

Managing Price Volatility in Contracts

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Road Map

- Negotiation Concepts
- Sample Clauses
- Employer Options
- Pre-Contract Cost Controls
- On Project Controls
- Remedies & Enforcement

A Serious Risk

- Cement Prices  30% since June 2008
- Steel Prices – was  45%, now 
- Fuel Prices – in 6 months > 40% 
- Fuel Prices – now in 2 months <35% 

- July 2008 – 200 Contractors returned Letter Of Award

Employer's Perspective

- Avoid Contingency Pricing
- Avoid Delay, Contractor Insolvency
- Avoid Dispute
- Avoid Suspension of Works
- Avoid Termination by Contractor
- New Contractor – all price increases will be borne by Employer

Factors in Price Fluctuation

- Price Adjustment Clauses
 - Variable Options Available
 - Standard Clauses or Bespoke
- Period of Construction
- Consider the Materials - All/Specified/Major Only?
- Standard of Proof
 - Baseline Price & Rationalization
 - Price Index
- Evaluation
- Administration & Payment Structure



General Concepts

Shared Pain & Shared Gain

Actual Cost Sharing Adjustments

High/Low Ceiling Trigger

Re-measurement post-CPC
Adjustments

Percentage Sharing

Transferred Pain

Shared Gain if Shared Pain

Shared Gain up to Shared Pain

Shared Pain & Shared Gain

- Share increase & decreases
- Beneficial to both parties



- But more beneficial to Employer
- Can cover large number of specified materials

Actual Cost Sharing

- Actual incurred cost incurred
- Can be all materials total adjustment
- Or can be a dictated percentage to cover all materials and consumables
- Beneficial to both parties
- No profit margins on total or specified materials and no risk at all to Contractor

High/Low Ceiling Trigger

- Adjust price after ceiling price is exceeded



- Ceiling must be reasonable & relative to impact
 - Consider Volume of Material Impacted
 - Consider Cost per unit of Material Impacted

Re-measurement post-CPC Adjustments



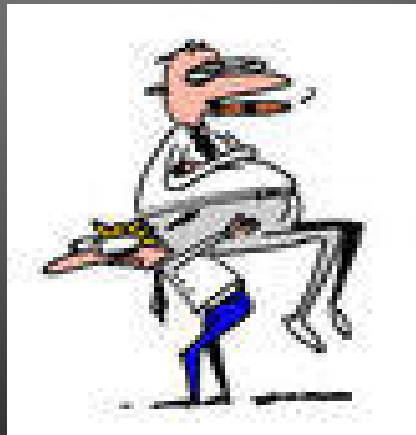
- Which Trigger Period and what increases applicable uncertain?
- Presume an average of the increases for all the Trigger Periods

Percentage Sharing

- Share % of Increase or decrease
- Declining/Inclining Scale %
- Incentive / Disincentive for Controls on Cost Escalations

Transferred Pain

- Employer share burden of price increase
- If price decrease, Contractor keeps benefit
- Pure Contractor beneficial
- OK if very limited specified materials



Shared Gain if Shared Pain

- Decreases shared only if shared increases occur
- Beneficial to both parties but still slightly more beneficial to Employer

Shared Gain Up to Shared Pain

- Decreases Shared only up to value of Shared Increases
- Beneficial to both parties and equality in value pain/value gain
- Large number of specified materials

Delay Period Price Adjustments

- If Contractor culpable delay period
 - No price adjustments at all
 - Or share gains only
- If Employer culpable delay period
 - Price adjustment clause applies
 - Share burden
 - Allow Contractor to claim loss & expense

Options to Employer

- Convert to Provisional Sum Works
- Convert to Prime Sum Works
- Decrease Quantities
- Change Specifications

Options to Employer

- Omit Entire Supply from Scope of Works
- Re-Negotiate? Option to find supplier with lower cost & bound to use such a supplier
- Discharge of Contract

Be Clear

- Specify the materials
- General Language – No
- “*Building Materials*” – No
- Void for Uncertainty

Courts must be able to ascertain intention from the clear mechanism & formula prescribed

Sample 1 – Shared Pain

“The amount of this Contract is subject to increase if the cost of products increase by more than 10% over the amount quoted to us between the date of this Contract and delivery of such products to the Project.

In the event of such increases, and upon written documentation establishing the extent of the increase, the contract amount will be equitably adjusted.”

Problems?

- “Products”?
- “Equitably adjusted”? – necessitates a re-negotiation
- What “written documentation”? – proof of escalation
- What was “the amount quoted to us”? – base price

Sample 2 – Shared Pain

“The Builder agrees to use his best efforts to obtain the lowest possible prices from available building material suppliers, but should there be an increase in the prices of these specified materials that are purchased after execution of contract for use in this residential construction project, the Owner agrees to pay that cost increase to the Builder. Any claim by the Builder for payment of a cost increase, as provided above, shall require written notice delivered by the Builder to the Owner stating the increased cost, the building material or materials in question, and the source of supply, supported by invoices or bills of sale.

