Managing the Impacts of Material Price Fluctuations on Construction Projects

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This article discusses how to manage material price fluctuations that affect construction projects.

Recent fluctuations in the prices of construction materials have threatened to wreak havoc on otherwise well-planned and well-managed construction projects. Economists and industry professionals have identified numerous factors causing or contributing to these fluctuations, including COVID-19-related shutdowns and restrictions, lingering tariffs and quotas, increased construction activity among single-family homeowners, and even instances of hoarding and profiteering. Whatever the underlying cause, material price fluctuations represent a profound and lasting risk to construction projects by causing unanticipated spikes in construction costs and threatening to delay project completion dates due to material rationing or unavailability. This article explores how to manage the impacts of material price fluctuations by (1) allocating the risk and responsibility through contractual provisions, and (2) taking proactive measures to avoid or mitigate impacts on the project.

Contractual Provisions

While extreme fluctuations in construction material prices is a relatively new phenomenon, managing fluctuations in a contract is not a novel concept. For decades, parties conducting business across borders have included provisions

in their contracts addressing exchange-rate fluctuations. These provisions—which are vast, varied, and supported by a well-developed body of law—serve as excellent examples of how contracting parties can allocate risk for fluctuations in construction material prices. Drawing on these examples, below is a list of approaches that parties to a construction contract can take to allocate risk for material cost fluctuations. This allocation can be applied either to material costs in general, or to specific types of materials that are particularly high risk (e.g., steel, lumber, or copper).

- **Contractor-at-risk.** No changes will be made to the contract for any increases in material costs and/or any delays caused by material unavailability.
- **Owner-at-risk.** The contractor is entitled to a change order to account for any increases in material costs and/or any delays caused by material unavailability.
- **Risk splitting.** The parties mutually agree to split the cost of any increases in material costs based on a predetermined allocation (e.g., 50:50).
- **Threshold.** The owner or contractor agrees to bear the risk for increases in material costs up to a predetermined threshold (e.g., 5% of the assumed cost), beyond which the risk shifts to the other party.
- **Trigger (allowance).** The contractor carries the material costs at an assumed value in the contract. If the actual costs are higher than the assumed value, the contractor is entitled to increase the contract sum to reflect these costs. If the actual costs are lower than the assumed value, the savings accrue 100% to the owner. This is similar to an allowance in the construction industry.
- **Indexation.** The parties mutually agree to link the cost of a particular material to an index, such as the NYSE American Steel Index, rather than to the cost being charged by an individual supplier.
- **Freezing.** The parties mutually agree to a predetermined cost for the material or materials in question. The price is not subject to change regardless of price fluctuations in the market.
- **Guardrail.** The parties mutually agree to a predetermined cost for the materials in question and a maximum and minimum amount that the materials cost may fluctuate. The contractor bears the risk for increases beyond the maximum amount, while the owner bears the risk for decreases below the minimum amount.
- **Combination.** The parties can mix and match different elements from the above-listed provisions to fit their particular circumstances. For example, the parties could agree to a 5% threshold, beyond which they share the risk on a 50:50 basis.

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Beyond risk allocation, contracting parties should also consider material price fluctuations in the context of the suspension and termination provisions of the contract. For example, owners are well-advised to include such fluctuations as an express basis for suspending the commencement or progress of construction. This option may prove useful if the unavailability of materials will impact the planned sequence of construction, thereby causing a prolonged delay and extended general conditions costs. In extreme circumstances, the severity of the impact may warrant terminating the contract altogether. In that instance, the owner would likely need to rely on a termination-for-convenience provision, unless a reasonable argument can be made that the contractor is in material breach due to the material cost overruns or delays caused thereby.

Unfortunately, many owners and construction professionals entered into contracts before the extent of recent material price fluctuations was widely known. As a result, many parties to existing contracts did not include provisions addressing how to deal with such fluctuations. Making matters worse, many contractors guaranteed their pricing—either through lump sum or GMP/GMAX contracts—without anticipating the oncoming spike in prices. In those instances, contractors are well-advised to review their contracts for either force majeure or hardship clauses. Even without such clauses in the contract, contractors may still be able to assert common law defenses, such as frustration of purpose or the doctrine of impossibility, particularly if the unavailability of materials makes it impossible or impracticable for the contractor to perform.

Proactive Measures

Whether the contract addresses material price fluctuations or not, both project owners and construction professionals should consider proactive measures they can take to reduce the impact of such fluctuations on their projects. The starting point for reducing these impacts is communication. It is critical that material suppliers promptly communicate

price impacts and product unavailability to the general contractor, and equally critical that general contractors promptly communicate this information to the owner. If this information is not timely communicated, it will greatly narrow or eliminate the options available to address the problem.

Once the problem has been identified, the project participants should consider all available options, including unusual or creative ones. Just as important, the project participants should be flexible—and not overly rigid—when it comes to implementing these solutions. For example, as-planned sequences may need to change, contingencies may need to be tapped, design features may need to be changed, and additional funds may need to be contributed, each as needed to promote the success of the project. Specific solutions the parties may consider include

- offering "sweeteners" to the supplier to ensure performance (e.g., paying a substantial down payment, agreeing to cancellation fees, and/or promising additional work on other jobs);
- identifying alternative or supplemental suppliers, including those located in neighboring cities or states;
- direct purchasing between the owner and the supplier to reduce markup;
- buying out all of the needed materials early in the construction project;
- securing space in warehouses or lay-down yards for storage of excess materials until they are scheduled for installation; and
- proposing substitutions or alternates to the materials specified in the design.

Due to the uncertainty surrounding commodity price fluctuations in the construction industry, some developers may decide to suspend or postpone planned construction projects. Those who do move forward with projects in the current economic environment are assuming the risk that further fluctuations will lead to increases in construction costs, delays in the construction schedule, and/or disputes with contractors and material suppliers. However, these risks can be reduced or avoided by including provisions in the contract that fairly allocate responsibility in a manner that is mutually agreeable to the parties. Lastly, for those projects that are already underway, it is essential that the parties open a dialogue to explore ways to proactively mitigate the impact of commodity price fluctuations or material unavailability on the project.

Conclusion

Material price fluctuations present risks for construction projects. While price fluctuations are largely uncontrollable, clients can follow the practices outlined above to manage potential risks by allocating responsibilities through contractual provisions and taking proactive measures to avoid or mitigate project impacts. CL


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