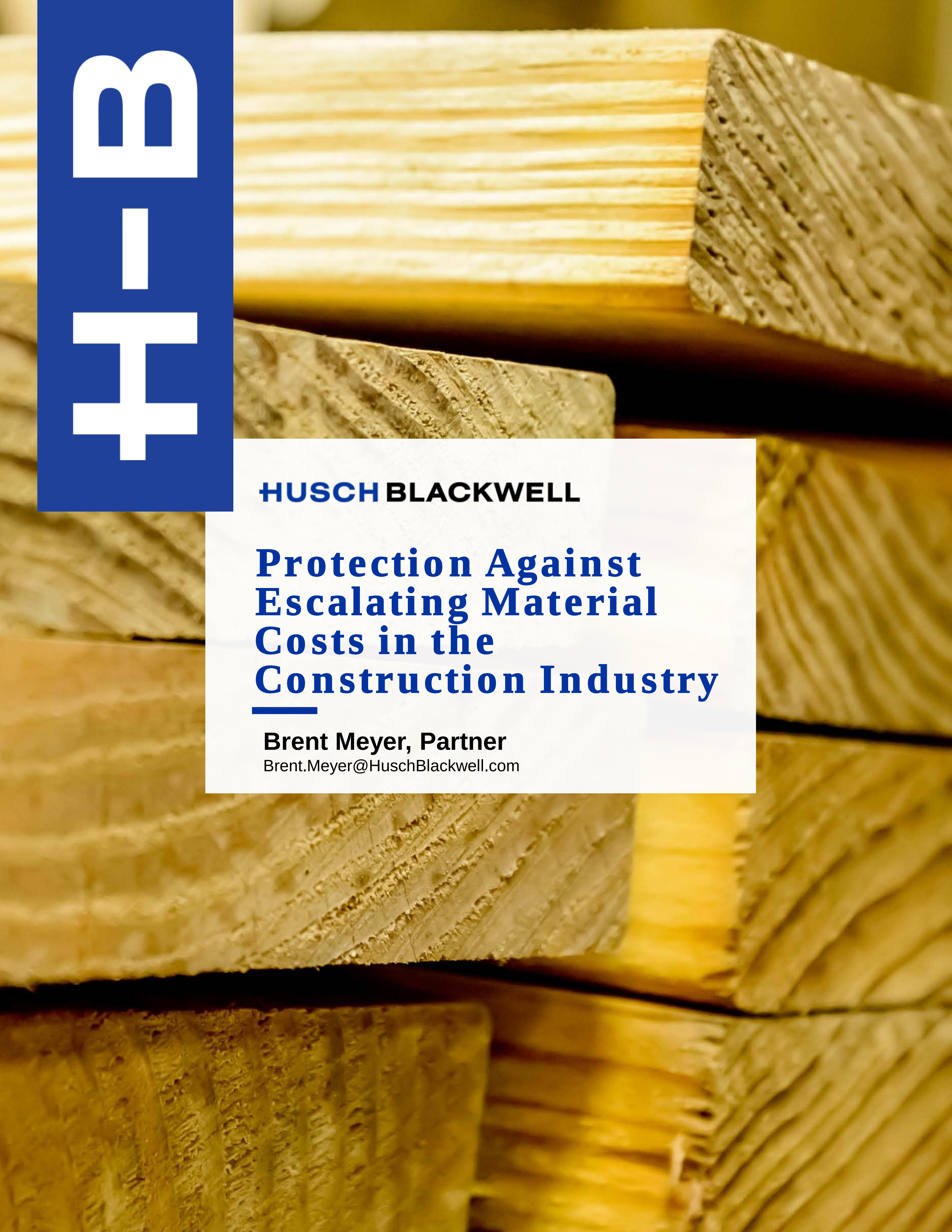

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Protection Against Escalating Material Costs in the Construction Industry

