



Welcome to the August 2016 edition of *Insight*, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

**This issue examines the role of Defined Costs and Disallowed Costs in the NEC3 Target Cost Contracts.**

## Overview of the NEC3 Target Contracts

Options C and D of the NEC3 suite of Contracts provide for what is known as a target cost contract.<sup>1</sup> This contains a mechanism for sharing risk and rewards known colloquially as a "pain/gain" mechanism. This fits well with the philosophy behind the NEC suite of contracts more generally which is designed to achieve more of a collaborative approach to contracting than the traditional JCT style contract using "foresighted collaboration" to reduce the risks in the construction process.<sup>2</sup>

As noted in the NEC3 Guidance Notes,<sup>3</sup> target cost contracts can be useful where the extent of the work to be done is not fully defined or where the risks anticipated are, for some reason, greater than usual. The financial risks are shared between by the employer and the Contractor in a way which is meant to ensure that the Contractor is motivated to carry out the works as cost efficiently as possible.

In such contracts, a target cost or price is agreed between the parties. This includes the Contractor's estimate of what are called "Defined Costs" in the NEC3 form plus a fee which is meant to cover the Contractor's costs, overheads and profit.

During the course of the works, the Contractor is reimbursed for its "Defined Costs" plus paid an agreed fee minus any "Disallowed Costs". Together, this is the "Price for Work Done to Date". Defined Costs (broadly speaking actual costs subject to the nuances detailed below) are assessed by the Project Manager during the course of the project by reference to Contractor's accounts and records which the Project Manager has the right to inspect at any time.

The target cost is adjusted during the course of the works for Compensation Events and (if selected as an option)

inflation.<sup>4</sup> At the end of the contract, a comparison is made between the final Defined Costs and Fee (the final "Price for Work Done to Date") and the target costs. If the final Price Work Done to Date is less than the target then the Contractor will make a share in the saving depending on the level agreed. If, however, it is greater than the target cost, the Contractor will pay a share of the difference (again at the level agreed). This "pain/gain" mechanism is designed to encourage efficiency and to align the Contractor's interests with those of the employer more closely, so it is argued, than the traditional forms of contracts.

## The Definitions of Defined Pre-Completion Costs and Disallowed Costs

So what is the definition of Defined Costs? The exact definition of "Defined Cost" (which also appears in Options E<sup>5</sup> and F<sup>6</sup>) varies depending on which NEC3 option is being used. Under Option C, Clause 11.2(23) it includes:

*"the amount of payments due to Subcontractors for work which subcontracted without taking account of amounts deducted for*

- Retention;
- Payment to the Employer as a result of the Subcontractor failing to meet a Key Date;
- The **correction of defects after Completion**;
- Payments to Others;
- The supply of equipment, supplies and services included in the charge for overhead cost within the Working Areas in this contract; and
- The cost of components in the Schedule of Cost Components for other work.

**Less Disallowed Costs**" [Emphasis added]

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## NEC 3 and Target Cost Contracts: Defined Costs, Disallowed Costs and Defects

In this edition of *Insight*, we examine the role of Defined Costs and Disallowed Costs in the NEC3 Target Cost Contracts and look at the confusion sometimes encountered when dealing with the defects (and the costs associated with rectifying them pre and post completion). As Claire King explains, the provisions are in many ways counter-intuitive and require both the Contractor and Employer to buy into the philosophy behind the Contract in order for it to succeed.



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Broadly speaking, Defined Costs are the actual costs incurred by the Contractor on the Works minus retention and any costs which would fall within the overheads covered in the Fee. From those are deducted "Disallowed Costs".

"Disallowed Cost" is defined by Clause 11.2(25). They are, broadly speaking, costs that the Project Manager has decided are either: (1) not justified by the Contractor's accounts and record; (2) shouldn't have been paid to a subcontractor in the first place; or (3) were incurred because the Contractor did not follow the acceptance or procurement procedures laid down in the Works information or didn't give an early warning notice as required.<sup>7</sup>

The Contractor's "Defined Costs" will generally be the subject of regular audits and, for large projects, the level of information required to justify "Defined Costs" (and that they are not "Disallowed Costs") can be substantial. The topic of establishing "Defined Costs" is, however, one for another article.

The costs of the following are also, amongst other items, expressly include in Disallowed Costs:

- "
- *Correcting defects **after** Completion; and*
- *Correcting defects caused by the Contractor not complying with a constraint on how he is to Prove the Works stated in the Works information."*

Unless defects occur AFTER completion, or as a result of failing to comply with a constraint in the Works Information, the Contractor is then entitled to be paid for correcting "defects" which occur before

Completion. To many, this is entirely counter-intuitive.<sup>8</sup>

## Costs of Defects and the philosophy of Target cost contracts

A degree of "rework"<sup>9</sup> or defects pre-completion is an inevitable part of the construction process, although it will obviously vary significantly from project to project. One study estimated that the median cost of re-work for construction projects was 4.03% of the total project costs but noted that the scale of rework was often significantly under-reported meaning that the actual costs associated with it were likely to be higher (at a median of 5.04%). In another Australian study, the means direct and indirect costs of rework were found to be 6.4% and 5.9% of the contract value respectively.<sup>10</sup>

Contractors used to fixed price contracts will price this rework or pre-completion defects into their prices. In fact, under the NEC3 Target cost contract, there is arguably no reason to do so as they should be paid for this in any event.

For those on the employer's side of the fence, who are used to fixed price contracts, paying for the costs of rectifying pre-completion defects and/or rework because it forms part of Defined Costs is a hard pill to swallow. As such, the natural instinct for Project Managers who have not understood (or fully bought into) the philosophy of the NEC3 Target Contract properly, is to resist paying for pre-completion defects and the costs of the rework associated with them (although no doubt this will depend on their scale and severity!).

