Managing Price Inflation

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1. What is the issue?

The construction industry has had a lot to contend with in recent years to mitigate the effects of Brexit and COVID-19 but is now beset with additional inflationary pressures, not seen in the UK for 40 years, in the wake of the war in Ukraine.

Unfortunately, inflation is unlikely to be brought under control in the short term and will be with the industry for some time to come. This means that businesses across the supply chain 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, and this 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.

2. 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.

Fluctuations clauses in standard form contracts, such as JCT contracts, were usually deleted when prices for construction projects were stable, as contractors were prepared to accept the risk in the event of any increase in the cost of materials, plant and labour. However, recent events have caused price volatility not seen since the 1970s, particularly of key construction inputs such as energy, steel and timber, as well as wage inflation. The traditional way for businesses to deal with price increases was to seek inclusion in their contracts of fluctuation clauses which increase the Contract Sum in accordance with objectively measured price rises.

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.

3. Where can I find fluctuations clauses in standard form contracts?

In **JCT 2016** contracts, fluctuations clauses can be incorporated by reference in the Contract Particulars. The Contract Conditions also include the operative clauses in the payment provisions of each contract which are essentially additions to the interim payments.

There are three fluctuation 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.

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.

4. If currently negotiating a construction 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 particular 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, Energy and Industrial Strategy (BEIS)]() and the [Building Cost Information Service (BCIS)](). Whatever index is used, check that 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.

5. 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 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.

- Consider the **overall risk profile of the proposed project**, including programme, and whether there is a way to mitigate delays or exposure to them, 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.

6. What measures can I take if ordering and paying for 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. An increase in thefts is already being reported as prices rise.

- 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, therefore carefully consider the terms being offered.

7. If a construction contract has already been entered into, what can be done about inflation?

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.

8. If a shortage of materials is causing a delay, can I seek an EOT and claim additional money?

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 may appear to be the most obvious ground to apply to delays caused by the war in Ukraine. However, it will depend on the precise wording in the contract concerned if force majeure is defined. 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.

Generally, proving force majeure is 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. However, historically successful force majeure claims have been made in relation to disruption caused by regional or large-scale conflicts. The war in Ukraine is not a war that the UK is directly involved in, so it remains to be seen if the effects on trade with the UK are held by the courts to come within the common law meaning of force majeure.

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, for example if performance of the contract has been impacted by sanctions imposed on Russia and certain Russians by the UK.

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.

9. Will works insurance cover any increase in construction costs if an insurance 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.

10. 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.

As with COVID-19, 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.