Supply chain cost increases lead to proliferation of cost escalation on construction projects

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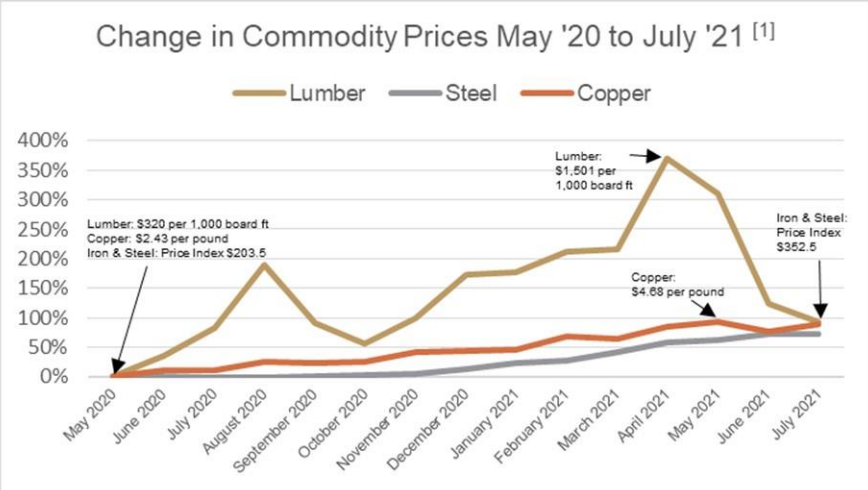
1. Introduction

Multiple current events including the closing of the Suez Canal, COVID-19, a depleted work force, multiple stimulus bills, and rising inflation have led to increases in the costs of construction materials and equipment worldwide. Steel, lumber, copper and PVC piping, glass and other materials have seen notable spikes in cost in recent months, and costs are expected to continue to increase as construction maintains a strong pace throughout 2021 and into 2022.[1]



With increased frequency, contractors are trying to recoup these increased costs through requests tied to cost escalation. The practice, whether warranted and appropriate or not, can result in disputes and claims.

This article examines cost escalation and its place in construction projects. The article also discusses common contractual clauses that address cost escalation, and leading practices for evaluating and managing escalated costs. In addition, the article overviews recent case law involving cost escalation claims and highlights what both owners and Contractors should expect in the coming months as COVID-19 (hopefully) wanes and the industry ramps up construction activity.

2. Cost Escalation - An Overview

Cost escalation is not a new concept. Accordingly, when sought and agreed to, construction contracts for decades have afforded Contractors certain protections against future increases in material and equipment costs. These clauses vary, mostly through defining what qualifies as a compensable escalation, and the extent of the recovery for escalation that the contractor may be entitled to. By including cost escalation clauses in contracts, Contractors can exercise some self-protection, tender project bids that more realistically reflect present-day construction costs and simultaneously leave room for reasonable increases that mirror market changes.

In times of stagnant or minimal rise in pricing, as had been experienced over the previous decade, cost escalation clauses and their potential implication to overall project costs may have been either ignored or given little focus. However, in the past 16 months, rising prices have become extreme, and the clauses governing cost escalation have garnered increasing attention and use, as the industry grapples with an unprecedented coalescence of challenges. The global pandemic, extreme weather events, rising inflation, interrupted production and pervasive labor shortages have strained supply chains throughout the world. Even more contentious may be circumstances where the contracts do not contain cost escalation considerations; and throughout all circumstances, generally speaking, projects are still expected to meet budgets. As the construction industry continues to ramp up to meet demand, these challenges are expected to continue well into 2022.

3. Recent Events Impact

3.1 Materials Shortages

The emergence of COVID-19 in early 2020 led to worldwide shutdowns, and many manufacturers did not immediately reopen when restrictions began to ease. As manufacturers began reopening, they faced unprecedented labor and raw materials shortages, which created production delays and further drove costs up. When construction was deemed essential in the US and abroad, and projects worldwide were re-started and often fast-tracked, those shortages and delays became even more apparent, as suppliers struggled to keep up with rising demand.

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The initial spike in prices on some building materials such as wood, steel and copper, occurred in July of 2020, and continued their surge through May of 2021. However, demand continues to remain largely unaffected, which solidifies the need for contractors and owners to take into account the impacts from these shortages, *e.g.* on budget and scheduling, plan carefully in advance for capital projects from the initial bid, drafting of contract language, and through project execution. The party procuring the materials (*i.e.* a general contractor, subcontractor, or supplier) usually bears the risks of material price escalations, at least in fixed-price contracts and guaranteed-maximum-price ("GMP") contracts, unless a price escalation is caused by a condition that is otherwise addressed in the contract.

