



Controlling Inflation Under Standard Form Building Contracts

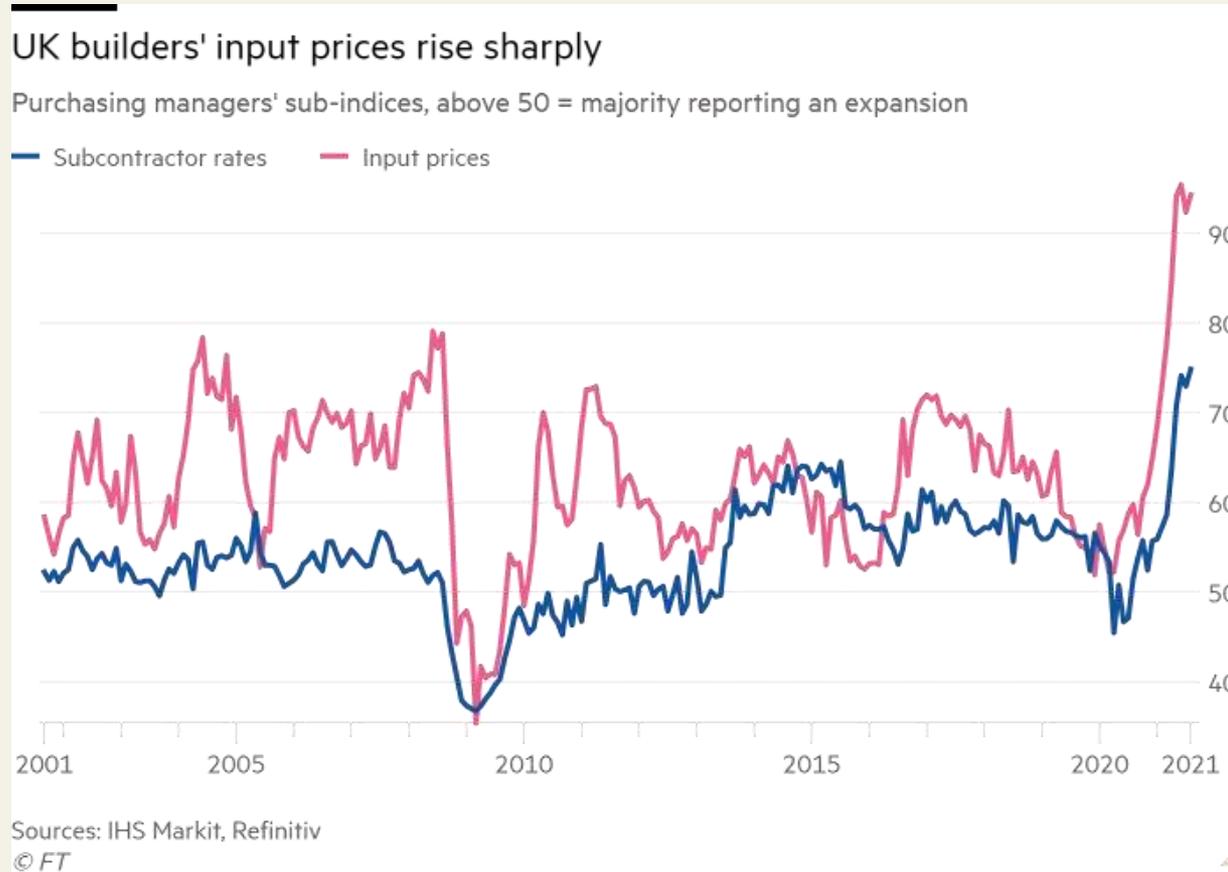
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Inflation Problems

- Serious current problem in construction industry
- Market conditions are unusually volatile with prices of materials, labour and energy rapidly increasing
- Possible causes: Recovery from Covid disruption, war in Ukraine

Movements in Builders' Input Prices



Construction Material Prices Index (BEIS)

The UK's Cost of Construction is Soaring

Material prices index for all construction work in the UK from January 2016 to July 2021 (2015=100)



