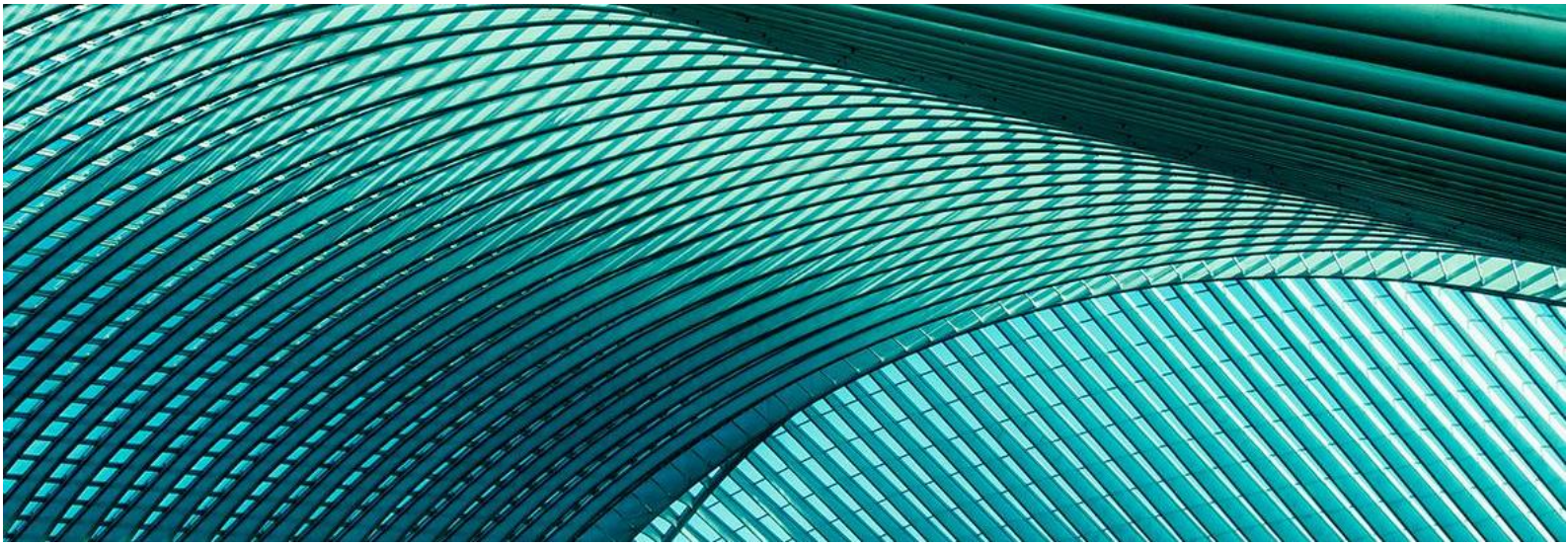

How market turmoil can affect large projects

Turmoil in the global economy is exposing an increasing number of large projects to unprecedented productivity and financial pressures. Severe microeconomic issues can arise on projects that stem from unforeseen macroeconomic events. We discuss this evolving situation and potential mitigants below.

Introduction

Turmoil is defined as “a state of confusion, uncertainty, or disorder”[1], or “a state of great worry in which everything is confused, and nothing is certain”[2]. Perhaps the standout word here in the context of project execution is “uncertainty” which, from a construction and engineering project stakeholder’s perspective, means a greater exposure to financial risks.

A combination of macroeconomic events has resulted in many contractors on lump sum contracts suffering the impacts of unforeseen and exceptional increase in costs of materials, equipment, instrumentation, labour, and personnel. Some other impacts to projects, not always immediately considered to be directly market-linked, include delays and disruption to progress of the works, and reduced cashflow due to either lower revenue, increased costs, or a combination of both.

Large scale high-value projects under lump sum contracts that are scheduled to be constructed over longer periods, and in many instances on lower percentage profit margins, are generally vulnerable to changes in macroeconomic conditions. This is primarily driven by the scale and complexity of some projects, especially those with high specialist material quantities and labour requirements, which could in some instances have construction schedules over multiple years and CAPEX of hundreds of millions. On these projects profit margins can easily be eroded by macroeconomic factors due to their global exposure.

[1] https://dictionary.cambridge.org/dictionary/english/turmoil
[2] https://www.oxfordlearnersdictionaries.com/definition/english/turmoil

Current causative trends

Those projects, especially of a scale that require significant engineering, construction, and logistical input from around the globe, and which were procured during and shortly after the start of the COVID-19 pandemic, are being affected by supervening events which may include:

- Slow resumption of the activities of global markets after the initial COVID-19 lockdowns;
- The war between Russia and Ukraine;
- Global supply chain shortages, ports congestion, lack of containers and transportation costs; and,
- Region-specific severe weather and other types of force majeure events that on their own would not have impacted projects on such a global scale but exacerbated the microeconomic impacts on projects already battered by global market turmoil.

