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What is the Price of this Construction Contract?

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I had a conversation about a price term used in construction contracts that I thought the person I was talking with should have known. When I reflected on that conversation, I realized that it has taken me some time to understand the terms used in construction contracts and that others may like to see a review of certain contract terms. This article will address pricing terms and provide some benefits and concerns about each.

Lump Sum/Stipulated Sum

This is likely the most basic way to price a contract. The party providing the work agrees to perform all the work for a specific price. The party buying the work agrees to pay a specific price for all of the work.

A benefit realized by the paying side is knowing exactly how much will be paid. The party providing the work may realize increased profits by controlling costs and less intense record keeping is likely required which can further reduce overhead and increase profitability.

A problem with this type of pricing for the paying side is the potential for the party providing the work to cut costs in an effort to increase profits. This concern can be addressed in other contract terms; for example, allowing for audits or over site of the quality of work provided.

A problem for the party providing the work arises if the estimate that lead to the agreed lump sum was low resulting in lost profits or actual out of pocket losses on the contract.

As with all pricing terms, the parties must carefully define the work so that each knows exactly what is being done for the amount paid.

Cost Plus a Fee

This pricing situation results in the amount being paid for the work being equal to the total actual costs of the work plus a fee for the party providing the work.

Problems arise in determining the “costs” and the amount or method of calculating the fee. For example is equipment needed to perform the work a reimbursable cost and is the fee based on the amount of the costs.

The party purchasing the work can benefit from lower costs than the estimate but the party providing the work may have no incentive to control costs if the fee is tied to the cost of the work.

The person buying the work must carefully review documents requesting payment to ensure that they are only paying the costs defined in the contract and to ensure that they are paying for costs actually incurred in performing the work.

Guaranteed Maximum Price ("GMP")

GMP is the term that precipitated this article. This provision should usually be included with a cost plus a fee pricing scheme to ensure that there is an upper limit on the amount to be paid.

In this contract-pricing situation, the party providing the work guarantees that the party buying the work will pay no more that the GMP for the completed work. This sort of sounds like lump sum pricing. However, the GMP usually includes a calculation of savings. The savings is the difference between the GMP and the cost of the work plus the fee paid to the party providing the work.

Generally, the party buying the work receives the full benefit of the savings. However, the party buying the work can offer a portion of the savings to the party providing the work as an incentive to complete the work for less than the GMP.

We hope that this review of price terms in construction contracts can help you negotiate future contracts to your benefit.