Options to Deal with Construction Price Fluctuation and Supply Chain Disruption

The Middle East construction sector is thriving (growth of 3.3% in 2023)[1] and is forecast to enjoy consistent year-on-year growth for the next few years. One of the major issues that the industry faces is high inflation and upward pressure on key materials, a trend that is likely to continue for a number of years, especially as the Saudi Arabian giga-projects ramp up.

"More than one in four projects (26.6% are embroiled in cash flow and payment issues"[2]

Traditionally in the Middle East, the risk of material price fluctuation has been placed with contractors. To consider the potential impact of material price fluctuation, it is worth noting the reinforcement bar fluctuations that occurred in 2008 and the ramifications of which were felt throughout the UAE industry:

In December 2007, reinforcing bars in the UAE cost AED 645 per ton. In July 2008 the price had risen by over 238 percent, to AED1,540 per ton, before plummeting to AED 440 per ton by November 2008[3]. These fluctuations caused chaos in the market, causing delays to projects as well as unforeseen economic problems.

[1] https://construction.globaldata.com/
[2] HKA Crux Insight, Sixth Annual Report (Middle East section)
[3] https://www.mesteel.com/

As was demonstrated by that episode, the potential problems arising from disrupted or volatile supply chains and prices are not limited to cost. Perhaps a bigger risk is delay due to the unavailability of materials, or a cash-strapped contractor's appetite or ability to suffer excessive commercial losses to avoid critical delays.

The effect on raw materials caused by the issues in Ukraine is another reminder that large price fluctuations can happen, largely unforeseen, and can cause significant strain on construction projects. Analysis by HKA in 2023, identified that the cost of diesel in the UAE increased by an average of 65% since the start of the Ukraine-Russia crisis. The knock-on effect to plant, machinery, and material costs from this one issue were significant.

Employers may consider recourse to delay damages for events such as material supply delays. However, delay damages are usually capped at 10% of the contract price and tend to hit the cap within 100 calendar days of delay. Beyond the 10% cap, an employer's options are usually more drastic and risky.

Termination brings its own issues, usually leading to project completion well beyond the original planned completion date and with significant additional costs to complete, coupled with expensive disputes to resolve. Furthermore, replacement contractors are well positioned in negotiations and will adjust for market rates (and then some) for materials, equipment, staff, labour, and consumables.

Assuming the terminated contractor was performing adequately other than the commercial squeeze or delays due to market fluctuations, or supply chain problems, termination would not typically resolve the issues, but simply pass them to the replacement contractor, unless they become the employer's risks anyway.

Another grave potential outcome is bankruptcy. Contractors operate on relatively small margins and the industry has a tendency to contract with onerous clauses. Of course, this tends to be a disaster not only for the bankrupt contractor but also for the employers left with incomplete projects and lengthy delays as solutions are found to the problems this tends to bring.

Potential solutions to material price fluctuations very much depend upon whereabouts in the lifecycle a project is:

Pre-Contract

A pragmatic approach to risk apportionment when drafting contracts is recommended. Who is best equipped to take-on the risks? How can an employer secure the best price at tender whilst ensuring that they haven't created a situation where commercial factors threaten to derail the project later on?

The procurement model to be used itself should be brought under scrutiny:

> "…many employers – not least in oil and gas – are exploring alternative procurement models to lump sum contracts with a view to managing risk more effectively. Options include cost plus or target price, still novel in the region".[4]

[4] HKA Crux Insight, Sixth Annual Report (Middle East section)

Of course, if a change in procurement strategy is deemed a step too far, the FIDIC suite of contracts, both the Red and Yellow Books include formulaic mechanisms for adjustment to items to be included in the Appendix to Tender (in both 1999 and 2017 versions). The parties are free to agree what items or materials are to be included. Those that are not included are considered to be included within the contract sum and not subject to adjustment. Whilst the applicable sub-clauses appear troublesome and are often deleted, in practice they can provide a relatively fair adjustment of key materials such as reinforcement. The existence of such clauses provides the parties with a number of benefits, including:

a) Competitive pricing at tender (lower risk for bidders to factor contingency in material prices);

b) Lower risk of claims/disputes;

c) Employer enjoys the benefit if costs decrease; and

d) Less likelihood of serious default by the contractor.

Given the apparent complexity of these adjustment formulae, it may be advisable to restrict the number of materials or other elements which are subject to adjustment only to those which are especially susceptible to large fluctuation and for which such fluctuation would be of particular impact to the project.

The drafting of the applicable formulae and their application warrants significant consideration and should be worked through between suitably qualified representatives of the parties.

Post-Contract

The majority of contracts in progress within the Middle East at the moment do not incorporate provisions for contractual relief in the event of substantial price fluctuations. Furthermore, the majority of contracts specifically preclude claims for price fluctuations, whilst confirming that the contract price is accepted by the contractor as being sufficient to meet all obligations and 'everything necessary' for the execution of the works.

The parties are not entirely without options, but they tend to be limited. In the first instant, diligent contract management can help to improve a contractor's cashflow. This includes ensuring timely agreement and payment of variations and claims as well as on time payment. It may also be possible to alleviate cashflow by providing other relief, such as reduction or early release of retention (or acceptance of a retention bond).

In the event that the employer decides to make payments for material price fluctuation, it is prudent to assess how much contingency the contractor had allowed for in its tender for fluctuations. Given that the risk was placed and priced with the contractor, the aim should be to provide relief only against the 'extraordinary' element of price fluctuation, or in case of ensuring consistent supply, the premium paid to ensure supply. An open book approach is recommended.

Conclusion

In summary, price volatility is likely to be a feature of the Middle East construction market for years to come as most countries in the region are focussing on their own future vision plans all at once, added to which the Kingdom of Saudi Arabia is booming like no other time before. A pragmatic approach to risk apportionment at tender time is highly recommended, since apportioning material price fluctuation risk to contractors as a matter of course may not be practical or represent best value to the employer.

Contact details

Alastair Gray
Partner
AlastairGray@hka.com
T: +971542891235

Craig Mcpheator
Associate Director
CraigMcpheator@hka.com
T: +971563648380

This article presents the views, thoughts, or opinions only of the author and not those of any HKA entity. While we take care at the time of publication to confirm the accuracy of the information presented, the content is not intended to deal with all aspects of the subject referred to, should not be relied upon as the basis for business decisions, and does not constitute professional advice of any kind. This article is protected by copyright © 2023 HKA Global Limited - Abu Dhabi.