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In favor of higher contractor contingencies to cover uncertain risk created by economic volatility

INSIGHTSARTICLE

APRIL 27, 2022

As economic volatility continues to affect the global economy, contractors and owners would be wise to re-evaluate their construction project pricing. To state the obvious, projects are at greater risk of increased costs due to global economic volatility. There are numerous approaches that contractors and owners can take to address these risks:

- Price escalator clauses for material or labor

- Schedule extension clauses if material sourcing issues or supply chain disruption occurs
- Force majeure clauses for additional time or money
- Specific allowances or time and material time and material contingencies for identified scope that is volatile
- Clauses that allow for early ordering, warehousing and insuring of materials with advance payment
- Clauses that allow greater flexibility for substitute materials or change orders in event of supply chain issues

Another approach, especially for fixed price contracts: simply bake the expectation of increased costs into the bid price by buffering with a higher bid to protect the contractor.

Unlike fixed price “hard bids,” one of the more popular contract and pricing methods on private commercial projects is a cost-plus-fee with a (not to exceed) guaranteed maximum price (GMP). Under this method, generally, the constructor will invoice the owner the costs of construction, tack-on an agreed upon markup percentage as the fee to cover profit and overhead and the total amount cannot exceed a specified GMP.

For these types of contracts, the typical buffer to cover potential cost events is a contingency line item in the budget that is part of the GMP. Even prior to recent economic volatility, contractor contingencies were standard to ensure that funding is in place to move the project forward in event of troubleshooting that may arise on any given project. A common item traditionally covered by contingencies is price volatility and supply chain issues. The specific coverage of a contractor’s contingency, however, is malleable and depends on the specific language in the contract. It is best that a contingency be negotiated and clearly written in the contract upfront.

The contractor’s contingency in this volatile economy

Ultimately, the contingency exists to earmark and budget funds for problems, errors, and issues that inevitably are a risk on a construction project, including price escalation and supply chain issues. In this current economic situation, it begs the question: If economic volatility has increased the risks of pricing issues, should the contingency likewise be increased to account for this new volatility?

Nearly all contractors have their own opinion and business model regarding the proper percentage for a contingency budget. Conventional wisdom and experience suggests that the typical contingency is approximately 5% (more-or-less) of the hard costs of the work, depending on the project, the owner and the contractor.

It is no secret that the current economy is very volatile. Inflation continues to increase costs; materials are difficult to source; energy prices continue to rise; and material prices also continue to increase. There are many different approaches towards addressing these volatile risks, including the ones identified in the beginning of this article. Each project is unique and requires its own analysis. But one item that should be considered on all projects is whether the contingency itself should simply be increased. If a contractor has historically used a 5% contingency for decades to cover the risks of volatility, and now greater volatility exists, wouldn’t it make sense to increase the contingency at this time?

It would seem reasonable to explain to an owner that contingency on a project has historically been 5%, but due to economic forces, we are now budgeting a 10% contingency, or perhaps 15%. If the prices remain stable, then the savings on the contingency can be allocated to the owner. But, if the economy remains volatile and prices increase,

then the project is simply more expensive and that should not be a risk for the contractor. The possibility of global economic forces making a project more expensive is a risk that should be carried by the owner, who has decided to build a project during an economically volatile time period. By approaching a project with custom contract clauses and a proper contingency, it would reason that a project can proceed with reasonable risk and benefit for both contractor and owner.

Saxton & Stump attorneys Ron Pollock and Matt Chabal are available to advise companies on contract issues, project delivery methods and construction litigation disputes.

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