

## CONSTRUCTION CONTRACT & MANAGEMENT ISSUES

In this third quarter issue of Master Builders Journal for 2014, BK Burns & Ong Sdn Bhd, a subsidiary of **BK Asia Pacific**, an international construction consultancy group providing project, commercial and contractual management services joins with **Entrusty Group**, a multi-disciplinary group, collectively named **BK Entrusty**, to present a **new series of construction contract and management articles** in areas related to project, commercial, contracts, risks, quality, value and the like. This article on **“Rates Rationalisation Practice in Construction Industry”**

### INTRODUCTION

In the construction industry, a construction project is usually awarded by an employer to a suitable contractor through tendering process, which may involve several tenderers who have been prequalified by consultant/s. Often, the successful tenderer or contractor is usually the lowest, if not second lowest, in tender price, which is derived from a breakdown of priced items, usually in a bills of quantities (BoQ), which formed part of the tender documents.

The common notion in the industry, is that the tender price when agreed between an employer and a contractor, which forms the awarded contract price, is a reasonable and feasible sum. However, competitive pricing and uncertainties in resources, economy and other risks, often make it difficult for the successful contractor to carry out and complete the construction project profitably. Consequently, some contractors resort to relying upon pricing strategy, variations and/or loss or expenses claims, to maintain and/or enhance profitability of their construction projects.

In order to ensure a fair and reasonable pricing regime and practice, many employers employ consultants, usually quantity surveyors, to prepare tender documents and conduct tender exercise. Thereafter, they undertake to review and rationalise or adjust prices and rates contained therein, normally without changing the tender/contract sum, prior to awarding the construction project to the successful contractor. Such rationalised or adjusted prices and rates can then be appropriately applied to corresponding variation works during progress of the construction project.

In this article, BK Entrusty aims to provide readers with an understanding of the practice of rationalisation of prices and rates in the construction industry, by the following contents:-

- Definition of rates rationalisation;
- Importance of rates rationalisation;
- Timing and criteria for rates rationalisation;
- Standard forms of contract (relevant clauses);
- Case Law;
- Summary/Conclusion.

### Definition of Rates Rationalisation

Rationalisation of prices and/or rates (hereinafter referred to as “rates rationalisation”), is usually performed after tendering and during contract formation stage by a consultant, who reviews and determines whether the itemised prices and rates for the works stated by a selected tenderer or contractor in the tender document are erroneous, reasonable or not. If not, these prices and rates are rationalised or adjusted to a reasonable level, usually without affecting the tender sum, for acceptance by the contracting parties. Such practice also enables reasonable spread of overheads and profit in the priced items of works over the entire construction project.

Rates rationalisation practice is usually conducted at main contract level by the employer’s consultant/s, but it can also be done at sub-contract level, although at this level, it is the contract/commercial department of the main contractor, usually its contract administrator, contract manager or quantity surveyor who conducts such rationalisation exercise, prior to the awarding the sub-contract to the successful sub-contractor.

Rates rationalisation can apply to priced BoQ items, ‘rate only’ items and/or schedule of rates, usually without any alteration or change to the tender/contract sum, quality and/or delivery requirements, unless they are erroneous.

The following are typical examples of error adjustment and rates rationalisation provisions under different sub-headings in tender/contract documents, commonly found and practiced in Malaysia.

### Conditions of Tendering or Instructions to Tenderers in Tender Documents

*Errors in extensions or casting shall be rectified and adjusted before the signing of the Contract. All such corrections shall be so rectified that when correctly calculated, the total of the Final Summary will represent the same amount as that on the Form Of Tender. The net deduction or a net addition will be calculated as a percentage adjustment in the Final Summary, provided always that P.C. and Provisional Sums shall not be subject to a percentage adjustment.*

*All unit rates for the Contract throughout the Contract Bills shall be subject to such percentage discount or premium as the case may be and the adjusted rates shall be the basis for the assessment of remeasurement and variations under the Contract. Details of the adjustment shall be notified to the tenderer in writing.*

