

Australian Constructors Association

# Construction cost inflation

Ways to address an escalating issue

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AUSTRALIAN  
CONSTRUCTORS  
ASSOCIATION



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# Introduction

Established in 1994, the Australian Constructors Association (ACA) is a trusted voice for the construction industry. We are the only representative body covering the three key sectors of the industry—vertical, horizontal and services. Collectively, our members construct and service over 90 per cent of the value of major infrastructure projects built in Australia.

## About this paper

The construction industry is facing significant headwinds and the public sector, as a major purchaser of building services, must be conscious of the pressure construction firms are experiencing when approaching the market, negotiating contracts and delivering projects. The public sector has an important role to play in helping safeguard the sustainability of Australia's construction industry.

The construction industry already accounts for almost 25 per cent of all business insolvencies in Australia and this number is increasing. Business failures lead to increased costs and project delays—not to mention the wider socio-economic impacts.

This paper considers the impact of significant cost inflation in an industry with slim profit margins. It proposes solutions to ensure projects continue to be delivered and without delay, enabling the construction industry to fulfill its important role of building Australia's economy.

## Uncertain times

COVID prompted record investment in infrastructure by governments nationwide and at the same time caused significant delay and disruption to many projects. The increase in work caused huge demand for workers, and flooding events and ongoing wet weather on the East Coast has further delayed projects and increased demand. Then, geopolitical instability sent oil prices skyrocketing along with the cost of energy intensive construction materials and reduced availability of common commodities such as timber.

A market sentiment survey undertaken in February 2022 of the nation's largest contractors found

the cost of materials with high iron content like reinforcement, structural steel, ductwork and cables have increased most significantly. The survey, undertaken by the ACA in partnership with Arcadis, found some contractors have reported an increase in supply costs of up to 70 per cent over the last year (See Table 1 - Basket of goods over past 12 months).

## Issues with escalation

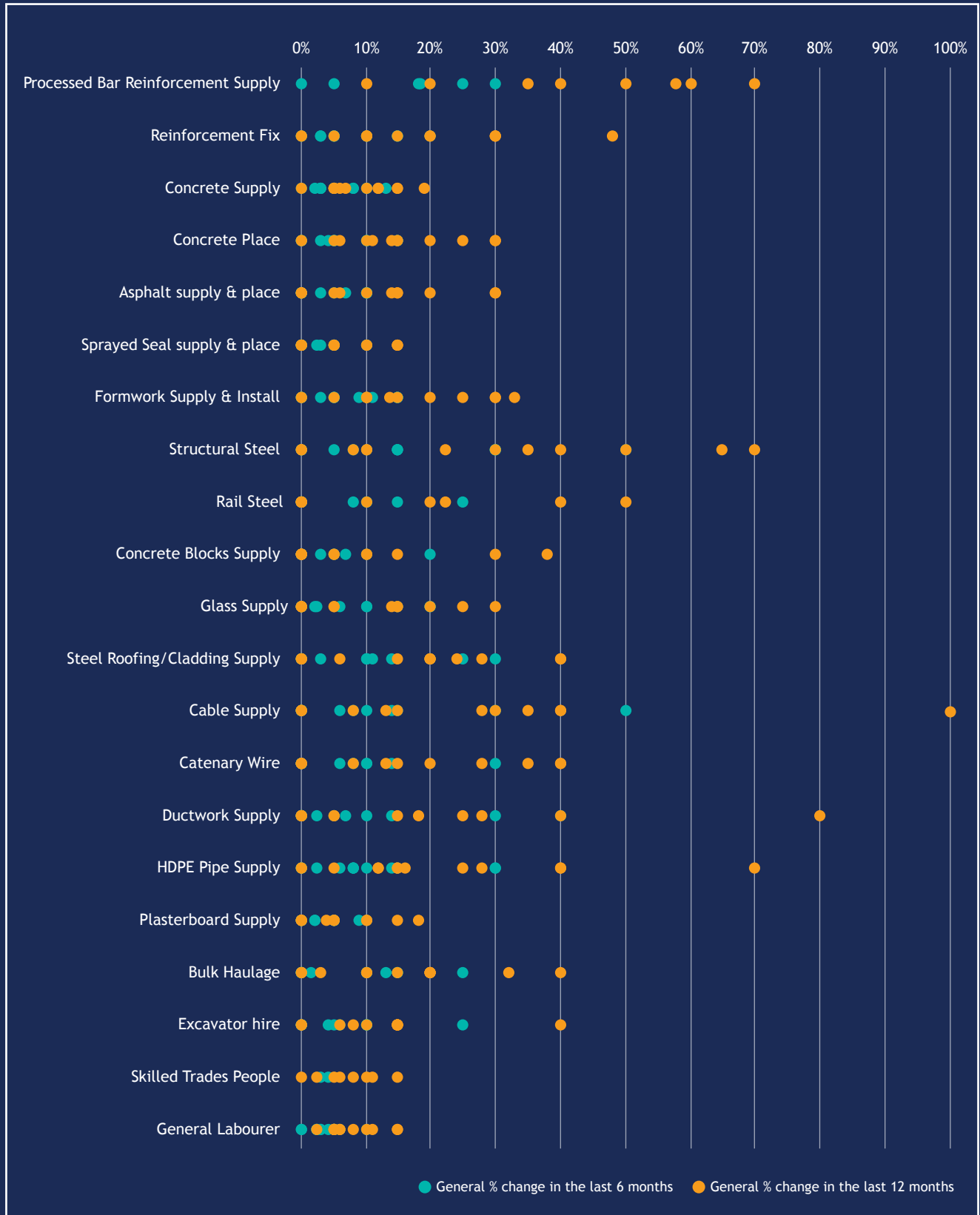
Double digit inflation of input prices in an industry with single digit margins is a recipe for disaster but more so for an industry that is required to lock in prices for projects that can take years to construct (See Table 2 - Condev case study).

