



Bulletin

Fixed-Price Construction Contracts, Material Price Volatility and Contract Cost Adjustment Clauses

Introduction

Volatility of construction material and equipment costs is greater now and in recent years than previously has been the case. That volatility and uncertainty in stable pricing and commodity availability is likely to grow worse in coming years, not stabilize. The combination of raw material and natural resource scarcity, burgeoning infrastructure demand worldwide, with concomitant commodity and construction demand in the Far East and elsewhere, and unpredictability of world political stability (and shipping infrastructure too) all argue strongly for ever-greater vigilance in commodity purchasing and price commitments in procurement planning for fixed-price construction contracts.

Even worldwide climate change can affect commodity availability and price stability. In some cases, drought has led to hydro-electric power rationing and cutbacks in mining and material production which has cut material availability and put upward pressure on prices unpredictably.

Construction Material and Equipment Cost Volatility Will Continue to Increase

Given that price stability is no longer the norm, sound procurement planning and contracting policy call for more routine assessment of the benefits of including price

adjustment clauses in fixed-price construction contracts as a matter of equitable risk allocation. With volatility emerging as the norm in the 21st Century, fair contract risk allocation will more frequently require an equitable cost adjustment clause in fixed-price construction contracts as the most specific way to adequately address an otherwise uncontrollable and unforeseeable risk factor.

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Specific Cost Adjustment Clauses are Better Than More General Force Majeure Clauses

Cost adjustment escalation clauses set the basic parameters for the foreseeable range of price fluctuation by a set baseline – either actual costs, catalog prices, or common price indexes and then allocate shared risk of volatility beyond that range between the

contracting parties. This approach benefits the contractor, the owner and the project as a whole. The shared risk approach to either exceptional increases or decreases in price can help eliminate bid contingencies, avoid defaults and delays mid-project for the benefit of all parties and the project as a whole.

Force Majeure and Contract Impossibility Defenses are not Adequate to Address the Problem

Such clauses operate in somewhat the same way as common unforeseen site conditions clauses but are more immediate problem avoidance, risk sharing clauses. They allocate uncontrollable and unknown risk equitably, rather than putting all the risk on just one party. Unbalanced risk-shifting subjects the owner and the project to project disputes based on that unbalanced risk. Cost adjustment clauses address material cost volatility and unavailability in a way that is much more specific than a standard *force majeure* clause. *Force majeure* clauses (superior force, acts of God, etc.), in most cases, on their face, are limited to very extraordinary extraneous events, often are subject to very narrow interpretation by courts, and may be limited to time extension remedies only. Similarly, contract breach/non-performance defenses relating to impracticability/impossibility of performance have been developed for uniform commercial code applications, are often subject to very narrow interpretation as well, and are not directly applicable to construction services contract cases in the first place. And, in any event, such defenses are called on after the project suffers the adverse impact; cost escalation clauses stem the adverse impact on the project by spreading the risk equitably and keeping the project on track.

Short-Term Price Commitments from Suppliers are Becoming More Common

In recent years, with the unprecedented economic growth and infrastructure expansion in China, India and the Far East,

and political instability world-wide impacting both supply and shipping, and with the world-wide competition for raw materials and construction commodities heating up and down more frequently and with greater spread of changes, the argument for considering price adjustment clauses in otherwise fixed-price construction contracts becomes ever more prudent. In that context, increasingly material and equipment suppliers abjure long-term pricing commitments (often no more than 30 days), making a fixed-price construction contract with longer-term material/equipment purchases a considerable gamble, with those cardinal risks and changes leaving all contract parties vulnerable and the project success ultimately in jeopardy.

Below are some standard form contract clauses that address this issue.

Influential Public and Private Contracting Policy Documents have been Responsive to Price Fluctuations and Risks

ConsensusDOCS Policy

The primary private sector contract cost adjustment clause is the ConsensusDOCS, 200.1, *Time and Price Impacted Material Amendment 1*. It recognizes the need to assess the context of price volatility as an element of procurement planning. It addresses both contract price volatility and excusable delays for material/product unavailability (without reliance on the *force majeure* clause).

The 200.1 document recites the existence of market conditions warranting equitable adjustments for price volatility and delays because of product/material unavailability. It calls for a baseline for price adjustments and rules out duplicative increases under other document contingency provisions. It calls for a 30-day notice period of claim impacts, and documentation of covered changes. It doesn't set definite limits on the amount or

percentage of increase or decrease permitted. The 200.1 document also provides that overhead and profit are not included in the equitable adjustment based on changes from the baseline. Increases or decreases are permitted only for items purchased and delivered after the date of the change. The document does not set any specific percentage change limits (as the FAR does). **[NOTE: As a private-sector form document, such percentage limits and adjustments must be left to the negotiations among the contracting parties.]**

AIA Supplementary Conditions Addresses the Subject

The American Institute of Architects standard form general conditions (A-201, 2007 Edition) does not address the subject. However, there is mention of the subject in the 2007 Edition of the *AIA Guide for Supplementary Conditions* (A-503), which says:

Section 3.8 Allowances In recent years, unanticipated price escalations in construction materials after the contract is executed have caused concern to owners and contractors. If the owner and architect are concerned about facing such price escalations in certain materials, they should identify those materials prior to the bid and provide for them in the bidding requirements as allowances.”