### Pricing of Bills of Quantities

*Should the Contractor make any errors in his extensions and/or casts or in carrying forward to or in casts of the summary, such errors shall, before the signing of the Contract, be so rectified and adjusted that when correctly calculated, the total of the Final Summary shall represent the same amount as that tendered by the Contractor in the Form of Tender. The nett aggregate amount of such errors, whether a nett deduction or a nett addition, will be calculated as a percentage adjustment in the Final Summary. All items throughout the Bills of Quantities shall be subject to such percentage discount or premium as the case may be. Provided always that Provisional or Prime Cost Sums shall be excluded from the calculation and shall not be subject to such percentage discount or premium.*

### **Pricing and Arithmetical Errors**

*Before the signing of the Contract any sums or unit rate inserted by the Tenderer in the tender which are obviously erroneous shall be adjusted so as to form a fair and reasonable basis for valuation of variations in accordance with Clause 11 of the Conditions of Contract, but the total of the Final Summary shall represent the same amount as the tendered by the Contractor in the Form of Tender. The nett aggregate amount of such errors will be calculated as a percentage adjustment in the Final Summary.*

*Should errors in pricing and/or errors in arithmetic be discovered in the Tender before the acceptance of the Tender, the Tenderer agrees that the Tender shall be subjected to a plus/minus percentage adjustment, whereby all rates and prices (excluding Prime Costs, Provisional Sums and Preliminaries) inserted therein by the Tenderer in his detailed breakdown of costs or in the Tender Summary are to be considered as increased or reduced in the same proportion as the corrected total of the priced items falling short of or exceeding the original total of such item.*

### **Preliminaries**

*Any error or omission in the rates and calculations set down by the Contractor in the Contract Documents shall, before the signing hereof, be so rectified that when correctly calculated the total amount of the Approximate Bills of Quantities shall represent the same amount as that entered by the Contractor in his Form of Tender and for this purpose the nett aggregate amount of errors shall be calculated as a percentage of the total and all unit rates throughout the Approximate Bills of Quantities shall be subject to such percentage discount or premium.*

*The rates contained in the Bills of Quantities, and Daywork Schedule shall be rationalized by the Employer to reflect the reasonableness and consistency of rates and prices without affecting the Tender Price prior to signing of the Contract.*

### **Rationalized/Adjusted Rates Basis For Valuation of Variations**

*All unreasonable tendered rates shall be rationalized to the satisfaction of the Architect prior to signing of Contract and all the adjusted rates and/or prices shall then form the basis for valuation of interim certificates including the valuation of any variation of omission and/or extra works which may be ordered by the Architect from time to time.*

*The Architect shall rationalize any rates which are found unreasonable, with the Contractor's approval and the amended rates shall be used for valuations and measurement of variations.*

### **Importance of Rates Rationalisation**

Contractors in pricing the tender of a construction project are at liberty to determine their own pricing strategy in pricing the items of construction works in any way they choose. Some contractors may price low on some or all the unit items, but risk financial loss when these unit item work quantities increase during progress of the construction works. Other contractors may price high on similar unit work items, thereby may achieve a windfall when these work items subsequently vary with substantial increase in quantities during construction stage.

In other circumstances, some contractors may even attempt to 'front loading' when pricing the tender documents, essentially, to allow a high or more profitable price on items such as works relating to site preparation, mobilisation, excavation and substructure, which they know will be carried out at the initial stage and lower rate pricing on those work items to be carried out at later construction stage such as finishing trades of the construction

project. Contractors who apply this strategy assume that they can get more money at the beginning of the construction project to finance its cash flow, without having to take up any bridging finance or loan, thereby lowering its tender price so as to become more competitive or to enhance their profitability, if not.

However, these contractors, after obtaining the front loaded interim payments from the employers, may have little incentive or interest in completing the remaining construction works. Such pricing strategies are common commercial and pricing strategy and practice by contractors, which are not considered unlawful, unfortunately.

In the cases of *Sist Construction v State Electricity Commission of Victoria* [1982] VR 597 of 606, and *Convent Hospital v Eberlin & Partners* [1988] 14 Con LR 1, the Contractor priced lower rate on items which they believe the actual quantities are likely to be less than the quantity stated in the BoQ, and priced higher rate for the items where they believe the actual quantities will exceed the original quantities stated in the said BoQ, without altering his final tender price.

