

# Yours, mine, ours

## Offloading all risk risks raising the price

**G**OVERNMENTS – DESPITE BEING large customers – generally pay more for what they buy than the private sector. One possible reason may be the growing tendency to allocate all risk to the supplier rather than determining what is yours, theirs and should be shared. This is particularly evident in the area of construction procurement where many risks must be allocated between the parties including design, environmental, weather, planning, labour-relations and labour availability related risks.

Understandably a municipality would want to insulate itself against such risks to the maximum extent possible, particularly where the project involves a type of construction with which the municipality has little experience. Limited relevant experience is common since many construction projects contemplate one-of-a-kind facilities – at least from the municipality’s perspective. The goal in allocating risk to the contractor is to secure “price certainty,” but arbitrarily allocating risks to the contractor becomes a serious risk to the buyer.

In a construction project, risk may be defined as the possibility of economic gain or loss relating to a particular aspect of the construction process. Every risk has an associated cost that must be borne by one party or another. Every risk assigned to the contractor will increase the price charged to the buyer for the project. Simply stated: Price to the customer = supplier’s cost of supply + risk assumed by the supplier + profit.

Moreover, current market conditions within the construction industry may worsen the problem. Price competition is limited in a seller’s market, which means that the buyer will likely pay a hedging cost when risk is assigned to the contractor. If the probability of a particular type of risk arising is low, then the cost of having the risk assumed by the contractor is likely to be disproportionate to the benefit obtained.

Many uncertainties arising from construction (such as hidden site conditions and weather related risks) present risks that contractors are in no better position to manage than is the owner. Some risks are more easily dealt with by the owner than by anyone else, such as design related risks where the contractor is not the designer, as well as risks relating to factors within the owner’s control such as delays resulting from site inspection by the owner’s consultants.

Ideally, the risks in a construction project will be divided among the stakeholders – owners, design professionals, other professionals and contractors – on the basis of who would best manage the risk in question. The term “manage” means to anticipate, price for, and avoid or mitigate the risk. Government contracts often assign risk with little consideration of best management. For instance, where a municipality reserves the right to vary the volume of supply (in a contract for goods or services), or to terminate the project – a decision that is entirely within the municipality’s control – additional risk is created for the supplier. Even though the risk of the municipality buying less than the original order is slim, suppliers naturally increase the price to reflect that risk.

To avoid paying more as a result of unrealistic or uniformed approaches to risk allocation, it is important for municipalities to access and gain a greater understanding of the range of risk allocation alternatives available within the construction market. A variety of alternative project delivery systems have evolved to reduce the owner’s risk exposure and when employing one of these standard models, risk will be allocated in a rational manner.

In the traditional government-construct approach design deficiencies and changes pose a high risk to the owner. Under a construction management approach, the construction manager (CM) assumes some of these risks. If the project is completed successfully, the CM is compensated for assuming and managing the risks in question. In a design-build arrangement, more risk is allocated to the contractor since the contractor takes responsibility for design. However, the “price” to the owner is that the owner has less control over the design process and must detail its project specifications to a far greater extent. Problems arise when a contract is written that gives the municipality the best of all worlds.

Some aspects of risk allocation appear relatively uniform, irrespective of which project management system is employed. Growing evidence suggests that risks relating to *forces majeure* events are best shared between the contractor and owner. In some cases, risk is best insured (e.g., in relation to property damage). A realistic approach entails identifying which party’s insurers will provide insurance at the lowest cost.

The assignment of risk for design adequacy varies depending on the type of delivery system. In traditional design-bid-build, the owner warrants the adequacy of the design and can manage that risk through retaining a highly qualified design professional and providing adequate scoping information and fair compensation.

Unrealistic allocation of risk also gives rise to hidden costs, such as reducing both the number and quality of those who will participate in the competitive process: Frequently, the contractors best placed to deliver the construction project on time and within budget (and who naturally seek to avoid taking on high-risk work) will elect not to bid for the contract. These suppliers are also the least likely to perform their work badly. Unrealistic allocation of risk may limit the municipality to second (or lower) tier contractors and may also increase the risk of deficient performance.

Many municipalities tend to over-focus on the price of a contract, undermining efforts to allocate risk responsibly. Where a low bid is received from an inexperienced or smaller contractor, the bidder may lack the financial resources to absorb the risks allocated to it, should they arise. A low bid may mean that the contractor who submitted the bid did not realistically assess the risks associated with the contract. Should serious problems occur, the municipality will receive a claim. While it may be entitled to reject that claim under the terms of the contract, the contractor may then cease to perform or go out of business. Even if costs are successfully passed back to the contractor, any hope of an on-going cooperative relationship will evaporate, resulting in unanticipated cost consequences in terms of reduced quality, late completion, and reduced building functionality as well as probable increased legal costs.

Do not assume that a court will accept an unreasonable allocation of risk. The court may read down what it considers to be unreasonable contract conditions, particularly where the allocation of risk was hidden under a blanket of lengthy and detailed contract provisions. For instance, if on a design-build project the terms of the contract

appear to pass to the contractor the responsibility for any errors in the municipality's own performance specifications or design criteria, the court may disregard the strict wording of the contract, unless this unusual allocation of responsibility was made clear to the contractors bidding for the contract.

Municipal owners need both to understand and evaluate their selected project delivery system so as to identify and allocate appropriately each risk relating to a given contract. The system selected should be chosen based upon a careful evaluation of its compatibility with the municipality's needs, priorities, and capability. Risk may often be dealt with effectively by building into a contract incentive plans that contemplate payments tied to the successful management of specific risk consequences or conditions.

The risks related to a contract are efficiently allocated when each of them is assigned in the manner that will lead to the lowest aggregate cost to the parties. A number of common mistakes in construction contracting in relation to risk that tend to lead to higher prices for government work include:

- The assumption that risk under a construction contract may be efficiently allocated in the same manner as under a sale of goods contract. Numerous differences between sales and construction contracts make a typical sales allocation an inappropriate model for construction. In a sales contract, an existing product is sold to a customer and the actual performance capacity of that product is known at the time of delivery. Construction deals with the sale of a future product and eventual performance may only be estimated. Timely delivery of construction products cannot be estimated with the same precision possible with those goods produced on an assembly line basis.

- The use of a tender or RFP process lends itself to a situation where, as part of the contract documentation, risk is allocated by municipal "back office" staff who may well have too little understanding of the price implications of the allocations made. In contrast to the private sector, there is little opportunity in a contract competition to negotiate a more efficient allocation of risk.
- Time is often of the essence in government. Where a municipality insists that the contractor complete within a rigid deadline or pay a liquidated damages penalty, the contractor will factor the anticipated penalty for delay into the price that is bid. The result is that the municipality pays a higher cost for construction, even if the project is completed on time. The extra cost is hidden – unless one compares public sector costs with private.
- Certain types of construction models increase the risk level to both parties. For example, where a long-term commitment (e.g., an extended warranty) is introduced into the construction process, the level of risk is increased, inevitably increasing the price of the contract.

At the end of the day, municipalities (and other governments) may be large customers, but they are only customers. Contracts that look good from the customer's perspective are not necessarily contracts that work in the customer's best interests. Arriving at a fair allocation deal usually proves more economical than a one-sided deal. *MM*

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