NASBP Blog

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How Can Contractors and Sureties Address Material Price Escalation and Shortage Delays?

By Kathy Hoffman posted October 3, 2022

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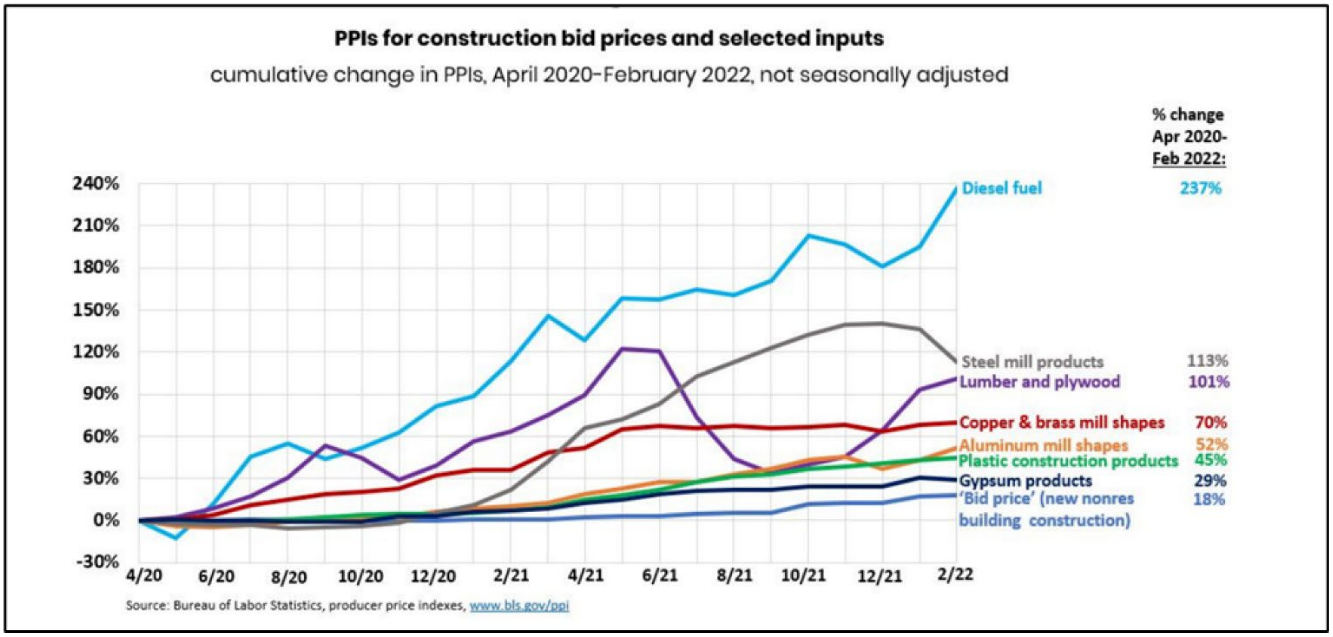
For more than two years, price volatility of construction materials has significantly eroded contractors' bottom lines. Multiple factors have caused prices for critical construction materials to soar to unprecedented heights. These include the COVID-19 pandemic, which continues to plague the construction industry; global supply chain disruptions; natural disasters (including California wildfires); the Suez Canal blockage in March 2021; the Russian invasion of Ukraine in February 2022; fuel cost increases; and worldwide inflation. Over the past two years, the usual suspects impacted by price escalation—steel, copper, lumber, engineered wood products, and plastic-based materials—have fluctuated to a degree not seen in decades.

The Associated General Contractors of America's April 2022 "Construction Inflation Alert" provided the chart below, which depicts the magnitude of recent price increases for seven widely used categories of construction materials. For example, it shows diesel fuel price increases of 237%, steel increases of 113%, and lumber increases of 101%.



In the traditional hard bid, fixed-price contracting project delivery method, the contractor usually bears the financial risk of material price fluctuation. As a result, price volatility not only threatens a contractor's profit margin on a given project, but also, in some cases, the viability of construction firms. Whether it is the owner, contractor, or surety, financial failure of a contractor during the course of a project can have disastrous consequences for all involved, resulting in increased project costs and project delays.

For sureties, material price volatility in times such as this call for heightened awareness of risk avoidance during the underwriting process. Underwriters' traditional focus—the so-called "three Cs" of character, capacity, and capital—may not be enough. Consider adding a fourth "C"—contracts—to the mix and focusing on contract terms that shift and/or share price volatility risk. Underwriters and contractors should discuss ways to address the material price escalation risk before entering into a contract. Below are strategies underwriters can consider to help contractors deal with the economic uncertainty of the current and future markets.

Drafting Contractual Relief for Price Escalation

Fixed-price contracts, including unit prices or even cost-reimbursable contracts with guaranteed maximum prices, remain equally exposed to market volatility. That's because, in the end, contractors bear the risk of only being paid up to the final fixed price. The only sure-fire way to insulate against price escalation is by negotiating a material escalation clause. A typical escalation clause acknowledges that the contract price is based on current pricing for building materials, but that certain materials may be subject to sudden price increases. Escalation clauses allow an equitable adjustment if price increases exceed a certain threshold percentage of the as-bid price. In some instances, material escalation clauses provide for an adjustment due to price increases realized from the day the contract was executed by the parties. These are commonly referred to as "day one escalation" clauses and essentially convert the material procurement into a "cost-plus" scenario.

