Price Adjustment Clauses in Public Works Contracts
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I. Introduction:

A. Asphalt costs have increased 48% since May 2005. (Engineering News Record, Price Escalation is Stuck in High Gear, p.69 (6/26/2006).) Where asphalt supplies are constrained, public agencies see few bidders due to the risks and this problem is especially acute when the contracts lack an escalation clause. (Id.) Diesel fuel prices rose 40% since 2005. (Engineering News Record, Inflation Maintains Strong Momentum, p.67 (6/26/2006).) The average prices for steel in wide-flange, channel and I-beam shapes increased 50% since July 2003. The increase was 14% in the last year. (Engineering News Record, p.23 (7/24/2006).)

B. Unpredictable construction cost escalation presents a dilemma for public agencies. Typical low-bid, lump sum contracts place the risk of inflation on the contractor. Absent a price adjustment clause, competitive bidding laws limit the public agency’s ability to make retroactive price adjustments (See, Greer v. Hitchcock (1969) 271 Cal.App.2d 334.) However, reasonable contractors cannot expose their companies to the risk that material cost escalation during the course of construction will ruin their companies. In an environment of cost escalation, even the low bid likely contains a contingency amount to provide a cushion against future escalation. But, if the escalation is less than anticipated, the public agency still pays for that extra cushion, without any corresponding benefit. Therefore, it may not be in the interest of the public agency for the bidders to inflate their bids in order to provide a cushion against possible future cost escalation.

C. Even where the low bidder fails to build sufficient contingency into her bid, the public agency may suffer the consequences. In some cases, the contractor may default on the contract (sometimes initiated by the default of a key subcontractor) if escalation renders performance impossible. It is not in the interest of the public agency to push contractors into default as a result of spiraling materials costs. At a minimum, project completion will be delayed while the surety arranges to complete the contract. In extreme cases, the cost to complete a project may exceed the penal sum of the performance bond, thus making it insufficient to complete the work. In such case, the public agency could potentially end up with the worst of all worlds—contractor default, followed by delay while the surety brings in a 

1 The opinions expressed here are solely those of the author and do not express the policies of the Board of Port Commissioners or the City of Oakland.
completion contractor (which exacerbates the escalation impact), followed by the agency paying out-of-pocket the difference between the penal sum and the actual cost to complete the work.

D. To reduce the risk of these occurrences, some public agencies have elected to include price adjustment clauses in their public works contracts. The legal principles and practical examples of such clauses are explained in this paper.

II. Legal Background

A. General Escalation Does Not Excuse Performance. With a few rare exceptions, American courts hold a party to its promises, even if the cost of performance increases unexpectedly. This rule has two general exceptions.

1. First, where the unexpected event is of a catastrophic nature such that performance is impossible as a practical matter. This is known by the legal term “force majeure” and typically connotes a major war, natural disaster, or pandemic. Most contracts contain a force majeure clause defining the types of events that will excuse performance. However, general price escalation is typically not included as a force majeure event. Contractors and suppliers bear the risk of general increase in costs even for causes outside the control of the contracting party. (Transatlantic Financing Corp. v. U.S., 363 F.2d 312 (D.C. Cir. 1966); American Trading and Production Corporation v. Shell International Marine, Ltd., 453 F.2d 939 (2nd Cir. 1972). These court decisions illustrate the difficulty of obtaining relief due to a force majeure event. The cases involved shipping companies that had contracted to transport goods to the Middle East in 1967. The shipping companies quoted prices based on transit through the Suez Canal. The canal was unexpectedly closed due to a war between Israel and Egypt. As a result, the vessels were forced to use the far longer route around Cape of Good Hope, at greatly increased cost. The courts held the shipping companies to their promises, finding that performance was still possible, it simply cost more than expected.

2. The second exception is where the contract contains a price adjustment clause. The purpose of a price adjustment clause is to reduce the bidder’s reasonable fear of escalation by establishing a contract mechanism to adjust the contract price to compensate for...
escalation in the cost of particularly volatile commodities. Only the element of the contract price which corresponds to the volatile commodity can fluctuate; the rest of the contract price remains fixed.

a) The form of the price adjustment clause may vary and is within the discretion of the contracting agency. With the exception of the Federal Acquisition Regulations, the law does not prescribe a particular form of price adjustment clause. Generally, the basis of measurement of price fluctuations must not be under the control of the contractor and should reflect an objective standard other than the bidder’s own prices as the basis upon which the price adjustments are to be made. (*Glopack Corporation v. U.S.*, 12 Cl. Ct. 96; 1987 U.S. Cl. Ct. LEXIS 48 (1987).)

b) As with any other contract term, an ambiguous price adjustment clause will be construed against the drafter. (Cal. Civ. C. §1654.)

