Owners Perspective

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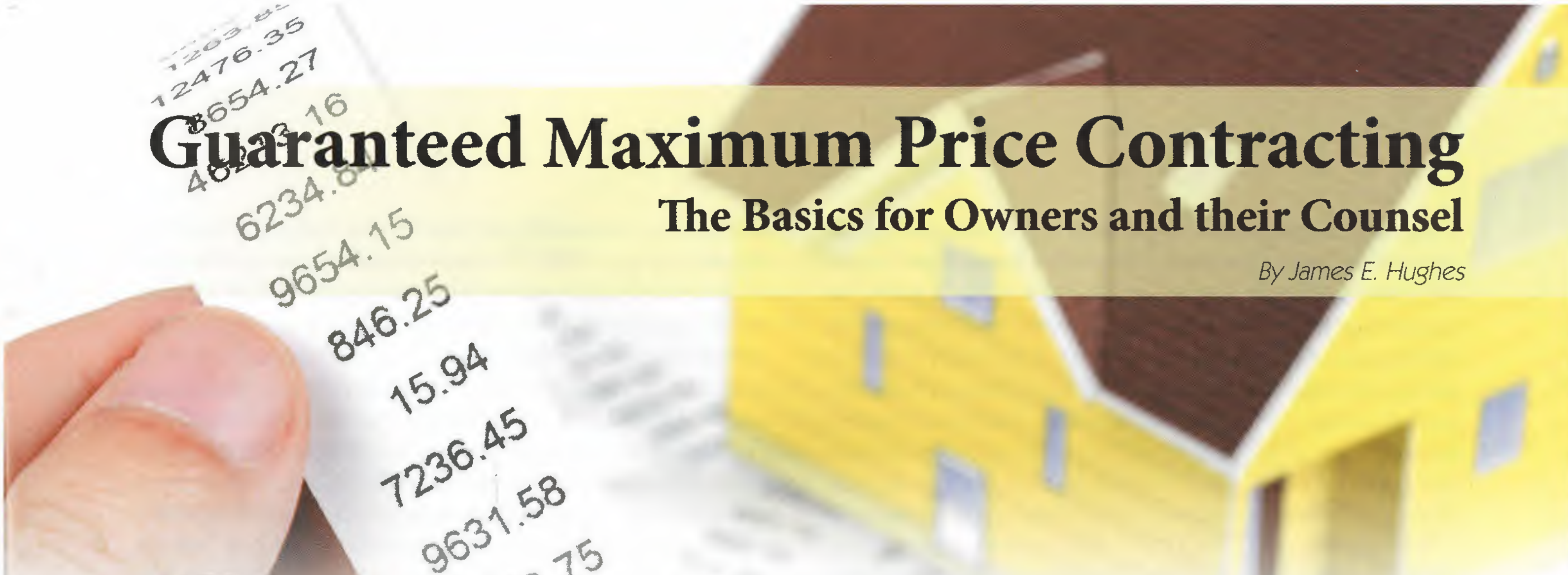

Guaranteed Maximum Price Contracting

The Basics for Owners and their Counsel

By James E. Hughes

Construction services are often procured by soliciting bids based upon a completed set of contract documents. This method of procuring construction services is referred to as Design-Bid-Build (DBB). It usually employs fixed pricing as the main pricing method. DBB with fixed pricing is generally accepted as a reliable way of ensuring a competitively priced project.

Different procurement models and pricing methods are generally available. For example, Construction Manager at Risk and Design-Build are procurement methods that commonly employ a Guaranteed Maximum Pricing (GMP) method to establish the amount to be paid to the builder. Even Design-Bid-Build is not restricted to use of fixed pricing.

Here, we'll explore the use of the Guaranteed Maximum Pricing method and its main features.

Overview of Pricing Alternatives: The following are common methods for pricing construction work.

- **Fixed price:** The work is performed for a fixed price. Every dollar the builder saves during construction drops to the bottom line, creating a powerful incentive to work quickly and efficiently. Since builders of lesser integrity may cut corners and shortchange the owner, the owner should conduct real-time project inspections to verify that the work is performed properly. Since the fixed price is commonly paid in installments allocated on the percentage of work completed, real-time inspection is also used to determine the percentage of completion for payment purposes.
- **Time and Materials (T&M):** This is also known as "Cost of the Work, Plus a Fee" or "Cost Plus". The builder is reimbursed for labor and materials plus a fee for profit and overhead. There is less incentive to work quickly and efficiently because the builder bears little cost risk. For the same reason, the builder is not incentivized to consider lower-priced subcontractors. In addition to monitoring the work for budget and quality control purposes, the owner must audit costs to determine eligibility for reimbursement.
- **Guaranteed Maximum Price (GMP):** The work is reimbursed on a time and materials basis, with the builder agreeing to complete the work without additional payment if a fixed price ceiling is reached. The builder agrees to accept the lesser of the actual cost of the work plus a fee, or the fixed ceiling amount. This model is a hybrid of lump sum and time and material. It allows an owner to enjoy both budgetary certainty and the benefit of any cost savings. When properly administered, it provides flexibility for work that cannot be fully specified at the start of construction or is subject to another constraint that precludes use of DBB. Guaranteed Maximum Pricing requires significant sophistication and additional resources to administer in a disciplined fashion.
- **Disciplined Procurement:** When using DBB, the work being bid should be fully specified. The description of the work, as set forth in the plans and specifications should be straightforward and unambiguous. If the plans, specifications, and related contract documents are properly prepared, bidders will have a common understanding of the work to be performed. Well-prepared contract documents also increases the likelihood of receiving bids with fewer errors.

