

Can I Use a Price Escalation Clause in My Construction Contract?

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With the impact of COVID-19 wreaking havoc in the supply and demand chain, construction materials have skyrocketed in price, and in some cases, have caused painfully long lead-times for materials. Contractors skilled and experienced in quoting a fixed fee or a guaranteed maximum price (GMP) are leery giving such quotes without some cushion to absorb the risk in these steep price increases. As a result, many contractors have been scrambling to put price escalation clauses in their standard construction contracts. These price escalation clauses give the contractors the cushion they need to move forward with a project.

What is a price escalation clause?

An escalation clause allows a contractor to impose price increases in materials upon the owner after a contract has been signed, thereby shifting the risk of absorbing the price increases from contractor to owner.

These clauses are typically used where there is a lump sum/ fixed fee or GMP contract, especially where the duration of a construction project is long and complex, so that there can be an adjustment to the price to be paid by the owner if there are sharp increases in the price of materials or labor. These clauses are not necessary where you have a time and materials contract because the owner already takes on the risk of having to pay higher prices due to fluctuations in the market during the construction project.

How should I negotiate such clauses?

Contractors may have some difficulties inserting such clauses in a lump sum/fixed fee or GMP contract if an owner insists that he or she wants the price guaranteed even if there are excessive increases in material costs or labor. These owners will especially resist an escalation clause that pushes the risk of the price increase completely on the owner. That said, most owners recognize the impact of the pandemic on the construction industry and may be willing to work with a contractor to accommodate these price increases. In addition, a contractor who educates and informs his owner as to the unstable economy, material shortages, and the need for such a clause will have a better chance to include it in the contract.

One way to make the escalation more palatable to an owner is to have the contractor absorb the price increase up to a certain percentage, as it normally would do in a more stable economy with a fixed fee or GMP contract, and then have the owner pay for any increases above that percentage. Another method is to have the owner and contractor just split the difference in the price increase. An owner may also want to offset the escalation clause by also including a de-escalation clause so that the owner can benefit from any price decreases. Another consideration is to have a maximum percentage increase that the owner will pay so that the owner knows there is a limit to the price increase.

What is the best way to use an escalation clause?

When there is a substantial price increase, the contractor should provide notice to the owner and provide evidence of the price increase, substantiated with dates and prices from the original quote and the current quote. The contractor should prepare the change order for the price increase using the formula in the escalation clause so that he or she can see the impact of the price increase on his or her budget for the project. This will aid the owner to make an educated decision as to whether to procure the materials or perhaps consider substitute materials with a lower price. Either way, the contractor should have the owner sign the change order before ordering the higher priced materials so that there is no question that the owner agreed to pay the higher price. This will make for a better case before a judge or an arbiter if the owner refuses to pay for the price increase.

What are some other considerations in using these clauses?

Be ready for the owner to require you to order materials in advance to keep prices down. The owner will want to see that a contractor is diligent in staying ahead of the market and protecting the owner from being blindsided with exorbitant price increases. Be ready for these clauses to be used only for certain materials. The owner may want more stability in the pricing of the project by restricting the escalation clause only for materials currently fluctuating in the economy and not every material to be used for the project. Be ready with a reliably drafted clause. While the American Institute of Architects (AIA) does not provide a sample escalation clause, the ConsensusDocs have a sample escalation clause that can be used. And, of course, reach out to your attorney to have him or her draft a clause so that you can be steady in an unstable market.

If you have any questions about escalation clauses in construction contracts, please [contact me](#) or any member of the [Barley Snyder Construction Industry Group](#).

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