Inflation and supply chain disruption risks

The COVID-19 pandemic was an exceptional event which caused unprecedented disruption to commerce and industry worldwide. Comparatively speaking, the UK construction industry weathered the storm well; at least in the sense that work on-site generally continued to some degree.

Nevertheless, the pandemic did create significant challenges for the construction industry, notably in dealing with interrupted supply chains and price spikes arising as a consequence of that scarcity of supply.

Optimists hoped that the challenges were pandemic specific and temporary. Unfortunately, whilst some of the immediate challenges (such as restricted site operating practices) have dissipated, the time and/or money risks associated with material shortages, price spikes and underlying inflationary pressures have not subsided and, in many cases, have gotten worse.

Why are these issues a major risk for the construction industry?

Many in the construction industry have been particularly affected by shortages in the supply of timber and steel but material price spikes can occur wherever and whenever supply chain shortages occur. These shortages, and the consequent price volatility, are being seen against a generally challenging market backdrop where the Bank of England is forecasting inflation to peak at 10% this year. In reality whilst RPI is a good guide to general inflationary pressures in the economy, it is worth noting that building costs are likely to rise at significantly higher rates than RPI. Download a copy of the BCIS Mitigating inflation risks on projects booklet.

The majority of building contacts in the UK are let on a fixed price basis, agreed prior to commencement of the project. Price inflation on key materials can wipe out small profit margins particularly when coupled with the possibility of liquidated delay damages being levied on the contractor where they are delayed due to an inability to source these key materials.

With China still in-and-out lockdown, the war in Ukraine, and the UK Government ready to threaten a trade war with the EU over the Northern Ireland Protocol, the risks arising as a consequence of supply chain disruption look set to continue. If these risks are not tackled head-on then they are likely to prove existential for some in the supply chain with the consequent knock-on consequences for employers "upstream" who quite reasonably sought to achieve some degree of price certainty but potentially end up having to face the consequences of the insolvency of their main contractor.

Until now lawyers involvement in advising clients on risks arising from supply chain disruption have been more reactive than proactive. Energies have either been focused on interpreting existing building contracts, to see whether they give rise to entitlements to time and money for the risks now faced, or drafting bespoke clauses to be added to future contracts that address the supply chain risks which derive from a particular events, such as Brexit or COVID-19.

As the dust has started to settle following the disruption caused by some of these specific events, what is now clear is that the future business environment is going to be far less predictable going forward. Now employers and contractors are both looking to their legal advisors to pro-actively offer both practical and legal solutions which would better allow them to allocate and manage the risks which flow from supply chain disruption more generally.

So, in a market place where developers remain keen to commission projects and contractors continue to want to contract, how are the risks presented by supply chain disruption and inflation being dealt with? Are there potential solutions out there, and what are their pros and cons?

Are there any solutions?

Unfortunately, what we are often seeing is a delay in parties "getting into contract" due to an understandable reticence on the part of contractors to lock in a price which is too low and an unwillingness on the part of employers to pay too much where price volatility may mean that prices spike but then fall dramatically and tender returns have all priced on the assumption of higher materials costs.

Here are some of the more common approaches we are seeing being adopted:

Early Contractor Involvement

In our view, one of the best ways of dealing with the risks outlined above is for employers to engage with their prospective contractor early and carry out good tender due diligence.

Some contractors are likely to be better placed than others to manage the current supply chain issues; this could be due to their size, specialist expertise or their establishment in the market place and an employer can benefit from this. Purchasing power, established supply chain relationships and innovative know-how should lead to the identification of particular problems early and effective solutions being adopted, for example:

- Early reservation and procurement of specific goods or materials with long lead times where supply is known to be an issue.
- Innovative design solutions involving reduction and/or replacement of certain products or materials with more easily sourced alternatives.

Letters of intent/ advance procurement

The use of letters of intent are something which lawyers generally steer their clients away from where possible. This is because the employer is exposed to a number of legal and practical risks including a lack of overall project price certainty. "Mission creep" is a key concern and arises where a letter of intent is initially entered into on very specific terms to allow for very limited works or services but is then extended and extended to cover a much wider scope of works. This scenario now arises much more frequently because of a failure on the part of the parties to agree a fixed price for the project due to current market volatility but where the employer remains faced with the competing need to achieve an early completion date and cannot afford project delay.

