

# Subcontractor Methods for Protection from Material Price Escalation

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Contractor's Compass

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Although supply chain issues and material costs gained considerable attention during the COVID-19 pandemic, these are hardly new to the construction industry. Contractors and subcontractors have long grappled with ways to protect themselves from rising material costs and delays in material orders, particularly for long-term projects. There are several effective ways of handling the highly common occurrence of material costs rising during a project and delays or long lead times in material orders.

## 1. Early material purchase and owner payment for material storage

To properly price a project, a subcontractor must know the scope of work and the necessary materials. Because material prices can increase—particularly in multi-year projects—some subcontractors may purchase all necessary materials at contract execution to lock in the quoted price. However, this method comes with its own challenges, as project materials may be voluminous, and therefore expensive to store.

Subcontractors can overcome this expense by including a provision in their contracts that requires the contractor to pay for storage of the materials. This saves subcontractor warehouse space and storage expense while ensuring that the specified materials can be purchased at their quoted prices.

Early procurement of materials can also introduce additional hurdles for design and/or scope changes. Subcontractors should make sure that their contracts are clear regarding who is responsible for costs related to design changes, such as restocking fees when returning materials, disposal of materials that are no longer applicable to the project and cannot be returned, and replacement materials.

Whether and to what extent the contractor will agree on this approach will likely depend upon the contractor's negotiations with the owner. For instance, some owners may not be willing to store (or pay for) swaths of material for years at a time, and some materials cannot be stored for long periods of time. However, where possible, the approach of ordering the materials as promptly as possible with owner and contractor payment for stored materials and storage costs allows subcontractors some insulation from material cost increases. If adopting this approach, subcontractors should be sure to maintain insurance upon the stored materials to protect against casualty while in storage.

## 2. Allow for replacement of specified materials with those of like kind and quality or a corresponding time adjustment if specified materials become unavailable

Certain materials cannot be purchased in advance. For instance, some projects require custom-made products which must be fabricated to as-constructed field measurements. Alternatively, items such as concrete, mixed paints and other chemicals have a shorter shelf-life and should be used upon delivery. Fuel is also not purchased in advance because it is generally purchased on an as-needed basis. Purchasing materials in advance may also impact the availability of warranties provided by manufacturers and/or suppliers.

A subcontractor may protect themselves from situations in which it cannot purchase materials ahead of time by incorporating a clause in their contracts that allows replacement of specified materials with those of like kind and quality. Such a provision allows subcontractors to opt for less expensive alternatives, particularly in cases where specified materials have increased in price, in order to manage project costs without impacting the quality of the work being performed.

Similarly, a subcontractor may include a provision entitling it to time adjustments when the contractor (or owner) requires or prefers a specific product that will be more expensive than a product of like kind and quality. Instead of rush ordering and paying a premium, and/or paying extra due to supply shortages, tariffs, or other force majeure conditions, it may be preferable for the subcontractor to receive a time extension and wait for products to come on what may be a slower-than-standard timeline. Given recent uncertainty over the imposition of government-imposed tariffs and other delays resulting from global conflict, contractors may prefer a time extension to avoid ordering during a potentially temporary price increase.

Inclusion of this clause has the added benefit of providing some protection for subcontractors from liquidated damages or other project delay costs. The clause can be drafted to list or incorporate excusable reasons for delay or substitution, such as supply-chain disruptions stemming from governmental acts, extreme weather, or similarly uncontrollable events. Being able to opt for a comparable product can help a subcontractor keep a project on schedule and budget. Again, however, a subcontractor's ability to negotiate such a clause into its contract with the contractor may be dependent on the contractor's ability to negotiate similar language into its prime contract.

### **3. Include a material price-escalation or time-adjustment clause in the contract**

Some subcontractors include a material price escalation clause in their contracts, which directly insulates them from material price increases. In such instances, the subcontractor reserves the right to charge more than originally quoted when a material price increase occurs.

This option can be unappealing to contractors (and owners) who prefer a fixed project cost. Subcontractors can sometimes reach a compromise with contractors (and contractors with owners) wherein the material price-escalation is only passed up the contract chain once a certain threshold of increase has occurred. For instance, a contract may entitle a subcontractor to a change order or price adjustment only when the cost of specially identified material, product, or equipment has increased by more than three, five, or ten percent since the quote was issued.

The ConsensusDocs® Document 200.1 is a standard material price escalation clause that subcontractors can adopt or add to their contracts for this purpose. More information about that document is available here:

<https://www.consensusdocs.org/contract/200-1-time-and-price-impacted-materials/>.

### **4. A time and materials contract**

The contract form may provide as much insulation as the specific provisions it includes. A subcontractor may opt for a time and materials contract, which is an agreement where the contractor pays the subcontractor for the costs incurred by the subcontractor in performing the work plus a markup for overhead and profit. A time and materials contract ensures payment of labor costs and the actual cost of materials, regardless of price increases. While this provides full insulation from material price escalation, it generally requires the subcontractor to provide detailed records to the contractor to justify costs. Furthermore, subcontractors have to share pricing with contractors, which can limit the subcontractor's discretion to build in profit margins or improve upon anticipated margins through efficiencies during the project. If a subcontractor and contractor agree to payment on a time and materials basis, the contractor would also benefit from any price decreases, however unlikely those are to occur. A subcontractor considering this type of contract must then weigh insulation from material price escalation with these drawbacks.

As the above options demonstrate, there are various ways subcontractors can seek contractual protection against price escalation. Unfortunately, however, regardless of which approach a subcontractor chooses to pursue, the subcontractor may be unsuccessful if the contractor is unable to negotiate similar language or payment mechanisms with the owner. Thus, to the extent possible, subcontractors should raise the notion of price escalation protections with the contractor as early as possible to enable the contractor to broach the same with the owner prior to execution of the prime contract.

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