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UNITED STATES GOVERNMENT

Memorandum

DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY

DATE: JUL 18 1974

In reply refer to: Price escalation — Constr. Contracts

SUBJECT: Washington Statute on Construction Cost Increases

FROM : General Counsel

TO : Chief Counsel, FHWA

I have reviewed your proposed memorandum to Mr. Mendenhall holding that there is not any legal obstacle to FHWA participation in increased highway construction costs incurred by the State of Washington pursuant to Substitute House Bill No. 1366.

Although I agree that FHWA has discretionary authority to assume a share of increased project costs when they have been substantiated in accordance with the usual administrative criteria, the new Washington statute sets forth none of the standards and safeguards generally called for by Federal contracting policy. Consequently, I do not agree that FHWA participation would depend solely upon a mere showing that the State, under its new statute, has "a sound legal basis" for consenting to an upward revision in contract costs, as your memorandum appears to suggest. 1/ Generally, requests for increases in Federal aid to highway projects in progress should be denied except where related to FHWA-approved changes in a project's plans and specifications.

Provisions of the Washington Statute

The new Washington statute provides relief to contractors whenever the "cost of petroleum products" exceeds by more than 20 percent the "current market price thereof as [of] the date of the contract award." 2/ In

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1/ Furthermore, even if FHWA participation in such increases were deemed appropriate, the additional Federal contribution would not necessarily be "authorized by the project agreement," as indicated in your memorandum. Such participation would probably require the execution of a modified project agreement.

2/ The statute also furnishes relief whenever a contract between a "contractor or a first tier subcontractor and his suppliers" of petroleum-related products is "superseded, with resulting increased costs of performance of the public works contract, by force majeure, regulations, rules, allocations, or rulings issued by any federal, state, or other agency acting pursuant to any federal or state economic stabilization act, petroleum allocation act, or other legislation authorizing the same...." Washington Substitute House Bill No. 1366, § 1.

such circumstances, project costs may be increased in one of two ways. A contractor may petition to terminate its contract and be paid for work completed and stockpiled materials. If the State permits the contractor to terminate, it would then be required to let new contracts for the completion of the project. Alternatively, the State may refuse to permit termination, but it must then agree to bear 80 percent of the increase in the cost of materials for the project.

A. Termination of Existing Contracts

The first situation -- termination of existing contracts and the letting of new contracts -- is already treated in PPM 21-6.3, paragraph 25. Subparagraph b of that paragraph provides:

> Normal Federal-aid PS&E, advertising, and award procedures are to be followed when a State awards the contract for completion of a Federal-aid contract. Under this procedure, the construction amount eligible for Federal participation on the project should not exceed either:
>
> (1) The amount representing the payments made under the defaulted contract plus payments made under the new contract or
>
> (2) The amount representing what the cost would have been if the construction had been completed as contemplated by the plans and specifications under the original contract, whichever amount is the lesser.

This rule reflects sound contracting policy, and there would not appear to be any basis in the new Washington legislation for deviating from it. In any event, a deviation from the rule without a prior amendment of the PPM would probably be unlawful. 3/

B. Allowance of Increased Costs

In most instances, however, the State would probably opt for the second alternative -- bearing 80 percent of material cost increases -- in order to avoid the expense and delay associated with the termination of one contract and the letting of another. The question for FHWA then would be whether the resultant increases in project costs would be eligible for Federal participation. In most cases that question should be answered in the negative.

3/ "Federal-aid funds shall not participate in any cost which is not incurred in conformity with applicable . . . policies and procedures prescribed by the Administrator." 23 C.F.R. §1.9.

1. Modifications in General

FHWA procedures clearly contemplate the possibility of modifications, based on changing conditions, in its contractual arrangements with the States. For example, 23 C.F.R. §1.13 permits changes in a project which result in increased costs, provided that such changes are approved in advance by the Administrator. 4/ PPM 21-6.3 sets forth procedures for the proposal and approval of project changes subsequent to the execution of a project agreement. The procedure for modifying a project agreement is prescribed by PPM 21-7.

But it is clear that these procedures call for the exercise of administrative discretion by appropriate FHWA officials on a case-by-case basis in accordance with normal contracting standards, and that they do not constitute authority for blanket participation in State-wide construction cost increases incurred as the result of a State's determination to waive its rights against its contractors.

2. The Contractual Nature of the Federal-Aid Highway Program

The relationship between the Federal Government and the States within the framework of the Federal-Aid Highway Program is based essentially on orthodox contract principles. The Secretary's approval of the plans, specifications, and estimates for a project constitutes, according to 23 U.S.C. §106(a), a "contractual obligation of the Federal Government for the payment of its proportional contribution" to that project. The project agreement then entered into by the Federal Government and the State reduces this obligation to "precise terms," 5/ and it must "make provision for State funds required for the State's pro rata share of the cost of construction of such project and for the maintenance thereof after completion of construction." 23 U.S.C. §110(a). The State's duty to maintain the project is explicitly referred to in 23 U.S.C. §116(a) as an "obligation to the United States."

