



ABC STEEL ADVISORY

MARCH 2004

SUMMARY

The construction industry is facing a dramatic surge in the raw material cost of steel, resulting in widespread increases in the price of all steel materials used in construction. ABC member companies are caught in a pricing squeeze, between steel suppliers that have imposed “surcharges” on their products and the construction purchasers, including federal and state governments, which often negotiate fixed priced contracts in their bid specifications.

The volatility of the steel market and the capricious nature of steel as a commodity is affecting the way ABC members engaged in private sector construction must conduct their business. Generally, steel suppliers only guarantee the price of their steel for five (5) days. We have heard, however, from some members who have experienced price increases as often as every 48 hours. This uncertainty in steel price quotes is making the bidding process for ABC members extremely difficult and financially dangerous.

There are a number of market forces, both domestic and international, that are contributing to the drastic price increases our members face today. Increased demand for steel – both here in the U.S. and in China and Korea – have caused the price to increase. The cost of raw materials and other products used to create various types of steel have surged dramatically as well, driving up production costs. China and other countries that supply raw materials have imposed restrictions on their exports. When the depreciation of the U.S. dollar vis a vis foreign currencies is factored in, the result is what some analysts have termed the “perfect storm,” which has created the situation our members face today.

OUTLOOK & ABC POSITION REVIEW

ABC National has been monitoring and researching this sudden surge in steel prices since January of 2004 when the Chairman of our Legislative Committee voiced his concerns. At his request, ABC National met with the President of the Steel Manufacturers Association (SMA; website is www.steelnet.org) to discuss what their group was doing and to see if it would be appropriate for ABC to play a role.

SMA helped found the Emergency Steel Scrap Coalition (www.scrapemergency.com), which will be producing an economic study on the reasons why steel costs have surged and become so unpredictable. The coalition is also drafting a petition urging the Department of Commerce to intervene and impose export controls on domestic steel and scrap. Under section 7 (c) of the Export Administration Act, the Department of Commerce may prohibit or curtail the export of scrap steel if a number of criteria are met, including proving that there is an excessive drain of scarce materials, a threat to national security and that significant harm to the US economy or domestic industries have occurred. This process could take a number of months while Commerce conducts an investigation to see if the requirements under the Export Administration Act have been met. Moreover, there is no guarantee that the Commerce Department would find evidence that satisfies the criteria listed under the Export Administration Act, thus precluding their ability to impose export controls.

Opponents of export controls suggest that this action would impact the Chinese steel industry, causing China to retaliate by further reducing the amount of raw materials they export to the US, and thereby further exacerbating the problem. The United States government currently opposes export controls and taxes maintained by South Korea,

Russia, and the Ukraine on steel, scrap steel and raw material exports. Many believe it would be politically unrealistic for the U.S. to impose a practice it strongly opposes.

ABC's Government Affairs Coordination Committee (GACC) and Legislative Committee met in February 2004 during ABC's National Convention in Hawaii and addressed the steel issue. Based upon information provided to those committees by the SMA, other steel lobbyists, and discussions held by ABC lobbyists with White House and Hill staff, both the GACC and Legislative Committee decided that it would be best for ABC not to support financially the Emergency Scrap Steel Coalition at this time. Both committees felt that the philosophical nature of our association and our core beliefs of free enterprise, open competition and allowing the free market system to run its course were contrary to their coalition's wish to impose export controls.

(Those members who support export controls may contact and join the Emergency Scrap Steel Coalition by visiting www.scrapemergency.com.)

Politically, ABC does not believe the Bush Administration will look favorably upon addressing the steel issue through administrative action considering this is an election year and they just repealed the section 201 tariffs in December of 2003. Moreover, many intimately involved with the steel issue, including other steel lobbyists, commodity analysts and Hill staffers believe that imposing export controls could ultimately be more detrimental in the long term than helpful in the short term.

