



CONTRACT RISK ALLOCATION AND COST EFFECTIVENESS

Bureau of Engineering Research
The University of Texas at Austin

Publication 5-3
November 1988

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Contract Risk Allocation and Cost Effectiveness

**Prepared by
The Construction Industry Institute
Contracts Task Force**

**Publication 5-3
November 1988**

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Printed in the United States of America.

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SUMMARY

Risk allocation in construction contracts has been the subject of considerable debate in the construction industry for many years. Careful attention to the design of contracts was recommended by The Business Roundtable Construction Industry Cost Effectiveness (CICE) Project.¹ The Construction Industry Institute (CII) also identified risk allocation as influential in project success and recommended a balanced approach.² Nonetheless, many owners and contractors resist modification to their normal practices, unless forced to do so in specific cases by marketplace and competitive pressures.

This publication presents results of a study sponsored by the CII Contracts Task Force to evaluate the risk allocation practices and experience of CII members over a range of approaches. The primary objectives were to identify inequities and determine their impact on project performance and on owner-contractor relationships. The study focuses on fixed-price contracts, which are the most problematic.

Methodology for the study involved selection of specific clauses, completion of a questionnaire, and follow-up discussions in group interview sessions. Thirty-five CII member companies, evenly distributed between owners and contractors, responded to the questionnaire and provided 45 experienced contracts and project management personnel for the group interviews. Data was analyzed from both qualitative and quantitative perspectives.

The following aspects of contract risk allocation are addressed in this publication:

- Indemnity
- Consequential damages
- Differing conditions
- Delay

These aspects are examined relative to a number of research hypotheses, then each is discussed in greater depth.

Areas of future research suggested by this study include:

- In-depth examination of the contractor-subcontractor contractual arrangements on project cost effectiveness and working relations.
- Identification of mechanisms and processes used to obtain owner and contractor objectives in claims management and analysis.

Details of the study, including details of methodology used, background information on each clause area, and significant results are contained in a research report³ prepared by The University of Texas at Austin, and which is available from CII.

INTRODUCTION

Today, few construction projects of consequence are built without a thoroughly planned and reviewed construction contract. The purpose of the contract, which is to define an agreement between the parties as to the tasks involved and the risks to be assumed, has not changed, but complications have developed. Construction owners must now choose between a variety of contract types. Changes in contract types represent differences in risk allocations available. The two principal contract types, cost reimbursable and fixed price, depict opposing ends of the contractual spectrum. Cost reimbursable contracts allow an owner greater project control, but in so doing relieve the contractor of much cost responsibility. Fixed price contracts require the contractor to assume most of the cost responsibility, but restrict owner control.

Lump sum contracts are the focus of this study. This report examines risk allocation and equity within construction contracts for four particular contract clauses—indemnity, consequential damages, differing conditions, and delay. Through this analysis, the research attempts to improve project cost effectiveness and participant relationships. The data gathered for the study provides numerous examples and a potpourri of previous experience. The information is then related to hypotheses about equity of certain risk allocations and impacts on project performance and working relationships. Finally, cumulative recommendations about effects and impacts of these four clauses, derived from owner and contractor suggestions, serve to conclude the report.