Planning for Cost Uncertainty

Keep your profit when prices soar

By Keith A. Bannon

Owners are typically exposed to cost uncertainties when they enter unit price or cost plus contracts, while it is commonly believed that owners and contractors share this risk by entering a fixed price contract. However, in recent years many contractors were surprised by drastic increases in commodity prices, which significantly increased their costs to the point where the cost of contract performance was greater than the fixed contract price.

The scenario of contractor's performance costs being higher than the contract price may seem extreme, but in a competitive bidding situation, where profit margins are tight, a surge in material costs can easily create this result. This picture seems even less likely when you consider that the contractor clearly accepted these foreseeable risks (i.e. an increase in steel prices) when it negotiated and entered a fixed price contract. But it happens and, as a result of these risks being foreseeable, the courts have been reluctant to shift losses due to commodity price increases to the owner.

Backing Out of the Contract

The two arguments that have been most prominently used by contractors to avoid losses resulting from increasing material costs are frustration and force majeure. However, both arguments have had little success.

For contractors to argue frustration of a contract on the basis of a material cost increase, it is necessary to show that the change was entirely unforeseeable. This is a very difficult argument to make considering that commodity price fluctuations are discussed routinely throughout the industry and now many buyers negotiate price escalation clauses in anticipation of these fluctuations. Moreover, the courts have recognized that the parties were very much aware of the risk of commodity price fluctuations when they entered their contract.

Construction contracts commonly include force majeure clauses. These clauses typically only allow a contractor additional time to perform the contract when faced with work disruptions such as strikes or inclement

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weather. As a result, a force majeure clause may provide a contractor additional time to purchase materials that are in short supply but it is unlikely to allow a contractor to shift the loss from a material cost increase to the owner.

Risk Management

When entering a fixed price contract there are ways contractors can mitigate the risk of increasing material costs, including:

1. Purchasing large quantities of raw materials to preserve current pricing. Unfortunately, this option is typically only available to large companies that have multiple projects ongoing in the same area.

2. Entering agreements with suppliers for price commitments on critical materials, equipment, and supplies, specifically targeting materials that are particularly vulnerable to price escalations.

3. Negotiating a price escalation clause to share the risk of material cost increases with the owner.

Price Escalation Clauses

A well drafted price escalation clause is the best way to fairly reallocate risk. However, owners are reluctant to allow such a clause despite the fact that these clauses should allow more competitive bids, since contractors will not need to increase profit margins to account for possible increases. Contractors are equally reluctant to accept that these clauses may result in a credit to the owner, should there be a decrease in a material cost.

When drafting price escalation clauses, further price certainty should be obtained by identifying specific materials that are vulnerable to cost escalations and setting out the unit prices for such materials in the contract document. Much like drafting a contractual mechanism for identifying an unforeseen condition or a change in the contract work, the contract should set out notice periods for identifying price increases, future indicators of market price increases, and periods during the contract performance when the market increases may result in a contract price increase.

Drafting a well defined price escalation clause is essential. Without clear-cut terms for the factors influencing contract price fluctuations, owners' fears that such a clause will result in unfounded claims for extras will not be subsided and interpreting such a clause is more likely to result in work disruptions and litigation.

Ultimately, by negotiating a sound price escalation clause, market price increases may be accounted for within a fixed price contract in the same manner that the industry has traditionally treated other significant project intangibles, such as weather, strikes, and design changes. However, both owners and contractors must come to see the benefits of further allocating this risk within a fixed price contract for the use of the price escalation clause to gain wider acceptance within the industry.

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