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Inflation and material shortages: Protecting your position

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Introduction

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- What are the issues being faced by the industry?
- How can the standard forms assist?
  - JCT
  - NEC
  - FIDIC
- Things to think about including changes you might want to make to those forms

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What are the issues faced by the industry?

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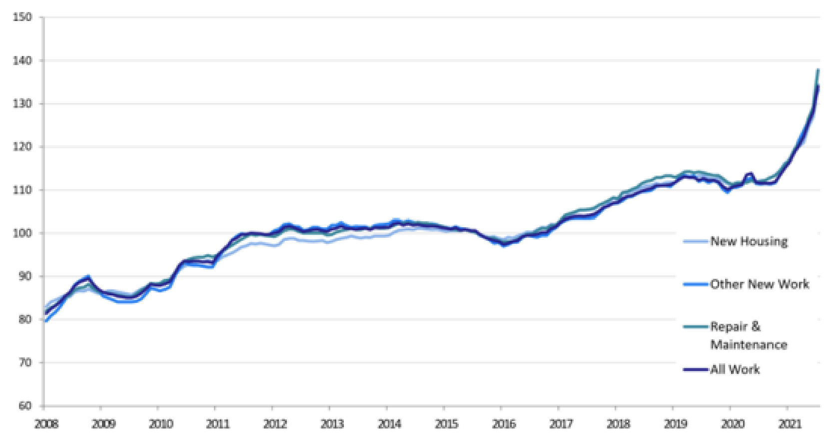
- Inflation

Material Price Indices

Chart 2: Construction Material Price Indices, UK
Index, 2015 = 100



Source: Monthly Statistics of Building Materials and Components, Table 1

Year-on-year change (July 2020 to July 2021)

New Housing	19.8%
Other New Work	19.6%
Repair & Maintenance	23.0%
All Work	20.1%

Month-on-month change (June 2021 to July 2021)

New Housing	5.8%
Other New Work	3.1%
Repair & Maintenance	6.7%
All Work	4.5%

- Looking at the longer-term change, the material price index for **'All Work' increased by 20.1%** in July 2021 compared to the same month the previous year.

[Source: ONS website]

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What are the issues faced by the industry? (2)

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- Shortages:
  - Cement, plasterboard and insulation being rationed by some manufacturers

    [Jewson as quoted in the Guardian on 6 September]

  - Steel, aluminium and timber all have longer lead-in times

- Delays:
  - Eg concrete roof tiles – lead times 24-30 weeks

    [CLC's September update]

  - Increased global demand following COVID-19
  - Transportation issues
  - Brexit in the UK
    - Shortage of hauliers
    - Shortage of Petrol!
  - Shortage of gas from Russia

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Risks?

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- Increased insolvency risk at all levels of the supply chain
- Choices:
    - Pricing material increases into tenders
    - Passing down the risk to subcontractors / suppliers
- Increased cost claims
    - Express contractual provisions (if applicable)
    - Within claims for variations or delay

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How can the standard forms assist?

JCT provisions (1)

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- What's the position under existing contracts?
- It's all about the contract. English law lets you divvy up the risks as you wish and assumes you've understood what you've signed
- Fluctuations provisions (an option within the Contract Particulars). Rarely used. Is this going to change?
- Every bit of the contract is relevant - the priority clause (see 1.3) says just this. Did those tender clarifications make it into the contract documents? Is there a useful email trail post-contract (perhaps in relation to provisional sums) that warns of lead time issues or elements of a price being subject to increase?
- "*All materials and goods for the Works shall, so far as procurable,…[be as set out in contract documents]. Contractor cannot substitute without consent (that consent must not be unreasonably withheld or delayed).*" (See 2.2.1 DB and 2.3.1 (SBC). Consent covered in 1.10 and 1.11)
- What does this all mean and what does the contractor need to do?
    - applies only where they are not available – this is not the same thing as them being on a longer lead time, general shortages (eg piecemeal / late deliveries) or just more difficult to source
    - The obvious sweetener is a cost saving for the substitution – a factor in the employer/CA acting reasonably? Could an employer ask for a saving as a condition of giving consent?

JCT provisions (2)

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- Consent under this clause is not the same thing as an instruction from the employer/ CA. An instruction would trigger time/money in the usual way
- Law on "*unreasonably withholding*" consent. The burden is on the contractor would need to prove this
- It does not cover labour (previous JCTs gave time for this) or current transport issues – limited to availability of goods and materials

- Do relevant events apply?
  - "*Strike, lock-out or local combination of workmen…*" (2.25.11 / 2.29.11)
  - *"The exercise after the Base Date…. of a statutory power"* (2.25.12 / 2.29.12)
  - *"Impediment, prevention or default…by the Employer"* (2.2.26.6 / 2.29.6)
  - *Named subcontractors / specialists.* Optional provisions (see Contract Particulars). Rare in practice but can give rise to time and money
  - *"force majeure"* (2.26.14 / 2.29.14) – even if Covid was caught by this, are the current supply chain issues attributable to this? There is a perfect storm of global demand, gas prices, HGV drivers, fuel, border delays and shipping. Are these just usual market forces and so within the commercial deal?

