Secretariat

The Price is Right… Until it Isn't: Navigating Disputes in a New Era of Construction Cost Escalation

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Article Highlights

- **What is an escalation claim and why are they so common now?**
- **Key global events driving construction cost escalation.**
- **How escalation manifests in disputes and how it's measured.**

What is an Escalation Claim?

Quite simply, escalation is defined as "*a rapid increase or rise*" and is generally paired with either 'cost'[1] or 'price'[2] when referring to a claim in a construction dispute. Depending on the context, a party may claim escalation which relates to specific construction materials (e.g. steel or concrete), or more general escalation which involves increased costs across multiple categories (e.g. materials, labour, plant and overheads). These increases can significantly impact the forecast budget and often cause financial losses to a party (typically, a contractor).

Why Has Escalation Become a Ubiquitous Issue?

In the decade prior to 2021, inflation remained relatively low. In fixed-price contracts[3], contractors could price inflationary risks associated with labour, materials and plant with a greater degree of confidence based on their experience and relatively stable market trends. Similarly, in fluctuating-price contracts[4], contractors could focus on pricing the works based on experience, without the need to include risk allowances for price fluctuations, as the contract provided a mechanism to recover cost increases from escalation.

1 'Cost' in literal terms means the actual cost paid for the commodities; typically includes the cost of labour, plant and materials required to procure materials or carry out works.

2 'Price' generally refers to the price or value agreed under a contract with either a contractor, subcontractor or supplier and will often include a mark-up for overheads and profit. The 'price' will typically exceed the actual cost of the underlying commodities due to the additional mark ups.

3 In fixed-price contracts, the contractor takes the risk of escalation.

4 In fluctuating-price contracts, the risk of escalation is taken away from the contractor and will often include a fluctuation mechanism which adjusts the contract price based on changes in material or labour costs over time. For example, allowing additional payments to be made to the contractor in case of escalating prices of steel according to the built in formula and indices, however as noted below issues may arise over the suitability of the indices built into the contract.

However, since the pandemic, there have been many global events which have adversely impacted the supply chain, compounded by inflationary pressures and currency fluctuations worldwide, leading to unprecedented levels of price escalation. As a result, we are now experiencing a new era of cost escalation on construction projects around the world.

Global Events Impacting Construction Escalation

As the world began to recover from the pandemic, the construction industry was faced with labour shortages and instability in global supply chains. This was further compounded by logistical disruptions to the shipping industry across the world including record high port congestion in Shanghai[5] and Los Angeles[6], Houthi attacks in the Red Sea and blockages in the Suez Canal.[7]

Furthermore, in February 2022, following the invasion of Ukraine and the ensuing conflict, a multitude of economic shockwaves reverberated across global industries, particularly the construction industry, as supply chains faced significant disruption, including:

- Destruction of Ukrainian ports causing blockages, and subsequent avoidance of shipping routes, in the Black Sea which has impacted availability of certain construction materials and caused increases in transportation costs;
- Energy prices surged across Europe, and beyond, as sanctions were placed on Russian energy companies and Russian gas flows to the EU were dramatically reduced. This led to a major re-balancing of supply chains with LNG[8] rising to prominence and extreme volatility in the natural gas market;
- Escalation of steel prices driven by unavailability of materials in Ukraine and Russia, combined with production cost increases due labour shortages and spikes in energy costs; and
- Extreme volatility in nickel markets (a major alloy used in stainless steel). Prior to the war, Russia was a top supplier of nickel and provided competitive pricing but withheld exports in response to a ban on Russian imports by countries in the West following the invasion of Ukraine. In March 2022, the cost of Nickel doubled from USD c.25,000/t to USD c.50,000/t in the space of a few days.[9]

As we near the end of 2025, with the ongoing conflict in Ukraine showing no sign of resolution and the unpredictable introduction of tariffs fuelling global trade tensions, the outlook remains bleak. It is too early, and difficult, to fully assess the long-term effects of the US sanctions introduced earlier this year and any retaliatory sanctions from other countries. With geopolitical economic policies moving quickly, and unpredictably, it is difficult to estimate the impact on future construction costs, but the outlook suggests more of the same in terms of volatility and rapid escalation (and sometimes de-escalation) of certain commodities central to construction projects.

How Does Escalation Manifest in Construction Disputes?

Over the last few years, there have been several different ways in which escalation has become a major contributor to claims, frequently leading to disputes on construction contracts, both with and without escalation clauses.

For contracts with escalation clauses, a party (typically, a contractor) may argue that the mechanism for compensating the cost increases is no longer fit for purpose; for example, due to an event which has caused unprecedented escalation beyond what is compensable through the prescribed indices under the contract. In these circumstances, a contractor will often therefore attempt to claim extra-over costs arising from the escalation; a contractor "*may conceivably argue that its actual increased costs were greater*

5 https://www.spglobal.com/market-intelligence/en/news-insights/research/insight-congestion-in-shanghai-cjk-freight-signal-monitor
6 https://blog.vesselsvalue.com/2021-port-congestion-report/
7 https://www.bbc.co.uk/news/world-middle-east-56505413
8 Liquefied Natural Gas
9 https://www.spglobal.com/market-intelligence/en/news-insights/articles/2022/3/nickel-price-spike-and-lme-trade-halt-presages-extended-nickel-deficit-69269697

than those recovered under the clause so that it was entitled to recover the difference as damages,".[10]

For contracts without an escalation clause, a party (again, typically a contractor) may claim that it faces an ongoing hardship due to unprecedented cost escalation on the project and may attempt to claim an adjustment to the contract price and/or even termination of the contract by relying on legal grounds such as a force majeure clause, or alternatively a hardship clause or change in law clause in the contract. If not in contract, then a party may attempt to rely on civil law principles where applicable.

