Connecticut Law Tribune

MARCH 7, 2011
VOL. 37, NO. 10 • $10.00

An ALM Publication

CTLAWTRIBUNE.COM

All's Not Well

WITH OIL PRICES RISING, PRICE ESCALATION PROVISIONS MAY BE A SMART MOVE

By JARED COHANE

As we head into the spring building season, there is a great deal of uncertainty facing our construction clients, and it is not just the result of the stagnant market.

Unrest in the Middle East has caused a sharp rise in the price of crude oil; its highest level since 2008. Unrest in Libya alone, which pumps 1.6 million barrels of oil a day, threatens to push oil prices in excess of $100 a barrel.

Fluctuation in oil prices touches all trades, but can have a devastating impact upon site and heavy-highway contractors due to their reliance upon diesel and oil-based materials like bituminous concrete. The construction industry felt similar price uncertainty during the past decade, when a construction boom in the Middle East and China heightened the demand for steel, causing steel prices to skyrocket. A number of specialty steel contractors saddled with lump sum, fixed-price contracts suffered significant losses – except those contractors who had the foresight to negotiate a material escalation clause into their contracts.

Having such a provision can provide both contractors and owners a level of assurance that dramatic material price increases will not affect performance.

Price escalation clauses are nothing new in construction contracting. They are typically found in larger commercial projects with a duration expected to exceed a year, where the project itself calls for building materials that have pricing volatility. These provisions are commonly found in federal and state heavy highway contracts, where hot-mix asphalt, cement and steel are the most frequently utilized materials.


Jared Cohane

Over the past decade, the Connecticut Department of Transportation (ConnDOT) has developed special provisions that address market fluctuations for hot-mix asphalt, cement, reinforcing steel and fuel – commodities that historically shift unexpectedly.

By way of example, special ConnDOT adjustment provisions for reinforcing steel, cement and fuel come into play where the fluctuation for the commodity is greater than 5 percent based upon the bid price versus pricing over the performance period.

For asphalt, ConnDot utilizes an Asphalt Adjustment Cost formula, with payment being made for an increase in costs and a deduction in favor of the Department for decreases. ConnDot's material escalation adjustment scheme provides a good model to consider when negotiating these provisions into other construction contracts to avoid potential disputes during construction should a major price shift in materials occur – identifying the specific commodities subject to price fluctuation and defining a precise formula quantifying the adjustment.

First, when negotiating an escalation clause, consideration should be given to the type of construction the contractor is performing to identify the materials most frequently used and, more significantly, those materials that are most subject to a rapid shift in pricing.

Since the purpose of this clause, from the contractor's perspective, is to shift the risk of cost increase from the contractor to the owner, one might expect the negotiation to become particularly contentious. With the state of the economy creating an environment where bidding a project at cost versus bidding a razor-thin profit margin could mean the difference between landing a project and the wasted investment of being a disappointed bidder, a narrowly-tailored clause that specifically identifies the materials that will be subject to price adjustment will certainly be more palatable for an owner than a broad clause attempting to cover price fluctuation for all building materials incorporated into a project. It can, conceivably, be the difference between profit and a loss on a project for the contractor.

Thus, for a home improvement contractor who frequently builds residential additions, the negotiation might include escalation clause for oriented strand board, plywood, drywall or copper piping. On the other hand, a civil contractor would naturally seek protection from pricing fluctuation for concrete products, cement and fuel

Jared Cohane is a partner in the Hartford office of Hinckley, Allen & Snyder LLP. Mr. Cohane is a member of the firm's Construction and Public Contracts Practice Group.

CONSTRUCTION LAW

costs. Careful planning and clarity in the negotiation process is the order of the day.

Owner Upside

But why would an owner agree to the risk shifting if there is no potential upside? Counseling owners to avoid bearing too much of the risk, while keeping a contractor from submitting an unbalanced price that hedges the risk of more mercurial materials by building up the contingency in less-volatile contract items.

A sure way to make the material escalation provision more palatable for the owner is to effectively make the provision not just an escalation provision, but a shared-savings provision as well – essentially transforming the pricing for certain materials to actual cost, with savings inuring to the owner's benefit entirely with small markup, or to a split savings percentage between owner and contractor.

The owner will want to ensure the clause clearly delineates that the savings does not create a contingency for the contractor's benefit should there be other busts in the contractor's pricing, but is a realized savings for the owner.

ConnDot's threshold of 5 percent price shift for rebar, cement and fuel pricing, again, is a starting point for consideration. Not every entity has the negotiating power of the State of Connecticut. Consider offering a range of pricing shift (perhaps 2.5 percent to 3.5 percent shift from the as-bid price) on the most erratic commodities utilized in a given project. Under this proposal scheme, the original bid price will endure, unless the buyout for these items result in a cost increase or decease of 2.5 percent to 3.5 percent from the initial quote or estimate.

For the contractor, gaining the extra profit or extra protection will fall to the skill and prowess of its estimating department and the buyout team. For the owner, it is the potential for added construction cost savings and avoidance of a dispute during the course of a project resulting from a market price fluctuation for a key commodity.

The parties should also agree upon a defined pricing index for the material in question so there is a clear line of demarcation for adjusting the price. The owner should insist that the contractor provide evidence backing up the basis for the quoted price for the material in question, and insist on transparency through the process should the parties have to adjust price during performance.

Finally, it is also advisable for general contractors on multi-trade projects to secure price adjustment clauses down the contractual chain to their trade subcontractors. Significant price fluctuation can incapacitate a specialty subcontractor, implicating its ability to perform, and perhaps throwing the entire project into disarray.

Termination of a non-performing subcontractor makes litigation a virtual certainty and, in the end, a replacement contractor will undoubtedly pass through the very price increases that caused the initial subcontractor to fail in the first place. A cooperative approach from owner to contractor to subcontractor can give all parties involved a little peace of mind in uncertain times. ■