JCT provisions (3)

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- Do any relevant matters apply?
  - The contractor would need to rely on changes or some act of prevention on the employer / CA (eg in unreasonably withholding / delaying consent to a substitution of materials)
- Don't forget the basics and follow the contract to the letter: notify of potential delay *forthwith*, seek consent under 2.2.1, explain the problem and provide all information to allow employer/CA to make a decision
- Any unreasonable delay or refusal triggers time and money – make sure the employer/CA has the information to make that decision and has it in good time. Ask what more information the employer /CA needs to make a decision. Set out when you need the decision by and why
- Best endeavours to mitigate delay
  - Create an audit trail explaining what you are doing and, more importantly what cannot be done and why. May include alternative suppliers, change in materials, design or programme
  - Invite comments from the employer/CA to whether they agree with you or what they consider you should be doing to meet this obligation
- The problem is fundamentally the contractor's and so the contractor needs to drive the process

NEC4 provisions re inflation (1)

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- Without express provision:
  - Risk of inflation is solely **at the Contractor's risk** for Options A [Priced Contract with Activity Schedule] and B [Priced Contract with Bill of Quantities]
  - **Contractor and Employer share the risk** in Options C [Target Cost with Activity Schedule] and D [Target Cost with Bill of Quantities]
  - Employer takes the risk for:
    - Option E [Cost Reimbursable]
    - Option F [Management Contracts]

NEC4 provisions re inflation (2)

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- Option X1: Price Adjustment for inflation (used only with Options A, B, C and D)
  - Price Adjustment Factor is applied when this option is selected
    - Options A and B: The Prices for Work Done to Date are adjusted for inflation at each application / stage payment
    - Options C and D: Target (the total of the Prices) is adjusted for inflation
  - If the Contractor is delayed no adjustment for inflation AFTER the Completion Date
    - Option X1.2
    - Contractor takes inflationary risk if they are in culpable delay

NEC4 provisions re inflation (3)

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- Important to identify an appropriate index or indices:
    - Eg Resource Cost Indices produced by the Building Cost Information Service (BCIS) on behalf of the Department of Business, Innovation and Skills (BIS) has a wide range
- How often is the index updated?
- Be clear precisely which index you are referring to
- Provide for what happens if the index in question ceases to be produced?

NEC4 provisions re inflation (4)

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- Contract Data requires the following provisions:
    - What requires adjustment? (e.g. equipment, plant, fuel, people?)
    - Proportion of the value of that element to be subject to the index
        - Not all the value has to be subject to the index
    - Base date for the indices (e.g. Contract Date)
    - The Index (indices)
- NEC4 – calculation not repeated where there is a new index
- NEC3 – calculation redone with new index

NEC4 – anything else?

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- Limited other assistance in compensation events
- Possible hooks include:
  - Clause 60.1 (19)

    "An event which

    - *stops the Contractor completing the whole of the Works or*
    - *stops the Contractor completing the whole of the Works by the date for planned Completion shown on the Accepted Programme, and which*
    - *neither Party could prevent*
    - *an experienced contractor would have judged at the Contract Date to have* ***such a small chance of occurring that it would have been unreasonable to have allowed for it*** *and*
    - *is not one of the other compensation events stated in the contract."*
  - Option X2 [Change of Law]
    - Brexit

    <u>BUT</u>

    - Must occur after the Contract Date

FIDIC and indexation

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- Red Book, Yellow Book and the Pink Book contain provisions for indexation
  - 2017 editions found in Clause 13.7
- Do not apply unless expressly selected
- Schedules of cost indexation must be included in the Contract
- Provisional indexes used for issue of Interim Payment Certificates until updated indices issued
  - Good reason to choose an index that is updated regularly!
- If works not completed before Time for Completion:
  - Index/price applicable 49 days before Time for Completion <u>OR</u>
  - Adjustment using current index
  - Whatever is more favourable to the employer

FIDIC – anything else?

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- Clause 13.6 [2017 YB]
  - Possible adjustment for Change in Law after the Base Date [Brexit?]
- Clause 8.5 (d) [2017 YB]
  - Extension of time (subject to notifications under Clause 20.2) for:

    "***Unforeseeable*** *shortages in the availability of personnel or Goods (or Employer-Supplied Materials, if any) caused by epidemic or governmental actions…*"

    "*not reasonably foreseeable by an experienced contractor by the Base Date*".