III. Federal Acquisition Regulations

A. The Federal Acquisition Regulations are inapplicable to local contracts. However, the FAR provide interesting guidance on the use of price adjustment clauses based on a long history of use in federal procurement. (48 CFR Pt. 16, §16.203-1, et seq.) Because the U.S. Government purchases a vast array of supplies in large volumes with multi-year contracts, it has been using price adjustment clauses for decades. They are reviewed here solely to illustrate some concepts regarding the use of price adjustment clauses.

B. The FAR defines three general types of price adjustment clauses:

1. Adjustments based on established prices
2. Adjustments based on actual costs of labor or material
3. Adjustments based on cost indexes of labor or material

C. Price adjustment clause is to be used when:

1. There is serious doubt concerning the stability of market or labor conditions that will exist during an extended period of contract performance; and

2. Contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract. (48 CFR §16.203-2.)
3. The contracting officer determines that the price adjustment is necessary either to protect the contractor and the Government against significant cost fluctuations or to provide an adjustment in the event of changes in the contractor’s established prices. (48 CFR §16.203-3.)

D. Price adjustments based on established prices should normally be restricted to industry-wide contingencies. (48 CFR §16.203-2.)

E. Price adjustments based on labor and material costs should be limited to contingencies beyond the contractor’s control. (48 CFR §16.203-2.)

F. The contract involves an extended period of performance with significant costs to be incurred beyond one year after performance begins. (48 CFR §16.203-4(d).)

IV. Considerations in Development of a Price Adjustment Clause. Whether an Owner is developing its own unique price adjustment clause or choosing to use a pre-existing clause, there are nine issues that should be considered.

A. The Owner should define by policy or contract the category of contracts to which the price adjustment clause will apply. The official or body charged with determining when to include a price adjustment clause should also be identified. Some examples of categories are contracts of a certain dollar amount, duration or which use a particular commodity.

B. The contract should precisely define the commodity or material to which the price adjustment clause will apply. Ideally, the commodity or supply can be isolated into a bid item in a unit price contract. For example, the Port of Oakland utilized a steel price adjustment clause which applied to specific bid items, such as “furnish steel crane rail” and “furnish mooring bollards.” Obviously, the greater the extent to which the commodity is entangled with other materials or components, the less accurate the price adjustment will ultimately be. If the material or commodity in question is not isolated to a particular bid item, additional administrative effort may be necessary to actually implement the price adjustment.

C. For those price adjustment clauses which rely on a commodity index, it is important to choose the appropriate index. If the Owner selects a pre-existing industry index, it should confirm that the sampling program is representative of actual prices in the local area. If the Owner elects to create its own index, then it will bear the administrative burden of selecting the samples and administering the sampling process.

D. The contract or policy should define the starting base-line price or index level. For example, the most recent issue of Platt's Oilgram prior to
the receipt of bids. Ordinarily, the adjustment intervals are monthly and correspond with the pay application process. Longer adjustment intervals are disadvantageous to the Owner because in an extremely volatile market, the cumulative increase in the contract price may significantly erode the Owner’s project contingency. The contractor’s next adjustment request may contain a nasty surprise.

E. The price adjustment clause must set the float range within which the price adjustment clause is not triggered. It is common to specify that no adjustment will be made for price fluctuations of less than 10%. That is, the index must change by more then 10% to trigger adjustment. The parties simply accept this amount of change as a business risk. Alternatively, the index may be used only to invoke the right to an adjustment, but actual quantification may be based on actual amounts paid.

F. The price adjustment clause should specify the amount of price fluctuation which is actually compensable. For example, if the trigger point for an adjustment is 10% increase, and the index price increases by 15%, what amount does the contractor receive? The full 15% or just the amount which exceeds the 10% trigger point? This is potentially a significant issue for the contractor and should not be left to interpretation.

G. Responsibility should be on the contractor to request increases and inform the Owner of decreases. However, do not assume that the contractor’s failure to request an increase when warranted will result in a complete waiver of his rights. Generally, courts are reluctant to find that a valuable right has been forfeited simply by the failure to comply with a contractual time requirement.

H. The policy or contract should specify whether the price adjustment clause is applicable during periods of schedule delay. If the contractor causes an unexcused delay, should he enjoy the benefits of the price adjustment clause during the period of delay?

I. If the project will receive grant funding, confirm in advance that the grant agency has no objection to the inclusion of the price adjustment clause in the contract.

