Mitigating the Effect of Construction Price Escalations

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Over the past year, the volatility of construction material prices has wreaked havoc on construction budgets and caused many disputes between owners, general contractors, subcontractors, and material suppliers. For example, lumber prices have tripled, PVC and copper prices have almost doubled, and certain material suppliers have refused to hold pricing for more than twenty-four hours. This begs the following questions: Who bears the risk of these price escalations, and how can construction stakeholders mitigate these risks?

The answer to the first question depends on the terms of the contract between the parties. However, the party procuring the materials, i.e. a general contractor or a downstream subcontractor or supplier, usually bears the risks of material price escalations in fixed-price contracts and guaranteed-maximum-price contracts unless the price escalation is caused by a condition that is otherwise addressed in the contract. For example, the AIA A201-2017 and ConsensusDocs 200 Owner/Constructor Agreement typically allow additional time for unavoidable delays associated with construction materials and arguably allow additional compensation for newly enacted taxes and tariffs, but they do not specifically address price escalations caused by unidentified market forces. In any event, the better practice is to specifically address price escalations during the bidding process and include price escalation clauses in your construction contracts going forward to mitigate these risks.

Mitigating the effects of price escalations should start in the bidding process. During the bidding phase of a project, contractors, subcontractors, and suppliers should identify which materials are most susceptible to price volatility and discuss them with the upstream contracting party. Downstream contractors and suppliers also should be wary of bidding requirements which require them to bear the sole risk of any price escalations and should modify their standard bidding forms and proposals to include general price escalation clauses. For example, a downstream contractor or supplier may include language in its proposal stating that any price increases after the date of the proposal are not included in the contract price and shall give rise to an equitable adjustment of the contract price and time. If price escalation clauses are not included in the bids, contractors and suppliers may attempt to include allowances or large contingencies to account for potential price escalation or shorten the timeframe in which their bids are open for acceptance. Including price escalation language in a bid also may benefit the owner because it may reduce the bid amounts since large contingencies for potential price escalation can be avoided.

The best way to mitigate risks associated with material cost volatility is to include price escalation provisions in your contracts. There are many different types of price escalation provisions that can be included in a construction contract, but the three most common types are: (1) any-increase escalation clauses, (2) threshold escalation clauses, and (3) delay escalation clauses. Under the first type, a downstream contractor or supplier is entitled to reimbursement for any price increases that occur after the signing of the contract or submission of the bid. These provisions often identify the specific types of materials which are subject to the clause and set baseline prices for those materials. This also can be accomplished through allowances. Threshold escalation clauses, on the other hand, only allow the downstream contractor or supplier additional compensation for price escalations which exceed a certain percentage or dollar amount. A threshold escalation clause also may include a cap on the total amount or percentage increase allowed. For example, the Federal Acquisition Regulations (FAR) allow price escalation clauses in certain circumstances, but FAR § § 52.216-2 and 52.216-3 default to a 10% maximum allowable increase in the contract price. State public project standard specifications may also include price escalation provisions. Like any-increase clauses, threshold escalation clauses typically identify the specific types of materials that are subject to the clause and include baseline prices, which often are tied to actual pricing, a published material cost index, established catalog pricing or other objectively verifiable ways to identify cost and market fluctuations. An example of a standard-form threshold price escalation clause is the ConsensusDocs 200.1 Amendment No. 1 Potentially Time and Price-Impacted Materials. The third general type of escalation clause, which is known as a delay escalation clause, holds a fixed price for a limited period of time and allows the downstream contractor additional compensation if the project is delayed beyond a given number of days or a specified date. It is intended to reimburse the downstream contractor for increased costs that occur during the delay. Of course, each of these types of price escalation clauses can be modified to provide more protection for an owner, contractor or supplier. We suggest consulting with an attorney to help craft a provision that is best for your situation.

The price escalation provision included in the final construction contract often is the product of negotiation between the parties. For instance, Owners may require that a price escalation clause includes a cap on the amount or percentage of price increase allowed and ensure that the contract sum is decreased by any price decreases which occur after the contract is executed. Owners also may request that contractors provide support for their contract prices, such as actual subcontractors' bids, building cost indices, or catalog pricing, to ensure they reflect accurate market prices and specifically reference them in the contract. On the other hand, downstream contractors often would rather include broad price escalation provisions which do not limit their ability to receive extra compensation for any differences in pricing between their bids and the final costs incurred to procure the materials.

Downstream contractors also can mitigate their risks during the construction and procurement phase of the project, regardless of whether a price escalation clause is included in the contract. For example, a contractor should regularly monitor its costs in relation to its estimate and provide notice of any price escalations as soon as they are identified and, in any event, no later than is required by the terms of its contract. A contractor also may mitigate some of the effects of potential price escalation by purchasing materials with the most volatile prices as early as possible or purchasing materials for multiple projects at once. However, early and/or bulk purchases may cause increased storage or material handling costs. As always, prompt and early communication is important to address and perhaps avoid a dispute related to cost escalations during the construction phase.

Whether your project is in the design phase, contracting phase or construction phase, it is better to proactively implement the changes suggested in this article now than to procrastinate until price escalations affect your bottom line.