

CONSTRUCTION & ENGINEERING ALERT

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While the world wars on, contracts without an escalation clause could leave contractors embattled, high and dry

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The war between Russia and Ukraine as well as increasing inflationary pressures around the globe have contributed to increased economic volatility and led to, amongst other things, shortages of raw materials resulting in price increases in their costs. For example, the price of materials like copper, which are commonly used for heating, plumbing, and cladding have increased since the inception of the war. The price of imported materials and finished items used in construction have also become more expensive.

Construction contracts are usually structured in a manner that contains a lump sum contract price, which includes what is commonly referred to as an escalation clause. This clause allows for a change in the agreed contract price should there be price fluctuations in materials and labour during the execution period of the contract. Escalation clauses

are common in standard local and international construction contracts as the slightest change in the price of materials can have a significant impact on how financially viable a project ultimately is. These clauses are generally incorporated into contracts for long-term construction projects where the price of materials is likely to fluctuate, to mitigate the risk and uncertainty that arises from sudden changes in the price of material and the knock-on effect on a contractor's cashflow and ability to complete construction.

CONTRACT PRICE ADJUSTMENT PROVISION

However, in circumstances where the construction contract is a fixed-price contract that does not contain an escalation clause (usually contracts of a short duration), the contractor may find itself in a position where it will be required to cover any increased cost of materials and labour since project inception without an avenue

for compensation from the employer. In South Africa in the mid-1970s, due to the increasing rate of inflation affecting contracts, contracts incorporated a formula called the contract price adjustment provision (CPAP) which calculates any cost escalation that has taken place since the date of tender. This was based on the cost indices published by the Central Bureau of Statistics, which had already been universally utilised in the building industry. The CPAP was also incorporated into the JBCC Series 2000 contract documentation. It is, however, not uncommon in fixed-price contracts of short-term duration and modest value to have the CPAP adjustment omitted, with the contractor being required to make due allowance in its tender for any anticipated cost increases.

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In such instances, some contractors initially “rear end load” their tenders by placing a low rate for early works and a high rate for later works in an effort to avoid the risks of having to absorb the increased cost and financial constraints which may result from increases in the price of materials and labour.

CASE STUDY FROM INDIA

In the case of *K.N Sathyapalan by Lrs. v State of Kerala and Ors.*, AIR [2007] on appeal before the Supreme Court of India, the issue of escalation arose in the context of a claim for an extension of time and cost. The contractor (K.N Sathyapalan) had entered into a construction contract with the State of Kerala for the construction of the Chavara Distributory. During the construction contract, local unrest had resulted in the contractor being unable to access the site to perform the agreed works. As a result, the time to complete the works had to be extended and

there was an increase in the price of materials during this time. The contractor was also not provided with a dumping space within a specified distance from the construction site to dump excess earth, as had been contractually agreed between the parties, and was instead forced to dump the excess earth at a location which was far from the site. Moreover, the rubble and metal necessary for the project were not provided at the departmental quarry, which resulted in the contractor having to obtain these materials from another location that was twice the distance from the departmental quarry.

The contract provided that if failure to complete the works was the result of delays on the part of the state in supplying materials or equipment it had undertaken to supply under the contract; from delays in handing over sites; from an increase in the quantity of the work to be done under the contract; or because of force

majeure, an appropriate extension of time would be given. Finding that the clause was operative, the state extended the time for completion, but in doing so made it conditional that such extension of time would be subject to the execution of a supplemental agreement to the effect that the contractor would not be eligible for an enhanced rate for the work done during the extended period.

The question which the Supreme Court was required to answer was whether, in the absence of any price escalation clause in the original agreement and a specific prohibition to the contrary in the supplemental agreement, the contractor could have made any claim on account of escalation of costs and whether the arbitrator had exceeded his jurisdiction in allowing such claims, as had been found by the High Court.

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In dealing with the absence of an escalation clause, the court adopted a broad approach and decided that the contractor should be paid the escalated costs incurred by virtue of fulfilling its obligation. In this regard, the essence of the court's ruling was embodied in the following statement:

"Ordinarily, the parties would be bound by the terms agreed upon in the contract, but in the event one of the parties to the contract is unable to fulfil its obligations under the contract which has a direct bearing on the work to be executed by the other party, the arbitrator is vested with the authority to compensate the second party for the extra costs incurred by him as a result of the failure of the first party to live up to its obligations."

This case illustrates that the court was willing to find in favour of a contractor's claim for compensation based on escalated rates, even in the absence of an escalation clause, however, it remains to be seen whether courts in other jurisdictions will follow suit. As such, and particularly in the current inflationary climate, it would be prudent to opt for contractual regimes that include clauses which provide for an increase in the costs of materials and labour during the execution period or extended execution period of the contract, or bear the risk of being put out of pocket where unexpected price increases occur.

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