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Insights

# RISK MITIGATION IN A VOLATILE PRICE MARKET

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SUMMARY

The construction industry will continue to face rising material prices, volatile markets and inflation. Disputes go hand in hand with rising prices as projects become much more difficult to complete on time and within budget. However, contractors can take some steps to protect themselves in a volatile market and manage liabilities and disputes if they arise.

## CONTRACTUAL RISK ALLOCATION: THE FIRST LINE OF DEFENCE

The traditional lump sum procurement route, which locks in the price the customer pays at the outset of the contract, leaves the contractor exposed to price increases and fluctuation risks. Other contractual structures provide greater security against growing market uncertainty, for example:

- **Target cost contracts**: These are based on looking at the actual cost of the project at the end against the original target, and sharing any cost overruns or underruns (often referred to as a pain/gain share mechanism). This means the parties share the impact of cost increases.
- **Reimbursable contracts**: Here the customer reimburses the contractor for the actual cost incurred, in addition to allowances for overheads and profit. It is therefore the client who bears the risk of price increases.

## PRICE FLUCTUATION CLAUSES: A SECOND LINE OF DEFENCE

Lump sum contracts can still protect contractors if they include a price fluctuation clause.

Fluctuation clauses pass some or all of the price-increase risk from the contractor to the customer by adjusting the final contract sum in certain circumstances. The client may prefer this option together with the contractor tendering on best price, rather than the contractor including a large risk allowance for uncertain future cost increases.

When considering a price fluctuation clause, be specific and select an appropriate price index that best reflects the work, materials or components it is applied to. The NEC form of contract contains X1 as an optional clause for dealing with price adjustment for inflation. The JCT 2016 forms of contract also include a price fluctuation option clause.

In practice, we see parties amending these clauses or using bespoke clauses to manage these risks, for example by identifying specific components and/or materials. Another common bespoke arrangement is a form of risk-sharing, which may be perceived as more collaborative, where price rises up to a certain ceiling, or variations within a certain range, are borne by the contractor and only passed to the customer after a certain threshold is exceeded.

## PRE-CONTRACT RISK MITIGATION

If it is not possible to adopt one of the risk allocation measures set out above, the contractor is left to consider what allowance its tender should include for the risk of price increases. This is, of course, difficult when seeking to submit a competitive tender, and may involve adopting specialist inputs and technologies, but it is key to avoid liabilities and disputes during the project.

In addition, the contractor should increase supply chain due diligence to reduce unexpected risk caused by price increases. Early procurement of (particularly volatile or risky price) materials (and the cost of storing them) may be cheaper than paying the increased costs of the materials in the future. That can be presented as part of the tender, proposing terms that provide for the client agreeing advanced payments for materials that are likely to increase in costs.

For projects already in full swing and where the contractor carries the risk of price increases, it needs to identify a strategy for managing that risk. That will typically include reviewing its supply chain contracts and identifying to what extent that risk can be passed, but also approaching the client and seeking to agree terms that would help manage that risk – for example early payment for early procurement of materials – on the basis that all parties would benefit from limiting cost increases.

In any event, as with any other contentious issue, good contract administration and record-keeping will help contractors remain on the front foot when presenting their position. In particular, it is helpful to identify any possible mitigation measures and keep good records of steps taken to reduce the impact of cost increases.

The current climate means that contractors submitting tenders now need to consider how price fluctuations are dealt with under the proposed contract and seek to negotiate terms that will reduce that risk. Risk-sharing is a common option bearing in mind the uncertainty and it is usual to see bespoke arrangements as well as an increasing use of the standard form clauses.

Where the contract terms have been agreed, it is best to identify the true position as to who carries that risk and consider the way to mitigate that risk where possible, such as advance purchasing.

Where that is the case, good records, transparency and communications should help reduce the risk of disputes escalating.

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