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Prices are Stabilizing - at High Levels

It started with steel. The construction industry had enjoyed a decade of relative price stability, but starting in late 2003, it was hit with the largest price increases for materials since the early 1970's. The causes were many, but the most significant factors related to China's superheated economy. China's insatiable demand for steel meant it not only started to devour the world's supply of scrap steel, but also halted its coke exports. These conditions, and the resulting price trend, have continued well into 2004, with steel prices escalating between 20% and 60% in the first quarter. Other materials were not unaffected. Rises in the price of structural steel, rebar, and steel pipe were accompanied or followed by increases in the cost of lumber, plywood, drywall, insulation, copper, stainless steel, and fuel.

According to the November 2004 issue of McGraw Hill's ENR, inflation in the construction industry started this year at about 3%, and is expected to peak at 9-10% by the end of the year. ENR's recent reports indicate, however, that prices for metal products are stabilizing, but not yet declining. Structural steel and stainless steel prices increased by 2% in October, leaving prices for these materials at 22% to 24% above where they stood a year ago. Prices for reinforcing bars also went up 2% in October, and are 41% higher than they were in 2003.

During the second quarter, cement shortages developed throughout the country, but especially in the South. In many regions, concrete became available by allocation only, and weekend concrete pours have been curtailed. Shortages in steel, cement, and other materials equate not only to prices increase, but impacts on construction schedules.

China's economy is likely to remain a significant factor affecting the procurement of construction materials. This year China supplanted Japan as the world's second largest consumer of energy after the U.S., which means greater dependence on imported oil and gas. China has entered into large transactions with Brazil, Sudan, and Iran for oil exploration and production. Some of these deals likely will result in China's acquisition of oil at inflated prices. These trans-

actions will have broad effects on the world economy, both in terms of supply-and-demand, and in terms of geo-political stability. China's economic development and its need for resources have resulted in recent diplomatic battles with its rival states, including Russia, Japan, and, so far to a lesser extent, with the U.S. and Europe.

Some analysts predict that China's economy will falter, resulting in plummeting commodity prices. Aside from concerns internal to the Chinese economy, other factors are at play, not the least of which is the growing U.S. trade balance, and what it will mean with respect to the eroding value of the U.S. dollar. There is a growing international call for China to revalue its currency. John Mauldin, President of Millennium Wave Investments, says, "Much of the speculation about the Chinese revaluing the Renminbi focuses on the large trade deficit they have with the United States. If they buy all the dollars from the various Chinese companies who sell to the U.S., giving them Chinese currency, it is inflationary and can spark a bubble, which would result in a crash, much like the Asian crisis of 1997-98." Generally, however, experts are not predicting price drops in the near future, either for steel, or for construction materials overall.

These conditions have impacted the construction economy, including suppliers, fabricators, subcontractors, contractors, and owners. Fabricators and suppliers have attempted to control their exposure by shortening the duration of their bids and price proposals. Subcontractors and contractors have attempted to negotiate price escalation clauses into their contracts, avoid fixed-price arrangements where possible, and otherwise shift risks upstream. Vendors may be able to rely upon certain provisions of the Uniform Commercial Code that are not applicable to others in the industry. Owners have considered abandoning projects due to unstable prices.

If unexpected shortages occur, the first place a construction professional must look is at the relevant contracts, if any. The general rule in many jurisdictions is that, in the absence of an express agreement to the contrary, a contractor in a

fixed-price contract assumes the risk of increases in its costs of materials and supplies. Some contracts specifically address the issues of material shortages and their impacts on prices and delivery dates. The pertinent clauses tend to be the Changes and/or Change Orders clauses, the Time, Schedule and/or Delay clauses, the Changed Conditions clause, the Force Majeure clause, and the Claims and/or Disputes clauses.

On federally funded construction project, the Federal Acquisition Regulations must be consulted. For example, FAR 16.203-2 states, "A fixed-price contract with economic price adjustment may be used when (i) there is serious doubt concerning the stability of market or labor conditions that will exist during an extended period of contract performance, and (ii) contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract." FAR 16.203 also provides that "Price adjustments based on established prices should normally be restricted to industry-wide contingencies. Price adjustments based upon labor and materials costs should be limited to contingencies beyond the contractor's control."

The AIA General Conditions, Form A201-1997, provides in paragraph 4.3.2, that "If the Contractor believes additional cost is involved for reasons including but not limited to ... (7) other reasonable grounds, Claim shall be filed in accordance with this Section 4.3." It also states, "Claims by either party must be initiated within 21 days after occurrence of the event giving rise to such Claim or within 21 days after the claimant first recognizes the condition giving rise to the Claim, which ever is later."

With respect to delays, Paragraph 8.3.1 of that document also states, "If the Contractor is delayed by ... unusual delay in deliveries ... or other causes beyond the Contractor's control ... or other causes which the Architect determines justify delay, then the Contract Time shall be extended" Paragraph 4.3.7.1 provides, "If the Contractor wishes to make Claim for an increase in the Contract Time, written notice as provided herein shall be given. The Contractor's Claims shall include an estimate of cost and probable effect of delay on progress of the Work."

Another material AIA clause is found in Paragraph 4.3.3 of the A201 document, where it provides, "Pending final resolution of a Claim except as otherwise agreed in writing ... the Contractor shall proceed diligently with performance of the Contract"

In addition to contractual clauses, the rights and obligations of the parties in the event of unanticipated materials shortages may be affected by the applicable common and statutory laws. For example, a party may seek relief under the theories of mistake, impossibility, frustration of purpose, or commercial impracticability. As of this writing, however, it is difficult to characterize as "unexpected" the shortage of certain materials or increases in their prices. Therefore, it is more difficult to seek relief unless the law and/or the contract specifically address the issues.

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