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Dear Valued Client,

It's hard to believe that we're winding down yet another year. As the calendar initially turned to 2021 nobody quite knew what to expect. We as a society had adjusted to learn how to live and work while COVID remained prevalent, but we didn't precisely know how long COVID would persist. Now, as we close out 2021, it's apparent that COVID will be around for a while with new variants emerging every so often from somewhere around the globe. Many believe that how society is dealing with COVID as we end 2021 is, at least temporarily, the "new normal."

That leads anyone in the construction industry to question if where we find ourselves today is the "new normal" for the industry. There's tremendous strain on the global supply chain which has created a great deal of volatility in material prices and availability. Finding additional management or labor talent for your team is generally more difficult today than prior to the pandemic. While construction spending in the residential sector remains robust, spending in nonresidential segments that were most impacted by COVID has been slow to rebound. It's anyone's guess as to when these headwinds are expected to dissipate.

In planning each year's Catalyst Construction Journal, our main goal is to provide you with information which could help you position your company to face the market we're currently in. On the following pages you will find ten White Papers written for this publication by subject matter experts in their space of the construction arena. It’s our hope that you find at least one piece of useful information within this resource that brings value to your business. However, we would recommend that you consult with either the author of any White Paper of interest or with your existing professional in that space prior to enacting any changes. Every individual business is different - what might be prudent for one business may not be the best choice for another.

Lastly, thank you for placing your trust in our agency. It’s a responsibility that we do not take lightly. We're honored for the opportunity to play a small part in your company’s success.

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The Risk of Supply and Demand: Material Price Fluctuations in the Construction Industry

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One of the biggest issues being faced by the construction industry today is the uncertainty surrounding the cost of construction materials. For example, lumber prices were six times higher in May 2021 as compared to April 2020.[1] Though the lumber industry seems to have caught up to some degree, the cost of construction materials as a whole increased by 23.1% from August 2020 through August 2021.[2] Looking backwards, this means that projects sold months or years ago, before the cost of materials skyrocketed, may now have significant risk that is borne more heavily by one party versus the other. Looking forward, the potential for ever-increasing materials costs is now as well-known of a risk as any in the construction industry – there is no reason to not address it when negotiating future work, especially when construction costs are estimated to increase by another 4% to 7% into next year.[3]

While the market will do what the market will do – whether due to inflation, lingering (or new) tariffs, labor shortages, imbalances in supply and demand, etc. – construction professionals can help bring themselves a level of certainty as to how their contractual relationships react to market activity concerning material costs. Though not an exhaustive list by any stretch, I've laid out below a handful of front-end strategies for dealing with potential material cost fluctuations, as well as some practical considerations to keep in mind when work is underway

Contract Negotiation Option No. 1 – Do Nothing

There is a very simple option – don't read your contract, do nothing about your contract, and let the contract say what it says. What happens if the contractor bears all risk for an increase in material costs, and materials increase by 23% again? On a job with $1 million in material costs, that's $230,000 the contractor will have to spend and which it may have no avenue to recover. For some, that may take a contractor out of making money into the world of net loss. To play this out further, what happens when the contractor submits a change order, the owner rejects it, and the contractor decides to walk because it would rather deal with a breach of contract action than to lose $230,000 in unanticipated costs? While this is somewhat of a "doomsday" scenario, I point this out to illustrate that it is mutually beneficial to deal with this well-known risk up front. It is nearly assuring mutual destruction to do nothing. Bottom line: Do something.

Contract Negotiation Option No. 2 – Split It

One of the more reasonable ways to handle potential increased costs in construction materials, especially at the owner-contractor level, is to simply agree to a split of increased costs. Whether it's 50-50, 60-40, or some other agreed-upon sharing of the risk, this makes the most logical sense – the contractor wants to build the project to make money, and the owner wants the project built so that they can make money. If everyone is going to benefit from the work being performed, it follows that everyone should be willing to assume a risk which means they may make less money should construction costs increase.

[1] https://www.cnbc.com/2021/06/30/lumber-prices-dive-more-than-40percent-in-june-biggest-monthly-drop-on-record.html

[2] https://www.commercialsearch.com/news/construction-costs-will-keep-rising-heres-how-much/

[3] See Fn. 2.

Contract Negotiation Option No. 3 – "Allow" for the Increase

Another way to deal with the risk of increased construction costs which has been popular lately is to include a contractor-held allowance to be used in the event material prices go up. If the allowance gets exhausted but there are still increased costs to pay, the parties can then fall back to a version of Option No. 2 by having an agreed-upon split for increased costs that exceed that allowance amount. If the allowance is not exhausted, there could be any number of ways to handle the delta – (1) have it go to a shared savings, (2) have it be paid as a bonus to the contractor for keeping costs down, (3) have it revert to the owner (since it's their money anyway), or (4) deal with it in some manner that is a combination of the three foregoing options.

Contract Option No. 4 – Tie Prices to Something Else

The final option that I'll note here is to tie the cost of materials to an index such as the New York Stock Exchange's and/or Nasdaq's lumber index. While this gives some certainty to both the contractor and owner in terms of the price(s) they agree on, it may not mean a darn thing to the actual supplier of the materials, thereby still leaving someone holding the bag on potentially higher prices.

Practical Considerations

While there are any number of answers to the front-end question of how to deal with increased materials prices in a contract, it is equally important to consider how to mitigate risk during the course of a given project. Similar to the contract options noted previously, this list is not exhaustive either – mostly because construction professionals are some of the most creative people I've met in figuring out how to solve all sorts of problems.

- **Order materials early.** Get the owner or whomever is upstream to release you or your subs to obtain materials early, then store them somewhere until they are ready for use. This may increase storage costs for one party versus another, but may also have the impact of keeping overall costs down.

- **Reward suppliers.** Give them large down payments on materials in order to lock-in current pricing. You've then taken your own risk and passed it down further, while also giving the supplier the chance to have a good chunk of its money sooner.

- **Know your contract's claim procedures.** If you find yourself in a position to need to seek an equitable adjustment for increased materials costs, you need to know when you must submit a claim, how the claim is to be submitted, and to whom you should submit it. If you don't follow the claim protocol to the letter, you are at risk of waiving a potential claim.

- **Make sure you understand your lien waivers.** Some lien waivers waive all claims if they are not expressly reserved. Some lien waivers even go so far as to not provide a means for reserving claims. If you have submitted a claim for increased costs, it is important to know what your waiver document says. If it doesn't allow for a reservation of claims, tell your upstream party that you have a claim you asserted and need to reserve that claim – then agree on an attachment to the waiver that carves out the outstanding claim.

In sum, the risk of increased materials prices is now as well-known as the risk of project delay – how it will be dealt with must be contemplated in the contract documents. Benjamin Franklin's timeless quote rings true when attempting to mitigate material price risk in today's construction environment: "If you fail to plan, you are planning to fail."


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