

Price Escalation

Guidance and Recommendations for the Construction Industry

By Neal I. Sklar, Esq. and
Warren E. Friedman



Price escalation and volatility in construction material pricing has plagued the construction industry for at least the last 18 months as one of the fallout results of the COVID-19 pandemic. While price escalation is cyclical in the construction industry, the soaring prices for certain building materials has been unprecedented and, in some respects, determines the profitability or even viability of projects. To follow, is guidance and recommendations to navigate and deal with the economic uncertainties that stem from material price escalation.

PRICE ESCALATION PROVISION

In a perfect situation, you're protected from significant price fluctuations by a price escalation provision that affords an ability to seek relief in the event of pricing changes. While price escalation provisions were hardly considered in negotiations of the past, these provisions have become front and center today because of the current market conditions. Generally, these provisions provide for an adjustment in the event pricing increases, sometimes based on general increases and other times based on specific criteria like specified materials or a threshold percentage.

EARLY PROCUREMENT

In the absence of a provision affording an adjustment in the event of escalation, one strategy is the early and advanced procurement of material that may be subject to price escalation. Advanced procurement of materials is a strategy that works for certain supplies and materials but not for others. Some building materials have a shelf life or may be damaged in the ordinary course if not promptly incorporated into the construction project. Whenever early procurement is being contemplated, other considerations that matter include location of the materials, storage and moving of the materials,

and insurance protections, and these considerations come with a cost and need to be thought through.

OWNER DIRECT PURCHASES

While early and advanced procurement is a means to avoid increasing prices, owner direct purchases of materials is a means of shifting the risk of material price escalation to the owner. Certain institutional owners already directly purchase materials from suppliers in order capture the benefit of potential tax savings, but project participants can utilize the concept to avoid or mitigate the issue of material price escalation. However, with this comes other concerns—who is going to handle storage? Who will pay for storage? Where will the materials be kept? Who insures the materials? Who is responsible in the event of a loss? These are some of the inquires that require discussion and negotiation between the parties.

ESCALATION CONTINGENCY/ALLOWANCE

Another potential strategy is to include an escalation contingency or allowance. Such a contingency or allowance can provide limitations as to types of products or supplies. Although many project owners would prefer not to set aside any additional funds and would prefer to avoid exposure to the contingency amount for what is typically a contractor risk in a fixed price or GMP price setting, some owners will recognize that, by setting aside such a contingency, it is limiting its risk by setting up a maximum exposure. Additionally, the escalation contingency or allowance can be set up so that if escalation does not occur, the remaining funds would inure to the benefit of the owner.

PHASING THE WORK

Some projects just need to get started whether it is for financing or to meet a

promised commitment to an end user, and sometimes phasing of the work can be a vehicle to protect a contractor or the owner from material price escalation. Where the work is phased and the project participants have some level of flexibility, it gives the parties an opportunity to monitor pricing and lock in that pricing when pricing is more economically favorable. As an example, in the first and second quarters of 2021, lumber pricing skyrocketed but by the third quarter of the same year, it had dropped significantly. A project with a phased plan could benefit from watching the market and possibly avoid or mitigate material price escalation. Phasing also creates a risk-balanced approach. For instance, project participants could agree to a first phase that is lump sum with no escalation entitlement and then separately agree to a second phase that is subject to a re-pricing within a set time from the anticipated commencement. If the re-pricing is within a defined percentage of the original price for the second phase, then the parties would be bound to proceed, but if the re-priced number is greater than the defined percentage, then the parties (and typically the owner) would have the option to terminate.

There are other provisions in construction contracts and other concepts in the law that may apply when disputes arise concerning material price escalation, but with advanced planning and fairly allocating risks upfront, project participants will hopefully avoid having to argue those other concepts in a dispute resolution setting.



Neal I. Sklar is a Partner with Friedman Sklar PLLC in Miami, Florida and is Board Certified in Construction Law. A substantial portion of Mr. Sklar's practice involves providing on-site counsel and day-to-day

guidance to clients on small, midsize and some of the nation's largest construction projects.

(305) 332-5767 Mobile