J. The Owner’s project contingency must be carefully planned and managed to account for potential increases in the contract price. Personnel involved in financial management must understand and monitor the increases in contract price throughout the life of the project, especially where funding is split across fiscal year appropriations. (See, Project Management Institute, A Guide to the Project Management Body of Knowledge, Ch. 7 (3rd ed.) and Government Extension – 2000 edition.) For some projects, it may be wise to inform the governing board or council
of the inclusion of the price adjustment clause in the contract and its potential consequences.

K. The price adjustment clause should incorporate a “circuit breaker” which requires the contractor to obtain the Owner’s permission to proceed if the costs escalate beyond a certain amount. For example, if the price of asphalt rises in excess of 25% during an overlay project, the contractor should stop and obtain permission before continuing the work. The Resident Engineer needs to have timely notice if escalation rises out of control and threatens to consume the Owner’s project contingency.

V. Asphalt Price Adjustment Clauses

A. Caltrans Construction Policy Bulletin – October 1, 2005 (Ex. 1.)

1. Applies to materials containing paving asphalt, in projects with at least 4500 tonnes of asphalt concrete or 225 tonnes of paving asphalt and 50 or more working days.

2. Relies on Caltrans’ own California Statewide Paving Asphalt Price Index (see attached)

3. Incorporates 10% float range before adjustment is triggered.

4. Requires the RE to issue a change order at the beginning of work

5. During period of delay, compensation adjustment is determined by index price during month in which delay commenced.

B. New York DOT (Ex. 2.)

1. Eligible work is identified in each contract and applies “throughout the life of the contract.” Possibly, it would also apply during any periods of unexcused contractor-caused delay.

2. Does not apply to change order and force account work.

3. Relies on NYDOT’s index for Performance Graded Binder.

4. Triggered when the PGB index price per unit increases by greater than $10.00/unit.

VI. Steel Price Adjustment Clause (Ex. 3.)

A. Port of Oakland – Berths 32-33 Wharf Rehabilitation Project
B. Applies to designated steel products with corresponding bid items. Mooring bollards and bolts, Steel and Covers for Crane Bus Trench and Utility Box; reinforcing steel, crane rail.


   1. Average of No. 1 Heavy Melt (Portland/Seattle) and Shredded Auto Scrap (Portland/Seattle).

D. Index is used solely to trigger right to adjustment. Actual quantification of adjustment is based on actual price paid by Contractor vs. bid price.

E. Incorporates 10% float range before adjustment is triggered.

F. Only the portion of escalation/descalation exceeding 10% is compensable. The Port and the contractor each accept 10% escalation at their respective costs.

G. Contractor’s responsibility to note price adjustments in monthly pay application when it requests payment for the material in question.

H. Circuit Breaker. If cost adjustment exceeds 25%, Contractor must notify RE and obtain written to proceed with the work.

I. No escalation adjustment during periods of unexcused delay.

VII. Fuel Price Adjustment Clause

A. New York DOT (Ex. 2.)

   1. Bid documents fix reference price for a single liter of fuel (No. 2 fuel oil and unleaded gasoline) which becomes the “fuel index price.”

   2. NYDOT monitors fuel prices based on published refinery or terminal prices in New York, Philadelphia, Detroit and Boston on a monthly basis.

   3. Adjustment trigger point is price fluctuation of greater than $0.03/liter.

B. New Jersey DOT (Ex. 4.)

   1. NJDOT employs a complex fuel adjustment clause which relies on stated assumptions about the fuel consumed by a wide-variety
of construction activities. For example, the specifications list over 40 activities, such as “roadway excavation, earth.”

2. Fuel Price Adjustment = (MF-BF) x G

   a) Where: MF = Monthly Fuel Price Index

   b) BF = Basic Fuel Index (index at time of bid)

   c) G = Gallons of fuel eligible for price adjustment

3. NJDOT determines the monthly fuel price index based on retail prices for No. 2 fuel oil and unleaded gasoline, as established by the NJ Department of Energy.

4. Circuit breaker. If the monthly fuel price index increases by more than 50% above the basic fuel price index, all further work (on items eligible for the adjustment) must be approved in writing by the Executive Director.

5. Float range. Price adjustments are only triggered if the monthly fuel index rises by 5% or more.

C. Montana Department of Transportation (Ex. 5.)

1. Applies to diesel or gasoline when price changes by more than 25%.

2. Applies only to fuel stored and used in vehicles and equipment dedicated to the project.

3. Base line price is the average of the high and low price for the five days before bid opening.

4. Monthly change is based on comparison to average of high and low price on Wednesday of each week in Platt’s Oilgram Price Report for Billings, Montana.

5. The adjustment applies only to the difference exceeding 25%. Contractor absorbs first 25% of increase.

6. Adjustment does not apply to fuel purchases made after the contract time has expired.