Understanding Contractual Pricing Arrangements – Fixed Price, Cost-Plus, and Guaranteed Maximum Price

A central part of any construction contract is the pricing and payment arrangement. Owners and contractors may utilize many different types of arrangements depending on the circumstances of the project. Budget concerns, certainty of cost, time and schedule constraints, and the type of construction are all factors that impact that selection. This article outlines the most common pricing arrangements for construction contracts and discusses the advantages and disadvantages of each. Selection of a pricing arrangement is an important decision for owners and contractors alike and should be given fair consideration on each project.

Fixed Price / Lump Sum / Stipulated Sum

A fixed price contract, also known as a lump sum or stipulated sum agreement, is likely the most common pricing arrangement for a construction project. A fixed price contract is most suitable for a project where the architect and engineers have prepared the plans, specifications, and other construction documents to a point sufficiently complete such that a contractor can provide a reasonably accurate cost estimate. The owner will often provide the construction documents to multiple contractors for competitive bidding and award the construction contract to the lowest responsible and responsive bidder. This project delivery method is commonly referred to as “Design-Bid-Build.”

A variation of this system is the “Design-Negotiate-Build” system. Under this system, the owner will similarly provide reasonably complete construction documents to one particular or a few select general contractors. The owner may seek preliminary estimates from the contractors and then choose to negotiate a lump sum contract with one of the contractors, basing its decision not only on the estimate, but also the qualifications, experience, and reputation of the contractor.

From an owner’s perspective, a fixed-price contract has the advantage of limiting exposure and liability for the costs of construction. Barring unforeseen conditions, changes to the scope of the work, or other circumstances that may be set forth in the agreement, the contractor is obligated to complete
the work for the agreed upon contract sum and, conversely, the owner is not required to pay for any of the contractor’s cost overruns. As a result, the owner may be able to predict the total building cost with reasonable certainty. This is often important for securing a construction and permanent loan.

However, due to the fixed nature of the contract sum, a contractor typically builds a contingency in its bid in order to protect itself from any such cost overruns and other conditions that will not be recoverable from the owner. As a result, the owner may end up paying more money to the contractor in the event that those contingencies are unrealized and the contractor is able to complete the project for a sum significantly lower than the accepted bid amount.

A traditional design-bid-build approach with lump sum pricing may create other potential problems for the owner. For example, the design team may not be sufficiently knowledgeable about constructability issues, current construction costs, or other factors that may require a redesign and/or reduction to the scope of the project. Accordingly, the project may experience delays to the completion of the project as the design team revises the construction documents, preventing the contractor from proceeding with the work.

Lump sum pricing may also cause an indirect decrease in the overall quality of the work. If a contractor is obligated to complete the project for a stipulated sum and will be liable for any cost overruns, it may acquire a “cheaper is better” mentality. The general contractor may decide to choose an inferior subcontractor that may not be as skillful or diligent in its work as opposed to a more-qualified subcontractor with which the general contractor is more familiar. As a result – although not necessarily – the quality of the work on the project may suffer.

Another drawback to the traditional design-bid-build system is the potentially longer timeframe for overall completion of a project. Since the owner cannot secure a reasonably accurate bid until the design is relatively complete, the owner typically cannot award a contract to a general contractor until later in the process. As a result, the construction work may not be able to start until later and may lead to a delay in the completion of the project.

Cost-Plus

Under a cost-plus arrangement, the owner agrees to pay the contractor the actual costs of construction of the project plus a predetermined fee, which may be in the form of a stipulated amount or a percentage of the construction costs. In such an arrangement, the owner will not select a contractor based on a specific price in a bid proposal, but rather on other factors such as the contractor’s experience, reputation, ability, and proposed fee.

Such an arrangement may be particularly suitable for situations where the owner desires to involve a contractor in the design and preconstruction stages of the project. The contractor can provide valuable services such as a feasibility analysis, estimating, and value engineering to help the owner
develop and maintain the program and scope of the project within the owner’s budget, schedule, or other constraints. A cost-plus contract may also be appropriate when the owner wants to commence preliminary phases of construction (i.e., sitework, underground utilities, foundations, exterior shell, etc.) in a fast-track process, but has not sufficiently completed the design for the rest of the project.

Although a fast-track process may certainly bring with it the benefit of an earlier completion of the project, it may also bring with it increased construction costs. Since the general contractor will commence earlier stages of the construction before the entire design is complete, it may encounter conflicts that must be resolved after the work has been performed (rather than on paper before the work begins). These redesign and rebuilding costs, because of a late-realized conflict, may bring with them delay to the construction schedule. If these delays become increasingly significant, any schedule benefits from the fast-track process may be completely lost.

Another significant concern in a cost-plus arrangement from the owner’s perspective is the fact that the construction costs are not capped and the owner may be liable for open-ended and indeterminate construction costs. Moreover, the contractor may have little incentive to reduce costs on the project because the owner is obligated to pay the contractor for all of the costs of construction. In fact, in a cost-plus arrangement with a percentage-based fee, the contractor will earn a greater fee if construction costs increase because the contractor’s fee increases in proportion to the higher costs of construction. The owner may be able to address this situation by basing the contractor’s fee on a fixed sum rather than a percentage of the construction costs since the contractor’s fee is then unaffected by the actual costs of construction.

