GUEST ARTICLE

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PRICING LUMP SUM DELETIONS: PRINCIPLES AND GUIDANCE

Pricing deductive changes to a lump sum contract can be like trying to unscramble an egg. Contracts frequently provide detailed requirements for valuing extra work, but all too often omit a methodology for pricing scope deletions. Deletions to lump sum contracts are particularly problematic because owners are rarely entitled to look behind the total lump sum price, at a contractor's actual costs. Notwithstanding the inherent difficulty in pricing these types of changes, Canadian case law provides surprisingly little guidance for dealing with this kind of dispute.

Due to the dearth of Canadian jurisprudence on this issue, this article canvases American case law to provide an overview of the commonly accepted guiding principles that courts have relied on when weighing disputes related to deductive changes to lump sum contracts.

Bruner and O'Connor on Construction Law has said that the general approach "is to price deductive changes based on the reasonable cost of performing the deleted work". Thus, the starting point for the analysis should be the contractor's actual costs.

In *Appeals of Fru-Con Construction Corp.*, the court found that any contract price deduction should be based on the amount the contractor reasonably would have spent to perform the deleted work**,** *i.e.*, the contractor's net savings. The overriding principle appears to be that the contractor should be left in the same position it would have been in had the deductive change not occurred. This requires that the cost to the contractor, not the price to the owner, be the basis of the credit.

Where available, it is tempting for owners to use a project's "schedule of values", or similar breakdowns in bid documents, to price deletions of work packages that appear in that document. Courts, however, have recognized that such practice is inherently problematic, as these imperfect work breakdowns (generally used for progress payments) contain all kinds of costs included in the contractor's overall price, such as time related indirects and overhead, that may not relate to the deleted scope. For example, in *Contracts Management Inc. v. Babcock and Wilson Technical Services Y–12 LLC*, the court found that even where a subcontractor was required to provide a balanced bid, its cost breakdown could not be relied upon:

> … the court finds that CMI distributed its key personnel, labour, and management costs among the five proposed waterline sections in order to avoid an unbalanced bid. These costs related to the total duration

> of the project, but CMI plan to work on multiple water lines at the same time. As a result CMI could not and did not isolate these costs for each of the five
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> water lines individually. Instead, CMI distributed the overall management and labour cost of the entire project between the five line items.

So how do you determine "actual cost" for work that has necessarily not been performed? Certainly, if the parties are dealing with unit price work, this would be uncontroversial. But for non-unit price work, determining a contractor's actual costs often leads to disputes.

Where the deleted work involves repetitive work — similar work that has already been performed on the project — the contractor's actual cost records provide the best evidence for the contractor's reasonable cost to complete the deleted work. In this circumstance, determining a contractor's reasonable cost to complete the deleted work is relatively straightforward. However, it is not always this easy.

Disputes about a contractor's reasonable cost to complete deleted work arise when documents, like a contractor's bid or schedule of values, conflict with a contractor's proposed credit, an issue the court addressed in *M.J. Paquet, Inc. v. New Jersey Department of Transportation*.

In *M.J. Paquet*, the government, acting as the owner in a bridge rehabilitation project, deleted all bridge painting work from the general contractor's scope of work, and sought a credit based on the cost shown in the bid documents for painting work. In response, the contractor admitted that its bid was unbalanced, and that using the bid documents would result in a credit much higher than its actual cost to complete the deleted work.

The court found as a fact that, just prior to executing the contract, the contractor received an estimate from its painting subcontractor to paint the bridge for half the price listed in the bid documents. Due to time constraints, the contractor lowered the bid price of mobilization to compensate for the now inflated cost of the bridge painting, instead of adjusting the painting bid item. The court found that the contractor's estimate of the cost to perform the bridge painting, based on the estimate of the subcontractor, was the correct value for the deleted scope credit, as it reflected the contractors actual net savings.

As *M.J. Paquet* shows, complications arise when a contractor uses a "plug number" to estimate a portion of the work for its lump sum bid, and subsequently gets a more favourable price, after award, when it actually subcontracts the work.

In situations where the general contractor has subcontracted the deleted work, intuitively the general contractor's cost to perform the deleted work is equal to the value of its contract with the subcontractor to perform the work. In the *Appeal of J.A. Jones Construction Co.*, a contractor submitted its subcontractor estimate for the deleted work as evidence of its reasonable cost to perform the deleted work. In determining whether the subcontractor's estimate was a good indication of the cost to perform the work, the court stated that:

> [I]t appears almost self-evident that the source that would have the best and most current information on the probable costs of installing the deleted rock bolts would be the subcontractor that was already engaged in performing similar work in the same location. Thus, we regard the subcontractor's estimate … to be the best evidence of the reasonable cost to Jones of the rock bolt deletion …

Of course, the converse must also be true in situations where a contractor's subcontract price exceeds its bid value for the deleted work. In this situation, contractors must accept the risk that the credit for the deleted work should reflect the actual higher subcontract cost.

American case law puts the burden on the owner to disprove the contractor's "would have cost" estimate, and where the contractor performs the work on a unit-price basis, has cost records for the same or substantially similar work, or relies on the estimate of its subcontractor, these will be difficult for an owner to overcome. Of course, if the contractor's actual costs prove to be higher than estimated, as happened in *Appeal of Arctic Corner, Inc.*, or circumstances change resulting in a "would have been higher" cost for the contractor to perform the deleted work, the credit to the owner will be larger.

Finally, certain questions will continue to plague this analysis. For example, how should parties treat anticipated profit on scope deletions under a contract that prohibits a contractor from claiming profit on deleted scope? In the context of a lump sum project, this may not be straightforward. How should one evaluate profit on mid-contract change when the contractor is already in a loss position? Arguably, profit may only be assessed on the basis of a contractor's total cost versus the total contract price. This does not lend itself to a tidy solution when the project is only partially completed.

Until Canadian courts grapple with these issues, the authors regard American jurisprudence as a reasonable guide to a fair and equitable approach to pricing lump sum scope deletions. Given the underdeveloped nature of the law here, owners and contractors would be wise to keep this issue in mind when negotiating contracts and should as far as possible address these issues ahead of time, in the contract, rather than after the fact.

CASE SUMMARY

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A NEW (JUDICIAL) ERA FOR ALBERTA ARBITRATION AGREEMENTS: A SHIFT CONTINUED BY *SASKATCHEWAN POWER CORP. v. ALBERICI WESTERN CONSTRUCTORS LTD.*

Saskatchewan Power Corp. v. Alberici Western Constructors Ltd.

Arbitration clauses in construction contracts are intended to streamline disputes and give parties control over their own processes. However, in practice, it can be increasingly difficult for such provisions to accomplish these goals, particularly since many construction disputes reverberate up and down the contractual chain and involve subcontractors, consultants, vendors or other entities who are not part of the agreement to arbitrate. If these additional actors do not consent to take part in arbitration, the parties to an arbitration clause seeking to include them in the dispute have no choice but to commence a parallel litigation action; instead of streamlining dispute proceedings, the parties end up multiplying them.

This issue is compounded by the fact that provincial arbitration legislation generally does not permit parties to a binding arbitration agreement to litigate against each other: s. 7(1) of Alberta's *Arbitration Act*, for example, provides that "[i]f a party to an arbitration agreement commences a proceeding in a court in respect of a matter in dispute to be submitted to arbitration under the agreement, *the court shall… stay the proceeding*". This mandatory stay of litigation proceedings is subject *only* to a limited set of exceptions in