HML Project Management

PROCUREMENT - CONSIDERATIONS IN AN INFLATIONARY MARKET – Oct. 2022

History & background – problems to be solved

Developers, Funders, Contractors, and members of the design teams, not just in Estonia, must be somewhat concerned as to the viability of projects given the effects of the war in Ukraine, the Energy crisis, rising cost of money, and the extremely high levels of inflation related to materials, transport, and labor.

In the Private and Public sector, we currently see projects being put on hold, and Contractors unwilling to bid as the risks are unjustified. This is affecting even short-term contracts of up to 6 months duration.

We see a complex set of factors that need to be addressed by the development and construction sectors.

Potential solutions/thoughts

Some considerations on how to draft contracts to cover for price **inflation** are given below. Is it realistic or reasonable for contracts to rely on a Lump Sum contract where all the risk is transferred to the contractor? It seems to make sense that Clients take steps to pay for inflation only when it occurs. Transparency is the key and should be the spirit of the day.

Below are some of the mechanisms used in other jurisdictions that could be considered –

Provisional Sums can be used to combat increases in prices. Provisional Sums are developed based upon detailed specifications and an estimation is included in the contract. The Client may choose not to undertake these works and/or maintain the right to have a different contractor to undertake the works. It is important to ensure that the impact on the provisional sum is considered in the program for the project and that budget for preliminaries, overhead and profit are allocated to the project costs. An example of this would be to separate all Mechanical/Electrical and Plumbing or the fit-out portions of the project.

- **Prime cost** allowances can be used for specific materials, e.g., steel bars, flooring finishes etc. but the costs should be clearly understood – e.g., whether it is inclusive of all subcontract on-costs, margin, transport, waste etc.

- Client or Contractor **buying critical materials** early or paying to secure future production slots.

- Get trade partners **early involvement** to assure the cost and availability of materials/labor/transport are fully aligned to the project goals and budget.

- **Discuss, at the earliest stage, risk sharing with stakeholders**. Have open discussions with project owners about potential challenges and consider sharing the risk of inflation under contract conditions, whether through alliance-style agreements or alternate contract conditions for both new and existing contracts.

- **Price Fluctuations** clauses can be drafted to reflect the changes in the cost of material and labor during the contract period. It is important that the wording of any price fluctuation clause is written clearly. They may cover a broad spectrum of the work or relate specifically to clearly identified materials. A robust Bill of Quantities assists with the control of fluctuations. Careful thought must be given to how the material will be indexed.

- **Cost Plus contracting** is another way to manage the construction price inflation. The contractor is reimbursed for actual costs plus a fee for their overhead and profit. Downside is an unknown final cost and lost incentive for the contractor to manage the cost.

Summary and call for action

Let's be honest – most contractors work on slim margins and incorrectly pricing of costs into a bid can have catastrophic effects on their budgets and solvency.

We don't want to see subcontractors or contractors becoming insolvent.

The above potential solutions do not take away the need for the Client to obtain security via performance bonds, retention bonds, vesting certificates and parent company guarantees.

Funders need to show much more flexibility in procurement routes and understand that Lump sum contracts are not the way forward.

For those in the midst of project delivery, our advice is to bring all parties around the table to address cost concerns as early as possible. In doing so, project teams can openly reflect on the market forces at play and seek alternative approaches – including changes to specification – that still enable the client to achieve the desired outcome.There is not a perfect solution to deal with rampant inflation in the construction sector but there are pragmatic steps to ensure realistic conversations are undertaken to tackle the challenges faced and to apportion the risk in a reasonable manner.

For more information on howw HML can help, please contact:

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