Public and international construction contracts may contain a material escalation provision. For example, some New York public contracts include a clause that provides for a price adjustment when the increased cost of materials exceeds 15 percent of the contract price. However, price escalation or price revision clauses are not always common practice in construction contracts in the United States. When there is no such provision, generally, the party procuring materials that are a component of its fixed price bears the risk of a price escalation on those same materials.

3.2 Labor Shortages

In recent years, shortages in skilled labor have been a nagging concern in the construction industry and COVID-19 has exacerbated these shortages. Shutdowns, illness and concerns over health and safety kept many skilled workers at home, and those that continued working were forced to institute time-consuming safety protocols that slowed their productivity. Now, as projects and related manufacturing and other supply-chain operations previously stalled during COVID-19 are jump-started, labor shortages continue to deepen.

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Wage escalation may be recoverable, if the Contractor is required to pay its laborers at a rate higher than anticipated due to delays, changes, or other acts of the owner that push performance of the contract into a higher wage period. However, contractors typically bear the risk of escalated wages during the original period of contract performance.

3.3 Changing Safety Requirements

In addition to direct Material and Labor shortages, COVID-19 safety requirements have an impact on the cost of materials and labor. For instance, hand washing stations, employee temperature checks, loss of productivity for changes to manufacturing layout, and increased absences due to illness all drive increased costs.

3.4 Inflation

The effect of inflation is particularly acute in the construction industry, where the cost of labor and materials escalate rapidly, and is particularly pronounced when the material is based on a petroleum product. The Personal Consumption Expenditures Price Index ("PCE") released each month reports the changes in prices of goods and services purchased by consumers in the US and reflects the change in inflation. From January 2020 through April 2020, the monthly change in PCE varied from a high of 0.2 percent to a low of 0.5 percent, representing low or no inflation. Then, from May 2020 to May 2021 the average cost of goods and services in the US, tracked as the PCE, increased 3.9 percent.[2]

4. Why Do You Care?

In today's environment, the types of cost escalations discussed above should be expected on any construction project of significant duration. Cost escalation claims, asserted to recoup unforeseen or unpredictable costs increases, may be appropriate or not, depending on the contract terms and relevant facts. The burden is on the contractor making the escalation claim to prove the cost escalation is recoverable. The following sections outline allowable and appropriate instances of cost escalation claims and highlight certain instances where such claims may be denied.

4.1 Allowable and Appropriate Uses

The three most common types of cost escalation clauses are (1) any-increase escalation, (2) threshold escalation, and (3) delay escalation. An any-increase escalation claim entitles a contractor or supplier to reimbursement for price increases that occur after the execution of the contract. Typically, an any-increase escalation is attached to specific types of materials like wood, steel, or copper, and will have a benchmark and allowance associated with the specific material. A threshold escalation clause typically allows for an increase in material costs up to a certain amount or threshold, a standard is 10 to 15 percent. For government projects a threshold escalation clause may be standard, set by the federal, state, or local government. A delay escalation clause entitles the contractor or supplier to claim for increased material costs due to the delay in the project's progress beyond a pre-determined date or days.

4.2 Risks and Unallowable Uses

Without an express price escalation clause in the operative contract or a right of recoupment grounded in a statute or government regulation, the contractor or supplier harmed by pricing increases will face a steep, uphill battle in contending a right to recoup increased costs on a fixed-price contract. The default position in such circumstances is that the contractor or supplier bears the risk of such escalations. And, no matter what escalation clauses are included in a contract, they almost never allow a contractor to recoup costs resulting from underbidding a job when the contractor chooses to not rely on information relevant to the bid preparation. For instance, the price of wood increased dramatically from March 2020 through May 2021 before beginning to ease in June and July of 2021. A contractor who relies on March 2020 pricing to bid a job in March 2021, ignoring the change in price, will have a hard time proving and recovering a cost escalation.

5. Best Practices for Employing and Evaluating Cost Escalation

5.1 Ensuring Cost Escalation Clauses, If Included, are Properly Applied

Cost escalation claims along with delay claims are on the rise as the post-pandemic recovery continues. It is important for contractors to understand their contractual rights to ensure claims are allowable under the terms of the agreement. Successfully putting forth and collecting on a cost escalation claim requires more than just a story. A sound cost escalation claim is reasonably detailed with sufficient relevant evidence. The escalation clause and the contract's notice and claim provisions are primarily important to review and understand, so that compliance with notice, claim and proof of escalation requirements may be achieved.