Construction companies are required to provide fixed prices for 12-18 months or even two to three years to the ultimate asset owner, yet suppliers are unable to give or hold fixed prices. Subcontractors and suppliers tend to have lower capital reserves and pushing the risk down to small subcontractors/suppliers is undesirable, unachievable and unsustainable. Even if prices are provided by the supply chain at tender, in circumstances of hyper-escalation the supply chain is often unable or unwilling to supply for the initial price indicated (and included in the head contractor's tender).

Without an adjustment mechanism, head contractors are left unable to pass significant and often unforeseen price increases back to the asset owner. Losses are faced on all contract types—not just lump sum contracts, although losses can be much greater for those contract types. While some contracts have an option to include for rise and fall, these are not commonly used and where they are used it is mainly for construct only forms of contract and using a generic index with a substantial 'lag factor'.

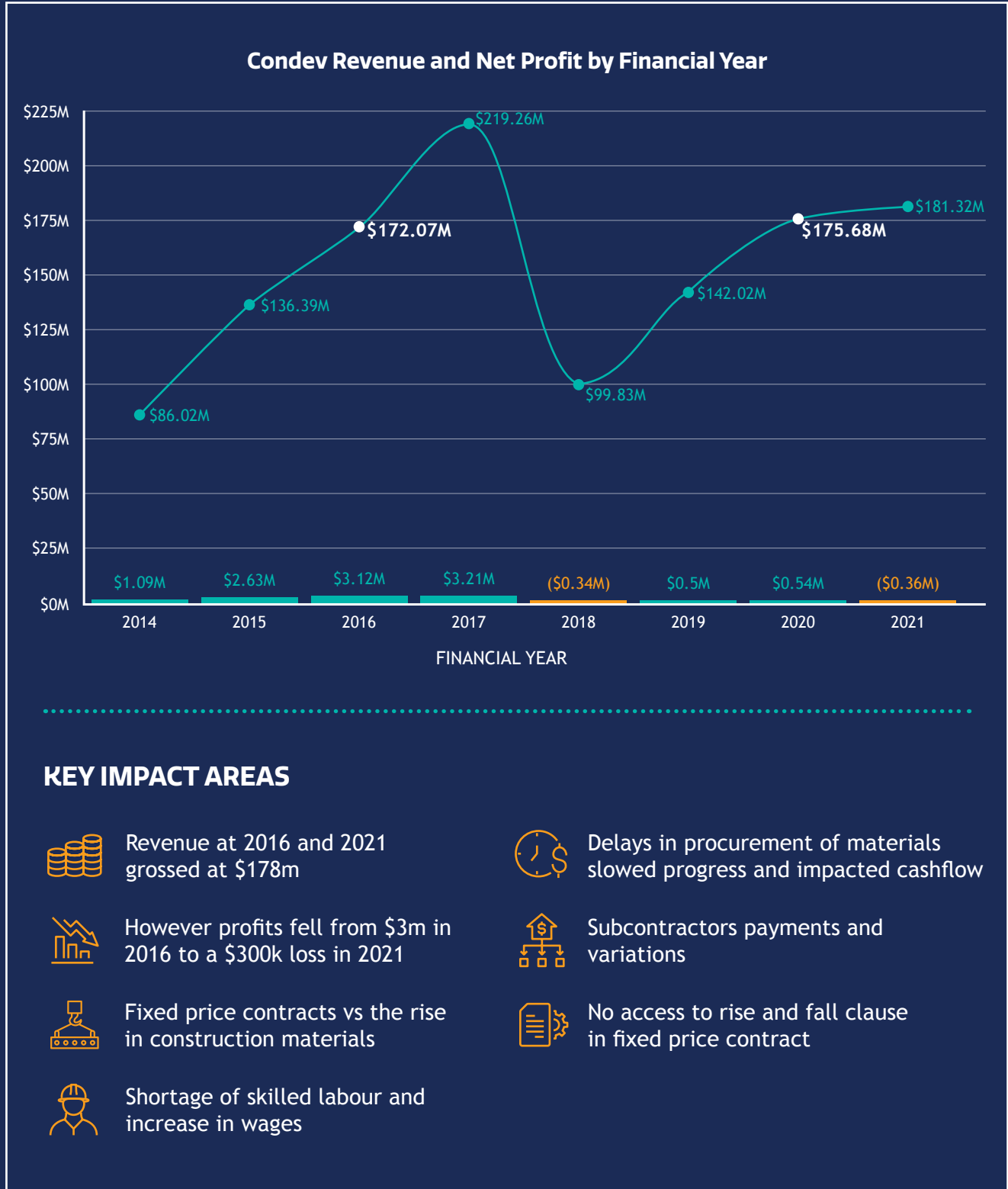
**TABLE 1**

**Basket of goods over past 12 months**



## TABLE 2

### Condev case study



The above chart prepared by Turner & Townsend as a case study of the Condev collapse from March 2022 shows the impact of slim profit margins combined with unforeseen escalation and resources shortages.

# Challenges

Government and industry need to work collaboratively to address the challenges associated with input cost escalation. Outlined below are the key challenges.

## Pricing for hyper-escalation

Asking contractors to price for hyper-escalation is considered a lose-lose outcome as:

- » it is difficult to adequately foresee which items may be subject to rapid price increases
- » contractors with realistic pricing risk losing out to those that do not adequately price the risk
- » clients risk paying a premium should input prices decline
- » hedging may be available for limited trades for a short timeframe but is not widely available and is expensive.

## Risk sharing contracts

Risk sharing contracts such as Incentivised Target Cost models still put contractors at risk of losing overhead recovery and profit for an event that is largely outside their control. While this is better than a fixed price without adjustment where contractors risk losing much more, it is still not an equitable outcome.

## Rise and fall

Rise and fall clauses, outlined below as part of the solution, are not routinely included in contracts outside some construct-only standard forms. Clauses with adjustment mechanisms based on a generic index can be inaccurate, not include reference to a relevant item and will likely have a substantial lag from data collection to publication of index.

