“Contract Pricing and Payment”

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by

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I. Contract Pricing

Lump Sum or Fixed Price

A lump sum or fixed price contract typically sets one price for the entirety of the scope of work. The price is established before the work begins. This lump sum or fixed price can be established pursuant to competitive bidding or negotiated between the owner and contractor.

Structure

A lump sum or fixed price contract typically has one amount placed in the contract to cover the entire compensation to the contractor. Contracts of this sort quite often have built in arrangements for procedures for change orders to cover changes requested by the owner or unexpected changes in the scope of work encountered by the contractor. The contract itself may include a mechanism for pricing change orders. For example, it is not unusual to have a set unit price for certain kinds of work to be done on a change order basis. Or, the contract may be silent on the pricing for a change order and thus require negotiation between the owner and contractor as to an acceptable basis for compensation for the extra work. Often, the owner and contractor cannot agree at the time the change order is requested on the amount of compensation

and this can lead a contractor to do the work reserving its rights to pursue a claim later for the amount of compensation to which the contractor believes it is entitled.

Special Issues

Probably the most significant special issue associated with a lump sum or fixed price contract involves the contractor's assessment of risk associated with completing the work for a contract price. Stated another way, an experienced contractor knows that when it is responsible for a given scope of work and will only be compensated at one set price, the contractor must build into that price a certain amount of risk for unknown circumstances that may affect contractor means and methods yet would not entitle the contractor to additional compensation. To account for this unknown amount of risk, the contractor typically increases the amount of the lump sum or fixed price by some percentage to "cover" this unknown risk. If the unknown risk does not materialize, the contractor makes additional profit. If the unknown risk does materialize but within an amount that had been quantified by the contractor, the contractor ultimately receives in compensation what it thought it would receive. If the unknown risk is greater than originally anticipated or quantified at the time of bid or contract inception, the contractor receives less profit and may, in fact, incur a loss for the work.

While an owner may feel there is security in a lump sum or fixed price contract, such contracts often lead to requests for compensation for extra work (in the form of a change order). This often leads to claims by contractors for

additional compensation and disputes over whether the contractor is entitled to more money. Thus, while the owner initially anticipated stability in the contract price, the end result may be exactly the opposite.

As a result of the large number of potential claims and litigation often associated with lump sum or fixed price contracts, the construction industry in the last several years has explored in earnest alternative methods to compensate the contractor including many discussed below.

Unit Price

A unit price contract compensates a contractor at a set, agreed-upon amount for each unit of work performed. An example could be $20/per ton for each ton of rock removed from the construction site. Unit pricing works well when the scope of work items can be clearly defined and are repetitive. Unit price contracts have the contractor profit and overhead built into the established unit price. Sometimes unit price contracts are at a set amount for a certain magnitude of work and then at a different amount for additional work that exceeds that magnitude. Compensation for the additional work could be more or less depending on the type of contract and the nature of the work.

Structure

A unit price contract is relatively easy to structure. It simply is an agreed amount of compensation for unit of work. Typically, there are fewer disputes over the compensation because the price has been agreed upon even though the total amount of compensation is in flux.

Special Issues

Owners often are concerned in a unit-price contract about how much contractor overhead and profit is included in that unit price. Accordingly, owners want to know whether they in fact are receiving a "fair price" for the work performed. Competitive bidding from multiple contractors is a frequent occurrence for contracts based on a unit price. This allows an owner an opportunity to determine the true, fair market price for the work to be performed and provides the contractor with some comfort that if his bid is the lowest, the owner more easily can accept the price as being reasonable.

Owners typically are concerned in a unit price contract about the magnitude of the total compensation to be paid to the contractor. Often, the quantity of work is unknown and thus the owner may have to pay far more to a contractor than initially anticipated. Owners are often more comfortable with a unit-priced contract when the quantity of work can be established before the work begins.

As referenced above, unit-priced contracts are sometimes contained as a default mechanism within a larger contract for certain types of work to be performed by a contractor (such as pursuant to a change order) or when other methods of compensation could not be agreed upon in advance. Therefore, it is not unusual to see smaller components of a large scope of work being performed on a unit-price basis while the larger contract is on some other basis such as a lump sum or fixed price.

Guaranteed Maximum Price (GMP)

A Guaranteed Maximum Price (GMP) contract, as the name suggests, establishes in theory the highest amount that an owner will pay a contractor for specified work to be performed. Numerous large construction projects over the last 20 years or so have used a GMP as a measure of compensation.

Structure

Typically, a GMP contract contains a designated amount (say $1 million dollars) that is the maximum the owner will pay the contractor for the work. However, a GMP contract inveribly includes other pricing components. For example, it is very common for a GMP contract to provide additional compensation to the contractor if the work is completed for less than the established GMP. An example could be that the owner and contractor share 50/50 in each dollar that the final contract price is below the GMP. This provides an incentive to both the owner and the contractor to bring the work in below contract price.

By contrast, some GMP contracts establish that if the contract price in total exceeds the GMP, the additional money must be made up by the contractor. In other words, for each dollar that the contractor spends in excess of the GMP, that dollar comes out of the contractor's pocket. This method of compensation can create tremendous risks and burdens on a contractor.

