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Leveling the Peaks and Valleys: Best Practices to Proactively Address Price Fluctuations in Construction Materials

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Over the course of the pandemic, contractors and material suppliers have been forced to find creative ways to maintain a competitive business model while accounting for the meteoric rise of building material costs. When upstream parties have predictably sought to cap their costs by enforcing fixed pricing in the current volatile market, contractors and suppliers have attempted to rely on *force majeure* clauses to avoid untenable agreements and have sought to transition to cost-plus pricing and implement price escalation clauses, among other measures. Reliance on these measures has been mostly reactive and is often met with opposition. In this alert, we review best practices in addressing price fluctuations before your project starts.

Reevaluating Guaranteed Pricing

As the economy opens up and material prices begin to find some equilibrium – lumber recently fell nearly 50 percent from May's record high of over $1,700 per thousand board feet – best practices learned during the pandemic should be proactively incorporated into future agreements. Guaranteed pricing six months prior to delivery may not – and perhaps should not – be as widely used as it was in the past; suppliers may not want to offer it and contractors may not want to accept it. Parties will need to reevaluate whether they should accept the risk of mid-term price fluctuations because price corrections do not reliably occur on a predictable basis.

There are a number of practices that parties can use to limit their risk in material supply contracts. Some, like pre-ordering materials and using options and futures to hedge against volatility, are unlikely to gain purchase as long-term solutions because they reduce liquidity and commit otherwise-available resources. The negotiation of other traditional contractual provisions to address unexpected impacts during construction, such as *force majeure* and equitable adjustments/change order clauses, seek to address the parties' right to monetary relief for commodity price fluctuations caused by unexpected delays and events. However, pricing volatility can and should be addressed more directly on the front end of the project if possible. One of the best tools for maintaining this predictability and an appropriate allocation of risks of fluctuating prices is a detailed price escalation clause.

Implementing Price Escalation Clauses

We have learned from the COVID-related instability in commodity prices that a detailed price escalation clause should be an essential contract term. However, while the inclusion of a price escalation clause should be a standard practice, its provisions should be anything but boilerplate. The clause itself should be appropriately detailed and, depending on the project scope, may vary in complexity from a short paragraph to simply set expectations to multi-page addenda that contemplate nearly any event that could arise.

Whether long or short, a properly drafted price escalation clause should contain a few critical terms to ensure clarity and enforceability. The clause should identify the specific construction materials to which pricing adjustments will apply. Any adjustment under the clause should also be tied to an objective, agreed-upon measurement such as catalog prices, actual material costs, material cost indices, or established market prices. To make the clause more palatable, the escalation clause should be mutual. Accordingly, price savings should inure to the benefit of the material purchaser to a similar extent that the seller should be entitled to an equitable adjustment for price increases. A sample price escalation clause is included below for reference:

If, during the course of Contractor's performance on this Project, the price of materials or equipment[1] significantly increases, through no fault of Contractor, the original contract price of the materials or equipment shall be increased by Change Order for the entire increase in the price of such materials or equipment.[2] As used herein, a significant price increase shall mean any increase in price exceeding __ percent, based on actual costs experienced by Contractor from the Effective Date of the Agreement.[3] Such increases in actual costs shall be documented through quotes, invoices, or receipts. Any price increase shall not include additional overhead and profit.

Timing is also key when implementing clauses allowing for pricing adjustments. A subcontractor or supplier should insist on a price escalation clause early during contract negotiations to allow any upstream parties the opportunity to account for these terms in their agreements. If appropriately implemented, this approach places the risk and decision of whether to move forward with the project on the ultimate beneficiary of construction, the owner.

Takeaway

To be clear, price escalation clauses should not be used to protect sloppy bidding or guaranteed pricing well beyond a commercially reasonable timeframe. These clauses should be implemented to ensure that contractors and suppliers can return to the predictability and profitability of the pre-pandemic market.

Baker Donelson's Construction Practice Group has extensive experience counseling, advocating for, and negotiating favorable agreements and outcomes for its clients related to material price increases and volatility during the ever-evolving developments in construction law related to the pandemic. If you have any questions or have a project that may be impacted, contact Luke P. Cantrell or a member of Baker Donelson's Construction Practice Group .

[1] To increase certainty, either specific materials (i.e. lumber, steel) or reference to materials identified on a specific exhibit or material takeoff provided by a supplier can be inserted here.

[2] A provision for cost-sharing of any savings due to price decreases could also be inserted in this sample clause.

[3] As an alternative to defining significant price increase based on actual costs, the clause might tie the definition to an agreed-upon price index, such as the Producer Price Index.