## Timing of issue of final drawings (construct only contracts)

Another challenge is the timing of Issued for Construction (IFC) drawings in a construct-only context. Materials will not be ordered prior to the IFC documentation being issued. If IFC drawings are not included in the tender documentation, the prices obtained from suppliers will be out-of-date when IFC documentation is issued.

## Existing contracts

Existing lump sum contracts (potentially with a minimum threshold value and duration) should also be eligible for escalation relief. It is widely accepted that the rapidly rising costs being experienced were not foreseeable previously. Accordingly, there are contracts in place based on pricing provided by subcontractors and suppliers at time of tender that are substantially under-priced now.

It is not reasonable or fair for clients to require contractors to stand by those prices when many subcontractors and suppliers simply cannot maintain the original price provided. To do so will result in clients obtaining an asset for below actual cost and requiring contractors to either suffer a loss or do the work for free.



# Solutions

Solutions are required to appropriately allocate risk between contractual parties to prevent losses in the circumstances of unprecedented and unforeseen hyper-escalation of construction input costs.

The sustainability of the supply chain is of primary importance. Industry should not face the undesirable choice of requiring a subcontractor or supplier to maintain a price that is no longer adequate, or to select another subcontractor or supplier, or to wear a loss itself. This is a collective issue that requires collaborative solutions. There are several levers asset owners can consider to address the challenges.

## Validity periods

Extended procurement processes tie up bid teams for unreasonable periods when they could be undertaking more productive work. Moreover, they cause stress to the supply chain in circumstances where industry is unable to hold prices due to rapidly changing markets. Each client request for an extension to an already lengthy bid period results in further requests to the supply chain to revalidate their pricing, impacting capacity constraints further.

Shortened validity periods and the ability to re-price for certain items prior to contract close are simple solutions to address the risks associated with today's volatile environment and will assist the entire supply chain.

In a positive step forward, the South Australian Department of Infrastructure and Transport recently reduced tender validity periods to 60 days. Another example is a recent major project where the preferred tenderer was provided the opportunity to re-price rates prior to award due to a lengthy tender process.

## Priorities

It is important that government clients seek to leverage both the economic and social benefits of infrastructure spend. Government procurement

policies that seek to optimise local subcontractors and suppliers are welcome in normal operating environments. However, where there are capacity constraints and rapidly escalating prices, industry calls on government to be flexible to achieve lower cost outcomes.

As with 'buy local' policies, opening up preferred/prequalification lists of suppliers provides an opportunity to expand the available pool of resources and improve competition.

## Design-related solutions

As recommended in the 2021 Australian Infrastructure Plan, agencies that pursue standardised design elements help to drive productivity improvements across the industry by avoiding bespoke expensive items. Standardised elements also broaden the potential suppliers including local supply chain participants.

Pre-agreed variations can work well to maintain overall budget where well-planned at an early stage. This enables optional increases and decreases in scope to be selected depending on the ultimate pricing of key materials and labour in an environment of rapid escalation.

Similarly, value engineering can assist with maintaining overall budget by enabling cost/scope reductions to offset increases outside the control of the contractor. Industry needs the ability to innovate and incorporate alternative materials where feasible. Government delivery agencies need to move away from the prescriptive specifications that have been used for decades to more performance-based specifications that enable greater innovation and solutions including more sustainable outcomes.

## Contractual price adjustment clauses

Price adjustment mechanisms (rise and fall clauses) address the symptoms although it is acknowledged they do not address the cause of the problem. Nonetheless, these are an important measure to manage the risk. Such provisions can be based on an objective price index or open book approach.

There are pros and cons of each approach. Adjustment mechanisms linked to an index are objective and efficient to administer. However, generic indexes such as an ABS index are unlikely to be sufficiently specific for some regions or materials and there is an unavoidable 'lag' between the published index and the increases in price experienced in circumstances of hyper-escalation. ACA has discussed this issue with the Australian Bureau of Statistics (ABS) directly, and it is clear that ABS indexes are not created or published for the purposes of contractual price adjustment mechanisms. The data is collected over a quarter, prices can be averaged, and not all materials are included. ABS has advised that changes would only be made to an index if there is a long-term trend indicated by the data. Therefore, ABS indexes are unlikely to be an adequate mechanism to address hyper-escalation of particular materials.