ABC is meeting with federal agencies, including the General Services Administration (GSA), the Federal Highway Administration (FHWA), the U.S. Army Corps of Engineers and the Office of Federal Procurement Policy urging their acceptance of cost escalation clauses or price adjustment clauses for federal work. ABC urges its members to seek inclusion of price escalation clauses for both current and existing construction contracts. **(See What a Contractor can do - Contract Clauses below)** These clauses would allow a dollar for dollar pass through of the surcharges and steel increases which our members must pay and over which they have no control. Escalation clauses would also help ensure that projects are not delayed and that ABC member companies continue to be competitive.

This document does not constitute legal advice and contractors should seek competent legal counsel regarding their rights and obligations under contract and public procurement law.

WHAT A CONTRACTOR CAN DO

Assess the Circumstances

Contractors should evaluate what products will be affected by the increasing costs of steel. Structural steel beams, cables, fasteners, girders, rebar, metal wall studs, sprinkler pipe, steel mesh wire, steel guardrail and nails are all examples of supplies and materials affected by the cost of steel. Evaluate the current supply and future needs for the products under existing contracts. This risk assessment will help contractors determine what losses might be expected.

Losses may come in the form of increased prices of supplies and materials or delays as a result of unavailability.

Competent legal counsel with construction contract experience should be retained to review current contracts. First, contracts for construction must be evaluated. Fixed-price contracts for construction will have the most severe impact on contractors, so counsel should identify any provisions (such as changed circumstances or equitable adjustment clauses) that could be relied upon to justify contract price changes. Depending on the severity of the market conditions, contractors may argue that conditions have so severely changed that a price adjustment is warranted. However, counsel is necessary to determine a contractor's options. For cost plus contracts, contractors may be in a better position. However, delays are another real possibility and delay clauses should be carefully scrutinized for possible damage claims.

For federal construction contracts, there is generally no relief for a contractor that entered a fixed price contract without a price escalation clause. The Board of Contract Appeals and the Court of Federal Claims have consistently held that a contractor assumes the risk of unexpected costs in the absence of a clause shifting such risk to the government.

Second, quotes or other contract documents from vendors setting fixed prices of supplies and materials need to be analyzed. Suppliers may have provided bids on products that are now either unavailable or have increased significantly in cost. Suppliers may be relying on provisions of the Uniform Commercial Code or the terms of the quote document to argue that fixed prices do not have to be met if delivery was made impracticable by radical changes in the basic assumption about the market when the contract was made.

After knowing more about the legal options, contractors should contact vendors to determine the current market price and any expected increases. Additionally, contractors need to determine if supply is expected to be delayed or reduced. The more information a contractor has the better able it is able to prepare for losses, reduce risks and educate others affected.

In addition to supplies, contractors anticipating the purchase of vehicles and heavy equipment in the near future should consider that the costs of these are expected to escalate as the price of steel increases. If a larger contract will necessarily trigger the purchase or lease of vehicles or heavy equipment, increased prices should be anticipated. Obviously capital purchase schedules might be accelerated as well.

Educate Owners and/or General Contractors

Public and private owners must be educated about the steel crisis. Additionally, subcontractors need to educate general contractors on the implications of the steel price increases and the shortages. Whether contracts provide for the price changes or not, owner education is critical because of the magnitude of price increases and possible material delays.

Where possible, contractors should work to negotiate amicable measures to spread the costs associated with the increased prices or delays of supplies. For price increases, a price adjustment clause is the objective of the negotiations that would be limited to the materials directly affected by the steel price volatility. For delays, an amendment allowing for delays due to supply shortages without penalty should be pursued. **(See Contract Clauses below.)**

For public works, contractors should seek legal counsel about the procurement laws or practices governing price adjustments. Because fix-price contracts are so common in public construction, owner education is critical.

Key points to make with owners and general contractors are:

- Most products made of steel rely on the scrap steel market. The price of a ton of scrap steel fluctuated predictably between 1996 and 2003 (a high of \$155 and a low of \$75). However, from October 2003 to February 2004, the price went from \$150 per ton to \$300 per ton and is expected to continue to climb in the next year.
- Once U.S. tariff restrictions on steel exports were lifted in December 2003, the world market began to gobble up the U.S. steel scrap supply. In particular, China has driven up the demand (currently buying 30% of all scrap steel) and left supply low and prices high.
- Other countries with steel suppliers have implemented steel export restrictions because of their depleting domestic supply, furthering the pressure on the U.S. steel supply.
- Prices of other key commodities (e.g. coke and iron ore) that are involved in the production of steel products are also experiencing price increases, which exasperate the price increases of materials.