May-July 2021=provisional

Source: Department for Business, Energy & Industrial Strategy



statista

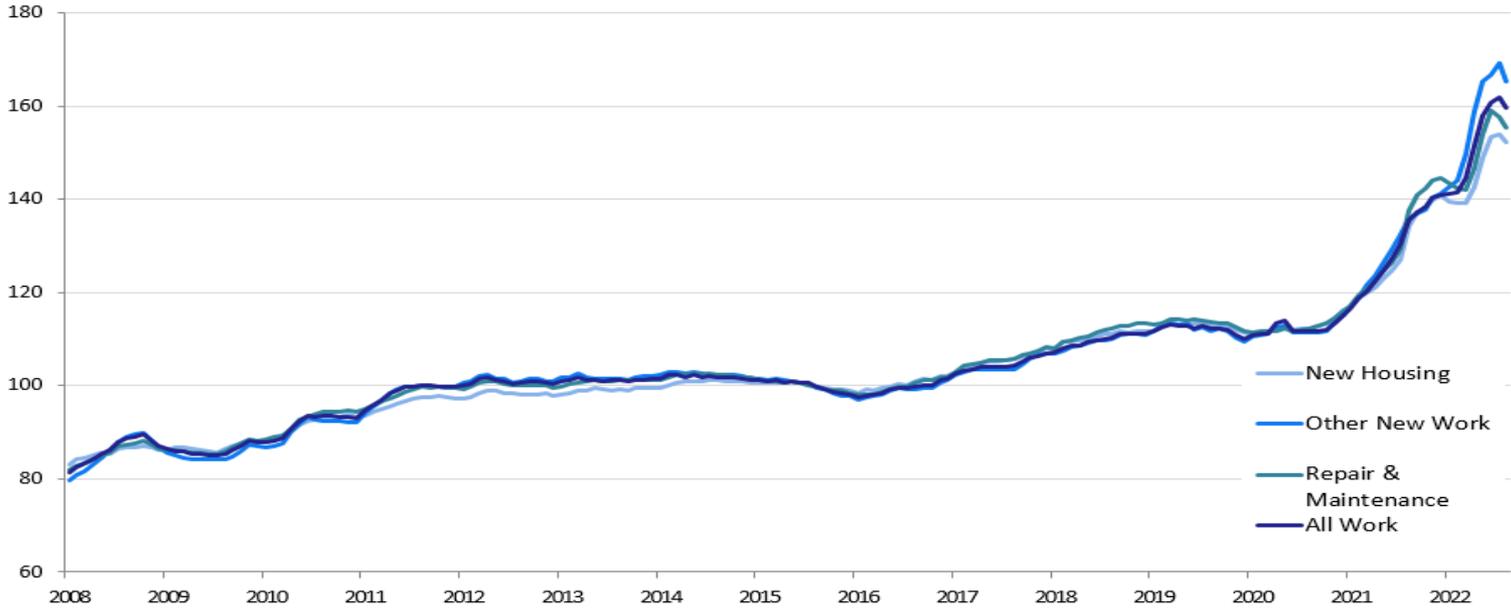


Construction Leadership Council

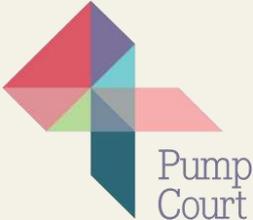
■ Product Availability Statement May 2022

“price inflation remains a critical issue, the latest data published by BEIS shows that annual material price inflation increased to over 24% in March for a basket of materials.”

Most recent BEIS dats



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



Result

- As well as increased material, labour and energy costs, interest rates are increasing
- Cost of projects are increasing as are borrowing costs
- Projects that were viable now less so
- Likelihood of more disputes as projects cost more to carry out and profits negligible

Inflation

- Who bears contractual risk of inflation?
- How is it addressed in standard form contracts?
- What options are available?

General Position

- Inflation hasn't been commonly addressed in construction contracts, largely because it wasn't a big issue
- Majority of construction contracts in use in UK are 'lump sum' or 'fixed price' contracts
- Examples include: JCT Standard Form, JCT D&B, NEC Option A and FIDIC Yellow and Silver Books
- 'Reimbursable' or 'cost plus' where employer takes risk of inflation are quite rare.
- NEC Options C and D 'target cost' – pain/gain sharing

Inflationary Cost Increases – Claim?

