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‘Cost-plus’ contracts’ true costs not obvious

Such deals offer benefits, but the devil’s in the details

Most major commercial building and condominium projects sprouting up in the area are done under “cost-plus” contracts. Rather than negotiate a lump-sum price for the construction, an owner under this type of contract agrees to reimburse the contractor for its costs and pay a fee for profit and general overhead, usually a set percentage of the costs. Typically, the cost and fee payments to the contractor are subject to a cap (i.e., guaranteed maximum price, or GMP), over which the contractor is not entitled to any additional payments unless a change or increase in the project scope occurs.

What advantages do cost-plus contracts have? The most common reason for using a cost-plus contract is that it facilitates contracting and even proceeding with construction when the design is not completed.

Theoretically, an owner and contractor could contract for a project on a lump-sum basis without a completed design. But the contractor would understandably want to include a guaranteed contingency amount in the lump-sum price due to the unknowns about the design. Cost-plus contracts are intended to avoid this automatic risk premium to the contractor.

With the owner committing to pay the contractor’s costs, the contractor gets risk protection, and the owner

LAW

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avoids automatically paying a contingency for a risk that may never materialize. So far, so good – but the devil is in the details.

An owner may expect that the contractor’s general overhead and profit will come exclusively from the fee portion of the contract sum and that the contractor’s costs to be reimbursed will be its true costs. This may or may not be the case, depending upon how costs are defined and calculated under the contract.

Many times, the contractor’s costs include elements of additional profit, which may not be recognized by the owner – particularly when assessing the reasonableness of a contractor’s fee or in comparing proposals made by different contractors.

For instance, a contractor’s actual labor costs should certainly be reimbursed under a cost-reimbursable contract. However, questions may arise as to whether the cost of bonuses, general safety programs and the like should be allocated to the reimbursed labor burden and, if so, at what rate.

Additionally, some portions of the labor burden, such as unemployment insurance costs, cap out at certain income levels so that the labor burden is not usually a static number. Depending upon what elements of general costs are allocated and the burden figures used, labor costs charged to the project may exceed the contractor’s actual costs.

Also, many times, for simplicity’s sake, contracts will specify the labor rates to be charged on the project rather than requiring the labor cost – including burden – to be calculated based upon the contractor’s actual costs. What may be gained in efficiency and ease of cost calculation may be lost if the agreed labor rate exceeds the contractor’s true labor costs – even with full burden.

Insurance cost is another fertile area for hidden markup in the name of reimbursing costs.

In today’s climate of insurance limitations and increased costs, many contractors offer owners contractor-controlled insurance programs or other insurance coverage at a percentage of the project cost. Usually, these insurance rates result in a significant profit potential for the contractor over its actual costs – particularly on a retroactive basis if project claims are few.

Even in the absence of special project-insurance products, a contractor’s specified rates for its own liability coverage or subguard insurance may exceed its actual cost so that additional profit is realized outside the fee.

Any time a contractor self-performs work or charges rent for its own equipment, the potential exists for profit and overhead payment outside the fee. The contractor will insist that the owner should be satisfied if the cost for rental or self-performed work is competitive in the market. This may be true, but the embedded profit for contractors on these cost items should be recognized and taken into account by owners in assessing the contractor’s fee proposals. Prudent owners will want to put the issue on the table in contract negotiations.

A contractor must receive a fair return on its work, taking into account the many risks of a typical construction project. Also, many owners are unconcerned about profit to the contractor outside the fee if the overall cost of the project is reasonable and pencils out financially.

However, transparency in assessing the contractor’s true costs and profit is usually the best policy for both the contractor and owner.

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