Increase in Construction Costs

How to manage material cost increases?

Construction costs have risen steadily over the past 10 years and at a rate much higher than the national inflation rate.

This is largely due to the fact that during this period, trade costs and wage labour rates in building and construction have risen sharply.

However, the increase in the costs of building is not just due to labour costs alone. The price of raw materials represents approximately 60% of the costs of construction in the residential housing sector and these costs have been moving upwards as well.

Steel prices have been particularly volatile. Global steel prices have risen approximately 40% since the start of 2008 alone. HIA expects further sharp increases during the next 6 months.

As a result, many steel suppliers and manufacturers have indicated that will no longer be able to hold fixed prices for the length of any project and that they reserve the right to apply cost increases clauses.

Clearly this issue will not go away.

What does this mean and what are the implications for building contractors?

First what contract are you using?

Two basic forms of contract are used in the construction industry – lump sum (or fixed priced) contracts and cost plus contracts.

Under a fixed price contract the contractor agrees to bear any costs above the fixed price, except for those costs incurred because of variations requested by the client or matters outside the control of the contractor, such as a fire, war, strike or natural disaster.

But what if continuing to perform under the fixed price contract becomes unprofitable?

Even if a rise or collapse in the market dramatically pushes up the price of materials, it is unlikely a Court will intervene and help out the contractor. The argument is that future material price increases should have been contemplated when the contract was quoted. Just as an owner is not able to reduce the amount paid if the price of materials decreases a contractor is not entitled to pass cost increases to the owner.

So when you have entered into a fixed price contract, there are very limited ways increases in the cost of labour and materials can be passed onto the client as the risk rests with the contractor.

Cost plus contracts?

Under a cost plus contract, the client agrees to take on any escalation in prices. The client is charged for the actual cost of construction “plus” profit, which is normally expressed as a percentage of the costs of construction.
Many owners baulk at using cost plus contracts. They want a degree of certainty in knowing how much the job will cost. The flipside is that most prudent builders will factor in anticipated price fluctuations when quoting for a fixed price job. Under a cost plus contract, the owner will only be charged the actual cost of materials. This may in fact, save the client money as there may be a significant difference between actual costs incurred and speculative contingencies included in the fixed price quote.

**Rise and fall clauses**

Another option is to include a price adjustment clause in a fixed price contract. Such a clause enables the contract price to be adjusted when there is a shift in price for a particular material, such as steel or cement.

Any price adjustment or rise and fall clause will have to be carefully drafted with the increase in contract price based on a formula, which will require disclosure of the contracted price of the material with the actual cost. Actual increases will need to be substantiated.

**Restrictions on cost plus contracts and rise and fall clauses in the housing industry**

Depending on the state you are in, you may not be able to use a cost plus contract or rise and fall clause. Such contracts or clauses are banned in some states or have a very restricted use:

The table below shows whether or not you can use a cost plus contract or a rise and fall clause:

<table>
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<tr>
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<th>NSW</th>
<th>QLD</th>
<th>VIC</th>
<th>WA</th>
<th>SA</th>
<th>ACT</th>
<th>NT</th>
<th>TAS</th>
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<tr>
<td><strong>Cost plus contracts?</strong></td>
<td>Not specified, but front page of contract must state that the contract price is not known and provide an explanation why</td>
<td>Prohibited under Act unless certain strict criteria are satisfied -- where the cost of the work cannot reasonably be calculated without some of the work being carried out</td>
<td>Prohibited under Act unless contract value is over $500,000 or where the work to be carried out involves the renovation, restoration or refurbishment of an existing building and it is not possible to calculate the cost of a substantial part of the work without carrying out some of it.</td>
<td>Contract must be headed “cost plus” contract and contain statement (signed by both parties) that Act does not apply.</td>
<td>Permitted provided margin does not exceed 15%</td>
<td>No legislation</td>
<td>No legislation</td>
<td>No legislation but there are proposals to amend.</td>
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<tr>
<td><strong>Rise and fall clauses for the price of materials and labour?</strong></td>
<td>Not banned</td>
<td>Prohibited for contracts under $200,000. Restricted to increases in contract price as a result of delays.</td>
<td>Cost escalation clauses illegal unless contract is more than $500,000 or form approved by CAV. Owner must sign a notice advising of effect of clause.</td>
<td>Prohibited. However, the builder can include a clause in the contract which allows for a price change to cover an increase in actual costs if: (a) government</td>
<td>Not banned. However the contract must contain a warning &quot;THIS PRICE MAY CHANGE&quot; or &quot;ESTIMATE ONLY&quot; adjacent to the price</td>
<td>Not banned.</td>
<td>Not banned</td>
<td>Not banned.</td>
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The above is intended to provide general information in summary form. The contents do not constitute specific advice and should not be relied upon as such. Formal specific advice should be sought by members with respect to particular matters before taking action.

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<table>
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<tr>
<th>Does HIA have a cost-plus contract?</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>No. Special conditions available on request to adapt NSW Cost Plus contract for use in ACT.</th>
<th>Yes</th>
<th>No. Special conditions to convert TAS Domestic Building Contract available on request</th>
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**Other options**

Depending on the nature of the work it may be possible to use provisional sum or prime cost items for specific trades to give an element of protection against cost increases.

**Outlook for the future**

Rising costs for raw materials is not new.

If you would prefer not to, or are unable to, use a cost plus contract or rise and fall clause, the best course of action is to continually review the price of all building materials and factor in any increases into the contract or tender price. Communicating the volatility of the supply market to owners is crucial.

Try and make sure any commitments you have made in a fixed price contract with an owner match those obligations the suppliers have to you.

If you wish to discuss these issues or seek advice, contact your Workplace Adviser on 1300 650 620.

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