Contractors are often, for quit understandable commercial reasons, placing pressure on employers to enter into letters of intent which are wider in scope so as to facilitate the early purchase of goods and materials with long delivery lead times or in order to secure favourable pricing terms with their supply chain. This is not something we would advocate but it is acknowledged that we are not dealing with optimal market conditions and we are not in an ideal world at present.

Where letters of intent are being proposed then the drafting is key, they may well need to contain bespoke drafting if they envisage allowing for the early procurement of goods and materials.

Provisional sums

Where the cost of a particular item isn't yet known, a provisional sum (cost estimate) can be inserted into the contract. Once the cost of the item is confirmed later on, the provisional sum can be replaced with the correct valuation – resulting in the overall contract sum either increasing or decreasing.

There are, of course, risks associated with providing for provisions sums in a contract. What if the employer later decides to omit works which relate to provisional sums? Unless the contact specifically provides for this, the contractor may be able to claim for a loss of profit.

Fluctuation clauses

A fluctuation clause is a compensatory mechanism within a contact which can allow for the overall contract price to be revised up or down to reflect changes in the cost of goods, materials, labour or even the tax rates on those goods, materials and labour. It is worth noting that most standard form contracts offer the option to select various types of fluctuation clause to give the contractor an entitlement to recover additional money for some or all of these price fluctuations risks.

With inflation predicted to remain at historically high levels over the coming year, the longevity of the issue is now resulting in employers and contractors alike turning hesitantly to the consideration of fluctuation clauses for inclusion in their building contracts.

Fluctuation clauses are not a perfect solution, as they fail to deal with specific material shortages or short term spikes in pricing but instead only afford the parties an opportunity to mitigate their risk in terms of the amount they can seek to recover or reclaim under the building contract for prices and taxes as they rise of fall over the period in which the contract operates.

For the purposes of this article we are only focusing on the JCT suite of contracts and more particularly the JCT Design and Build and JCT Standard Building Contract as these are the forms of contract which the vast majority of UK building (as opposed to infrastructure) projects are agreed on.

The JCT suite of contracts offers 3 standard fluctuation options which can be elected or struck-out as necessary by the parties (if none are struck out Option A is applied to the contract by default):

1. Option A allows for adjustments to be made to the contract sum as a result of changes to taxes, levies, and statutory duties.
2. Option B allows for adjustments to be made of the type identified in Option A but also, in addition to taxes, includes entitlement an adjustments for actual market price increases in goods, materials, electricity and fuel.
3. Option C is applies a detailed formula to determine the contract sum adjustment and is arrived at following the application of a complex set of rules (running to more than 60 pages).

It is worth noting that these fluctuation clauses:

- address price decreases as well as increases,
- do not afford the contractor any payment of additional profit as a consequence of increase costs, and
- do not create an entitlement for the contractor to benefit where an increase arising as a consequence of contractor delays, for which they are not entitled to an extension of time under the contract.

In addition your legal advisors can draft bespoke fluctuation provisions which can address project specific risks if necessary.

Fluctuation clauses have not been widely taken up until now due to the benign market conditions prior to 2016, but now that supply chain risks and inflation appear to be here to stay for some time both contractors and employers are coming to the view that there use may prove advantageous.

Next steps?

If you are a developer with a project commencing in the short to medium term then it is worth taking legal advice now as to legal and practical options available to which can be adopted to address the risks highlighted. In our webinar below, we also discuss navigating defects and inflation, which may be helpful.

If you'd like further advice on any of the points raised then please contact our construction team.

Construction law webinar: Navigating defects and inflation

In our webinar, we offer advice on how to mitigate the risks and if you do need help and have defects at various stages of the construction process, how we can help. These issues are common themes in building projects and present challenges in an ever-changing environment.

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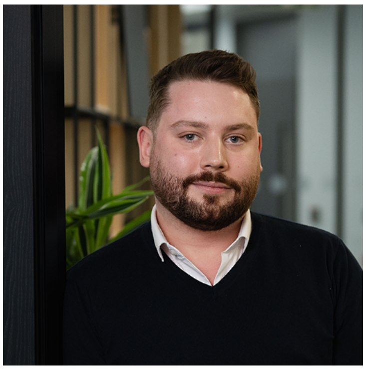

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