The project-specific impacts we see from these, or a combination of the above events include severe delays and disruption to engineering and construction works, and significant unforeseen increases in costs driven by:

- Overloaded vendors of materials, specialist equipment and instrumentation catching up on projects that were delayed and disrupted during the pandemic; and
- Raw material pricing, scarcity and global inflation causing significant escalation of the prices of materials, construction works and people.

What are the economic effects coming out of this?

Typical claims from contractors and employers include escalation in material prices, specialist vendor works, and subcontractor construction works cost increases, delays and disruption to engineering, procurement and construction affected by losses in productivity levels, and the costs of labour and site running costs.

Large scale projects are typically also affected by increased transportation and logistics costs, especially projects for which bulk materials are bought from various/multiple destinations outside of the regions or countries where the works are being undertaken.

As an illustrative example, many large-scale Oil and Gas projects have in recent years relied on the supply of steel and other metal products, and specialist equipment and instrumentation from Russian and Ukrainian supply chains. These supply chains are now disrupted by the logistical restrictions and closure of facilities in these two and their neighbouring countries. While not seeking to monetise or be insensitive to the humanitarian travesty which is this war, the mentioned supply chain issues combined with sanctions imposed on Russian entities have required the re-procurement of materials from other, lesser known markets with varying risk profiles.

These impacting factors could result in short term losses to productivity and delays, while prolonged exposure to or a combination of them, could result in compounding impacts that could also affect the cashflow of many contractors, incurring unplanned, unforeseen and greater levels of costs in the financing required for these projects.

In some instances, the levels and severity of economic impacts arising from this, could put at risk the completion and delivery of the assets that are being constructed, providing stakeholders with the real dilemma of non-completion or severely delayed completion of the developed assets.

The gathering of evidence to develop a compelling case

Only once the contractual legal framework has been scrutinised and the claim strategy has been decided, can the quantification of financial impact related to escalation in prices, delays, disruption, and other direct consequential effects be assessed.

Like most claims, causation in fact could be one of the most important pieces of the puzzle. To quote Mullen / Davison in 'Evaluating Contract Claims'[3] *"…the task of establishing the quantum of a claim is much simplified and stands a greater chance of success if the claim itself has been fully analysed and established from the root causes as anticipated by the chain of analysis."* In relation to the quantification of disruption claims as an example they state *"Analysis that goes back part way through the chain of causation to better detail of the effects of disruption can facilitate a more detailed approach to quantification."*

For complex cases that require detailed global market investigations and supporting evidence into the specific vendors, materials and commodities, obtaining specialised professional assistance could provide an advantage in finding the trail of macroeconomic causative links to the microeconomic effects felt on the projects.

How could the effects caused by global economic turmoil be particularised?

From our experience of the levels and standards of detail in which evidence is tested during international arbitrations, establishing the factual causation on a detailed particularised basis is a key aspect in discharging burdens of proof for claims. This is especially important where there is mixed liability and a high level of the disentanglement required for the causes and the effects.

A further key requirement is to allocate the additional costs to the causes on a detailed, factual and particularized basis. Cost evidence and transparency with pricing details provide further weight, especially when proving that unrelated costs have been excluded from claims. This will help to demonstrate that costs only relating to matters the claimant is not responsible for under the Contract are included.

For disruption or losses in productivity type claims, I highly recommend reading "The Analysis And Valuation Of Disruption" by Derek Nelson. Known methodology, such as the measured mile, in some shape or form is preferred in many jurisdictions and also mentioned in the Society of Construction Law Delay and Disruption Protocol ("the SCLDDP")[4] and other industry publications such as AACE International Recommended Practise No. 25R-03.

For this, productivity assessments based on actual detailed manpower or other resource records should be conducted, on a detailed discipline by discipline basis where possible, and could be supported by production efficiency calculations of manpower spent on works for example, manpower per ton of steelwork fabrication, or manpower per m2 of paintwork, which in some instances could provide additional supporting evidence.

Any delay-related claim assessments should be supported by contemporaneous records, based upon appropriate delay analyses, and the conclusions derived must be sound from a common-sense perspective.[5]

With regards to claims for price escalation, transparency of the contractor's pricing details is key, proving that changes in quantities or scope change related costs have not been included in these claims, and that only cost increase related to cost rates are included. Detailed fact-based narratives of the chronology along with

[3] Mullen J, Davison P, 2020, Evaluating Contract Claims, Third Edition, Wiley Blackwell, page 23.
[4] See pages 11, 12 and 14.
[5] The application of 'common sense' is mentioned in several sections of the SCLDDP, and in my view, a few more mentions could not have done any harm

transparency of the procurement processes and bid prices can also sometimes help to make a case more compelling.

Conclusion

It seems clear that market-related cost volatility will be a major consideration in the risk registers of large projects over the next few years, especially on those projects with higher probability exposure to severe impacts from long construction schedules, large quantities of materials and reliance on specialist labour.

It is therefore important for stakeholders to give particular consideration to how those risks have been allocated under their contracts, and to the required mitigating control measures.

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