However, owners desire price certainty; and they typically reject price escalation clauses—particularly “day one” or cost-plus types of clauses. One negotiating strategy to make an escalation clause more palatable is to limit the provision to specific types of materials (that is, copper or engineered lumber products) based on a threshold percentage of increase from the as-bid price. Another strategy is to include a commensurate savings clause that accounts for any decrease in materials pricing to the owner’s benefit. These options, of course, require cost transparency, adding another administrative level to the billing process; but they offer an equitable measure of protection for both sides. While owners may be reluctant to agree to such provisions, avoiding a troubled project (or, worse, a defaulting contractor) because of exorbitant price escalation makes considering these clauses worthwhile.

Another option that might already exist in a typical construction contract is the delay provision, which could provide an equitable adjustment for material cost increases that happen due to project delays beyond the contractor’s control. However, contractors need to be mindful of “no damages for delay” provisions, which can legally undermine a request for equitable adjustment for price increases incurred due to project delay. Many jurisdictions have common law exceptions to “no damage for delay” provisions, but, ideally, contractors should negotiate express exceptions to account for price escalation.

Contracts containing “time is of the essence” provisions are another potential avenue for relief from significant material price increases incurred during delays. Typically, these timing provisions are bilateral: the contractor commits to completing the project on time; and the owner commits to providing complete and accurate design information and access to work per the construction schedule. If a contractor is able to secure pricing with material suppliers for a given period based on the procurement and construction schedule, this could potentially preserve and strengthen a price escalation claim if there is an excusable and/or compensable delay.

Another strategy is to negotiate a financial contingency for material escalation. The contingency can identify specific types of construction material, such as steel, copper, or engineered wood products, which are traditionally unstable, and set a threshold percentage of increase in pricing that affords the contractor the opportunity to tap into this contingency. The contingency is for the benefit of the contractor, but it offers some cost certainty and dispute avoidance for the owner.

Finally, negotiating a provision for procuring and storing materials upfront is another means of protection. This allows the contractor to procure materials at the beginning of the job to ensure the material supplier’s quoted price at the time of bid remains viable. The contractor receives partial payment for stored materials, and the owner is assured that no claim for material escalation will arise later on.

Other Strategies for Dealing with Price Escalation Problems

While the contract strategies discussed above are the ideal ways to deal with price escalation problems, in this competitive market it is difficult for contractors to negotiate such clauses into their contracts. There is often little incentive for the owner to agree to any provisions that result in cost uncertainty. Often, the pressure is on the estimating team to find creative ways to account for material escalation while remaining competitive. That said, there are other strategies for contractors to consider in dealing with a volatile market.

It is critical to include flow-down provisions in subcontracts and purchase orders that bind subcontractors and suppliers to the same contractual terms that bind a contractor to an owner. Contractors should limit any relief subcontractors and suppliers receive for price escalation claims to the same relief that contractors obtain from owners.

In addition, negotiating with material suppliers for extended fixed pricing windows can limit price volatility risks, especially when there is a delay between the bid and the start of construction. This is obviously dependent on the contractor’s relationship and negotiating strength with suppliers. Qualifying bid pricing to the owner based on negotiated windows of held pricing from suppliers may preserve delay-related price increase claims. But that strategy could be fraught with risk, as qualifying the bid could result in rejection for being non-responsive. Ultimately, if a qualified bid is accepted, it is essential to ensure that the proposal is incorporated into the contract.

If all else fails, there is potential recourse under change of law provisions often included in construction contracts. Change of law provisions offer the strongest option for recapturing price increases when the contractor can demonstrate that a change in law, such as tariffs or other regulations affecting the international trade of construction goods, resulted in an unforeseen cost increase.

Arguing cardinal change or *force majeure* may be another avenue for relief. However, price increases alone typically do not support a cardinal change or *force majeure* event absent extenuating, unforeseeable circumstances, such as COVID-19. As a result of the pandemic’s early impacts, *force majeure* clauses were utilized as a legal basis for pushing material cost increases upstream. However, we have been living in the COVID-19 world for more than two years, and the strength of the *force majeure* argument has waned significantly, particularly for projects that bid during the height of COVID-19.

Additionally, contractors may also attempt to excuse performance based on common law doctrines of impossibility, *impracticability,* or frustration of purpose. These doctrines are interrelated and operate to discharge contractual duties to perform when an unexpected event frustrates the underlying purpose of the contract and prevents or substantially impacts a party’s ability to perform. However, these equitable remedies are difficult to prove; and courts are often reluctant to grant such relief for pricing increases alone.

In the end, contractors and owners should use the bid phase to hold an open dialogue about how they’ll address the current economic uncertainty in a fair and equitable manner. By fairly allocating this risk in the beginning and negotiating reasonable contract provisions, the parties can avoid impacts during construction and, ultimately, litigation. Litigation avoidance is a strategy that proves mutually beneficial to owner and contractor alike. Surety professionals need to be a part of this conversation as well. There is simply too much at risk in these turbulent times.

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