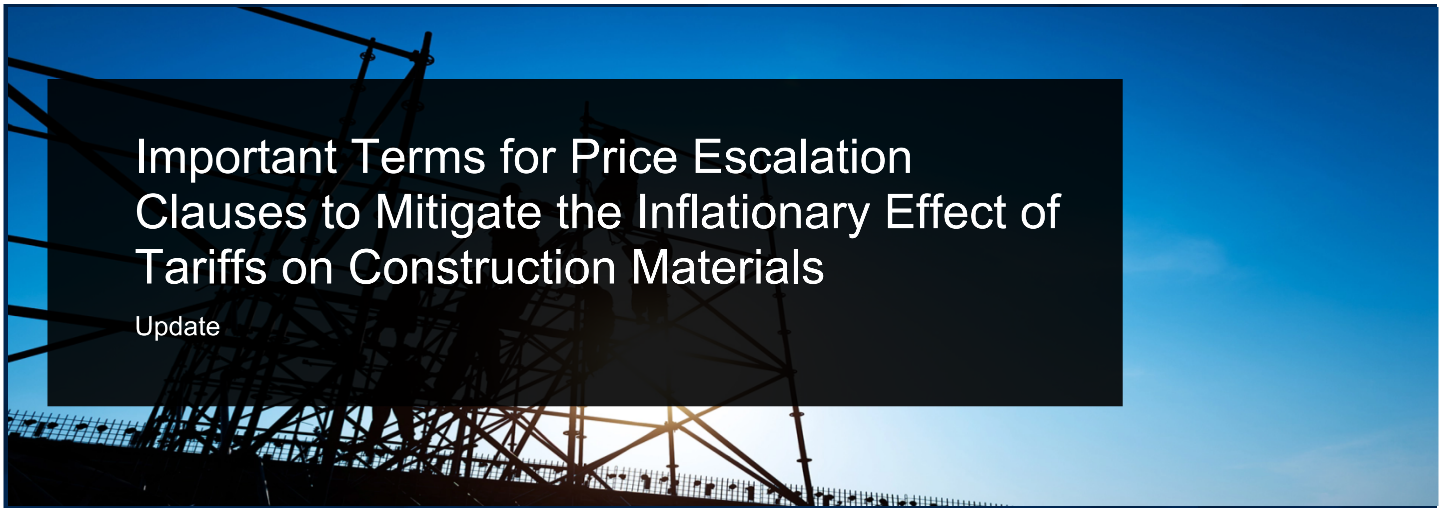
BRACEWELL



Important Terms for Price Escalation Clauses to Mitigate the Inflationary Effect of Tariffs on Construction Materials

Update

February 12, 2025 | 4 minute read

The prospect of 25 percent tariffs being imposed on all steel and aluminum imports by the newly elected Trump administration, together with the 10 percent increase on tariffs already levied on Chinese imports, has created uncertainty in the construction industry. The uncertainty is permeating existing construction projects because of likely inflation in product and material costs due to shortages and supply chain interruptions. It is also affecting contract negotiations between owners and contractors for new projects. If fully enacted, the tariffs could inflict higher costs for many products and materials, including concrete, lumber, steel, aluminum, drywall, appliances and electrical component parts. Estimates for the increased monetary costs imposed by these new tariffs range in the billions of dollars.

The new tariffs are particularly problematic for GMP contracts where owners and their lenders desire some degree of certainty about how much a project will ultimately cost, especially public or quasi-public projects that rely on bond financing. Left unaddressed, rising tariffs threaten to discourage parties from engaging on new projects, or worse, scuttle projects that are ongoing. Indeed, a recent construction contract negotiation that Bracewell was involved in was significantly prolonged and complicated by protracted haggling over language in force majeure, contingency, allowance, change order and other contractual provisions that could be impacted by the new tariffs.[1] Ultimately, the parties were able to move forward because of an agreed price escalation mechanism that was written into the construction contracts.

