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Assessing the Amount Due under NEC3 Option C

The recent economic climate may have seen a degree of procurement strategy regression from some corners, yet Option C (target contract with activity schedule) remains one of the most popular forms of the Engineering and Construction Contract (ECC).

In principle, target cost contracts are simple: a realistic target is set, a fair share mechanism is agreed and the parties work together to share the risk and reward. If the *Contractor* outperforms against the target, he will share in the saving; if he exceeds the target, he will pay his share of the excess.

However, the fact that the ECC deliberately avoids use of the term “target cost” and that the definition of cost under Option C isn’t merely “amounts paid by the *Contractor*” hints that things aren’t always quite as simple as they may seem.

Through my own personal consultancy experience, one of the most common problems I have encountered with Option C (in addition to Employers wanting to have their cake and eat it by misusing the share mechanism!) is a lack of understanding as to how the amount due to the *Contractor* is calculated, with contractors often finding that when their costs are reimbursed in accordance with the contract it is not as they envisaged at tender stage.

I recently took the opportunity of conducting a series of surveys and interviews as part of an MSc dissertation to take a closer look at the provisions for assessing the amount due and attempt to determine:

- Does the industry understand how costs are reimbursed under Option C?
- If they don’t understand, why? Is it the fault of contract or the users?
- What can be done to improve understanding?

Is the contract clear?

Clarity and the use of plain English by the NEC has been the source of much debate, dividing opinion between respected legal authority as to whether it “*requires one to focus on what is truly intended and not on what is to be presumed*” (Humphrey, 2008) or if it is “*a triumph of form over substance*” (Edwards-Stuart, 2010).

Generally, I consider that the use of plain English is a success. The defining objective of the NEC3 being a stimulus to good management could not be achieved if it was not written and structured in a way that the users can understand. However, one must not forget that it is also a contractual document designed to create legal obligations and intended for a variety of applications both in the UK and internationally; therefore it is almost inconceivable that in its core form it can be distinctly clear and readily understandable to all people in all respects.

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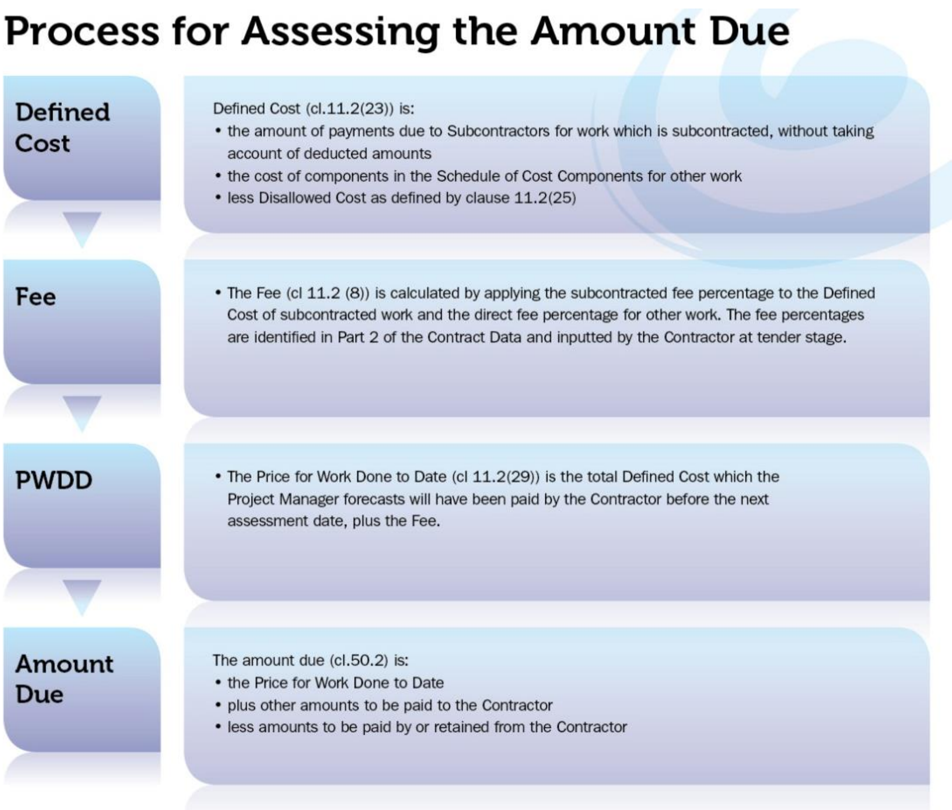
I believe that assessing the amount due under Option C is one of those respects - specifically the Schedule of Cost Components - and as such requires a little more thought.

