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COST-PLUS GUARANTEED MAXIMUM PRICE CONTRACTS

*This article summarises the key aspects of Cost-Plus Guaranteed Maximum Price ("**CPGMP**") contracts which must be examined when considering whether such a contract is appropriate for a project.*

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Overview

Pure cost-plus contracts are rare in many markets. However, cost-plus is more common as a method of calculating interim payments in contracts whose outturn cost is capped by a Guaranteed Maximum Price ("**GMP**") or target cost mechanism. CPGMP contracts are typically used where time pressure requires the letting of a contract before design development (or the analysis of some other major variable) is sufficiently advanced to allow a conventional lump-sum price to be fixed, and where financing or other constraints preclude the use of alternatives such as a two-stage contract or construction management.

Key aspects of CPGMP contracts are the definition and control of: (1) the GMP and its attendant cost savings/sharing mechanism; (2) cost; and (3) the fee uplift. All three are crucial: the typical funder or developer will always wish to achieve savings in actual cost/fee against the GMP, recognising that any initial GMP is likely to represent a sum in excess of the underlying true cost. Upside sharing alone (e.g. splitting savings against the GMP 50/50 with the contractor) gives the appearance of such an incentive, but may fail to deliver the reality. Contractors generally prefer to agree to receive 100% of a loosely defined cost than 50% of the saving which may be achieved by defining cost and fee more tightly.

The GMP Mechanism

The GMP itself is simply a monetary value which caps payments to the contractor. It should be accompanied by exclusive remedies wording of the kind used in conventional EPCs to prevent the contractor asserting parallel claims for damages, quantum meruit payments, etc. The GMP should be subject to adjustment in circumstances broadly comparable to those which justify changes to a lump sum price, for example employer variations and other risks whose financial impact is accepted by the employer.

In cases where the allocation of a risk to the contractor would be arguable in a lump sum context (for example, material price or exchange rate fluctuations), there may in theory be more scope for persuading a CPGMP contractor to absorb the risk within the GMP on the basis that the GMP is a "softer" number into which he must have built contingencies for risks of that kind. The prospects of winning such an argument depend on factors such as the rigour with which the GMP is interrogated before signing, the definition of cost and the size of the fee.

Cost

Contractors may argue that the employer in a CPGMP contract is sufficiently protected by the GMP to allow cost to be reimbursed on a completely unconditional and uncontrolled basis. Few employers or funders are persuaded by that argument. As mentioned above, real savings against the GMP are likely to be assisted by strict cost definition and control rather than by upside sharing alone.

In addition, the GMP protection is to some extent illusory. In theory, a contractor who manages to expend cost-plus fee equal to the whole of the GMP while completing only 10% of the work remains liable to complete the remaining 90% for no further payment. But that would represent a significant bet by the employer/funders on the credit strength of the contractor, and recovery on any termination would probably be further limited by liability caps and limited bond values.

In theory, payment should be based on vouchers or other evidence of actual cost. Most main contractors will in any event subcontract the bulk of the work, so that evidence will consist of subcontract invoices or payment records. Rights of retrospective cost auditing and spot checking should always be reserved, as well as approval/open book rights in relation to subcontracting.

The Fee

It is customary to pay the contractor a fee in addition to his costs (but normally subject in the aggregate to the GMP) in order to cover profit, head office overhead and risk. The fee is normally expressed as a percentage of cost. In some contracts the total amount of the fee is capped at a maximum cash value, or the percentage is reduced where the cost figure exceeds a certain threshold. It is advisable to list the items covered by the fee in order to avoid double counting between the fee and cost. In addition to gross profit and head office overheads (the latter meriting its own definition also), the fee might be stipulated to cover some of the financial risks absorbed by the contractor, such as tax increases and other changes in law and material price or currency fluctuation.

In certain circumstances it may be appropriate to deny the contractor any fee on a given cost item or (more realistically) to pay a reduced fee. An analogy can be found in FIDIC where certain claim events entitle the contractor to cost without profit. The adjusted fee is likely to be paid in many circumstances where cost is payable without any corresponding increase in the GMP, or where no extra economic value is generated.

Design

The CPGMP approach is often symptomatic of a less than normal degree of design evolution prior to signing. Close attention to the design development provisions in the contract is therefore merited.

Conclusion

There are many other issues which must be examined in detail before negotiations are complete and a CPGMP contract is signed, including but not limited to contingencies, reserves, sectional GMP, definitions such as prime and design costs, cost estimates, insurance recoveries, and overall risk allocation (to which CPGMP lends an altered overall perspective). A clear and comprehensive CPGMP contract is an effective tool in construction contracting in certain circumstances, but must only be used where close and well informed analysis confirms it as the appropriate choice.

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