The current circumstances beg the question: how can parties involved in construction projects adequately protect against cost overruns caused by the inflationary effect of the new tariffs? As discussed in the 2018 update from Bracewell referenced above, the most common mechanism used to address this issue is a detailed price escalation clause.[2] Unlike 2018, the current Trump administration's tariffs could be exponentially more expensive by

Related People

Richard F. Whiteley
Partner
HOUSTON
+1.713.221.1123
richard.whiteley@bracewell.com

Phillip L. Sampson Jr.
Partner
HOUSTON
+1.713.221.1307
phillip.sampson@bracewell.com

Related Practices

Construction Litigation
Litigation

affecting products and materials beyond just steel and aluminum, including Chinese appliances, component parts, and lumber from Canada and Mexico. Prior to the Trump tariffs in 2018, it was uncommon to find price escalation clauses in typical construction contracts. Surprisingly, even after the imposition of steel and aluminum tariffs in 2018, these types of escalation clauses are still uncommon and are not included in standard forms from construction contract authorities like the AIA, which instead rely on the change order process to address inflation.

A price escalation clause, where parties agree at the outset of a project to specific terms and mechanisms to address inflation (in this case imposed by tariffs), is the best solution. Parties are more likely to be able to agree on the parameters of how increased costs will be managed before those increased costs occur, unlike the change order process where one party will generally have leverage over the other and disputes are more common. However, price escalation clauses can be complex and must be fully thought out and sufficiently detailed to address as many contingencies as possible – the fewer variables the better.

Perhaps the most important term in a price escalation clause is the trigger, i.e., when is the clause activated? It does not make sense for a price adjustment mechanism to be triggered for trivial or nominal increases in product and material costs, and most parties, whether it is an owner in a cost-plus agreement or a contractor in a GMP contract, understand that it is customary for certain economic fluctuations to be absorbed by one side. Therefore, a triggering mechanism that is activated beyond smaller price increases is important. The most effective triggering mechanisms relate to a specific percentage increase in the cost of a product or material measured from the time the contract is executed and tied to a reliable and accepted index, like the Producer Price Index published by the Bureau of Labor Statistics (PPI). For example, a cost-sharing arrangement could be triggered when the cost of steel increases by 10 percent over and above the cost at the beginning of the contract as reflected in the PPI.

Another triggering mechanism may involve comparing the contractor's purchase orders at the beginning of a project to purchase orders issued later in the project. This form of trigger is generally harder to enforce and may be subject to varied interpretation and manipulation, but in some cases it may more accurately capture local economic trends.

It is important in any price escalation clause to clarify that only the increased costs beyond the trigger price are subject to sharing, and not all of the underlying cost increases. Of course, both parties should have rights to review and/or audit all documents used to justify the implementation of a cost-sharing mechanism once it has allegedly been triggered. It is also important to specifically set forth the cost-sharing mechanism between the parties for all increases beyond the trigger price. A customary way to document that mechanism is through percentages, i.e., owner pays 30 percent and contractor pays 70 percent of all increased costs for the product or material at issue. Other ways to handle the cost-sharing arrangement are through an express right of the contractor to draw off a contingency fund or through an allowance that is funded by the owner prior to the beginning of the project.

Finally, price escalation clauses should contain a ceiling that when reached allows the parties to either suspend or terminate the project. The protection of a ceiling provision is important because even with a cost-sharing mechanism in place, there is usually a point at which cost increases become so substantial that it is not economically feasible for one or both parties to continue the project. The ceiling should be negotiated up front by the parties and should use the same mechanism as the trigger component of the clause, i.e., a percentage above a certain price index. The price escalation clause should contain language providing options to the parties once the ceiling has been reached. The options may include suspension of the project, a termination for convenience, a declaration of a force majeure or other forms of agreed procedures. A project termination under these circumstances would normally allow the parties to recover their reasonable costs and overhead and would not give rise to a default or a claim for breach.

Price escalation clauses are a valuable tool for both owners and contractors to consider in today's economic climate to provide at least some level of control against rising product and material costs, but they can be tedious to draft and negotiate, so including outside counsel in the process can be helpful to expedite negotiations.

---

[1] Bracewell previously provided guidance on whether force majeure clauses can be implicated by steel and aluminum tariffs back in 2018, when the previous Trump administration imposed substantial steel tariffs on China. *See* "Steel and Aluminum Tariffs: Time to Dust Off the Price Adjustment Clause?," Bracewell Update, August 28, 2018, and "Steel and Aluminum Tariffs? Can You Turn To Your Force Majeure Clause?," Bracewell Blog Post, March 22, 2018.

[2] *See* "Steel and Aluminum Tariffs – Time to Dust off the Price Adjustment Clause?," Bracewell Update, August, 28, 2018.