contact execution lies with the supplying party. However, if the date of execution of the contract or commencement of the works is used as the Base Date, then the risk of inflation over this period rests with the employer.
- In **NEC contracts**, if Option X1 is utilised, the parties also need to specify the base date from which the inflationary indices will apply.

If the proposed **contract is entirely bespoke**, consider whether there are any existing clauses allowing for payment adjustments or variations due to price inflation and make sure they work for all parties.

If not using standard contract fluctuation provisions, consider seeking to agree to link price increases to other published **building and construction price indices** best suited to the project, such as those compiled by the Department for Business and Trade (DBT) and the Building Cost Information Service (BCIS). Whatever index is used, check that it is adequately and regularly updated as needed.

It is **not** recommended to use general indices such as the Retail Price Index (RPI) or Consumer Price Index (CPI), as inflation on certain construction supplies, such as steel and timber, may continue to run considerably ahead of general inflation.

If there is no scope for price increases in the contract, consider carefully at the time of tender what contingency you should add to your tender price to cover any such increases, or whether you want to tender at all.

WHAT COMMERCIAL STEPS CAN I TAKE TO MITIGATE INFLATION?

Early and ongoing collaboration across the project team will be key to addressing inflationary pressures for a particular project on a fair basis.

- **Early planning, design and sourcing** is even more important in inflationary times. Consideration should be given to whether there are alternative designs, suppliers, materials or components that could be substituted and are less prone to the risk of delay and inflation. If the specification/Employer's Requirements does not allow for substitutions, check whether that can be changed by agreement. Suppliers and those procuring from them need to consider availability and delivery times of key components and materials and how these may be secured before ordering. Proposed contract terms or terms of business should be carefully reviewed and understood before being accepted.
- Consider **early ordering of and payment for materials** or key components to lock in prices. JCT and NEC contracts provide for advance payments and for security for early orders and deliveries by way of advance payment and off-site material bonds.
- Carry out regular **financial checks on companies within your supply chain**. Consider whether these suppliers are sufficiently resilient and have their own plans in place to deal with shortages and delivery delays.
- Consider whether **alternative procurement methods** may be appropriate such as two stage tendering, open book procurement or a target cost approach. For example, two stage tendering enables the main contractor and certain specialists to be engaged early on the basis of agreed overheads and profit, with the contractor and its key sub-contractors participating in progressing the design, buildability, procurement and pricing, allowing for a later second stage tender to finalise the contract price.
- Consider the **overall risk profile of the proposed project**, including programme, and whether there is a way to mitigate delays or exposure to them, generally and particularly in relation to supplies, for example by reducing liquidated damages.
- Once in contract, **keep good written records** to assist with any variation/delay/loss and expense claims, and follow all notification requirements for possible delays or difficulties punctually and in accordance with the contract terms.
- As cash flow will be even more important, **apply for payment on time** and in accordance with the contract's requirements, and chase late and retention payments.

WHAT MEASURES CAN I TAKE IF PROCURING MATERIALS IN ADVANCE?

- Check the **terms of your contract** and contract documents carefully to ensure that they are consistent and reflect precisely what has been agreed about early delivery and payment. Most payers will want ownership of goods for which they pre-pay to be formally “vested” in them by way of a “vesting deed” to guard against supplier insolvency and ensure that the goods cannot be used for any other project.
- If materials are going to be **stored off-site**, consider who will pay the storage charges and when the legal ownership in those goods passes to the payer. Check suppliers’ terms of sale to make sure that if transfer of ownership of those goods is required early you are not prevented from doing so by “retention of title” provisions.
- Place greater emphasis on **security and protection for materials** and fuel both on and off site.
- If **off-site material bonds** are a precondition of early payment, consider if what is required can be obtained and which party will bear the cost. The bond market has hardened considerably since COVID-19, so consider carefully the bond terms being offered.

WHAT CAN BE DONE ABOUT INFLATION IN EXISTING CONTRACTS?

If the contract expressly includes any basis for price adjustment, for example a term or provision that states prices will only be fixed for a specific time period that has now elapsed, use those provisions.

If the contract does **not** include any fluctuations clauses or another way of being able to adjust prices, there may only be scope for additions to the agreed Contract Sum where there is either:

1) A variation or change, or
2) An entitlement to an extension of time and related loss and expense.

This will be by reason of specified delay events (Relevant Matters in JCT contracts and Compensation Events in NEC). All will need to be within the meaning of the contract provisions so careful consideration of the background circumstances will be required. If there are grounds for such an application, it is important to comply with all the contractual requirements to make a claim.

WHAT CAN I DO IF A SHORTAGE OF MATERIALS IS CAUSING A DELAY?

JCT contracts provide for specific grounds on which a contractor can seek to claim an extension of time (EOT), known as "Relevant Events".