The Court held that a contractual provision spelling out, either requiring the Contractor to act reasonably in pricing the BoQ or empowering the Employer and its Consultant to reject, rationalise and adjust the rates concern was necessary. Brooking J held that,

*"The need for some contractual provision, either requiring the builder to act reasonably in pricing the bill or empowering the person administering the contract to reject the rates in the priced bill, arises from the notorious practice of those who tender for building and engineering contracts of making what has been described as an unbalanced bid, that is to say, of pricing the bill in a way which, without affecting the amount of the tender, is calculated to ensure to their financial advantage. A tenderer may put down low rates for items where he believe that the 'as built' quantities are likely to be less than the billed quantities, and high rates for items where he believe the 'as built' quantities will exceed the quantities in the bill. He may also increase his rates for early work and reduce his rates for later work in order to give him a substantial cash flow at an early stage. The practice is also known as 'loading' the rates"*

On the other hand, in *Bell Bros Pty Ltd v Metropolitan Water Supply, Sewerage and Drainage Board* [1980] ACLD 343, the Contractor failed to recover his costs as the Court held that he could not claim the extra cost as a variation, as it cannot interfere with the contractual risk on the rates provided by the Contractor since they did not accurately reflect his costs for performing the work.

In view of the above practices, which some contractors may label as commercial strategy, but employers and/or consultants may find them unscrupulous, many employers employ consultants, usually quantity surveyors, to prepare tender documents and conduct tender exercises. Thereafter, they undertake to review and rationalise or adjust prices and rates contained therein to a reasonable and acceptable level, usually without changing the tender/contract sum, prior to awarding the construction project to the successful contractor. In doing so, such rationalisation practice discourages any unfair strategy and/or unscrupulous practice, so as to ensure fair and reasonable pricing throughout the priced documents. Such rationalised or adjusted prices and/or rates can then be appropriately applied to corresponding variation works during progress of the construction project.

### Timing and criteria for Rates Rationalisation

In most construction contracts, prices and rates quoted may not be adjusted, after the contract is formed. The prices and rates shall hold firm for variations, unless otherwise stated in the contract provisions to allow for adjustment due to difference in quantities, character, conditions, etc. Therefore, rates rationalization usually takes place after tender acceptance but seldom after the contract is awarded. In short, rates rationalisation should be carried out during contract formation. It must be done before the formal contract document is signed, unless otherwise stated in the contract.

On rates rationalisation, *Ir Harban Singh K.S in Engineering and Construction Contracts Management, Pre-Contract Award Practice* listed the following criteria :-

1. *Is the unit rates priced reasonably conformance with the Consulting QS's estimation and other tenderer's submission?*
2. *If awarded, what effect will the rates have on the total contract amount?*
3. *If quantities are incorrect, will the contract cost be increased when the quantities are corrected?*
4. *If there is any 'front end' or 'claim loading' unit rates, will they have a potential detrimental effect upon the competitive process or cause contract administration problem after award?*

Rates rationalisation can be applied to the following price or rate categories:-

1. Bill price or rate for work items as contained in the priced BoQ ;
2. Price or rate stated in Schedule of Rates, Schedule of Daywork Rates, etc.;
3. Other price or rate for services, supplies, maintenance, repairs, etc.

Whilst there are several approaches to rates rationalisation, the normal practice in the construction industry is to evaluate the prices and rates by price comparison. A useful reference normally is the pre-tender estimation prepared by consultant/s at design and pre-tender stage. If the tender prices and rates are within range of the pre-tender estimation, then they are often considered to be reasonable and acceptable by the consultant/s and employer.

### Standard Forms of Contract (Relevant Clauses)

The relevant clauses in standard forms of contract in Malaysia concerning rates rationalisation and error adjustment are:-

#### PAM 1998 & 2006 Form of Building Contract

Clause 12.2 of PAM 2006 (with Quantities) expressly provided that unless otherwise stated, the contract is a Lump Sum Contract. Any error in description, quantity or omission of items in the contract bills shall not vitiate the contract and shall be corrected by the Architect or Consultant. Under Clause 13 of PAM 1998 & 2006 (with Quantities), correction or rationalisation of price or rate is allowed where an error has occurred.

However, under Variation Clause 11.6(b) of PAM 1998 & 2006, fair rate adjustment is applicable when there is significant change in the quantity of work is executed under similar conditions.

