Considerations For Addressing Price Escalation And Supply Chain Concerns For Construction Projects In A Post-Covid World

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Over the past several years, supply chain challenges and material price volatility have plagued construction projects, strained the relationships among the project participants, and impacted bottom lines. In 2023, these challenges and volatility remain substantial risk considerations for parties negotiating construction contracts, even if not as widespread or drastic as seen the last few years. In light of this reality, parties contracting for construction projects need to continue to control these risks by closely evaluating pricing provisions and contract risk-shifting provisions based on the specific risks these issues pose for each project. Parties must also ensure contract documents accurately reflect the agreed risk allocation by paying close attention to clauses or exhibits that may shift some or all of those risks in unintended ways. Likewise, parties need to consider the impact of risk shifting provisions on pricing and evaluate options for sharing or mitigating risks that could lead to better costs outcomes. The contract provisions will then need to be carefully aligned . Careful consideration and open communication about these issues at the contracting stage can help prevent unwanted surprises and allow parties to plan for the risks they have assumed.

Under cost plus contracts, owners typically assume the risk of price escalation. On the other hand, under lump sum or fixed price contracts, contractors often bear the risk of price escalation and supply chain challenges that increase costs. Under both price structures, however, contract provisions can shift those risks both intentionally and inadvertently. As a result, parties should closely review proposed changes to contracts and inclusion of exhibits as contract documents to ensure the documents clearly reflect their understanding of who has assumed what risk.

For example, inclusion of a guaranteed maximum price (“GMP”) in a cost plus contract shifts the risk of price escalation to the contractor once the GMP is reached. However, price escalation provisions or addenda may shift that risk back to the Owner by increasing the GMP in the event of price escalation in excess of certain amounts or percentages. Similarly, price escalation provisions included in a lump sum or fixed price contract undermine the price certainty by allowing contractors to recover certain unpredictable cost increases. These provisions can lead to distrust and disputes about whether the contractor could have anticipated or controlled the costs with proper diligence. By discussing expectations, parties may find ways to share the risk in ways that allow encourage expected mitigation efforts by all participants, including splitting or capping recoverable unexpected costs. Linking recovery for price escalation to indexes or percent increases may result in quicker resolution. If the parties elect to address the risk through contingency (or a lender so requires), expectations regarding approval and appropriate use of contingency should be discussed and addressed in the contract.

Owners focused solely on the pricing language in the contract may overlook certain force majeure provisions that offer contractors relief from some or all price increases over which the contractor had no control. Contractor proposals, clarifications, and assumptions regarding scope and pricing may significantly change risk allocation if incorporated as contract documents. Contractors may try to address escalation concerns through the "excluded scope" clarification. Close review of all incorporated documents will ensure the signed documents do not include changes not intended by one party. Attention to language establishing the order of precedence of documents is also critical

Inflexibility regarding contract provisions during negotiations may limit opportunities for cost savings. For example, Owners seeking fixed price or lump sum contracts that strictly preclude any opportunity to contractors to recover for unforeseeable and uncontrollable price increases should anticipate that pricing proposed by contractors will include sufficient contingency for escalation risks. Those risks may never materialize, resulting in owners paying more than they needed had they improved procurement practices or considered other options for addressing price escalation risk. Provisions or contingency buckets that allow contractors to recover for unforeseeable price escalation over which they have no control may reduce an owner's project costs, particularly when paired with contract language detailing the contractor's obligation to undertake mitigation strategies and to demonstrate the basis of the price escalation claim.

Alternatively, provisions that share the impact of price escalation among the owner and contractor create incentive for the parties to collaborate on risk mitigation options, including early procurement/fabrication, owner direct procurement of certain materials, and flexibility regarding alternatives or substitutions. Standard contract provisions must be reviewed closely for alignment with mitigation strategies and consideration of risks created by those strategies. The contract may need to provide greater flexibility for early procurement and storage of materials offsite, including payment to contractor for offsite materials. Those changes, however, will also require more robust provisions regarding insurance of the materials, security of material, transfer of ownership to the owner, right of access to the storage location for inventory purposes, and right of owner to assume lease of storage location in the event of a contractor termination.

To avoid unnecessary over-pricing of risk by contractors, owners may also want to improve procurement processes to ensure they are attracting contractors who are willing and able to mitigate the price and supply chain risks and consequently offer lower prices. Contractors who improve predictions of price/supply risk should have a competitive advantage over contractors that include contingencies for the substantial escalation rates experienced in prior years rather than rates more aligned with expected market conditions. Likewise, contractors who invest in mitigation strategies such as locking in pricing with suppliers or subcontractors and pre-purchasing and storing materials, may be positioned to offer lower pricing than competitors who have made no attempt to control risks.

Questionnaires or interviews with potential contractors should delve into the contractor's evaluation of the specific and general price escalation risks, opportunities for mitigation, and relationships with suppliers and subcontractors. David Hurst, an experienced owner's representative, strongly advises that parties openly discuss material procurement practices during the interview and negotiation process. As he explains, "transparency is the key to accountability and equity in a complicated process." Thoughtful reconsideration of "form" contract provisions encourages transparency in negotiations to acknowledge and plan for risks in today's environment.