ACA welcomes the opportunity to discuss alternatives indexes and other objective mechanisms that may address the need for tailored and current data.

Open book approaches are more targeted but can be resource intensive. Examples of workable approaches include provision of evidence from a key supplier of a price increase, demonstration of rate increases above a certain percentage, or market quotes to evidence the price increase.

ACA calls on clients to include relevant price adjustment mechanisms in contracts, regardless of form.

## Early contractor involvement

The Early Contractor Involvement model, as the name suggests, seeks to involve the contractor earlier in the procurement process to provide constructability input into the development of the concept design and to investigate ways to mitigate project risk. Very early contractor involvement enables greater opportunity for contractors and key suppliers to consider escalation issues in design and consider alternative design solutions.

For some large-scale infrastructure projects, enabling the nomination of key subcontractors/suppliers with tenders to allow single sourcing of certain trades/materials can abate escalation risk (for example, a contractor can partner with suppliers/subcontractors for high-risk elements of the project using open book options at the earliest possible stage). This approach has been adopted successfully on UK infrastructure projects.

Early supply chain partnering and very early contractor involvement also enable innovations into the project. Value engineering and design innovations are one example, but others include resourcing innovation, productivity gains and environmental sustainability. If innovation is not considered at an early stage of the project, the opportunity is often lost.

## Faster and advance payments

Advance payment arrangements can enable early ordering and storage of materials with rapidly increasing prices to lock in a price as early as possible. Contractors cannot be expected to finance projects by operating on substantial negative cashflows. Advance payments for certain materials are part of the solution. However, where security bonds are required equal to the advance payment, this adds cost and administrative burden on the contractor and therefore should be avoided. There are other solutions to secure title in the event of a contractor failure that should be explored including registering an interest on the Personal Property Securities Register.

Faster payments also assist with cashflow. Faster payments to head contractors enable faster payments to suppliers.

## Collaborative contracting

The use of more collaborative contracting arrangements (which can be incorporated into various delivery models) provides an opportunity to align the interests of all parties to what is best for the project. This enables problems to be resolved as they occur to achieve mutually beneficial outcomes rather than for the benefit of one party over another. Collaborative contracting also facilitates greater engagement and earlier involvement of the supply change to identify potential issues and drive innovation.



# Government to act as a model client

ACA believes clients should commit to behaving as a ‘model client’ and act ethically and fairly without seeking to gain an unfair benefit. For existing contracts experiencing unforeseen hyper-escalation, the fair and reasonable response is to agree a mechanism to compensate industry for the increased costs, to avoid the situation outlined above.

A targeted solution to those elements impacted by hyper-escalation is required. Industry is not seeking to re-open all elements of a contract or make windfall gains. There are examples of clients agreeing reasonable compensation as a result of COVID-19 impacts, including the Infrastructure NSW ‘Guidelines to Support Negotiated Outcomes’ setting out guidance for resolving claims for additional costs incurred, including outcomes outside contractual provisions. Similar guidance could be issued in relation to hyper-escalation. As with the COVID-19 guidelines, contractors would be expected to mitigate costs and also propose value engineering/scope reduction solutions where feasible. Without centralised guidance within jurisdictions, prolonged claims and disputes may result (which may be contractual or based on common law/equitable principles).

The South Australian Department of Infrastructure and Transport has recently agreed to not only a price adjustment mechanism for future contracts but also

to retrospectively apply a rise and fall mechanism to payment claims in acknowledgment of the substantial and unpredictable inflation of building materials.

The NSW Government’s 10 Point Commitments are also relevant in this regard, and ACA submits these Commitments are broadly applicable to all jurisdictions. In particular, the commitment to partnership-based approaches to risk allocation and to managing projects in a collaborative way.

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