

Revisiting Price Escalation Clauses in a Time of Skyrocketing Material Costs

By Niel Franzese on April 23, 2021

Anyone monitoring construction industry trends is aware that the prices of raw construction materials, particularly steel and lumber, have been rapidly increasing since early 2020. Earlier this year, Associated Builders and Contractors reported that iron and steel prices were up 15.6 percent from January of 2020 to January of 2021, and that softwood lumber prices had increased by as much as 73 percent during the same period.

The reasons for these price increases are varied (ranging from supply chain and shipping disruptions to the increased demand for new home construction), and many have their roots in changes introduced to the global economy by the COVID-19 pandemic. Regardless of the explanations for the price increases, the reality is that builders and owners are more frequently facing busted budgets and difficult conversations, sometimes resulting in litigation, about which party is responsible for absorbing the increased costs. As is often the case, the answer to resolving these disputes likely lies in the particular provisions of the contract for construction.

For projects constructed on a cost-plus or time and materials basis, the contract is likely to identify the responsible party as the owner. The relatively open-ended pricing structures in these types of contracts provide the least price certainty to owners, and the most flexibility to contractors, in dealing with the fluctuations of the costs of materials as a project progresses.

On the other end of the spectrum are contracts which are priced on a lump sum, or fixed price, basis. Under these pricing structures, a contractor's pricing is generally locked in at the outset for a defined scope of work, and owners are unlikely to voluntarily provide any cost relief when material price escalations cause budgets to be exceeded for categories of materials that have not yet been purchased.

Contracts that are priced on a "not to exceed" or "guaranteed maximum price" basis lie somewhere in the middle. In these types of contracts, owners are generally better protected from material price increases due to the cap on total construction costs, and constructors often build allowances or contingencies into their pricing structures to protect against, among other things, unexpected material cost escalations. Contractual mechanisms like shared savings clauses can incentivize contractors to be smart with owners' funds even where material prices are skyrocketing, in the hope that intelligent procurement strategies will both save the owner money and provide a boon to the contractor's bottom line at final payment.

One important variable factor, however, is whether a given contract specifically addresses the risk of material price escalations with what is commonly referred to as an "escalation clause." Rarely needed in cost-plus contracts, these clauses are gaining popularity with contractors as a method of hedging against, or merely more equitably sharing, the risk of cost increases as a result of material price escalations in light of the reality that material prices seem to steadily increase year over year. These clauses can take a variety of forms, but they most typically address one of two scenarios.

The first form, often referred to as a “delay” or “event” escalation clause, typically provides that when a delay in material procurement of a certain duration, or other specific event, takes place, the contractor can seek additional compensation for increased material costs. In essence, a contractor is agreeing to stand by its material prices for a certain period of time (sometimes as short as the day the contract is signed) and, after that time, will look to the owner to share in or fully absorb any material price increases.

The second form, often referred to as a “percentage-based” or “threshold” escalation clause, provides that, once material prices on the open market have increased by a certain percentage beyond what the contractor estimated at the time that the contract was signed, the owner and contractor will adjust the contract sum to account for the excess, in the form of either full or partial additional compensation to the contractor for the cost increases.

The selection of an appropriate project delivery method and negotiation on whether to include a material price escalation clause are just two of the ways that owners and contractors are addressing the challenges of finding certainty in a rapidly changing market. Whether material price escalation clauses become the norm in response to these market conditions remains to be seen and, for now at least, they are one more variable to bear in mind before signing on the dotted line.

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