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**ADAPTING TO THE UNCERTAINTY OF CONSTRUCTION COSTS: WHY PRICE ESCALATION CLAUSES ARE MORE VITAL THAN EVER**

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Long over are the days of predictability in construction prices. The construction industry witnessed prices drastically fluctuate throughout the COVID-19 pandemic. Unfortunately, that reality has remained. Contractors and owners alike have not fully adapted to this new reality, instead relying on old form contract clauses that give a false sense of protection. These clauses generally fall short, and the new reality demands a new approach.

**Price Volatility in the Construction Industry**

Prices in the construction industry are at the mercy of varying factors, whether it be the price of raw materials, labor, equipment, or gas and energy that affect the transportation of materials. In effect, this can drastically increase or decrease the costs during the course of project.

Labor availability and price increases for construction materials and other inputs remains the top two concerns for the construction industry as a whole outside of customer demand.[1] The U.S. saw construction costs increase at an average of 4% in 2023 and costs are set to increase between 3-6% in 2024.[2] In Minneapolis, the cost is predicted to escalate by 4.5%.[3]

**The Status Quo of Construction Contracts**

Price volatility has meant that certain materials can see a drastic increase in cost during a project and before a contractor has ordered such materials, often leaving them with the burden. Generally, construction contracts are either cost-plus contracts or a fixed-price contract. In a cost-plus contract, the owner agrees to pay the contractor's direct and indirect expenses plus an additional, separate fee representing the contractor's profit. Due to the uncertainty of costs, this option often leaves owners feeling apprehensive to choose this option. On the other hand, under a fixed-price contract, the owner and contractor set a fixed price to complete the project. This type of contract relies on change orders to deal with the change of scope or prices of materials. Obviously, this

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[1] Tu-Uyen Tran, Fed. Reserve Bank of Minneapolis, *With lower demand, higher costs, construction industry expects leaner months ahead* (May 8, 2023) https://www.minneapolisfed.org/article/2023/with-lower-demand-higher-costs-construction-industry-expects-leaner-months-ahead

[2] Kathy Rembisz, GlobeSt., *Construction Costs Expected to Increase as Much as 6% This Year* (Feb. 21, 2024) https://www.globest.com/2024/02/21/construction-costs-expected-to-increase-as-much-as-6-this-year/?slreturn=20240531104415

[3] *Id.*

option is advantageous for owners but increases risk for the contractor who may either underestimate the total price or be faced with rapid increased prices in materials.

As previously mentioned, one method that has been used to combat price increases is by executing a change order. While simple in theory and par for the course as the owner revises the scope of work or unforeseen circumstances such as surprise foundation issues necessitate it during the project, owners may not be amendable to signing a change order to increase the cost simply due to the increase of material costs during the project. This predicament increases the risk of a dispute between the owner and contractor down the road.

Another commonly relied upon clause is the *force majeure* clause, which may allow the contractor to an equitable adjustment of the contract price caused by unforeseen circumstances beyond the control of the contractor. While this was certainly applicable during the COVID-19 pandemic, courts around the country have made clear that a *force majeure* clause generally will not protect contractors for rapid price increases due to market volatility absent express language in the *force majeure* clause.

**Protecting Both the Contractor and the Owner: Price Escalation Clauses**

Price escalation clauses are unique in that they protect both contractors and owners by allocating risk up front for unanticipated and/or uncontrollable price fluctuations in material or other costs. If prices increase, the owner must pay accordingly, and the contractor's bottom line is protected. Contrarily, if prices decrease, the owner enjoys the benefit, and the contractor still retains its profits. In either scenario both sides can make business decisions regarding the level or risk they are willing to bear with respect to unanticipated and/or uncontrollable price escalations after the contract is signed.

To be effective, a price escalation clause should set a baseline price as established by the schedule of values, an escalation ceiling price, and an escalation floor price. It should also be reciprocal and include language that protects both contractors, increasing the baseline price in the event of cost increases, and owners, decreasing the baseline price in the event of cost decreases. Moreover, the price escalation clause should state that any changes, increases or decreases, to the baseline price are based on an objective index, such as a consumer or producer price index, which the parties agree to during the contract formation stage.

Price escalation clauses are generally conditioned on an increase in prices based on a percentage rather than a set sum. The clauses should also include language that protects the owners so that any price increase is the not the result of the contractor, such as by contractor unexcused delays in ordering materials. Some clauses will specify materials for which it would apply to such as lumber, plywood, steel, sheet metal, fuel, manufactured products, etc. Thus, the price for any materials to be used on the project increases by a certain percentage or more between the time the contract is signed and materials for the project are purchased, in such a case, the owner shall pay to the contractor, on request, all sums by which the cost to the contractor for any item of materials has increased beyond the certain percentage.

Price escalation clauses offer protections for both the contractor and owner that a typical cost-plus contractor lacks. The cost-plus contract still leaves open the uncertainty of costs and does not offer the general price base line and protections that a price escalation clause does.

**Conclusion**

Because price volatility in construction projects is here to stay, relying on old contract clauses often fails to fully afford protections to both the contractor and owner. Incorporating price protection clauses into construction contracts, especially those in connection with prolonged projects, will ensure both the contractor and owner are protected from price volatility. Moreover, price protection clauses will bring a level of certainty in terms of risk and avoid potential disputes as the project proceeds.

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