#### JKR/PWD Form of Contract (203A – Rev 10/83, Rev 1/2010)

JKR Rev 10/83 Clause 26(d) or Clause 26.2 for JKR Rev 2010 expressly provided that the SO has the right to agree on the prices and rates in the Bills of Quantities submitted by the Contractor as to their reasonableness before executing the contract. Any adjustment, arithmetical error and/or omission shall be adjusted/rectified, without altering the tender amount, before its execution.

Further under Preliminaries and General Conditions in Jabatan Kerja Raya Malaysia Standard Specifications for Work 2005 expressly provided that,

*“Any rates found to be overpriced, inconsistently priced, underpriced or erroneously priced shall be subjected to adjustment and rectification before the signing of the Contract and the authority to fix the reasonable rates/ amount shall be with the S.O. The amended rates shall be used for computing the progress payments and the measuring of variations.”*

JKR Rev 2010 clearly stated that any adjustment of prices in the Summary of Tender according to the above clause and any arithmetical errors in the Summary of Tender shall be adjusted and rectified, provided the contract sum remain unchanged, before signing of the contract.

#### IEM Conditions of Contract 2<sup>nd</sup> Edition, 2011

IEM CE 2011 Clause 12.1(1) requires the Contractor to ensure the correctness and sufficiency of the Tender rates and pricing in the BoQ. Clause 55.5 (1) restricted the rates in BoQ to be adjusted in any way due to the actual executed quantities of work, unless instructed by the Engineer.

The relevant case law to support the rates rationalisation practice are:-

#### Relevant Case Law

In *Dudley Corporation v Parson and Morrin Ltd (1998)*, the Court of Appeal held that all final account quantities should be paid for at bill rates even though it was underpriced. The Contractor had claimed for increased/enhanced rate on the excess quantity when the rock excavation substantially exceeded the bill quantities.

The court in *Henry Boot Construction v Alstom Combined Cycles Ltd [1999] BLR 123 Technology & Construction Court*, held that the Contractor was entitled to use bill rates even though he has priced the item in the BoQ very high due to his pricing error on a lump sum contract for piling work. The subsequent appeal in the Court of Appeal (2000) upheld this decision. Humphrey Lloyd QC held that,

*“the basic consideration is that the contractor has agreed to do all work within the contract, original and varied, on the basis of his bill rates.... Be completely inconsistent with the wording of such a contract and the philosophy to be derived from it.”*

Any pricing errors by contractors in the tender cannot be corrected by subsequently setting aside the contract. In this regard, it is worth noting that Section 23 of the Contracts Act 1950 states;

*“A contract is not voidable because it was caused by one of the parties to it being under a mistake as to a matter of fact.”*

### Summary/Conclusion

Rates rationalisation or adjustment practice is usually undertaken by a consultant at the project outset. It should be dealt with, either before the tender acceptance or after the issuance and acceptance of letter of award/acceptance but before signing the formal contract.

The practice aims to rationalise or adjust the tendered prices and rates of the successful contractor fairly and reasonably befitting the work items concerned, including to correct any pricing errors and to avoid front loading claims, without altering the tender/contract sum. In doing so, it can avoid, or at least, reduce errors, inconsistencies, ambiguities and/or unreasonableness of priced rates when the contract is formed and signed, thereby minimising any dispute in connection with pricing arising thereafter during construction works progress. Mutual agreement between the contracting parties on the rationalized prices and/or rates is normally required before the signing of the contract. Upon such rationalisation, the prices and/or rates can be used in the valuation of variations, as appropriate.

In conclusion whilst rates rationalisation when correctly practiced at the construction project outset ensures fair play and reasonableness in tender prices and rates, it can also be subject of dispute if not or incorrectly practiced, particularly during the works progress, when one party can take advantage of the other by manipulating the prices and/or rates to their commercial advantage.

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18. References are also made to several standard forms of contract, namely:-
  - a) PAM Forms of Building Contract (1998 & 2006)
  - b) JKR/PWD Forms of Contract (203A – Rev 10/83 & Rev. 2007)
  - c) IEM Conditions of Contract for Works Mainly of Civil Engineering Construction (1st Edition – 1989)
  - d) CIDB Form of Contract For Building Works (2000 Edition)
  - e) FIDIC Contract (Red Book)
  - f) ICE Conditions of Contract

In the next issue of the MBAM journal the article will answer the question on  
**"An Update on Additional Preliminaries evaluation"**

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