

UNDERSTANDING AND CONTROLLING THE RISK OF VOLATILE MATERIAL PRICES

By Anthony D. Whitley (as seen in *Texas Construction* October 2008)

A few years ago, the construction industry began to endure prolonged and volatile price increases for major building materials such as concrete and steel. On the heels of such price increases came the affects of Hurricane Katrina and rising fuel costs. Today, the volatility of most construction material costs is even more pronounced. The causes given by economic experts range from increased global demand, the supply of oil, political strife, a weak currency, natural disasters and increased speculation in the commodities market.

Major newspapers and construction journals have recently reported on these conditions with renewed vigor in articles titled, among others, “Construction Materials Costs Go Through the Roof” (*Dallas Morning News*/dallasnews.com June 27, 2008 by Steve Brown), “Build Local, Price Global” (*California Construction*, July 2008 by Michael A. Moore), and “Surging Fuel, Asphalt, Steel Costs ‘Clobber’ Construction Budgets, AGC Says” (AGC of America press release, July 15, 2008).

A solution must be found to avoid the effects increasing material costs have on a fixed-price contract, or, even worse, on a company’s ability to keep its doors open. Rather than becoming better speculators, contractors should learn to manage this risk as they manage other risks on projects. Contractors must begin dealing with these issues in their *contracts* and avoid assuming these risks altogether, if possible. Otherwise, when the bid is blown, contractors will be at the mercy of the courts, which are not sympathetic to providing disaster relief.

The Law Offers Little Relief

In the absence of a well drafted contract, there are a few legal doctrines that attempt to deal with material price increases. Under the legal doctrines of “impossibility” and “commercial impracticability,” a contractor may be able to show that its performance was made impossible or impracticable due to an *unforeseeable* event. However, these doctrines rarely apply.

Under the aptly-named impossibility doctrine, it must really be impossible for *anyone* to perform, such as where there has been an intervening change in the law. A contractor who simply faces material price increases due to a natural disaster or a sudden increase in “global demand” cannot use the impossibility argument. If the result is simply lost profit, no matter how severe, the contractor will likely take the hit.

The impracticability doctrine, while somewhat less onerous, traditionally applies to supply contracts and is very difficult to establish. To obtain the benefits of this doctrine, the contractor must show that it had the ability to perform when the contract was made,

but circumstances beyond its control — and *unforeseeable* — later rendered the performance extremely or unreasonably difficult, *not simply unprofitable*. For example, a fixed price contract dependant on wood building components negotiated prior to Hurricane Katrina with a post-hurricane completion date would likely finish over budget leaving the contractor without remedy absent special contractual pricing provisions. Even though the contractor could not have foretold the disastrous *effects* of Hurricane Katrina on the market, in the eyes of the court the contract price will not increase because it is a *foreseeable* risk that a hurricane could hit New Orleans during August of any year. Again, foreseeability is the key to both the impossibility and impracticability doctrines.

Force Majeure Clauses in Contracts

What about “force majeure” or “acts of God” provisions? These provisions indeed shift some risks for adverse weather or natural disasters to the owner. However, force majeure clauses are typically geared toward obtaining additional time to complete the work due to *delays* and are unrelated to *price increases*. Whether explicitly stated or not, courts will often impose a similar foreseeability requirement before enforcing the force majeure clause.

Taking Control of the Risk

The best protection will not come from legal doctrines or force majeure provisions, but rather from carefully crafted contractual provisions that directly deal with the uncertainty of material prices. Just like any other risk on a project, contractors must mitigate the risk of rising material costs and/or shift it to the party who is in a better position to control or assume responsibility for the risk. The following recommendations will assist a contractor in ensuring that the fixed-price in its contract remains greater than its parts, rather than the parts overtaking the price:

- **Qualify the bid.** The contract should provide that the pricing is good for a set number of days, or include an escape mechanism in the event of material price increases. For example, “this price will only be held so long as the published price of material (copper, concrete, board-foot of lumber, steel, etc.) does not vary by more than 5%...” Contractors can obtain material prices from suppliers or on-line from institutions that track such costs.
- **Beef up “contingency” costs.** On a hard bid project, this may cause a contractor to lose the bid. However, for negotiated or cost-plus contracts, an owner may be willing to allow additional contingency funds, so long as it is disclosed on the front end and in sufficient time to secure owner financing.
- **Include a price escalation clause.** Provide the mechanism to institute a change order for price escalations beyond the control of the contractor. Enumerate a broad class of risks and triggering events, including acts of God, war, strike, terroristic activities, global/local market pressure and demands, material and labor shortages and other similar events.

- **Address delays.** Prices are not the only issue. If the project is delayed due to uncontrollable events, the contract should provide for a time extension *and* extended general conditions costs.
- **Limit rescission rights.** To the extent the contractor is bound to the price or completion date, its subcontractors and suppliers should be equally bound. Make price fluctuations and material and labor shortages foreseeable risks that the subcontractors and suppliers assume in their subcontracts with the contractor.

Material and construction prices are in a state of flux now more than ever. No one can foresee where the next increase will occur or how long it will last, but a well drafted contract will at least assist the contractor in controlling those risks and offer protection to the contractor's profit margin.