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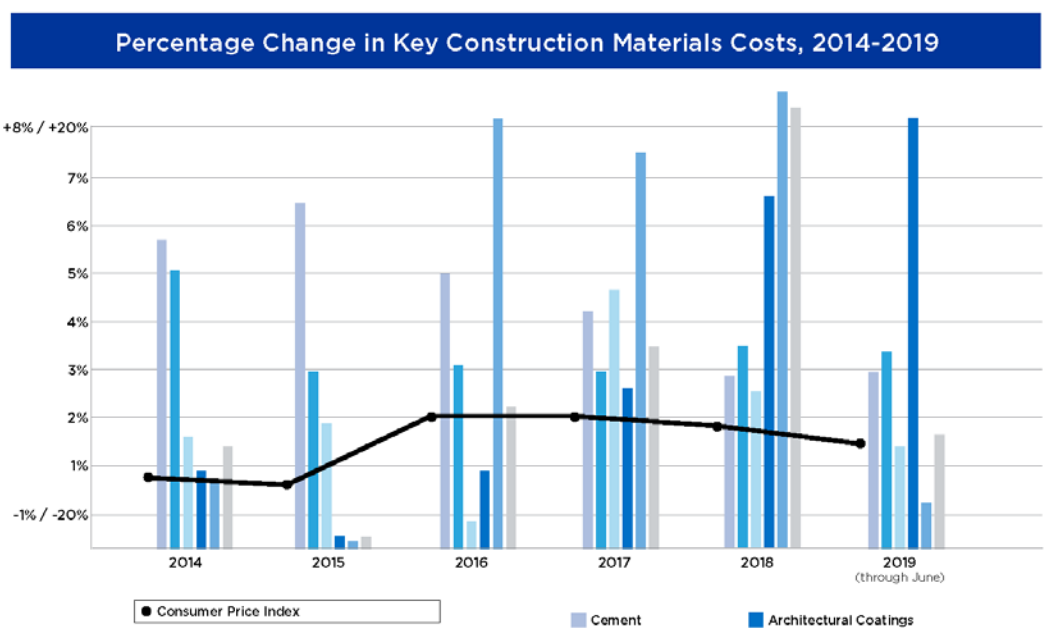
Protection Against Escalating Material Costs in the Construction Industry

As a matter of public policy, fighting inflation has not rated very highly on the list of priorities for some time now. Indeed, recent policy measures have sought to stoke inflation—something unimaginable a generation ago. The Federal Reserve professes to maintain an actual inflation target of 2% and claims that it would not at all be concerned it we overshot that target.

Of course, official inflation measurements leave out of their calculations the price movements of many things. Food and energy, for example, are generally deemed too "volatile" for core inflation metrics. For the man on the street, however, it is precisely these price movements that are most crucial to quantify and that bear most directly on personal and family finances. If you spend any time at all at family kitchen tables around the country, it becomes clear that official inflation statistics correlate poorly with the way many people perceive their economic situations.

Much the same could be said for businesspeople involved in the construction industry. While the official core inflation measurements so frequently publicized have continued to plod along well below their historical levels, the costs of key inputs in the construction industry have soared. The prices for materials, in particular, have experienced increases that far outpace core inflation, and some of those materials' price movements in the last few years have become more volatile.

This rapid escalation in the cost of materials has multiple causes, ranging from traditional supply-and-demand imbalances to natural disasters to extraordinary factors like the current administration's international trade policies. While the causes might be hard to pin down and the fluctuations difficult to predict, the effects are pretty clear. Construction material prices rose



Source: AGC of America. Percentage Change in Producer Price Indexes (PPIs) and Employment Cost Indexes (ECIs) for Construction, 2013-2019, accessed August 30, 2019.

3.3% during 2018, more than twice the rate of core inflation. Indeed, construction industry inputs have outpaced inflation for many years now. Consequently, nearly nine out of ten developers reported that the cost of materials was a “significant problem,” according to the 2019 National Real Estate Investor Survey.

With some materials the case is more extreme. The Producer Price Index measurements for key construction inputs registered double-digit year-over-year increases in several categories, including Iron & Steel (17.6%), Steel Mill Products (19.8%), and Natural Gas (13.9%).