FHWA's policies and procedures similarly reflect the contractual nature of the Federal-Aid Highway Program. The rule in PPM 21-6.3 governing terminated contracts on Federal-aid projects has already been cited. That rule limits the Federal contribution to the amount originally agreed upon, even if the need for a new contract to complete the project results in a higher project cost than was originally estimated. Closely related is PPM 21-5, which, in paragraph 7c, provides a maximum opportunity for State and Federal highway officials to arrive at a sound estimate of project costs prior to executing a project agreement:

4/ This responsibility has been delegated to the division engineers. FHWA Organizational Manual, Part I, Chapter 5, subparagraph 16a.

5/ Decision of the Comptroller General, B-164243, 47 Comp. Gen. 756, 759 (1968).

> If for some reason, for example price trends, either the State highway department or the division engineer considers that the engineer's estimate should be revised after it has been approved by the division engineer, it should be re-examined by both and agreement reached for either retention of the approved estimate or for a revised estimate.

The conclusion logically implied by this provision is that, once the estimate is incorporated in a duly executed project agreement, the parties are bound.

The project agreement itself, Form PR-2, makes this explicit. It provides that the Federal funds obligated for the project in question are "not to exceed the amount shown herein, the balance of the estimated total cost being an obligation of the State."

The Federal-Aid Highway Program has been treated consistently in administrative and judicial decisions as a program founded on contract principles. Thus, for example, in deciding that the Federal Government was not obligated to assume a share of increased highway construction costs in Pennsylvania resulting from a State arbitration award, the Comptroller General wrote:

> Under the agreement between the Commonwealth of Pennsylvania and the Federal Government covering the project in question, the maximum Federal obligation is fixed. The agreement establishes the basis upon which the Federal contribution toward construction of the project will be made.6/

Even as long ago as 1929, the Comptroller General held that the United States was entitled to base its total contribution to a project's cost on the estimates set forth in the project agreement. The Comptroller General wrote that —

6/ Decision of the Comptroller General, B-164243, 47 Comp. Gen, 756, 757-58 (1968). The Comptroller General held that, while the United States was not obligated to contribute to the increased costs, it was nevertheless authorized to do so where the increases were necessitated by errors in the State's project specifications, and where "there was no way in which the State could have avoided the additional amount it was required to pay, such additional amount having stemmed from the very basis upon which the contract was awarded." Id. at 758.

> in many instances it will be found that the estimates are incorrect and the work costs either more or less than the estimated costs, but this fact does not impose on the United States any obligation to pay the State . . . a percentage of the cost as finally determined. On the contrary, the statute clearly provides that the obligation of the United States was to pay the fixed percentage of the estimated cost of the approved project. 7/

This line of reasoning was adopted by the General Counsel, Bureau of Public Roads, in an opinion dated June 1, 1964, and appended to a circular memorandum issued on July 20, 1964. It was subsequently held, in keeping with this approach, that a State's claim for an increase in the Federal contribution to a highway project is so rooted in contract that it must be brought in the Court of Claims. 8/

3. Implications of the Contractual Nature of the Program

All of the foregoing suggests that, unless a project's plans and specifications have been modified with FHWA approval, the Federal contribution to that project should in most cases be limited to the ceiling figure set forth in the project agreement. In seeking an exception to this rule, a State should bear a heavy burden of justification.

Any other approach would be inconsistent with established Government-wide contracting principles. Noteworthy in this regard are the Federal Procurement Regulations (FPR), 41 C.F.R. Chapter 1, particularly Part 1-15 ("Contract Cost Principles and Procedures"). Among the factors which must be considered in determining the allowability of individual items

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7/ Decision of the Comptroller General, A-25880, 9 Comp. Gen, 175, 178 (1929). The Comptroller General has since decided that, where project costs are reduced by recoveries made by States in antitrust proceedings, the United States should reduce its contributions accordingly. Decision of the Comptroller General, B-162652, 47 Comp. Gen. 309 (1967).

8/ Massachusetts v. Connor, 248 F. Supp. 656, 659 (D. Mass.), aff'd, 366 F.2d 778 (1st Cir. 1966).

of cost in a Government contract is "reasonableness." 9/ "A cost is reasonable," the FPR says, "if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of a competitive business." 10/ In determining the reasonableness of a given cost, consideration must be given to:

> (a) Whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;
>
> (b) The restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and State laws and regulations, and contract terms and specifications;
>
> (c) The action that a prudent businessman would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government, and the public at large; and
>
> (d) Significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs. 11/

4. Application to New Washington Legislation

As a general matter, add-on costs incurred by virtue of a policy under which contractors are permitted to increase the price of any project whenever material costs rise by some predetermined percentage would not appear to satisfy the "reasonableness" criterion set forth in the FPR. Such a policy would hardly appeal to "an ordinarily prudent person in the conduct of a competitive business," nor would it reflect a "generally accepted sound business practice" or "arm's length bargaining."