DBB maximizes the owner's bargaining position and should nearly eliminate the time and expense needed to negotiate a construction contract. DBB is said to create an adversarial relationship because a low bidder cannot afford to absorb the cost of contract ambiguities. However, the problems resulting from poorly prepared contract documents are universal to any procurement or pricing model.

Properly administered projects require the involvement of design professionals with relevant experience advising the owner through to completion of construction. Design professionals are usually paid a fixed fee established near the beginning of the relationship and do not share either the risk borne by a fixed price builder or the profits a competent builder might enjoy. The design professional should be contractually obligated to the owner to assist in monitoring the project and addressing issues related to the design as they arise.

Disciplined procurement is required under any procurement or pricing model. The following are additional concerns applicable to the use of GMP pricing.

Key Considerations for GMP

Construction Manager v. GC: In many respects, once construction starts, a Construction Manager (CM) on a GMP project is essentially the same as a GC.

General Performance Standard: GMP contracting is sometimes used by an owner who prefers to work with a specific contractor from the outset. A benefit of this approach is the contractor's greater participation in the development and design of the project which should result in less of a basis to claim a misunderstanding during the construction phase. Express language should be included in the contract obligating the contractor to produce a finished result that complies with the stricter of either the general project program or the reasonably inferred requirements of the plans and specifications.

When to Fix the GMP: GMP contracts are commonly executed in two parts. The first agreement, entered into early on, describes the services of the contractor acting as a design phase construction manager. During this phase, the construction manager provides cost estimating services, advice on alternate construction methods and materials and specialized administrative support. The first agreement usually provides a lump sum or hourly fee for services up to commencement of construction.

The second agreement is usually an addendum to the first agreement and fixes the GMP. It essentially results in a construction contract with the GMP pricing feature. The GMP should be established well ahead of the start of construction, before the owner loses the ability to consider other contractors. If a GMP cannot be agreed upon, a properly administered GMP project should be convertible to DBB project delivery through subsequent completion of plans and specifications and solicitation of bids. Where possible, keeping this option alive enhances the Owner's bargaining position.

Fixing the GMP while the owner still has a strong bargaining position usually means that the GMP is established well before the plans and specifications are fully complete. For this reason, a statement of assumptions and clarifications, commonly referencing a set of partially completed design development drawings, a statement of the project program and other terms and conditions, is included in the second agreement. The strength of commitments made in the second agreement is driven by the assumptions and clarifications, which should be carefully considered.

The second agreement should also include the construction manager's cost breakdown showing how the GMP is calculated. The cost breakdown will play a central role in determining eligibility of costs for reimbursement during construction. The owner's interests are better protected if the second agreement contemplates further refinement of the GMP and the cost breakdown before construction starts, since these adjustments will reflect the refinement of the scope of work as the plans and specifications become more complete.

Termination for Convenience: The first phase agreement should expressly provide an easy method by which the owner can terminate the relationship for convenience, strengthening the owner's bargaining position.

Construction Manager's Contingency is not Owner's Contingency: Fixed price competitive bidding assumes that the contract documents are free of material errors and ambiguities in specifying the scope of work. A competitive low bidder cannot be expected to freely absorb additional costs resulting from unclear or poorly prepared contract documents. Thus, owners commonly budget contingency funds as a cost-effective alternative to the substantially greater cost required to produce error-free plans and specifications.

The cost breakdown included in the second part of the agreement that fixes the GMP often includes a "construction manager's contingency", an amount that serves as a buffer between the construction manager's estimated cost and the GMP. The CM's contingency normally does not cover errors in the contract documents or unforeseen conditions that are otherwise eligible for additional compensation via change order.

The CM's contingency should not be confused with the owner's contingency, which is an amount maintained by the owner to provide additional compensation to the construction manager, should a significant error or unforeseen condition requiring additional work be revealed during construction. Obviously, this is more desirable than a work stoppage due to lack of funding. A contractor will not normally invade their own contingency when the cost can be imposed upon the Owner due to errors in the contract documents. Merely requiring Owner's approval to spend CM contingency, without express guidelines and conditions, is of little value and can create misleading assurance that the contingency is protected. If the contractor's contingency is expected to absorb costs due to errors in the contract, language shifting such risk to the contractor must be included. This may be difficult to obtain. Additional language should make clear that unused contingency is retained by the Owner and results in a lower final contract price.

