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Legal Update

Navigating the Impact of Inflation on Commercial Contracts

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After decades of low inflation, New Zealand finds itself in a high inflation world where rapid price rises have become the new normal and many businesses are suffering from margin compression. Many longer-term contracts have been negotiated with little thought about the possibility of high inflation returning. Some will become difficult or unprofitable to perform. By being proactive, businesses can take steps to protect themselves from the negative effects of inflation and margin compression.

In a high inflation environment, tensions between contracting parties are likely as manufacturers and suppliers seek to increase their prices to cover cost increases. On the other hand, customers want certainty and to pay no more than agreed or budgeted. Set out below are some practical tips to help you navigate your way through the impacts of high inflation.

WHAT CAN YOU DO AS A SUPPLIER?

Whether you are a supplier or a customer, being proactive and engaging with your suppliers and customers early is important to help you manage the effect of inflation on your business. Practical tips for suppliers include:

- Consider the likely impact of price increases on customer demand, and the dynamics in your market. Understand your costs and what is likely to happen to your costs in the forecast period so that you can appropriately price your goods and services;
- Check your contract terms carefully for price adjustment mechanisms which allow you to increase prices. Ensure you comply with any procedural requirements;
- Engage with key customers and do so early. You are more likely to receive a favourable outcome if you justify your price increases with supporting evidence and show how you have mitigated your cost increases;
- Give notice of price increases with sufficient warning so your customers can budget for the increase and, if necessary, pass the cost increases on to their customers;
- For international contracts, ensure you factor in exchange rate movements – as the NZ dollar is a volatile currency. Consider mitigating your risk of exchange rate movements with hedging strategies – but get expert advice as hedging involves significant risks;
- If a contract is uneconomic and you are considering terminating the contract, carefully check the terms of your contract. You are likely to find it difficult to escape a contract purely because the contract has become uneconomic but there may be other termination rights. Termination involves risks. It is important to carefully comply with the termination provisions. Consider taking legal advice;
- For new contracts, ensure your supply contracts and terms of trade allow you to increase your prices. Price adjustment mechanisms can range from a unilateral supplier right to increase prices through to price increases based on CPI or an index specific to the specific contract or industry, and more granular clauses that seek to pass on only specific price increases. Significant care needs to be taken with price adjustment mechanisms to ensure that they allow all relevant costs to be passed on to the customer; and
- Try to mitigate the impact of inflation, for example by agreeing fixed prices from key suppliers, considering efficiencies, product or ingredient switches, etc.

WHAT CAN YOU DO AS A CUSTOMER?

Price increases are inevitable in a high inflation environment. Practical tips for customers include:

- Check contract terms to ensure the supplier increasing prices has the right to do so;

- Ensure that any price increase is justifiable and fair. Remember that commodity and other cost increases will only represent a percentage of total costs. Check that the supplier is not trying to increase margin. For material contracts it is good practice to seek detailed calculations and supporting information;
- Budget for realistic price increases and engage with key suppliers about likely price changes.
- Engage with your key suppliers early. A commercial negotiation is likely to be the most sensible option. Many businesses are sympathetic to suppliers seeking price increases where they can be justified - particularly if the business is able to pass on the price increase;
- Shop around, it may be that new suppliers can provide better prices or service; and
- For new contracts, carefully negotiate price adjustment mechanisms. For example, consider fixed pricing, forecasts, notice periods for price increases, and more sophisticated price adjustment mechanisms. Take care to ensure that only relevant cost increases can be passed on to you.

FURTHER INFORMATION

For assistance or further information, please contact one of the lawyers listed below or your usual Jackson Russell advisor.

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