9/ 41 C.F.R. § 1-15.201-2. Subpart 1-15.2 of the FPR deals specifically with "Cost-Reimbursement Type Supply and Research Contracts with Commercial Organizations." But Subpart 1-15.7, covering "Grants and Contracts with State and Local Governments," lists, as one of the determinations that must be made prior to allowing a given cost, a finding that it is "necessary and reasonable for proper and efficient administration of the grant program...." (Emphasis added.) 41 C.F.R. §1-15.703-1(a). Furthermore, PPM 30-11 ("Third-Party Contract Administration") provides, in subparagraph 4b, that "[t]he cost principles established by the State shall consider. . . the cost principles and procedures set forth in Part 1-15 of the Federal Procurement Regulations...."

10/ 41 C.F.R. § 1-15.201-3.

11/ Id.

The new Washington statute is uniquely inconsistent with these principles in that it nowhere requires construction contractors to enforce rights they may have against their suppliers. 12/ Thus, a determination by FHWA to share the burden of cost increases under the Washington statute would create a situation in which normal business practices are abandoned at three levels. The contractors could waive their rights against suppliers; the State could waive its rights against the contractors; and the Federal Government would be waiving its rights against the State. Such a policy would seriously disrupt the established contracting routine, and ought to be avoided except in the most compelling circumstances. This is not to deny that suppliers and contractors might suffer some hardship without the relief furnished by the Washington legislation. But the Government has no duty to indemnify its contractors and subcontractors from the risks normally associated with business transactions.

This was the view adopted in the Act of August 28, 1958, 13/ which authorized the modification, without consideration, of Government contracts where necessary to "facilitate the national defense." The regulations promulgated under that legislation, at 41 C.F.R. Part 1-17, place great emphasis on the importance of using this extraordinary authority sparingly and in accordance with sound judgment:

> The mere fact that losses occur under a defense contract is not, by itself, a sufficient basis for the exercise of the authority conferred by the Act. 14/

12/ The FPR contract principles are to be "considered" by the States in developing contract policy. PPM 30-11, subparagraph 4b (see p. 6, n. 10, supra).

13/ Pub. L. No. 85-804, 72 Stat. 972, 50 U.S.C. §§ 1431-35. This legislation enacted into permanent law the authority first set forth in Title II of the First War Powers Act, 1941, ch. 593, 55 Stat. 838, and extended several times thereafter.

14/ 41 C.F.R. § 1-17.204-1.

> Whether, in a particular case, appropriate action . . . will facilitate the national defense is a matter of sound judgment to be made on the basis of all the facts of such case. 15/
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> Even if all the factors contained in any of the examples [set forth in the regulations] are present, other factors or considerations in a particular case may warrant denial of the request. 16/
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> Where an actual or threatened loss . . . will impair the productive ability of a contractor whose continued operation as a source of supply is found to be essential to the national defense, the contract may be adjusted but only to the extent necessary to avoid such an impairment of the contractor's productive ability. 17/

The contrast between the restrictive discretion called for by these regulations and the mandatory nature of the new Washington statute is instructive. The Washington statute does not call for the exercise of judgment on the part of State officials. It simply defines the circumstances under which a contract modification is required, and goes on to dictate the terms of the modification. Where normal contracting practice treats modifications unrelated to change orders as exceptions to the rule, the Washington statute would treat such modifications as the rule.

Conclusion

In general, therefore, FHWA should not participate in increased project costs incurred as a result of the new Washington statute. I would not object to selective participation in such costs, however, provided that FHWA bases its participation on its own independent evaluation. 18/ Among the factors to be considered are the following:

15/ Id.

16/ Id.

17/ 41 C.F.R. § 1-17.204-2(a) (emphasis added).

18/ "Whether . . . increased costs should be recognized [by the Bureau of Public Roads] would depend upon administrative conclusions concerning the factual basis upon which the Board of Arbitration made its award and the propriety thereof." Decision of the Comptroller General, B-164243, 47 Comp. Gen. 756, 759 (1968). See p. 5, n. 7, supra, and accompanying text.

-- Do the material cost increases claimed in a particular case reflect a general market trend evident in the appropriate multi-state region, and are they objectively verifiable?

-- Would the enforcement of the original terms of a contract impair the productive ability of the contractor, or would it merely reduce or eliminate the contractor's anticipated profits?

-- Does the contractor claiming increased material costs have an enforceable right to obtain the material at the cost originally estimated?

-- Has adequate consideration been given to the use of substitute materials? 19/

-- Is the State treating all requests for increases in contract costs uniformly, whether or not the contract in question is related to a Federal-aid project? 20/

-- Is the cost of petroleum-related products likely to be reduced in the near term, and, if so, would a delay in project completion be a more prudent response to current increases?

Please advise FHWA field personnel in the State of Washington in accordance with the foregoing guidance.

Rodney E. Hyster

19/ In a circular memorandum issued April 7, 1966, the Bureau of Public Roads responded to shortages of certain highway construction materials by suggesting, among other remedies, consideration of "the practicability of design modifications or acceptable substitute materials, in order to enable the project to be completed."

20/ See 41 C.F.R. § 1-15.703-1(b).