Bidding at the Subcontractor Level: Bidding a project to a GC on a fixed price basis requires the GC to assume the risk of subcontractor performance. Placing this risk with the GC provides significant value to an owner. The GC's ability to submit a winning bid is heavily dependent on his subcontractor and supplier relationships. This includes his understanding of the strengths and weaknesses of each subcontractor, his ability to enhance subcontractor performance with skilled support, the ability of the GC and subs to work with each other and the goodwill a GC can engender through the likelihood of future work. A GC submitting a fixed price bid is making subcontractor selections that balance the benefit of a lower-priced sub against the risk of failed performance. A reputable GC who selects a lower-cost sub is likely willing to work closely with and support the sub to assure timely and proper performance. GMP contracting reduces the GC's risk related to subcontractor performance. This is because the GMP price is usually derived from the sum of subcontractor informal bids rather than the lump sum bids of competing contractors. The owner and GC will tend to choose the most reliable subcontractors and the resulting higher price will be built into the GMP.

Real-Time Cost Accounting: The initial agreement should carefully specify those costs of the construction manager which will be eligible for reimbursement by the owner. The construction manager should certify that all costs submitted to the owner for reimbursement meet the cost criteria set forth in the initial agreement. The construction manager should be obligated to maintain books and records in an auditable form for the owner's review, and the owner should conduct real-time auditing of the monthly payment vouchers. Establishing the eligibility of costs in real-time is more effective than doing so retroactively, and knowing that costs are being audited reduces the temptation for abuse.

Use of Sub-GMPs: Sometimes additional sub-GMPs may be used, particularly for any work self-performed by the construction manager, which usually includes general conditions work. A sub-GMP is similar to the GMP except that it pertains to a subset of the overall work. The subset is included in the overall GMP.

Shared Savings: A shared savings clause provides that any amount remaining between the cost of the finished project and the GMP will be shared on a percentage basis between the owner and the construction manager. Some suggest that shared savings may incentivize a construction manager to pursue greater savings. Alternatively, such language can increase a construction manager's incentive to negotiate a higher GMP and contractor's contingency at the outset. To the extent that a contractor retains a portion of the contractor's contingency after the completion of 100 percent of the contract documents, a shared savings clause might only serve to grant a portion of the contingency to the contractor at the outset. This author generally recommends that owner's carefully consider whether a shared savings clause will serve their best interests.

Bonding Subcontractors: Construction Managers sometimes include the cost of surety bonds guaranteeing subcontractor performance in their cost breakdown. This cost, plus the construction manager's markup for profit and overhead, is borne by the owner. In lump sum contracting, GCs commonly forego bonding of subcontractors and assume this risk. Whether or not subcontractor bonding will be required should be considered early on in the process of selecting a construction manager.

The Construction Manager's Fee: The initial agreement should clearly specify the costs that are included in the construction manager's fee and thus are not reimbursable. An apparently favorable percentage fee might be the result of permitting separate reimbursement of significant overhead items one might not have expected. When comparing proposals from different construction managers it is important that such terms are clear. For this reason, it is usually best for an owner to provide a proposed agreement as part of an Request for Proposal (RFP) process if this method of soliciting proposals is being used.

Labor Burden: Reimbursable personnel expenses should be carefully defined, since standard form GMP agreements generally provide only an abbreviated description of reimbursable labor burden. "Usual training, education and holiday benefits" or "usual bonuses" can vary significantly from firm to firm.

Reduction of GMP at a 90% Buy Out: GCs generally seek to "buy out" a job once it is under contract with the owner. This means that the GC will enter into agreements with its subcontractors and suppliers as soon as possible to avoid price fluctuations once the overall price is fixed with the owner. One method that accelerates savings is to require 95% of the GMP to be reduced to the actual cost under contract as of a 95% buyout. Since a 100% buyout may not occur until late in the project, a percentage is used that should be achieved relatively early in the construction phase (90% or 95%). Further reduction at a 100% buyout might also be provided for.

Standard Forms: The American Institute of Architects (AIA) provides both construction manager and GC agreements that employ GMP pricing. Forms are also available from ConsensusDocs and the Engineers Joint Contract Documents Committee. These forms should be modified to fit the interests of the parties and the project. If an owner proffers a modified form at the outset, whether through competitive bidding or a RFP, he or she is more likely to achieve desired terms while expending less time and expense in negotiations. This will also benefit the prospective construction manager or GC by providing a clear understanding of the owner's expectations at the outset.

A Position of Strength

An owner's bargaining position is often a function of their capacity to seek alternate prices. Bargaining position is always strongest at the outset of a project. An owner should address the issues raised herein proactively and early on, when they are in the best position to do so.

James E. Hughes is a partner at the Syracuse-based law firm of Hancock Estabrook, LLP. Mr. Hughes has practiced construction law for more than 30 years, representing owners, contractors and design professionals. He can be reached at jhughes@hancocklaw.com.