



Sharing the risk

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Steel producers have returned as major players on the global industrial stage as steel prices have rocketed over the last 18 months. The causes of such increases are many, but the most significant is China's rapid economic expansion and its voracious appetite for raw materials. Whilst there have been recent reports suggesting a slowdown in steel prices and reduced demand from China, with the government of the UAE alone planning to spend in excess of \$20 billion during the next five years on infrastructure development, steel demand and consumption across the Gulf is set to keep growing in the short to medium term. And it is not all about steel. For example, recently there has been a 70% increase in the cost of red meranti timber, a popular substitute in the Gulf for expensive mahogany and cherry wood.

The very real problem for contractors and suppliers working in today's volatile materials market such as steel is that estimating, bidding and financing major construction projects becomes a challenge and many face significant losses or erosion of anticipated profits because the majority are locked into fixed-priced construction contracts where they bear the risk of material price and supplier cost increases.

Without a clearly drafted price escalation clause that allows for an adjustment to the contract price if there is an unexpected rise in the market prices of key construction materials, a contractor will generally have a difficult, if not impossible task in getting some form of respite from such increases. Even if the contract has become economically burdensome, that will not generally be sufficient legal grounds for performance to be excused.

Many contractors when faced with losing all of their profit, or worse claim that the contracts are impossible or frustrated. However legal doctrines such as "impossibility", "commercial impracticability", "frustration of purpose", "force majeure" all of which have much in common, require the facts to satisfy well-established criteria.

For example, under most legal systems, a party may be excused from performing an obligation under a contract if performance becomes "impossible" because of an unexpected event. But legal casebooks are full of examples of the Courts finding that the doctrine of impossibility will not apply simply because performance of the contract will be much more expensive than previously anticipated.

A number of contractors, wrongly, believe in the ability of the force majeure clause of a contract to come to their rescue. A force majeure clause is inserted into a contract as a means to protect parties if part of the contract cannot be performed because of some exceptional event, outside the control of the parties and which could not have been prevented by the exercise of reasonable care.

Construction contracts typically include force majeure clauses but generally such clauses only allow a contractor additional time to perform. Therefore whilst a force majeure clause may enable a contractor extra time to obtain materials that are in short supply, it is unlikely to assist him if he is forced to pay much higher material prices than he originally estimated.

The truth is that Courts generally do not like to allow someone to escape a contractual obligation. Fixed-priced construction contracts allocate risk and without a specific clause allowing for changes in prices, Courts are generally insistent that a contractor must execute the contracted work at the price agreed. In the UAE for example the local Courts are required by Federal Law to uphold agreements on price provided they are not contrary to public morals or order.

In the current Gulf economic climate, tender prices for EPC contracts are soaring and Contractors argue that the only way owners will get more competitive bids is to share more risk. Few owners agree. The Dubai Municipality's Conditions of Contract for Civil Engineering Construction are based on FIDIC contract conditions but as yet, do not reflect the recommendation by FIDIC in their 1999 suite that provisions for adjustments in price for changes in cost should be inserted where it would be unfair for a Contractor to bear the risk of inflationary costs. For an owner the idea of drafting a price-escalation clause in a contract may seem like writing a blank cheque, even though he may benefit. If the contract is based on current prices charged to the contractor and any actual increases, rather than a fixed-price quote with wild speculative contingencies, owners might save money.

At a recent construction procurement seminar held in Dubai sponsored by Masons Galadari, local developers were reluctant to talk openly about their attitudes to more risk sharing clauses in their contracts. Off the record however a number of them were

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willing to admit that they were alive to the issue and were prepared to accept price escalation provisions in exchange for a price reduction - except no contractors have actually qualified their bids by proposing such clauses! Developers in the UAE are starting to feel the heat of stretched payment streams as they let more and more projects and this may be the time for Contractors to exercise a greater economic muscle. Contractors were also reticent about speaking openly, one suggesting that he was reluctant to confirm to the opposition that he was "bleeding". However it is a fact that contractors are suffering, one even suggesting he would now be prepared to walk off a current job in the UAE risking his security, rather than carrying on losing money on the scale that he is.

Assuming owners are receptive to the idea of price-escalation provisions, what considerations should the person drafting such provisions, have in mind? The clause should identify the specific materials considered to be volatile and the unit prices for such materials at the date the contract is executed. Typically the clause should provide that the owner will become liable for any price increases in those materials that cause the total contract price to be increased by an agreed percentage. A sensible clause will set out notice periods for identification of price increases and to avoid arguments later on, identify the class of documentation evidencing the increase, what events trigger an increase in contract price, what is the appropriate measure of market price, how many times the contract price can be increased and what are the time periods covered.

But what if owners do not respond to industry concerns and refuse to include price escalation clauses in bid documents and negotiations are similarly unfruitful? Contractors will need to take steps to limit their exposure.

Clearly it makes sense for them to deal with reliable and reputable suppliers. By fostering relationships with established suppliers, perhaps when prices and availability become an issue, such suppliers are likely to be more accommodating in sourcing material at an economic price. Even when reliable supply chains have been established, contractors must ensure that commitments received from their suppliers mirror their obligations to the owners. Suppliers quotes should be vetted carefully as they may have provided bids on materials that are now unavailable or have increased significantly in cost and contractors will not wish to be left picking up the tab.

It is also important for contractors, particularly those working away from home, to be adequately tuned into the local market. In this way they will be more alert to developments that could impact future prices and which point to trouble brewing. Such market knowledge may suggest the need to buy materials in advance. Of course this can bring its own problems such as draining cash flow and increasing storage and security costs. However it may be a sensible precaution on contract award to buy price-volatile material, perhaps negotiating delayed delivery times, to avoid storage costs.

The business strategy of contractors may have to change. For example it may be prudent to only bid on projects with short construction programmes which give prices less time to increase.

Where owners insist on fixed-price contracts, they can play their bit too. In owner-design contract forms, it makes sense to instigate thorough design review processes aimed at encouraging value engineering, procuring reliable cost projections and complete engineering plans and specifications to limit excessive contingencies. Design and build procurement may also keep costs manageable as the contractor is likely to adopt design options that help minimise exposure to volatile materials markets. If the owner has established subcontractor and trade contractor relationships, these could be nominated to the contract. Owners may also wish to procure materials themselves directly and as early as possible, thereby limiting the contingencies that may otherwise be applied.

Finally, for those contractors who have been successful in negotiating price escalation clauses into their contract, the story does not end there. As mentioned, such a clause will typically have a series of notice and documentation protocols and these must be followed to the letter to be effective and to avoid accusations that bad purchasing practice by the contractor is to blame for price hikes.

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