Special Issues

In theory, GMP contracts sound attractive to both the owner and contractor. The owner has some assurance that the contract will not exceed a

certain price. The contractor typically has an incentive to bring the contract in below the GMP and will receive additional compensation for doing this. In reality, however, GMP contracts have often resulted in substantial disputes between the owner and contractor and inevitably costly litigation. Often a contractor is not able to complete the work within the established GMP for a variety of reasons which leads to claims and disputes.

In addition, because of the very nature of the risks associated with the GMP, a contractor must spend considerable time at the bid stage or the pre-contract stage understanding carefully the scope of work and establishing with care the correct GMP.

Time and Materials (TM)

A time and materials (TM) contract is similar to a unit price contract in that an established rate is agreed upon between owner and contractor for time spent on work and an additional compensation rate will exist for materials purchased by the contractor. The time component can be broken down by the type of employee and can or cannot include compensation for "burden" items such as fringe benefits, retirement plans, overhead and related items.

Structure

The time and materials contract is somewhat simple to create in that there is literally an established price for the time and an established method of compensation for the purchase of materials. The time component is typically negotiated and can involve some detailed discussions and analysis of what makes up a fair method of compensation for contractor time. By contrast, the

materials component of compensation often consists of the contractor's actual cost for the purchase of materials and some additional markup for contractor overhead and profit. For example, a time and material contract could be at $25/per hour for each hour of contractor work plus reimbursement for actual contractor cost for materials plus 8% to cover contractor overhead and profit.

Special Issues

A time and materials contract, at least in theory, reduces substantially disputes between owners and contactors as to the method of compensation. Since the cost to do the work has been agreed upon, disputes are largely reduced to whether the contractor has efficiently completed its work and appropriately accounted for the cost for the purchase of materials. Much like a unit price contract, a time and materials contract can be open ended as to the final total amount of compensation to be paid for work to be performed.

A time and materials contract will often exist when the entirety of the scope of work is not known when work begins or cannot be quantified in advance. Time and materials contracts also work well when the owner is not certain how much work it wants a contractor to complete in any given stage and for an owner who wants maximum flexibility to terminate the work at various points in time.

Contractor risk is substantially reduced in a time and materials contract because the contractor already knows it will be compensated for each hour of work performed and therefore does not have to be as concerned about

unforeseen site conditions or other unexpected circumstances that would increase the amount of time necessary to complete work.

Cost Plus

A cost plus contract is similar to the time and materials contract in that it establishes a rate of compensation for contractor cost and additional compensation beyond that contractor cost. Many recent contracts have been based on some form of a cost plus for contractor compensation.

Structure

A cost plus contract requires careful consideration of what components constitute the contractor "cost". This typically involves negotiations, sometimes lengthy negotiations, between owner and contractor. Accordingly, a cost plus contract generally is not the product of a competitive bid but more typically is a private contract between the owner and contractor. Considerable attention needs to be spent on what items will be included to determine cost (such as consumables, small tool) and what items are not included in cost (such as general and administrative cost, and executive compensation on an oversite basis).

Special Issues

A cost plus contract often exists when an owner and contractor have either an established relationship of having worked on projects in the past, or are willing to engage in considerable trust at the pre-contract stage. This will facilitate an open dialogue between the owner and contractor as to what a contractor's true costs are and what items both owner and contractor feel

should be part of contractor compensation. Provided there is open communication, this type of contract often expresses a truer picture of what the costs actually are for work performed and what is a fair measure of compensation.

By contrast, the contractor is relieved of the burden of determining with great accuracy the total price for the contract. The risk component that is inherent in a lump sum or fixed price contract generally does not exist in a cost plus contract.

Cost + Overhead + Profit

More and more, contracts involving substantial amounts of construction contain as a pricing mechanism cost + overhead + profit. As with a cost plus contract referenced above, it is critical that the owner and contractor establish what items will make up contractor cost and what items will not be part of contractor cost. This typically involves considerable negotiation. Once the method of determining cost is established, an additional rate is applied for contractor overhead and an additional rate for contractor profit. These three components make up the pricing compensation to contractor.

Structure

A cost + overheard + profit contract often details considerably what items make up cost. From there, it is mostly a matter of math to determine the additional overhead and profit since they are both typically based on a percentage of cost. Negotiation between contractor and owner establishes what

the cost, overhead and profit numbers will be, once these are set, the actual numbers then used in the contract are relatively simple and straight forward.

Special Issues

These contracts, while deceptively simple in determining mathematically what the compensation will be, are remarkably complex in establishing what is the cost and then what percentage will be the overhead and what percentage will be the profit. It is not unusual for accountants to get involved in reviewing in detail contractor books and records to ascertain contractor costs and typical overhead and profit margins as a basis for determining the agreed-upon measure of cost and overhead and profit for the contract in question. It is also not unusual for contracts of this sort to contain elaborate provisions by which the owner can periodically review contractor cost as work is being performed to verify the accuracy of such cost.