FAR Policy criteria – The Federal Acquisition Regulations (FAR) now recognizes that contracting officers may include economic price adjustments in fixed-price contracts where “the Contracting Officer determines that it is necessary either to protect the contractor and the Government against significant fluctuations in labor or material costs or to provide for contract price adjustments in the event of changes in the contractor’s established prices.” (FAR, Part 16.203-3)

The FAR adds that a fixed-price contract with [an] economic price adjustment may be used, when: (i) there is serious doubt concerning

the stability of market or labor conditions that will exist during an extended period of contract performance, and (ii) contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract. Price adjustments based on established prices should normally be restricted to industry-wide contingencies. Price adjustments based on labor and material costs should be limited to contingencies beyond the contractor’s control.” (FAR, Part 16-203-2.)

The FAR sets out the basic dimensions of the price adjustment clause, as follows:

“A firm fixed-price contract with economic price adjustment provides for upward or downward revision of the stated contract price upon the occurrence of specified contingencies. Economic price adjustments are of three general types:

- (1) **Adjustments based on established prices.** These price adjustments are based on increases or decreases from an agreed-upon level in published or otherwise established prices of specific items or the contract end items.
- (2) **Adjustments based on actual costs of labor or material.** These price adjustments are based on increases or decreases in specified costs of labor or material cost standards or indexes that are specifically identified in the contract.
- (3) **Adjustments based on cost indexes of labor or material.** These price adjustments are based on increases or decreases in labor or material cost standards or indexes that are specifically identified in the contract.”
FAR, Part 16-203-1

FAR Contract clause – The FAR Economic Price Adjustment – Labor and Material clause (Part 52-216-4) calls for notice of covered increases or decreases to the contracting officer within 60 days, with supporting data, and contains the following

significant limitations: ... (c) any price adjustment under this clause is subject to the following limitations:

- (1) Any adjustment shall be limited to the effect on unit prices of the increases or decreases in the rates of pay for labor (including fringe benefits) or unit prices for the material shown in the schedule. There shall be no adjustment for –
 - (i) Supplies or services for which the production cost is not affected by such changes;
 - (ii) Changes in rates or unit prices other than those shown in the Schedule; or
 - (iii) Changes in the quantities of labor or material used from those shown in the schedule for each item.
- (2) No upward adjustment shall apply to supplies or services that are required to be delivered or performed before the effective date of the adjustment, unless the contractor's failure to deliver or perform according to the delivery schedule results from causes beyond the contractor's control and without its fault or negligence, within the meaning of the default clause.
- (3) There shall be no adjustment for any change in rates of pay for labor (including fringe benefits) or unit prices for material which would not result in a net change of at least 3 percent of the then-current total contract price. This limitation shall not apply, however, if, after final delivery of all contract line items, either party requests and adjustment under paragraph (b) of this clause. [Paragraph b provides for submission of price adjustment claims during the course of the contract, continuing performance during the term at agreed-upon rates, then overall percentage change adjustments at the end of the contract.]

- (4) The aggregate of the increase in any contract unit price under this clause shall not exceed 10 percent of the original unit price. There is no percentage limitation on the amount of decreases that may be made under this clause.

(d) The Contracting Officer may examine the Contractor's books, records, and other supporting data relevant to the cost of labor (including fringe benefits) and material during all reasonable times until the end of 3 years after the date of final payment under this contract or the time periods specified in Subpart 4.7 of the federal acquisition regulations (FAR), whichever is earlier." (FAR, Part 52-216-4). **[NOTE: Contracting parties should scrupulously avoid any claims for costs not actually incurred, as False Claims Act provisions are strictly enforced and sanctions for violations are severe.]**

Setting the Baseline for Change

Actual costs, catalog prices or common published indexes can all be used to set the baseline for cost adjustment clauses. ENR publishes a series on common construction material cost indexes. (Go to: www.enr.com). Also, the U.S. Department of Labor's Bureau of Labor Statistics publishes a very comprehensive set of Construction Material producer price Indexes along with a comprehensive guide on the subject, *Escalation and Producer Price Indexes: A Guide for Contracting Parties*. (Go to: www.bls.gov/ppi/home.htm).

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