Force majeure is typically associated with an occurrence or event that is (1) beyond a party's control which (2) hinders performance under a contract or makes it impossible to perform. Whilst it will depend on the precise wording in the contract concerned, proving force majeure is generally a high threshold and can be difficult to reach. This is particularly so under unamended JCT contracts because force majeure is undefined. It is therefore necessary to look to common law when considering whether or not force majeure may apply to the facts in any case, and historically successful force majeure claims have been made in relation to disruption caused by regional or large-scale conflicts.

However, now that the war in Ukraine is in its third year, parties cannot say that its effects have taken them by surprise. The same is true of tariffs now that the US Government's intentions have been announced. What is extremely difficult to predict is the extent to which the tariffs will be implemented, and the effects of retaliatory tariffs by other countries remain to be seen.

Depending on the terms of the contract, a **change in law** that directly affects the execution of the works may be a Relevant Event for which an extension of time can be granted. Examples would be if performance of the contract has been impacted by sanctions imposed on Russia and certain Russians by the UK or if legislation is passed to mitigate the effects of tariffs, which could not have been anticipated at the date of the contract.

Although under unamended JCT contracts force majeure and changes in law are not "Relevant Matters" entitling a contractor to claim for additional loss and expense for any EOT allowed, an EOT if granted will at least provide relief against liquidated damages. Further, if having regard to the contract terms there is a variation to the specification or change to the Employer's Requirements instructed by the Employer to mitigate the effects of materials and labour shortages and delays, such instructions may be treated as a variation or change and be valued as such.

In **NEC contracts**, the provisions for obtaining an EOT are assessed together with requests for additional money as "Compensation Events". Grounds include an event delaying practical completion which neither party could prevent and an experienced contractor would have judged as so unlikely to occur as to have been unreasonable to plan for (clause 60.1(19)), a change in law (Option X2), or where the scope requirements are impossible to perform (Clause 60.1(1)).

Clause 60.1(19) and Option X2 are likely to operate in similar circumstances to those under the JCT form of contract discussed above. Clause 60.1(1)'s threshold of "impossibility" is very high and makes clear that performance simply being more difficult or costly due to supply shortages will not be enough.

CAN I LAWFULLY TERMINATE A CONTRACT IF INFLATION MAKES IT COMMERCIALLY UNVIABLE?

Termination is unlikely to be an option if the supplying party has made what has become a bad bargain and the contract itself does not provide for such a remedy in the relevant circumstances.

It is also a risky strategy because if the terminating party gets it wrong and unlawfully terminates, then it runs the risk of a claim being made against it for breach of contract. The damages claimed will include the additional costs of getting the work completed by others, as well as the costs and expenses incurred as a result of wrongful termination. Depending on the precise circumstances, the following may be relevant for existing contracts:

- Does the contract have an **express force majeure clause** that precisely covers the post contract event giving rise to delay(s)/price increase(s) concerned? Events known about before the contract was entered into will **not** count. The courts will be reluctant to come to a conclusion that force majeure applies and will consider if the event in question materially undermines the commercial objective of the contract.
- Does the contract have express clauses dealing with **illegality/change of law** during the contract and relevant to the works which give rise to a right of variation or termination?
- Is there an express **sanctions clause** that relieves the supplying party of their contractual obligations? If so, does it apply?
- After the contract was entered into, has performance become frustrated, that is impossible or radically different to what was intended, due to **unforeseen circumstances** which defeat the commercial purpose of the contract? This is a high legal threshold to prove and inconvenience, hardship or financial loss will not be sufficient.
- Does the contract provide **alternative remedies** for shortages/delays/price increases, for example clauses allowing for substitutions/variations/extensions of time and can those clauses be utilised? If so, the courts are unlikely to be sympathetic to arguments that termination was appropriate.

For contracts currently being negotiated, termination clauses can be agreed for inclusion, either for specified circumstances, which will have to be carefully drafted, or for termination at will/without cause. However, a termination at will clause is currently unusual in English construction contracts.

Any party contemplating termination of a contract should carefully consider and/or seek advice on its terms, the circumstances that give rise to termination, and the consequences if that step is taken.

WILL WORKS INSURANCE COVER AN INCREASE IN COSTS IF A CLAIM IS MADE?

Contractors' All Risks (CAR) policies often include so-called escalation and inflation clauses to account for increases in the value of works undertaken during a construction contract.

However, CAR policies are not all the same. That which applies to a particular contract should be carefully checked to make sure that such a provision is included and that it adequately covers not only current inflation but higher rates of inflation during the life of the project.

If the insurance cover is not adequate for a particular loss suffered, the policy may contain an "average clause" proportionately to reduce the amount paid out to match the level of the policy. This means that if the insurance cover is inadequate the policy will not meet the total amount of the claim.

IS THERE ANYTHING ELSE TO CONSIDER?

In the current market, there is likely to be tension between employers and their funders requiring fixed prices for budgetary and funding reasons and the supply chain's ability to deliver at fixed prices, and to a pre-determined programme, over the life of a contract. This is particularly the case for a long programme and one that relies on materials that are in short supply.

All parties involved in construction projects are best advised to collaborate in finding solutions. More time spent planning ahead and thinking strategically about procurement is likely to be the first step towards successful cost management.