

Two-stage Tendering and GMPs

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April 2016

A Few Things to Know

Construction projects in the Middle East are often procured under a single stage tender process, pursuant to which the employer issues an invitation to tender to 5 or 6 contractors for a particular project and then selects the most competitive tender, usually based on price.

While this approach has clear and well-known benefits, it can be expensive for all concerned, encourages claims if the successful contractor has underpriced the project (which can easily occur if there was inadequate time to enable the contractor to evaluate risks) and fails to incentivise value engineering between the parties.

To address these issues, two-stage tendering is becoming more accepted in the Middle East (particularly in a design and build context) and is viewed as a real alternative to traditional procurement.

Procurement Structure

As a first step to implementing a two-stage process, the employer would typically approach several contractors, on a competitive tender basis, with basic information regarding the project (i.e. an outline design) and request an indicative price (including details of each contractor's profit, overhead and preliminaries) for the works as well as the contractor's proposal for executing the project.

Following receipt of this basic information, the employer will engage its preferred contractor to perform buildability services under a pre-construction agreement.

Under the pre-construction agreement, the contractor will usually work with the employer's design team to resolve buildability issues and undertake a concept programme for the project (typically on an accelerated basis), which is usually accompanied by a 'maximum ceiling price'. To arrive at the maximum ceiling price, the contractor will need to obtain indicative price quotes for key subcontract packages and the maximum ceiling price should be presented on an open book basis.

If the contractor is engaged to take the lead on the design, the employer may instruct the contractor to develop a concept design into a schematic design. However, it is important that the employer has the express right to terminate the pre-construction agreement if either the concept design or the maximum ceiling price fails to meet the approval of the employer (although a right of termination only tends to be activated following a period of unsuccessful negotiations).

If the contractor is requested to undertake the schematic design, the contractor may also be required to provide a guaranteed maximum price (also on an open book basis) for completing the project, which generally should not exceed the maximum ceiling price.

As with the concept design, the employer should have the express contractual right to terminate the pre-construction agreement if either the schematic design or the guaranteed maximum price is unacceptable to the employer.

Pre-Construction Agreement

There are no 'standard form' pre-construction agreements so careful bespoke drafting is required to ensure that the agreement is properly documented.

As well as the ability to terminate the pre-construction agreement at certain key points, the pre-construction agreement should also make it clear that the contractor has no expectation of being awarded the construction contract.

In the event of early termination of the pre-construction agreement, the contractor should therefore be paid for the pre-construction services performed as at the date of termination (i.e. principally for buildability and design work undertaken) but liability for such things as loss of profit, loss of expectation and loss of opportunity should be expressly excluded.

It is also important that intellectual property rights are addressed. In short, any designs prepared by the contractor should vest in the employer or, alternatively, the employer must be granted a sufficiently broad license to freely use and develop any designs prepared by the contractor following termination of the pre-construction agreement.

Conversion Mechanism

If the employer is looking to have a design and build contract, the employer will seek to engage the Contractor for the construction of the project under a design and build contract where the employer is satisfied with the schematic design and the guaranteed maximum price. This will enable the contractor to simultaneously undertake the detailed design and to commence the construction of the works.

A guaranteed maximum pricing mechanism often provides that the employer and the contractor may share any savings (i.e. the extent to which the cost of the project is less than the guaranteed maximum price) or alternatively the contractor may be entitled to a bonus.

In this situation, the construction contract needs to include an open book pricing mechanism pursuant to which the employer has full visibility regarding the actual cost of completing the project.

Advantages Of Two-Stage Tendering

The main advantage of two-stage tendering for the employer is that it facilitates the fast tracking of the project and this is particularly appealing if the employer is under time pressure to deliver (i.e. perhaps a development agreement imposes aggressive timelines on the employer). As the employer and the contractor are working together from an early stage, two-stage tendering will facilitate construction works commencing prior to the finalisation of the design.

Price certainty can also be achieved if a two-stage tender results in a guaranteed maximum price construction contract being executed. Allied to this point, risks are more likely to have been properly evaluated and priced by the contractor on account of the greater visibility afforded to him under during the pre-construction phase, thus potentially decreasing the contract price and the risk of variations.

Additionally, the contractor's involvement with the employer's designers from an early stage means that buildability and sequences issues can be addressed and resolved quickly while there is also greater scope for value engineering, which should also make the final contract price more competitive (and may facilitate a cost savings mechanism).

finally, two-stage tendering promotes more a collaborative approach between the parties and the possibility of disputes arising during the construction phase is therefore reduced.

Disadvantages Of Two-Stage Tendering

Two-stage tendering is not without risk.

Although the pre-construction agreement may provide the employer with the express right of termination at various points, the employer may, from a practical perspective, become ever more reluctant to exercise this right as the contractor becomes an increasingly entrenched member of the design team and this will lead to the employer's bargaining power being eroded.

The strength of the contractor's bargaining power may increase further if the contractor is permitted to perform significant construction works on site without a construction contract being in place.

Further, the employer may still face difficulties even if the employer terminates the pre-construction agreement. Terminations are seldom smooth and there is almost inevitably some form of fall out (regardless of how well the pre-construction agreement has been drafted). For example, the contractor may retain possession of key deliverables, difficulties may be encountered in transferring approvals and permits to the employer or to the incoming contractor while the contractor may also retain possession of the site (assuming that it has been granted access and has started work) until its claims have been resolved.

Even if the termination process is seamless, the project will almost certainly be delayed by the employer having to engage an alternative contractor, which may be something that the employer can ill afford if a two-stage tender was adopted on account of time sensitivities. A further point to consider is that an incoming contractor will almost certainly demand a price premium if he is required to accept responsibility for the design or works undertaken by a previous contractor.

From a practical perspective, employers could potentially mitigate these risks by prolonging negotiations for as long as possible with two interested parties, thereby retaining competitive tension. However, negotiating with two contractors can be a time consuming and expensive exercise which cuts across the underlying principle of collaboration and is unlikely to be a workable solution.

Another option may be for the employer to allow adequate float to provide a buffer against unforeseen and prolonged negotiations but again this may not be practical in the circumstances.

Regardless of the above, the main risk for the contractor is that it has no guarantee of being awarded the construction contract until it has been actually signed. This is a significant exposure as it is unlikely that payment under the pre-construction agreement will adequately compensate it for the extent of the design and collaborative work that it will have performed.

Concluding thoughts

There are many variants for two-stage tendering and, in our view, it is a realistic alternative to traditional tendering, yielding positive results for both the employer and the contractor. As with any other form of contracting, two-stage tendering should be approached with care and both parties need to ensure that their commercial interests are adequately addressed by a well-drafted pre-construction agreement and construction contract.