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Insights

SUPPLY SHORTAGES AND THE IMPACT ON CONSTRUCTION PROJECTS

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As has been well-known in the industry for some time and is also now being picked up by the mainstream media, UK construction is currently under considerable pressure due to global shortages of key materials. The combination of a worldwide surge in demand for essential materials, as existing projects are revived and new projects are greenlit following the uncertainty of the pandemic, compounded with many other factors such as Brexit, congested transport routes, rises in shipping costs, labour shortages (particularly in the haulage sector) and even climate change have meant that UK builders are especially exposed. Key materials, including bagged cement, Scandinavian timber, steel and aluminium have all been affected and there does not appear to be any chance of relief, at least in the short-term.

Consequently, it is important that employers and contractors agree how to mitigate the risk to their projects of increased costs and delays as developments compete for a finite number of resources. Traditionally, employers would usually expect to pass the risk of obtaining materials onto the contractor and, more often than not in our experience, contractors would generally be willing to accept this position. However, we are increasingly seeing contractors becoming more reluctant to contract on this basis due to the uncertainties in the market.

Fundamentally this a commercial issue. What is an appropriate risk allocation will vary from project to project depending on numerous factors such as the nature of the works, the parties involved and the *procurement route*. Needless to say, there are a number of different ways to approach it and this blog looks at some of the options we have been asked to consider recently.

Contractor-retained risk

Many employers are maintaining the traditional approach that procurement of materials is a matter for the contractor to manage with its supply chain. Employers want to agree a lump sum cost upfront for the whole project and for the contractor to take the risk (or benefit) of any subsequent changes in the price of materials.

Despite the pressures mentioned above, some contractors are willing to accept this position. However, this is usually in return for the employer agreeing to a higher initial lump sum, as the

contractor tries to offset any future price increases. This approach also potentially limits the range of sub-contractors and suppliers who would be willing to contract on the same basis and so restricts a contractor's options when it is tendering to the supply chain, which again will have an impact on price.

Advance payment

Some contractors have also been willing to accept retaining full risk for materials if they are able to place orders with suppliers sufficiently early in the project. This means that, not only are they able to secure a fixed price from their supply chain, but should also be able to mitigate any potential delays in delivery. In return for this, a contractor may require the employer to make an *advance payment* for such early orders. Before agreeing to this, the employer will need to consider the usual risks around making such a payment. For example:

- What protection does the employer have that the advance payment will be used for the agreed orders?
- Where will the materials be stored before they are delivered to site?
- Will they be clearly marked as belonging to the employer/the project?
- Is an *advance payment bond* required and, if so, which party should cover the cost of this?
- How will the advance payment be repaid?

In addition, so as not to delay matters while other parts of the main contract are still being negotiated, we are also seeing employers agreeing to instruct their contractors to place early orders for materials under a *letter of intent* or a *pre-construction services agreement* (PCSA). While this approach is not new, the costs of the orders included in agreements entered into recently are often higher than we would usually expect, as contractors are advising that more materials are ordered pre-contract for the reasons outlined above. While there is nothing inherently wrong with this approach, there are always risks for an employer that instructs a contractor in this way since the terms of such a letter of intent or PCSA will not be as robust as a full building contract. As a minimum we would expect the agreement to include a mechanism by which the employer can secure the ordered items directly if the building contract is not entered into for whatever reason.

Fluctuations

Some contractors have also requested that *fluctuation provisions* are included in their contracts to protect themselves against future price rises. These clauses allow for an adjustment to the contract sum in certain situations, which could include increases in the cost of materials or labour.

While this approach is clearly attractive to contractors, it is difficult to see how employers and, arguably more importantly, their funders would be willing to introduce such a level of cost

uncertainty into their contracts. Typically, and especially on UK projects where the parties contract using a *JCT form of building contract*, parties agree not to include fluctuation clauses. A potential solution could be to amend the contract to partially allow for fluctuations, for example for a capped amount or for price changes over a limited period of time, but it seems unlikely that the majority of employers and their backers will accept such a position.

Provisional sums

An alternative way for a contractor to mitigate the risk of future price increases could be to put *provisional sums* against the cost of certain materials within the contract sum. The parties would still need to agree these in the usual way, for example, whether they should be defined or undefined. In addition, employers will want to limit the proportion of the contract sum which is comprised of provisional sums as much as possible. However, employers and their funders are typically more familiar with the concept of provisional sums than fluctuations and so may be more receptive to this approach.

Delays

Typically, UK building contracts, particularly those based on a JCT standard form, will not allow contractors to claim an *extension of time* or additional *loss/expense* for delays in delivery of materials to site. Depending on the circumstances, such delays may be considered a *force majeure* event (which would usually entitle the contractor to an extension of time only), but given that the current supply issues are now well-known it seems unlikely that a contractor could successfully argue that any such delay was unforeseeable.

To address this, we are seeing parties include in their contracts new bespoke grounds for an extension of time or additional loss/expense in relation to delays in delivery of materials. Whether or not this is acceptable to an employer will depend on the circumstances, but where an employer is willing, in principle, to agree to include such a clause, we would expect this to be limited to a small number of clearly identified materials or delays caused by a specific event.

It is unclear how long the current material shortages will last. However, there does not appear to be any quick fix so this is likely to be an ongoing issue for UK projects in the short to medium-term at least. Employers and contractors will need to actively engage with these issues so that they can agree an appropriate level of risk allocation which is commercially acceptable to both sides.

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MEET THE TEAM

Christopher Skone James

London

christopher.skonejames@bclplaw.com
+44 (0) 20 3400 3733

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