These types of price movements are dangerous for unprotected construction entities who are not attuned to them and can wreck the profitability of key projects. Fortunately, there are some risk allocation mechanisms that these entities can employ, if not to negate completely the ill effects of material cost escalation, then at least to manage increases so that projects can be completed without imperiling the financial health of the entity.

Material Costs Risk Allocation

In a traditional lump-sum price arrangement it may appear that all of the financial project risk rests with the contractor and its subcontractors, and that’s true to a certain extent, but as projects grow in size, cost and complexity, a good portion of that risk ricochets back to the project owners, whether they are aware of it or not. Savvy contractors and subcontractors aware of the risk associated with fluctuating material costs will work in financial protection into their bids and pricing. As such, the project owner may be paying for the risk even if the material prices remain flat, which will only benefit the contractors, subcontractors or suppliers.

While a lump-sum contact provides a degree of certainty as to the total cost of the project, the lump-sum approach as a means of allocating risk is less than ideal. It is a static agreement incapable of dealing with fluid project parameters. Arrangements that set forth a guaranteed maximum price are better, as they provide a little more flexibility. Cost-plus arrangements provide for a kind of flexibility, but not one that most project owners would agree to since they are on the hook for virtually all manner of unforeseen expenses and overruns.

Escalation Clauses

To address the ever-growing risk of material costs fluctuations, contractual provisions which provide some flexibility or risk sharing on material cost increases have become more popular. These provisions have been labeled “escalation clauses” and vary in form. The key components of these clauses are (1) the triggering condition and (2) the scope of materials covered. The triggering condition could be a certain percentage over the per unit price or total material costs set forth in the agreement. These “threshold” escalation clauses tend to be material specific, such as for fuel, steel or a project-unique material. Another triggering condition could be a delay in the project. The idea behind the delay escalation clause is that contractor or its supplier carries the risk for a certain time. After that point of time has elapsed, the owner is obligated to pay the current price of the materials. The delay escalation clauses tend to cover all materials rather than specific materials, but it can also be focused on specific materials. Finally, another common escalation clause is a clause which places the cost escalation risk on the owner for a specific material, regardless of delay or amount of increase.

Integrated Project Delivery

An alternative to the inclusion of escalating clauses into a construction contract is to have the project delivery structured so that all parties reap the benefit of cost savings and share the risk of cost overruns. This is precisely what the Integrated Project Delivery method is meant to achieve. Both the AIA and ConsensusDOCS have published standard form construction contracts for Integrated Project Delivery; the AIA C195 and the ConsensusDOCS 300.

The starting point for the Integrated Project Delivery method is the calculated Target Cost when a project's detailed design is complete. From there, if project costs stay below the Target Cost, then the parties on both sides of the deal share savings as allocated in agreement; however, in the event that costs exceed the Target Cost, either the owner bears the risk for so-called "pure" costs over Target Cost or the excess costs are shared based on percentages set forth at the beginning.

By tailoring the contract so that the project owner and contractor entities share risk and cost savings, and therefore their interests are aligned, there is higher likelihood that the costs will be more effectively managed.

Conclusion

The analysis of material cost escalation risk must start with an understanding of the construction contract price arrangement. Once a project owner or contractor understands their respective risk under the proposed contract, they must ask themselves whether it makes more sense (and is cheaper) to push the risk onto the other party or to share the risk. With the consistent increase in material costs and the recent significant volatility, the utilization of escalation clauses and cost-sharing mechanisms will only increase. It is imperative that construction entities understand what is being proposed and what are the other available options to address the risk of material cost increases.

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Husch Blackwell's Construction Academy works to provide the industry with a solid understanding of the legal fundamentals of today's complicated environment. From project development to completion, in-depth knowledge is needed to break down complexity, allowing businesses to realize value in every aspect of their operations. The Construction Academy was developed with the belief that value is unique to the client, knowledge is created in application, and both need a forum of partners to share what has been learned in order to propel organizations forward in a world of constant change.

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Husch Blackwell leads our clients from where they are to where they want to be. From offices in 18 U.S. cities, we deliver legal insight and business leadership that helps our clients identify smart solutions, advance their goals and move forward.

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