FIDIC – anything else? (2)

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- Clause 18.1 [Exceptional Event]

  "means an event or circumstance which (but excluding financial inability to perform):

  (i) is beyond a Party's control;

  (ii) the Party ***could not reasonably have provided against before entering Into the Contract****;*

  (iii) having arisen, such Party could not reasonably have avoided or overcome; and

  (iv) is not substantially attributable to the other Party.

  An Exceptional Event may comprise but Is not limited to any of the following events or circumstances provided that conditions (i) to (iv) above are satisfied: ….:

  (f) natural catastrophes *such as earthquake, tsunami, volcanic activity, hurricane or typhoon."*

- Notice required within 14 days of becoming aware
- Duty to minimise delay
- Extension of time but <u>no cost</u> for natural catastrophe
- Right of termination if performance suspended for 84 days in a row or multiple periods of 140 days

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Things to think about

Advance payment?

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- Consider advance payments to enable:
  - Earlier purchase of key materials / equipment
  - Mitigation of delay risk
- How is the money protected?
  - Financial checks on the supplier
  - Where will the goods be stored?
  - Who will hold the title in those goods?
  - Is some form of Advance Payment Bond required?
  - How will that payment be “*earned back*”?
    - Check the money doesn’t to be paid back before the goods arrive on site!

Other drafting suggestions (1)

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- What changes could be made to a JCT to address the problems?
- Pricing issues require use of Fluctuations or some other drafting. Options A, B and C. May need to limit this to certain parts of the work (eg steel, concrete)
- If the deal is time and not money, a new relevant event can be added. A few tips on adding new relevant events:
    - Beware of drafting which refers to events not being "*reasonably foreseeable*". Lots of things are *reasonably foreseeable* (eg another lockdown, continued supply chain issues) but it does not mean a contractor has allowed for them or even could allow for them (at least not at a price/programme that would be acceptable to an employer).
    - Beware of using (old) Brexit and Covid wording (may be too narrow) – query whether the issues currently affecting the industry are related? They may be *indirectly* affecting things but not *directly*. Need to be more precise.
    - Clarify what must be done / does not need to be done to satisfy the best endeavours obligation. Is the contractor required to source materials elsewhere even if this is at additional cost?
    - The event will need to be one that is affecting the industry as a whole (or a good proportion of it) and not limited to the default of the contractor's supply chain. Consider how this would be proved if needs be.
    - Needs to be wider than materials - issues now include labour and transport.

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Other drafting suggestions (2)

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  - Consider benchmarking what *has* been allowed for (eg typical lead times for piling, steel frame, cladding etc are shown on the programme) so the impact can be more easily measured. The employer/CA could confirm this is a reasonable assumption made by the contractor based on the market as at the Base Date.

- Substitution of materials: consider stating when it would be unreasonable for consent to be refused (eg if the substitution performs the same or better, is not an aesthetic / design led choice, is not in a front of house area (eg reception, client areas), meets all statutory requirements and British Standards).
- Substitution of materials – needs to be wider than “not procurable” and should cover difficulty of procuring (ie most likely a longer lead time / delay by suppliers). Consider referring to problems affecting the construction industry as a whole.
- Drafting of ERs/CPs/Specs – CPs drafted loosely.   “Or similar approved” - whether something is similar is a matter of fact, whether something is “approved” brings into play other factors.
- Consider carving certain work out of PC. Can the building still be used with the effect part of the work carried out after PC? If there is a known risk (eg specialist lighting) can this be dealt with post-PC?
- Use of provisional sums. Defined or undefined? Check that the contract makes it clear.
- Below the line contingency. There is rarely anything that sets out what this is to cover.

Advancing claims

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- Usual rules apply!
- Use the hooks that are available in older contracts where possible
- Records, records and more records
  - How can you show the impact of delays to the delivery of goods?
  - Ensure delivery dates for key elements of the works are shown in the programme
- Issue to relevant notices and abide by any time bars
- Early warning notices, effective management of risk while still possible
- Think about how you can demonstrate that these issues were unforeseeable
- BUT:
  - Easier if the contract expressly provides for the risk in question

Overview

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- For new contracts:
  - Think about the appropriate level of risk allocation
    - Insolvency is not in anyone's interests
  - Use the provisions available in the standard forms for inflationary risks
  - Consider bespoke provisions to cover:
    - Key materials, equipment or plant that may be more expensive / delayed
    - Advance payments
    - Provisional sums to lessen the risks?
  - Consider any of the latest guidance from the government and/or the CLC etc
  - Diversify your supply chain / check its financial status
  - Hard to argue current issues are unforeseeable!
- For older contracts:
  - There may be hooks for claims based on COVID-19 and/or Brexit
  - Need to be utilised correctly
  - Records are essential

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Any questions?
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