This type of contract only works well when the owner and contractor have open communication and have established a level of trust that allows for an unusually broad exchange of financial information.

Contracts of this sort often blend features from the GMP contract by providing contractor incentives. These incentives can be based in part on establishing a target price for all work to be performed. This target price is arrived at by consensus between the owner, contractor and typically the design team to determine based upon all information available what they estimate will be the actual total cost for all scope of work items. This becomes the target

price. From this, incentives can be created for the contractor to complete the work at less than contract price and to be awarded accordingly.

In addition, cost plus contracts often involve establishing a matrix of key performance indicators, known as KPIs. These KPIs provide additional financial incentives for the contractor and can often allow for an increase in profit or a decrease in profit depending upon the level of achievement of the KPIs. Typical KPIs are safety, schedule, minority participation in the contract work, owner satisfaction, and meeting the target price or project budget. This method of compensation to contractor involves extra bookkeeping and is probably best utilized in large contracts that may take up to several years for the work to be completed. The larger expenditure of time and effort can justify a more elaborate method of compensation to contractor.

II. Payment

Both owners and contractors have a variety of methods at their disposal for payment. Examples include:

Payment at Fixed Intervals

Many contracts involving smaller scope of work items require the owner to pay a fixed percentage at the time of entering into the contract (for example, 50% down) and then the remainder of the amount due at the time of substantial completion or final completion. This method of payment works well with lump sum or fixed price contracts where the total compensation is well established at the pre-contract stage. As construction projects get larger, however, this method of compensation is seldom used.

Progress Payments

Construction projects today more typically involve progress payments. A progress payment can be based upon a percentage of work completed by the contractor. This percentage then entitles the contractor to a like percentage of the total contract price. Progress payments can work well when there is a very defined scope of work and a defined total contract price. Accordingly, the contractor's percentage of completed work can be measured against established KPIs.

By contrast, progress payments do not work as well when based on a percentage of work completion for unit price contracts or cost plus contracts as the total contract price is generally not known and thus there is no established way by which to measure a percentage of completion.

Cash Neutral

Cost plus contracts often involve contractor estimates for work to be performed within the next 30 days. The owner pays based upon that contactor estimate. In this sense, the contractor is "cash neutral" in that the contractor receives money in advance for work to be performed over the next 30 days. This allows the contractor to continue to maintain the cash flow without having to spend out of pocket for construction services. The estimates are then reconciled the following month with actual expenditures by the contractor.

Larger construction projects that involve multiple tasks and will be of an extended duration often base contractor payment on a cash neutral concept.

This does require more accounting, however, and more overall supervision by both the owner and the contractor.

Milestones

Many construction contracts apply milestone dates or events to establish when a partial payment will be made. For example, when a foundation is poured and completed, the contractor will receive $100,000. While the payment for achieving a milestone may not exactly equal the amount of money expended by the contractor, it does provide a defined basis and expectation as to when a payment will take place. Clearly defining milestone payments generally lessens disputes about when payments are due and generates greater understanding between the owner and contractor about contractor performance and owner expectancy.

Substantial Completion

No construction contract can exist without some discussion of substantial completion. Although there are many definitions for substantial completion, it often is defined as that period in time when the contractor has sufficiently completed the work such that the owner may use the work for its intended purpose. When substantial completion is achieved, contractors typically are entitled to all contractual payments required under the contract, minus any agreed upon retainage until final completion. Thus, a payment schedule typically includes the concept of some form of payment at the time of substantial completion. It is important that the owner and contractor clearly

understand and define what will constitute substantial completion and what money is due at that point.

Final Completion

When a contract is completed in a workmanlike manner and final completion has been achieved, typically the contract requires the release of all remaining money that otherwise is due to the contractor.

Retention

Retention refers to that amount of money that is withheld from any particular payment by the owner. Typically, it is an agreed-upon percentage of money that is otherwise owed. For example, when the contractor pours the foundation and is entitled to a payment of $100,000, the contract may specify that 5% of that amount or $5,000 is withheld from payment to the contractor. Thus, this $5,000 is the retainage. Retainage typically, per the contract, is released at the time of either substantial completion or certainly by the time of final completion. Retainage is the owner's best form of leverage over the contractor that work is performed in a satisfactory manner.

Retainage often exists in lump sum or fixed price contracts but is becoming less of a pricing mechanism in cost plus contracts which are based more on payments as a contractor performs work and less on retaining some arbitrary amount of money until a future date. Missouri's retainage statute limits owner retainage in many construction projects – both public and private – to 10 % of each progress payment. See Chapter 436 R.S. Mo.

Non-Payment

Contracts typically provide additional compensation to the contractor in the event of non-payment. This can include interest at an agreed upon percentage or as required by law. In Missouri pre-judgment interest on an ascertained amount of money that is due and owing runs at 9% and for construction projects can be up to 18% per year. Contracts also may include an attorney fee provision that provides that in the event the contractor has to seek recovery for non-payment, if the contractor prevails it is entitled not only to the unpaid amount do, but also to interest and attorney fees.