UP, UP, AND AWAY

# Cost Escalation Clauses

## mitigate the risk of rising materials prices

*By Luke J. Farley and Dixie T. Wells*

The construction industry has been left scrambling due to materials shortages and volatile pricing brought on by high demand and supply chains strained by the pandemic. Lumber is the most infamous example, up over 300 percent this past spring over its price at the start of the pandemic, but it's not the only commodity whose price rode a rocket to outer space. Steel now costs $1,380 per ton more than it did in September 2019. So, who bears the risk when prices go haywire? The contractor? The owner? It is a high stakes question. The answer can determine whether the contractor makes money or takes a loss on the project.

### THE PROBLEM

Due to the pricing structure of most commercial construction contracts the contractor bears the risk of an unexpected increase in the cost of materials. Most contracts put a cap on what the owner must pay for the work, either through a lump-sum, fixed price, or through a guaranteed maximum price (GMP) where the owner pays for all actual costs up to the GMP. Under both pricing arrangements, the contractor will be held to the price in the contract and ultimately bears the risk when the costs of materials rise, eating into anticipated profits. Contractors shouldn't expect any help from the courts if there is a lawsuit. As one federal court recently put it: "The normal risk of a fixed-price contract is that the market price will change."

### THE SOLUTION

A solution to this problem is to reallocate some or all the risk through a materials cost escalation clause. A cost escalation clause allows the contractor to pass through to the owner the increase in the cost of materials despite agreeing to a lump-sum price or GMP. Think of a cost escalation clause as essentially a differing site conditions clause for materials. Instead of the "known unknown" being a hidden subsurface condition like hard rock or a buried fuel tank, the "known unknown" is the price of steel in 6 months. By including a cost escalation clause in the contract, the contractor can avoid the need to price the "known unknown" risk of price increases into the initial contract price.

### ESCALATION CLAUSES

Cost escalation clauses can take a variety of forms. A good escalation clause will share the risk of cost increases between the owner and the contractor and include the following basic terms:

- a listing of the specific materials subject to cost adjustments
- establishment of baseline prices against which price increases will be measured (like unit prices in the contractor's bid)
- an objective way to measure changes in the price of the listed materials (like a published price index or the actual, documented change between the cost of materials as bid and as purchased)
- a threshold that will trigger the contractor's entitlement to increased compensation (say, a cost increase of 5 percent)
- an explicit agreement that the contractor will be entitled to an adjustment of the contract price when materials costs exceed the threshold

Of the standard industry contract forms (AIA, EJCDC, DBIA, etc.) only ConsensusDocs publishes a price escalation clause, the ConsensusDocs 200.1. The ConsensusDocs 200.1 includes most of the standard terms noted above, but it also has a few key variations like a de-escalation provision, meaning the owner is entitled to a deductive change order if the price of materials happens to decrease.

### TIPS FOR NEGOTIATING

While price escalation clauses are popular with contractors, owners have understandably been less enthused. Owners see these clauses as carte blanche for contractors to take advantage of a difficult situation. Contractors can change that perception by incorporating the following tips and suggestions into their next negotiation:

- Communicate early and often with the owner about the reality of the market conditions for construction materials; explain that contractors have virtually no control over the pricing of either raw or finished materials.

- Consider showing the owner the current pricing the contractor is getting from the contractor's own suppliers.
- Explain why it is in the owner's best interest to allow for an adjustment to the contract price based on market forces. In this environment, without an escalation clause, the contractor will price the risk of cost increases into its initial bid, which could needlessly raise the price for the owner from the get-go. If the owner refuses to allow the contractor to pass through price increases, the contractor might be forced to perform the work at a loss. Forcing a contractor to work at a loss rarely makes for a successful project. If nothing else, it ensures the contractor will never miss an opportunity for a change order.
- Agree that if materials costs decrease, the owner will receive the savings. As mentioned above, the ConsensusDocs 200.1 includes a de-escalation provision which returns savings to the owner.
- Agree that the contractor will not add a markup on top of any increased material costs that are passed through.
- Consider capping the owner's exposure for cost increases at either a percentage (say, no more than 10 percent) or a fixed sum (no more than $100,000).
- Consider allowing the owner to terminate the contract if materials prices increase by a certain amount.

## CLOSING THOUGHT

Volatility in the construction materials market isn't likely to go away any time soon. Contractors need a game plan for addressing substantial changes in the cost of materials so that their jobs stay profitable. The best way to account for that risk is to incorporate a materials price escalation clause into their contracts. While owners initially might resist such a clause, fair and open negotiations can help owners see that reasonable risk allocation is in their best interest too. ■


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