Protecting Your Business From Fluctuating Materials Prices

Written by: Tim Fandrey, Associate, Construction, Gray Reed, and JP Vogel, Partner, Construction Law, Gray Reed

HOW TO MITIGATE RISK & STRUCTURE A PLAN TO COVER YOUR PROJECTS

All construction industry stakeholders are aware that material prices, especially lumber, have seen steep increases that are unprecedented in the United States. With the COVID threat rebounding, the demand for raw materials, including materials to construct buildings and other infrastructure only seems to be increasing. From April 2020 through April 2021, prices for plywood rose 86%, steel 67%, copper and brass mill shapes rose 49%, and aluminum mill shapes rose 20%.

Despite that reality, projects still need to be completed and most have already been financed based upon material prices that have quickly changed. Owners and developers need their projects built and contractors, subcontractors and suppliers need projects to build. The question is, how do these project stakeholders manage their risks?

Knowing What's at Risk

To get to the root of a problem in almost any scenario, all you need to do is follow the money. The same is true in the construction industry. Construction projects are often slow-moving battleships that are not so easily able to materially change course. As projects are conceived and designed, the most immediate question is how they will be financed.

In most circumstances, construction projects are financed and underwritten based on design documents and contractor bids, which is a process months in the making.

So, what happens when certain material prices on a project suddenly increase by 15% to 25% from the time a bid is submitted, and work begins, or materials need to be secured? Subcontractors and suppliers do not want to be left holding the bag when they are forced to pay more, but contractually they are often in that position.

Prime contractors aren't exactly thrilled when presented a change order and assuming they will pass it through to the owner, you would be hard-pressed to find an owner prepared to raise its costs of construction. All of this creates a contractual quagmire, thus necessitating proper pre-construction planning and utilization of the proper tools.

Playing The Waiting Game

There are various tools available from a strategic perspective. One is simply to wait until material prices drop. This is akin to attempting to time the stock market and has its own risks. As people begin to return to their normal lives, ready to spend their hard-earned money, demand for materials and projects only seems to be increasing across the industry.

Relatedly, not all projects can wait. Many companies are facing a desperate need for additional workspace to increase capacity and output to meet increasing demand for products and services. These factors tend to indicate that waiting may not be a viable option for all projects.

Understanding Contract Terms

Another tool is to address material price increases is through contract terms. These are important tools and should not be ignored. For example, by setting a firm notice to proceed date instead of letting the commencement date be determined by the owner, contractors can be more confident in their material price quotes that are typically held open for only 30 days.

Contractors can also use allowances for different items of the project that may be sensitive to material prices increases, instead of quoting firm numbers for items of work. The amount that is spent in excess of the allowance is the owner's risk.

Relatedly, the owner and contractor can agree to set aside a contingency fund and could even earmark the contingency funds to address material price increases.

Another, more direct method, would be to include material price escalation clauses in the contract — this would shift the risk of material price increases above a certain level to the project owner.

While the contractual methods are certainly a necessary part of the risk management portfolio, each contract term proposed necessarily involves shifting the risk of material price increases to one party or another. And even if the risk is shifted contractually, the other party still bears the risk that the risk-bearing party will be able to perform, which may not be the case. Such a scenario would lead to an incomplete project where no one wins. How is this risk addressed?

Revisiting Insurance Options That Can Help

In response to the unprecedented material prices increases, some insurance providers are offering insurance to provide certainty in an uncertain market. The way the insurance generally works is that a contractor pays a monthly premium for the benefit of receiving an insurance payout if the contractor purchases a certain material or other input when the spot price is above a certain pre-determined price.

This type of insurance most directly benefits subcontractors and material suppliers who purchase raw materials. However, owners and contractors also stand to benefit because the subcontractors and suppliers will be better able to honor their original pricing set in their proposals.

Exploring Your Next Steps

As the world has recently learned, COVID-19 isn't going away and has created lasting effects on the ways many businesses operate. Commodity markets are still wildly fluctuating. Despite these significant market factors and prices remaining high, all indications are that construction projects are moving forward full steam ahead.

Contractors should be prepared to use the tools at their disposal to manage the risks associated with this market. To best accomplish this, be sure to consult with an experienced construction lawyer.

 

About the Author

Tim Fandrey is an associate, construction, at Gray Reed, a full-service, law firm in Dallas and Houston, Texas. Fandrey represents contractors and subcontractors on a wide variety of construction matters including construction claims and litigation, lien and bond claims, giving of real time project advice, and contract negotiation. Prior to law school, Fandrey worked as a civil engineer for more than 4 years, gaining experience in both the private and public sector as he designed dozens of bridges and roadways for the Missouri Department of Transportation. Contact Fandrey at tfandrey@grayreed.com.

JP Vogel is a partner, construction law, at Gray Reed. Vogel guides clients through every phase of commercial construction and helps them to resolve disputes when projects don't go as planned. Vogel focuses on brainstorming new ways for clients to seize opportunities and overcome challenges.His clients are major players across the industry, including owners, general contractors, specialty subcontractors, suppliers and manufacturers. Contact Vogel at jpvogel@grayreed.com.

About the Article

Republished from Construction Business Owner. Construction Business Owner (CBO) is the leading business magazine for contractors and is designed to help owners of construction firms run successful businesses. Founded in 2004, CBO provides real-world business management education and knowledge that is of real value to the owners of construction companies.

Any views and opinions expressed in this article may or may not reflect the views and opinions of the Construction Management Association of America (CMAA). By publishing this piece, CMAA is not expressing endorsement of the individual, the article, or their association, organization, or company.