Contract Clauses

New contracts should be negotiated that anticipate price volatility and delays, and existing contracts may be amended where all parties agree.

For new contracts, the cost-plus contract may be a good option if a substantial basis of the contract price is reliant on products made substantially of steel. For new contracts or amendments, an escalation clause for materials may be appropriate. A sample of such a clause for price increases is:

“Where the price of material, equipment, or energy increases significantly during the term of the contract through no fault of the contractor, the contract sum shall be equitably adjusted by change order as provided for in paragraph ___ of this Agreement. A significant price increase means a change in price from the date of the contract execution to the date of performance by an amount exceeding ___ percent. Such price increases shall be documented by vendor quotes, invoices, catalogs, receipts or other documents of commercial use.”

To prevent damage claims against the contractor for unavoidable material delays, a sample clause is:

“Where the delivery of materials, including but not limited to [insert specific materials made with steel], is delayed through no fault of the contractor, the owner shall not hold the contractor liable for costs associated with such delay.”

For federal construction procurement, an agency may include an economic price adjustment clause in a Request For Proposal (RFP) when a contracting officer determines such a clause is necessary to protect the government or the contractor against significant fluctuations in labor or material costs. However, a contractor cannot simply add an escalation clause to a bid or contract. The clause must be a provision of the RFP, so educating the government contracting officer is critical at the pre-proposal stage. The economic price adjustment contract provision is provided at FAR 52.216-2. (See also FAR 26.207(c) and 16.203-3.)

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ADDITIONAL BACKGROUND INFORMATION

THE SECTION 201 SAFEGUARD

On March 5, 2002 President Bush announced his plans to impose a section 201 temporary safeguard measure on imports of foreign steel. The 201 measure, which was originally set to stay in place until 2005, placed tariffs of up to 30 percent on all major steel imports, which were previously duty free. The President’s program sought to give the domestic industry temporary relief from the flood of imports and the breathing space it needed to survive and restructure. Many steel companies had already gone bankrupt due in part to the enormous legacy costs incurred for their retired workforce. Others were in desperate need of facility modernization. The 201 was designed to give American steel producers time to engage in major restructuring, more cost effective labor negotiations and consolidation within the industry.

On December 4, 2003 following the release of a World Trade Organization (WTO) Appellate Body report affirming an earlier determination by the WTO Dispute Settlement Body (DSB) that the US Section 201 steel tariffs violated world trade rules, President Bush repealed the 201. The European Union had said that it would impose retaliatory duties on \$2.2 billion worth of US goods if the safeguard remained in place after a final confirmation of the WTO ruling. The Bush Administration contends that they ended the tariff program ahead of schedule because the tariffs had already achieved their desired affect, not because of the WTO ruling and possible future trade war with the EU.

ECONOMIC REASONS FOR STEEL PRICE SPIKE: CHINA

Despite the varying hypotheses for the recent spike in steel prices and the complicated set of domestic and international factors, the majority of stakeholders recognize one common problem: The Peoples Republic of China. Since the mid 1990’s when China devalued their yuan by almost 80 percent and then pegged it against the U.S. dollar, there has been a massive shift in the manufacturing of steel, away from the United States to China. Due to the devaluation of their yuan, the United States trade deficit with China increased to \$125 billion in 2003.

Moreover, China’s sharp economic growth has led to an insatiable appetite for steel. China’s enormous consumption of steel has placed an incredible strain on the global raw-material industry. At the same time, China, which has

traditionally been a source of low-priced coke, has placed restrictions on the amount of coke they can export. Chinese coke prices have increased from \$55 per ton to almost \$300 per ton today. The sharp increase in the demand of raw materials for steelmaking, including coke internationally and scrap steel domestically, has resulted in increased costs for domestic steel companies.

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