We are aware of instances where, on large infrastructure projects, the NEC3 target cost form has been amended to include much more stringent restrictions on costs that can be recovered as part of Defined Costs and/or deducted as Disallowed

Costs. These include providing that costs related to "breach of contract" can be deducted from Defined Costs as Disallowed Costs and that Defined Costs have to be "reasonably and properly" incurred.

The risk in adding these bespoke changes is that it shifts (potentially fairly significantly if you consider the statistics on rework costs above) the balance of risk on which the NEC3 target cost contract is built. Permitting the recovery of the costs for the correction of defects pre-completion has, arguably, an indirect benefit to the Employer because when the Contractor is paid for remedying the defect, his Defined Cost increases. As a result, the Contractor's potential for making a gain share is reduced. If the Target Cost is exceeded, then the Contractor may have to give this money back. Therefore, the Contractor is incentivised to minimise the defects in order to keep Defined Cost down in the hope of ensuring a bigger gain share.

Other potential benefits that have been suggested include discouraging Contractors from hiding defective work rather than rectifying them at their own costs and also incentivising them to minimise any "snags" prior to completion.<sup>11</sup>

If, on the other hand, the costs of Defects before Completion are irrecoverable (either because they are not considered to be reasonably and properly incurred or because they are alleged to be a breach of the contract - albeit it is doubtful that a defect pre-Completion can be a breach given Completion has not yet occurred), then there is a very high risk that the Contractor will price the cost for this in somewhere else.<sup>12</sup> Where then is the Contractor's motivation to minimise re-work and or defects pre-Completion which the NEC3 target cost contracts state they are designed to achieve?



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Likewise, if the target is unachievable, the incentive to try to achieve it and to act efficiently in order to do so is effectively removed. The risk is then that the behaviours the NEC3 form is designed to try and discourage resurface in which case the whole point of using the NEC3 Target contract form in the first place should be reconsidered.

Drawing these strings together, it is arguable that Target cost contracts, being a variation of cost plus contracts, create inherently adversarial interests, in that the Contractor is primarily paid for his costs while the employer is required to scrutinise these costs to ensure that they are valid.

Not surprisingly, issues often arise as to whether the costs incurred by the Contractor may be disallowed. Disallowed costs can be difficult to identify in practice, as is the case, for example, with costs which the employer perceives to have been incurred as a result of the Contractor's inefficiency.

Further, there is less certainty for the employer under target cost arrangements about what the actual final cost will be: the nature of the Target cost contract is such that the employer also shares in the Contractor's risk. However, for those numerous instances where some form of cost plus contract may be more appropriate (for example, where a contract must be let before design development is sufficiently advanced to allow a lump sum price to be fixed; or where the employer wishes to participate in the design; or where Contractors are simply not prepared to take lump sum contracts due to the size and complexity of the project), the target cost option has clear

advantages. Incentives can work if they genuinely result in an alignment of objectives between the parties. A realistic target cost and effective project management can play an instrumental role in maximising the chances of a Target cost contract delivering benefits for both parties. Giving careful consideration to the pain/gain share mechanism and tailoring it to the particular needs of the project is also of utmost importance.

## Footnotes

1. Option C does this in relation to an Activity Schedule while Option D does this in relation to a Bill of Quantities.
2. See the preface to the Engineering and Construction Contract Guidance notes for NEC 3 dated April 2013 (the "NEC3 Guidance Notes") by Dr Martin Barnes CBE.
3. See page 14 of the NEC3 Guidance Notes.
4. Option X1. For Option D the costs are also adjusted as the works completed by the Contractor is measured (as to which see the NEC3 Guidance Notes).
5. Cost Reimbursable Contract.
6. Management Contract.
7. With certain exceptions, the Contractor must notify the Project Manager within eight weeks of becoming aware of an event that it considers to constitute a Compensation Event. If the Contractor fails to do so, it may not be entitled to a change in price (Clause 61.3), or if the Project Manager decides that costs were incurred – whether pursuant to a Compensation Event or otherwise – only because the Contractor failed to give an Early Warning Notice ("EWN") required under the contract, then those costs become Disallowed Costs (Clause 11.2(25)).
8. See "Disallowed Costs v Defined Costs in NEC Contracts" by Robert Gerrard, the NEC Users' Group Secretary, as published in the Magazine of the Chartered Institute of Building dated 3 May 2015, in which he noted that

a significant number of queries that are made to the NEC Users are on the question of Disallowed Costs in NEC Contracts.

9. One possible definition of this is: "Activities in the field that have to be done more than once in the field, or activities which remove work previously installed as part of the project regardless of source, where no change order has been issued and no change of scope has been identified by the owner". See Navigant's report "The Impact of Rework on Construction & some practical remedies" dated August 2012; and Fayek, Aminah Robinson, Majula Dissanayake and Oswaldo Campero, Measuring and Classifying Field Rework: A Pilot Study by the Department of Civil and Environmental Engineering, University of Alberta, May 2003.
10. See Calculating total rework costs in Australian construction projects by Peter E.D. Love and David J. Edwards as published in Civil Engineering and Environmental Systems on 25 January 2007.
11. See "Do Target Cost Contracts deliver value for money?" by Ian Heaphy dated July 2011 (SCL Paper D126).
12. Arguments as to the meaning of reasonable and whether it adds anything or not to "properly" (which is clearly aimed at propriety) also open the door to disputes and again may result in changes in behaviour away from the collaboration envisaged.

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Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Claire King. [cking@fenwickelliott.com](mailto:cking@fenwickelliott.com). Tel +44 (0) 207 421 1986

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Fenwick Elliott LLP  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN  
[www.fenwickelliott.com](http://www.fenwickelliott.com)