Guaranteed Maximum Price

A variation of a cost-plus contract is a guaranteed maximum price (“GMP”) agreement. Essentially, a GMP is a cost-plus agreement with a cap on the owner’s total liability for the costs of construction of the project. The owner is obligated to pay the contractor for the actual costs of construction up to a certain sum. If the construction costs exceed that sum, the contractor is liable for the cost overruns. The contract may provide, similar to a cost-plus agreement, that the contractor’s fee is based on a fixed fee or a percentage of the construction costs. Another common arrangement in a GMP is a shared savings clause, whereby the parties agree to split the savings if the actual costs of construction are less than the agreed upon GMP. These types of agreements protect both the owner and the contractor and thus have become extremely popular. The owner’s liability is capped at the GMP and may receive back a percentage of the savings on the project. The contractor, on the other hand, will be paid for all of its costs on the project, assuming that the costs do not exceed the GMP. The contractor is further compelled to reduce its costs on the project by the potential of sharing in the savings with the owner.

Although there certainly are numerous advantages to using a GMP pricing arrangement, there are accompanying risks as well. Since a GMP is typically a negotiated sum, the contractor may be
tempted to overestimate the GMP in order to minimize and reduce its risks. Although the owner is only obligated to pay the contractor for the actual costs of construction plus the negotiated fee, a higher or inflated GMP will protect the contractor in the event that costs are greater than anticipated. Additionally, if the contractor is able to increase the GMP during the negotiation stage, it may be able to enhance the potential for increased profits through a shared savings clause. An inflated GMP will make it easier for the contractor to bring in the project below the GMP and, therefore, increase the amount of money earned through its percentage of the shared savings clause.

If the GMP is developed early during the design and preconstruction stages, there is a possibility that the owner and contractor may disagree about what is in fact included in that sum. Changes to the design and scope of the project may affect the costs of construction and drive the cost of the work above the GMP. Therefore, owners and contractors should ensure that the terms of the GMP are clearly defined. At a minimum, the GMP agreement should establish which construction documents the GMP is based on, and the procedure for incorporation of subsequent changes to the scope of the project and adjustments to the GMP. Specifically, the owner and contractor should determine whether subsequent clarifications, design changes, or revisions to the construction documents will result in an increase to the GMP or whether they are contemplated in the originally agreed upon sum.

Unit Price

An owner and contractor may agree to structure the contract on specified unit prices for the estimated quantities of the work. Unit price contracts are somewhat more common on public works, engineering, and road building projects. In a unit price arrangement, the contractor is able to provide the owner with a specific price for a particular task or scope of work. However, the actual quantity or number of units may be undetermined or unknown. Accordingly, the owner agrees to pay the contractor only for the actual units that the contractor provides, installs, or constructs on the project. These arrangements are particularly well-suited for repetitive or easily quantifiable tasks such as removal or placement of soil, rock, or concrete. On the other hand, a unit price agreement is rarely suitable for a complex construction project. On vertical-building construction projects, as opposed to road-building or engineering projects, the contractor’s tasks typically involve the coordination of multiple trades and successful completion depends on a number of factors. Because of the number of activities and trades involved, it may be difficult to provide a reasonably accurate unit price for the work. However, the owner may incorporate unit pricing for alternates or to establish a specific price for certain changes to the work. For example, the owner and contractor may agree to a lump sum agreement and provide a stipulated unit price for additional linear feet of a certain wall type, added door openings, etc.

A unit price agreement provides benefits to both owners and contractors. The owner will only pay for actual quantities performed, supplied, or constructed on the project. Thus, if the estimated quantities
turn out to be greater than the actual amount of work required on the project, the owner will only pay for those actual quantities. This system may help to eliminate or reduce the inclusion of general contingencies that protect the contractor in the event that its quantity estimates are inaccurate. Ultimately, this may result in lower costs of construction for the owner.

On the other hand, a lump sum contract protects contractors in the event that the anticipated quantities or units are underestimated. Any overages in quantities or units are paid to the contractor at the agreed upon unit price rate. Therefore, as long as the contractor provides sufficiently accurate unit pricing, he should be protected and fully compensated for the work performed on the project. Unit pricing obviously requires detailed records of the actual work performed in order to ensure accurate invoicing and payment.

Conclusion

Construction industry participants should be aware of the different types of pricing arrangements that are available for their construction contracts. The type of project, the relationship between the parties, and other market and industry factors may lead to the logical selection of one form over another. However, no one single method is necessarily right or wrong for a particular project. Industry participants should consult an attorney when drafting and negotiating construction contracts to determine which pricing arrangement is appropriate and sufficient to protect their interests on their projects. Careful and thorough planning before the award of a contract can lead to the selection of a fair and balanced pricing arrangement.