- Whether inflationary cost increases are recoverable depends on contractual terms.
- ‘Fixed price’ or ‘lump sum’ – contractor has no right to recover, inflation at contractor’s risk
- But, the commercial reality may differ
- Increased risk of subcontractor/supplier insolvency

Negotiating New Contracts

- Does an Employer opt for certainty of a higher fixed price?
- Or, take some risk of inflationary price increases?
- Costs and benefits of both
- Depends on parties' respective negotiating positions
- Consider mechanisms within standard form contracts

Provisional Sums

- Regularly used where an element is sufficiently defined for a fixed price to be determined or where employer has not finally determined to proceed
- Usual process: contractor can amend Provisional Sum when costs known and employer can decide whether or not to instruct it and accept the increase
- May work when there is an element that isn't essential but not an answer to inflationary increases

JCT Price Fluctuation Options

- Schedule 7 contains 3 options: A, B and C
- Standard practice is to delete them
- If not deleted and no option selected, Option A is deemed to apply

JCT Schedule 7 Option A

- Contribution, levy and tax fluctuations
- Allows for adjustment of Contract Sum as a result of taxes, statutory duties or tariffs to labour and materials
- Adjustment made by reference to difference between tender rates at Base Date and actual rates
- Limited to taxes, duties, levies etc
- Doesn't help with inflation more generally
- Fluctuations may increase or decrease contract sum
- No increase (or decrease) to contractor's profit



Option B – Labour and Materials Cost

- Adopts the same approach as Option A (comparison between Base Date rates and actual) but not limited to taxes
- Applies to labour increases pursuant to rules/decisions of a wage-fixing body AND
- Changes in the market prices for goods, electricity and fuel.
- Addresses price increases and decreases
- Contractor's profit cannot increase
- Delays?



Option C – Formula Rules Adjustment

- Consists of 60 pages of complex formula rules
- Really beyond the scope
- Fluctuation adjustment formulas are based on indices that measure fluctuation over a defined period
- JCT publish formula rules
- Process largely dependent upon formula rules being published in timely manner and in pace with inflation increases
- Open to contractor and QS to agree

NEC – Option X1

- NEC3 and NEC4 include Option X1 ‘Price adjustment for inflation’
- Available for Options A, B (the ‘fixed price’ contracts) and the ‘target cost’ contracts C and D
- For ‘target cost’ Option X1 increases Prices as well as Defined Cost (contractor gets paid and target adjusts)
- Not an option for Options E and F (‘cost reimburseable’)
- Opt in clauses – if not selected, don’t apply

NEC - Option X1

- Target Cost contracts if Option X1 not selected, Contractor still gets paid increases within definition of Defined Costs
- Note that this does not include increased costs paid to subcontractor for inflation unless the subcontract permits recovery of inflation costs
- But target cost only changes if Option X1 selected. If not, pain/gain share swallowed by inflated costs

NEC – Compensation Events

- Inflation is not generally a Compensation Event itself
- If CE occurs, contractor can recover increased costs due to inflation
- Clause 60.1(19) possibly available where super-inflation:
 - Stops or delays the works
 - Could not have been prevented by either party
 - Is not on of the other CEs and
 - Had such a small chance of occurred it would have been unreasonable for the contractor to allow for it.

FIDIC

- The FIDIC suite includes a provision for a contractor to recover adjustments for changes in cost
- Clause 13.8 1999 FIDIC suite and clause 13.7 2017 Yellow Book
- Opt in clauses; rely on necessary information being identified and incorporated (table of adjustment data (1999 Red/Yellow/Silver) or schedule of cost indexation (2017 Yellow))
- 1999 Red and Yellow include a formula, Silver, Gold and 2017 Yellow do not.
- Formula crude but uncomplicated reimbursement



Other Solutions

- Parties can always negotiate their own solutions
- Some additional costs may be paid by agreement in lieu of contractor's dropping delay claims
- Negotiated suspension or termination