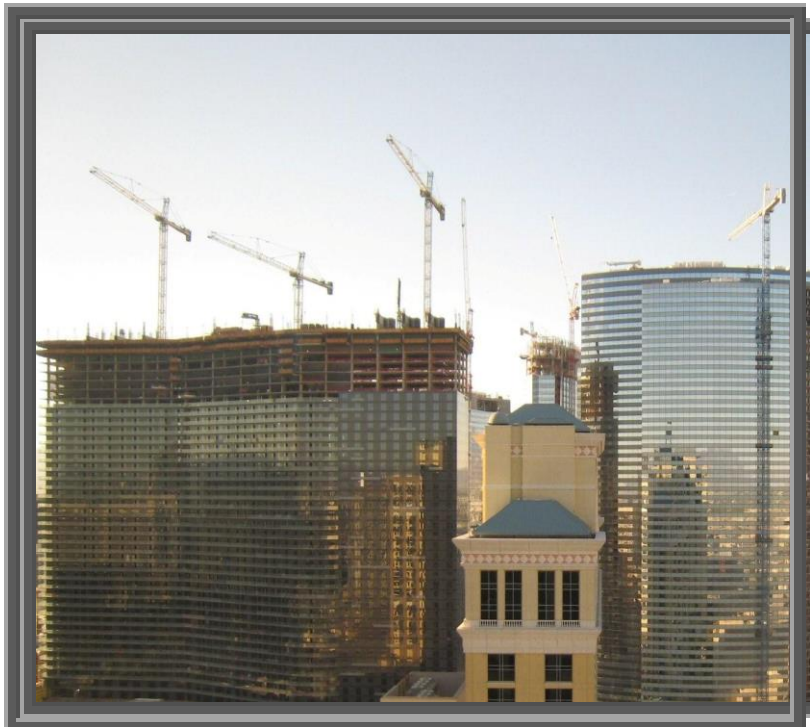


# Construction Audit and Cost Control Institute

## Use Caution Before Converting GMP Contracts to Lump Sum Contracts



In many situations, there are advantages for Owners and CM/GC's to hire key subcontractors based on qualifications rather than on traditional competitive bidding. For example, many Owner's and CM/GC's enter into negotiated "design assist" agreements with major subcontractors such as mechanical, electrical or window wall subcontractors. These contract arrangements often involve "design assist" services which allow the subcontractor to be part of the "team" during the design stage of the project before the plans and specifications are finalized.

Since the plans and specs are not finalized when these "partner" subcontractors are initially hired, the parties usually agree to "negotiate" a guaranteed maximum price after the plans and specifications are finalized.

(Note: The fee percentages for home office overhead and profit are usually pre-agreed upon when the design assist agreements are initially entered into.)



Before converting your Cost Plus Fee with Guaranteed Maximum Price (GMP) contracts or subcontracts to Lump Sum, you should consider the potential economic downside of such conversions...

With a negotiated cost plus fee with a GMP type contract, the advantage to an Owner is that any savings under the agreed upon guaranteed maximum price accrues to CM/GC and then to the Owner. (In some cases, the contracts will provide for sharing the savings with the subcontractor as an incentive to control costs. For example, the Owner may agree to pay the subcontractor a savings bonus equal to 25% of the cost savings realized up to a maximum of 1% of the GMP.)

Rather than leave these subcontracts as cost plus fee with GMP contracts, some Owners and CM/GC's have elected to "convert" their negotiated cost plus fee with GMP subcontracts to fixed price

subcontracts where all savings would accrue to the subcontractor in the same manner as a competitively bid fixed price subcontract.

In some cases the subcontractors offer the CM/GC a "contract price reduction" as an incentive to convert the GMP contract to the fixed price contract. For example, they may offer a discount of ½% or 1% or even 2% off of their proposed contract GMP. Or they may say that they will reduce their proposed contract price by the amount of cost accounting that they will be able to eliminate since they won't have to prepare monthly cost supported payment applications. They may also indicate that the Owner can also save the cost of auditing their cost records at the end of the job.

In one \$50 million subcontract contract example, by not converting to lump sum, the Owner realized an additional \$4 million in savings over the \$1 million in savings offered



Before Owners agree to these types of GMP conversions to fixed price contracts, we recommend they consider the following examples:

1. On one \$50 million cost plus 7.5% fee GMP subcontract, the CM/GC and their cost estimating consultants indicated that they had thoroughly reviewed the subcontractor's proposed GMP price and they were satisfied that the price was fair and they recommended that the Owner "convert" the subcontract to a fixed price subcontract for the proposed \$50 million. The Owner had the subcontractor's price proposal independently reviewed by their own cost control consultants who raised several questions about the pricing which resulted in the subcontractor agreeing to reduce their proposed price to a fixed price contract of \$49 million. (This would have resulted in an immediate cost savings of \$1 million or 2% of the previously proposed contract price). However, the Owner's construction cost control consultants recommended that they leave the contract a cost plus fee with a GMP type contract and perform a cost verification audit at the end of the project. When the project was finished and the subcontractor's costs were audited the actual reimbursable cost plus agreed upon fee amounted to only \$45 million resulting in a \$5 million savings accruing to the Owner rather than the previously offered \$1 million savings that the Owner would have realized if they had converted the GMP contract to a fixed price contract. (Note: The Owner's cost to perform the final close-out audit of this subcontract was approximately \$50,000.)



“Negotiated GMP contracts often have significant opportunities for savings to be achieved due to the non-competitive nature of the original GMP pricing.”

2. On a non-competitively bid \$4 million cost plus 15% fee with a GMP subcontract, the CM/GC let the subcontractor bill the Owner as though the contract was a fixed price subcontract. When the Owner conducted their contract close-out audit of the CM/GC's records they discovered that this subcontract was a cost plus fee contract rather than a fixed price contract. Therefore, the Owner requested the CM/GC to have the subcontractor prepare their final accounting of their cost plus fee which would then be audited. The subcontractor then submitted a final cost accounting of their cost plus fee which according to the subcontractor amounted to only \$3.5 million rather than the \$4 million which they have previously billed. The Owner's audit review of the subcontractor's final accounting and related records revealed that the subcontractor's final accounting included approximately \$500,000 in questioned costs plus fee. The final agreed upon cost savings to the Owner amounted to \$750,000 after all of the questioned cost issues were negotiated. (Note: The Owner's cost to perform the final close-out audit for this subcontract was approximately \$15,000.)

In both of the above case examples, the Owner would have missed the opportunity to realize significant savings if they had converted these subcontracts to lump sum rather than leave them as auditable cost plus fee with GMP type contracts. Negotiated GMP contracts often have significant opportunities for savings to be achieved due to the non-competitive nature of the original GMP pricing. When early conversions to lump sum contracts are contemplated, it is difficult for the Owner to realize the maximum potential savings due to the remaining unknowns at the time of the conversion.