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5.2 The Importance of Transparency

As discussed previously, a contractor seeking reimbursement from an owner for a material price escalation should be prepared to prove that the initial pricing used to bid the job was based on sound estimates and then-current data. Typically, a contractor seeking cost escalation relief would provide a bid sheet which estimates the price of the job down to the labor hour and material required. The bid sheet would be supplemented with the actual material invoices or quotes received for materials listed on the bid sheet or identified through change orders. It is good practice for a Contractor to receive multiple quotations when procuring materials, if possible. Finally, the contractor should provide a proof of payment that the material was actually purchased and paid for at the prices invoiced or quoted. It is important for a Contractor to be transparent in their escalation claim to avoid dispute while exercising their contractual rights.

When a contractor seeks reimbursement for a cost escalation claim, an owner may invoke contractual audit rights to evaluate the contractor's claim.   Depending on the contract terms, an owner may utilize their own in-house internal audit function to evaluate the escalation claim or may directly engage a separate construction claim consulting firm to perform the audit. The more transparent a contractor is in providing documents, the less room for reductions in the claim exist.

6. Case Study

HKA team members have been involved with numerous price escalation matters representing both owners and contractors. In one instance a contractor brought forth a price escalation claim, allowable through a clause under a GMP contract with escalation provisions, for high end finishes related to a newly constructed boutique hotel. The contractor exercised its contractual rights for price escalation primarily related to chandeliers for the lobby, ballrooms, and high-end luxury suites. The individual costs of the chandeliers varied between $5,000 and $100,000, and in every instance the price escalation claim was for 10 percent above the as-bid amount (the contractual limits within the price escalation clause).

The finishes were among the final items to be completed for the project and the owner was under pressure to open the property in order to meet certain financing milestones. The owner retained HKA team members to quickly evaluate the contractor's price escalation claim. The process began by reviewing and understanding the contractor's bid and analyzing it against other contemporaneous records related to the finishing materials at issue. The review revealed that the contractor received quotations to supply the chandeliers approximately 8 to 15 percent higher than included in the bid documents, which were compiled approximately 1.5 years prior to the end of construction and the claim. It was determined that the contractor's bid, which was used to award the project, was lower than it should have been. Other contemporaneous records including email replies from the contractor and supplier to the original quotations indicated that the contractor reasonably knew they would be unable to procure the finishes at the as-bid price. Taking this information into account, the owner and contractor amicably resolved the contractor's escalation claim for an amount consistent with the contractor's obligations in bidding the work.

7. Implications for the Future

As Isaac Newtown once observed: What goes up must come down. Material costs have risen, so shall they eventually fall. While some materials like copper continue to increase in price, we have already seen other construction materials like lumber begin to decline, as the lumber supply chain recovers. Not all price fluctuations are pandemic related - unforeseen events can occur at any time and have drastic implications as supply chains are affected, like the Suez Canal which serviced roughly 10 percent of the world's supply trade. Similarly, as governments negotiate capital spending projects, like those envisioned by the Biden administration's Bipartisan Infrastructure Framework, long term construction projects may impact pricing of materials which were unaffected by COVID-19. Changing consumer demands coupled with policy changes such as with wind and solar programs may also affect pricing of finished goods. In these volatile markets, with multiple unprecedented events, both contractors and owners must stay vigilant in determining cost drivers when bidding contracts, negotiating terms and dealing with cost overruns during performance.

8. Considerations to Avoid or Reconcile a Dispute

Contractors should be transparent in the cost escalation claims process to avoid formal dispute with owners. The best way a contractor can avoid a formal claim dispute is to bring forward claims supported in reasonable detail with sufficient and relevant evidence, all in compliance with the contract's terms, including but not necessarily limited to the price escalation clause and the notice and claims provisions. Owners should also stand vigilant in drafting and understanding their contractual rights to evaluate a contractor's claim for cost escalation. And, legal and consulting professionals with the relevant skills, knowledge and experience can assist contractors and owners in evaluating and resolving cost escalation claims.

Sources:

[1] U.S. Bureau of Labor Statistics, Producer Price Index by Commodity: Metals and Metal Products: Iron and Steel; https://tradingeconomics.com/commodity/copper ; https://tradingeconomics.com/commodity/lumber

[2] https://www.bea.gov/data/personal-consumption-expenditures-price-index

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