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Using material price escalation clauses to mitigate risk in an uncertain political climate - by Ciotti and Dockery

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Current economic conditions and recent changes to trade policy governing the importation of goods crucial to construction activities—aluminum, steel, fuel, etc.—have had a significant impact on the cost of these and other goods in recent years. As a result, owners and developers must be prepared with strategies to mitigate the risk of material price escalation in order to preserve the feasibility and profitability of their projects. As we will discuss in this article, there are a series of risk-mitigation strategies available at different stages of a project: At the time of bid; during procurement; during contract negotiation; and even after execution of the contract. The most effective risk-mitigation strategy, however, is the inclusion of a thoughtfully drafted material price escalation clause in the

contract itself.

What is material price escalation? Material price escalation—sometimes referred to as volatility or inflation—refers to changes in the cost or price of specific goods or materials in a specified economy over a period of time. While gradual growth in material prices are not uncommon, material price escalation is particularly problematic when material prices unexpectedly explode—such as when new regulations, taxes, or tariffs come into effect—causing the price of materials to increase more than would be otherwise anticipated.

In early March 2018, the Trump Administration announced intended tariffs of 25% on imported steel and 10% on imported aluminum. This had an immediate impact on the price of steel, causing it to rise, even though the tariffs in question had not yet gone into effect. Such an unanticipated and sudden increase in prices could have devastating results for owners and developers who fail to account for cost increases in their contracts.

How can owners and developers mitigate the risk of material price escalation? Owners and developers can employ different strategies to mitigate the risk of increased material prices at different points in the contracting process. First, at the time of bid, the owner/developer should determine whether the bid is tied to a cost index, such as the Building Cost Index (BCI) or Turner Cost Index (TCI), in order to estimate what the likely increase in material costs should be, and determine if the contractor's bid contains a contingency that accounts for potential cost escalation. It may be better for the owner/developer to allow some contingency instead of watching their contractor walk away from the project due to a substantial cost increase of a critical project material. However, the owner/developer will obviously want to be careful of overly generous contingencies. A smart owner/developer will discuss with their contractor at the time of bidding/cost estimating, whether the contractor has locked in material prices with suppliers, effectively shifting the risk of material price changes downstream. The owner/developer should also minimize the risk of material price changes during the procurement process by having the contractor purchase materials with the most volatile prices as early as possible. However, the owner/developer employing this strategy must also consider the impact of any potential design changes and must account for possible increased storage and handling costs. This approach requires a complete or reliable design early in the project and works best when the owner, designer, and specialty contractors are on board and working cooperatively. This is particularly beneficial when using a highly collaborative project delivery method, such as integrated project delivery or a design-assist process. Additionally, contractors can also build in further security through careful negotiation of supplier agreements. By limiting the suppliers' rights for material price increases to only those rights that the contractor has upstream, the risk of material price increases is limited.

Contractors can also employ fixed limits on their suppliers' ability to raise prices, thus capping the risk associated with these materials.

Finally, the best opportunity to negotiate risk sharing or shifting associated with material price escalation is to discuss an escalation clause at the time of contracting. In a typical lump-sum contract, the contractor bears the risk of any financial impact arising from fluctuations in material

prices, potentially putting contingency, overhead, and profit at risk. Although this may sound good to an owner/developer, if the material price increase causes a substantial increase in the project cost, the contractor may find it necessary to walk away from the project, causing the owner/developer project delays, increased project costs due to the delays, replacement contractor costs, additional material price escalations, and severe litigation costs. Thus, just when the owner/developer thought they were safe from any material price increase due to the terms of the lump-sum contract, they may experience greater costs than if they had shared the price increase or even accepted the price increase completely. By negotiating an escalation clause up front, the owner/developer and contractor can come to an agreement on how to fairly share or shift this burden to best handle the unexpected.

There are three types of material escalation clauses most commonly used in general contracts: day-one, threshold, and delay.

1. **Day-One Escalation Clause:** Requires the upstream party to pay for any increases in material costs once the contract is executed. The contract must define exactly what materials are subject to the clause, and must include baseline prices for those materials. For example, a day-one clause might look like the following: The prices of materials contained in this contract are those in effect as of (date); the contractor shall be reimbursed for all increases in the cost of material as of the date of purchase. This type of clause completely shifts the risk of a material price escalation to the owner/developer, which in most cases should not be acceptable to the owner/developer.

2. **Threshold Escalation Clause:** Shares the risk by requiring the upstream party to pay for material price increases above a defined threshold. The contractor is reimbursed only for significant price increases which occur between the bid (or contract date) and the date of installation or purchase of materials. This type of clause shifts the risk of significant price increases to the upstream party, but vests the contractor with the risk of price increases up to the threshold level, effectively capping the contractor's potential exposure. For example: In the event the price of certain materials (e.g. structural steel) increases by more than 10% between the date of this contract and the date of installation (or purchase by the contractor), the contract sum shall be equitably adjusted by the amount which exceeds a 10% price increase over the material's baseline price. The contractor's equitable adjustment shall be made by change order in accordance with the procedures set forth in the contract documents.

3. **Delay Escalation Clause:** Holds a fixed price for a limited period of time, but allows the contractor to receive an equitable adjustment if the project is delayed or, more commonly, if it is not feasible to purchase all materials for the project at the start of construction. For example: This contract contemplates that the contractor will complete its work by (date). In the event the work is not completed by that date, through no fault of the contractor, the contractor shall be reimbursed for all increases in the costs of the following materials: (e.g. steel, asphalt) plus overhead and profit. When utilizing a delay escalation clause, it may be helpful to use specific milestones as deadlines.

Mutual or bilateral escalation clauses can convince reluctant owners

Owners/developers and contractors should also consider including a mutual or bilateral clause where each party stands to accept some of the risk and some of the reward.

These clauses shift the risk of price increases (over a certain percentage or threshold) to the owner, but also provide a corresponding benefit if material prices drop. Such a clause should usually take the form of a threshold escalation clause. For example: In the event the price of certain materials (structural steel) increases by more than 10% between the date of this contract and the date of installation (or purchase by the contractor), the contract sum shall be equitably adjusted by the amount which exceeds a 10% price increase over the material's baseline price. The contractor's equitable adjustment shall be made by change order in accordance with the procedures of the contract documents. In the event the price of certain materials (e.g. structural steel decreases by more than 10% between the date of this contract and the date of purchase by the contractor, the contract sum shall be equitably adjusted by change order in accordance with the procedures of the contract documents to provide a credit to the owner for the decreased price.

What relief is available in existing contracts? Owners and developers should be aware that even when they believe that based on their contract (lump-sum or guaranteed maximum price) protects them from a material price escalation, there are other standard provisions in many forms of construction contracts which the contractor may use to attempt to shift the responsibility to the owner/developer. Owners/developers should carefully examine the change in law provisions and force majeure provisions to see if the imposition of new taxes or tariffs allows the contract price to be adjusted. The contractor may also argue the equitable theories of mutual mistake or commercial impracticability. These arguments, however, are difficult to make and win.

In the end, the best way to mitigate this risk, and ensure the project will continue to proceed through unexpected material price increases, is to proactively communicate and manage the bidding and procurement processes and to ensure incorporation of an appropriate materials escalation clause wherever possible.

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