Escalation claims can also be tied to delay on a project i.e. the contract period is extended and a contractor or subcontractors not only incur time-related prolongation costs, but also the impact of inflation and/or specific escalation of materials in the over-run period.

Similarly, an escalation claim may be associated with termination, as a contractor may argue that it cannot complete the works due to the impact of price escalation and therefore seek to terminate the contract, or an Employer may claim it has experienced increased costs because of a contract termination i.e. the costs of completing the works incurred by a replacement contractor are greater due to escalation in the post termination period and therefore claims the 'extra over' (i.e. costs in excess of the cost that would have been paid to the original contractor had it not been terminated).

Whichever scenario, a successful claiming party will typically need to show causation between the event and the losses claimed, that the event was beyond the claimant's reasonable control and that it has taken reasonable steps to mitigate the losses.

Measuring Escalation: Methodologies and Considerations

To assess a claim for cost escalation, a structured and evidence-based approach is required; this starts with the contract terms and, dependent on the contract provisions available, should set the course of the claimant's investigation towards a detailed evaluation of actual costs, analysis of relevant indices and consideration of the reasonableness of the claim.

CONTRACT TERMS ARE KEY

An essential first step is to examine the contract to determine whether it contains an escalation clause or any form of price adjustment mechanism. This could be a Price Adjustment Formula (PAF), a fluctuation clause, or other express provisions allowing for recovery of the cost of variations due to market changes. Where such a clause exists, the methodology, indexation, weightings, and any caps or limitations must be understood in detail.

If a fluctuation mechanism does not exist under the contract, then the claimant's investigations will be focused on what the contractor allowed for price fluctuation in the tender; if this cannot be identified from the evidence, then consideration would need to be given to what a reasonable contractor may have assumed for inflation and other pricing risks.

APPLICABILITY OF INDICES

The relevance and applicability of any linked indices must be considered both in the context of use in adjustment formulas and for use when assessing the reasonableness of the escalation amount claimed. The selection of indices is vital; for example, it must be relevant to the construction project and represent the goods and services required to complete the project.

In addition to applicability of an index, consideration must be given to the frequency of any adjustments under the contract using the relevant index. Monthly adjustments may capture volatility more accurately than annually, especially where mid-year price spikes occur.

TIMELINE AND DATES FOR ASSESSMENT

Establishing a timeline and periods for assessment is an important step of the analysis. In a But-For scenario this will typically involve two distinct periods:

- The "But For" period which establishes the baseline against which the escalation will be measured (e.g. period during which the tender

10 Keating on Construction Contracts 12th Edition, para. 9-057

was priced by the contractor or an agreed period of time prior to the escalation event); and

- The "Actual" period which represents when the increased costs were incurred due to the event/breach.

In any case, a reasonable timeline must be selected for assessment of both sides of the scenario; both periods should be of comparable length and contextually reasonable (i.e. relevant to project-specific events and/or external events.)

EVIDENCE OF ACTUAL COST INCURRED AND REASONABLENESS

As with all quantum claims, evidence of cost incurred should be provided in the usual way (i.e. detailed cost breakdown/invoices/payments etc.) and, where possible, a comparison should be made between the actual costs and what the cost would have been but for the claimed event(s). However, with escalation, it can be difficult and sometimes not possible to identify actual cost levels of what the resources would have cost but for the escalation event or, in the case of delay, the level of cost pre-delay. In view of this, the increased costs claimed should be supported by indices and other relevant data, to show that prices of the resources were escalating in line with market conditions and/or external factors causing the escalation. This is necessary to demonstrate the reasonableness of the evaluation.

The Bottom Line on Escalation

Since the pandemic, many global events (mostly driven by geopolitical forces), have caused unprecedented disruption in global supply chains together with inflationary pressures reaching all-time highs in many countries including the UK, Europe and the USA in the last few decades of recording.[11] As a result, in many respects, we are now in a new era of cost escalation on construction projects around the world.

Ongoing regional conflict and global trade wars are among the issues precipitating unpredictable and volatile markets which is adding to the difficulty of estimating future construction costs at the tender stage with the outlook suggesting more of the same. It is likely that escalation claims will remain prevalent in construction disputes. Given this situation, it is also increasingly important for Employers and Contractors to give careful consideration to the contract pricing mechanisms before entering into contract so that it is clear how the risk of escalation is allocated and to ensure that any fluctuation mechanisms are fit for purpose.

It is important to bear in mind that every construction project is different and, in order to assess escalation claims accurately and reasonably, one must fully understand the background to the dispute, which includes the following important steps:

- Understand the contract terms; these will dictate whether a compensation mechanism exists and the next step in the analysis;
- Robust evidence of actual costs incurred and, where possible, data-points for 'but for' cost levels;
- Potentially, evidence that the contractor took reasonable steps to mitigate the cost increases;
- Applicability of indices should be carefully considered and must reflect the actual inputs (i.e. the commodities to be used) to the construction project, in order to demonstrate the reasonableness of the increased costs claimed.

11 https://data.worldbank.org/indicator/FP.CPI.TOTL.ZG?end=2024&locations=1W-GB-US-FR-DE&start=2003

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