Specified Building Material /Current Price per unit /Date /Supplier

1) _____/_____/_____/_____

2) _____/_____/_____/_____”

Problems?

- ✓ Materials specified.
 - ✓ Documentary proof required is specified.
 - ✓ Owner to pay entire cost increase.
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- What is “best efforts”?
 - How to identify what could have been the “lowest possible price”?

Sample 3 – Shared Pain

“The house will require approximately _____ sq. ft/ tonnes of _____ (describe material : plywood, OSB, other). As of the date of this contract, the Builder’s cost of _____ (describe material) is _____ (price) per thousand square feet, based on _____ (describe basis for determining cost : name of supplier). The stated consideration to be paid under this contract is based on current material costs without margin for fluctuations in the price of _____ (describe material). The current market for _____ (describe material) is considered to be volatile, and sudden price increases could occur. The Builder agrees to use his best efforts to obtain the lowest possible price from available building material suppliers. But, should there be an increase in the price of _____ (describe material) purchased after execution of this contract for use in the construction of this house, in order to avoid inequities, the Owner agrees to pay this cost increase to the Builder. Any claim by the Builder for payment of a cost increase, as provided above, shall require written notice delivered by the Builder to the Owner stating both the increased cost and the source of supply, supported by invoices or bills of sale.”

Problems?

- ✓ Base price identified
- ✓ Estimated quantities specified
- “Best efforts” wording still there

Sample 4

Shared Pain, Shared Gain

- FIDIC, clause 13.8
- Using cost index
- Escalation & de-escalation shared
- Monthly adjustment of prices
- Formula used

Problems?

- Segregate adjustable portion from non-adjustable
- Estimate the proportion of each cost element
- Monitor cost indices
- Can your contract administration team implement this??



Type of Indices

- Finished Goods Price Index
- Component Materials Price Index
- Industry Specific Indices
- Commodity Indices

Using an Index

- Establish the base index prices (bid period)
- Don't quote the base index figure but refer to the period and latest index source
- Select the appropriate index
- Specify whether periodical adjusted index or yearly adjusted index is to be used
- State the frequency of the price adjustment evaluation periods

Using An Index

- Define the mechanics of the price adjustment
 - simple % change x base price method
 - simple % change x portion of the base price method
 - % increase in index points x(% increase leads to lower factors the higher the index moves)
 - composite indices & weightage to each index

Material Allowance Clause

- Cost escalation – pay the actual increase for specific materials, measured by actual cost or indices
- Cost allowance – once cost escalation of some materials occurs, it allows across-the-board % increase in contract price (for materials)

Sample 8

Material Allowance Clause

- JKR 2008 amendments
- Fluctuating factor to be used
- 50:50 sharing of risk - contractor & owner

Fluctuation Factor

$$= \text{Recovery Factor} \times \frac{\text{Current Index} - \text{Base Index}}{\text{Base Index}}$$

- Recovery Factor is pre-determined
- see Appendix A
- = amount of materials and plant employed which is deemed to constitute a % of the Effective Value of Works

JKR Design & Build

- 50:50 sharing of risk
- Payment based on actual difference in cost
- Materials used for works rejected by Project Director not included

Consumables

- Fuel, diesel, bitumen
- Pegged to CIDB Index (Base Price) and Government control/Shell pricing
- Adjustment only if fluctuation > 5% of Base Price
- Project Director to certify quantities based on contractor's record of consumption

On Project Management

- Foster Long Term Relationship with Suppliers – Economy Pricing
- Mirror Contractor's commitments with Supplier's commitments
- Lock in Price for Longer Durations
- Index Tracking
 - Pay attention and understand the trends
 - Know the content of the finished goods/materials
 - Know all the price drivers
 - Build a cost-push model
 - Build a supplier-margin model
- Advance Purchases
- Bulk Purchase (all Projects) = Bulk Discounts

On Project Management

- Price Related Re-scheduling of works
 - so as to delay delivery (if possibly price will reduce in short future)
 - risky as price may increase
- Option to Accelerate
- Budgets based on Current Pricing
- Forward Buying/Hedging/Stock piling
- Switching from Contract to Spot Buying
- Change or Modify Temporary Works or Method of Works to economise

Impossibility / Economic Frustration

- Frustration – performance is physically & commercially impossible?
- Practical Impossibility
- Section 57(2) Contracts Act 1950 - Impossibility in practical sense, deals with performance

Impossibility / Economic Frustration

- Proven & accepted financial hardship caused by National Economic Crisis of 1997 by itself does not amount to a radical or significant change in circumstances or to make the performance fundamentally different
- Fluctuating economic conditions is a risk that is foreseeable to every businessman

Other Contractual Arguments

- Indirect through Variation Provision
- Re-pricing only to BQ rates
- Where clause allows changes in rates if quantity > % of stated quantity

Other Contractual Arguments

- Force Majeure
 - Generally not a basis to change price
- Force Majeure - Act of God
 - Price manipulation is an act of man!
- Force Majeure – Shortage of Materials
 - If provable shortage nationally or globally
 - May give right to EOT
 - But doesn't help to claim higher price



End