How is cost reimbursed under the contract?

Before I explain the process for assessing the amount due, a cursory glance at the diagram below is advisable, especially for those with no prior experience of Option C. Whilst the *Contractor* may submit an application for payment, it is the *Project Manager's* duty to assess the amount due at each assessment date.



The amount due is the Price for Work Done to Date (PWDD) less amounts to be paid by or retained from the *Contractor.* The PWDD is the total Defined Cost the Project Manager forecasts will have been paid by the next assessment date, plus the Fee. Defined Cost is the amount of payments to *Subcontractors* for subcontracted work (without taking account of deductions) and the cost of components in the Schedule of Cost Components for other work, less Disallowed Cost. 'Simples'!

The aim of the approach taken by ECC is to clearly define boundaries for the reimbursement of cost that reflect the way in which costs are incurred and to move away from traditional methods of rate-based cost reimbursement that it can be argued are not representative of the *Contractor*'s true position. The question is, has it succeeded in practice?

What the industry thought

The findings of my survey showed that a staggering 77% of respondents thought that *Contractors* didn't understand the categories of cost to be reimbursed in accordance with the Schedule of Cost Components (SCC), with 68% answering the same for *Project Managers*! Worryingly, in our current fragile market, only 10% of respondents thought that the *Contractor*'s costs were reimbursed as they envisaged at tender stage.

To try and discover the cause of such a lack of understanding, I posed a survey question that was perhaps more 'exam' than 'survey', listing 15 common items of cost and requesting respondents to allocate them to a

component in the SCC. A significant number (15%) of respondents exited the survey before completing the question; of those that remained only 63% of respondents allocated the cost to the correct component.

The results showed the two most commonly misunderstood areas as being People and Charges, which perhaps is not entirely surprising given that elements of these components represent the most significant departure from traditional practices.

People

For People costs, the *Contractor* is reimbursed according to time worked in the Working Areas but must split the cost as defined by components 11 to 14 of the SCC. In practice, this means that for people directly employed, the *Contractor* must collate the cost to employ for all people in the Working Areas (which may be made up of payroll summaries, pension costs, car costs, travel costs etc.) and allocate these costs to the contract based on the time spent Providing the Works in the Working Areas. This can be quite an administratively complicated calculation and requires a completely open book approach by the *Contractor* which - even when they are willing - can be a difficult task if their cost systems do not lend themselves to such scrutiny. My research findings supported this with 48% of respondents considering the *Contractor's* cost systems least suited to the People component.

In issue 36 of the Users' Group Newsletter, Michael Rawlinson surmised that "*more could have been done to simplify the people section of the schedule, for instance by providing a schedule of rates for different grades of staff, tradesmen and operatives to be provided by the contractor at tender, rather than leaving the administratively complicated calculation needed for every individual to who the schedule applies*." However, the intention of the SCC is to move away from these traditional practices where the *Contractor*'s actual cost position may be disproportionate to their cost position when reimbursed through the use of the rates. Similarly, when Compensation Events arise, the provisions for assessing cost are supposed to establish a fairness for both parties and ensure that Compensation Events put the party in the position they would have been in had the event not arisen.

Survey respondents were asked to consider if they felt an auditable schedule of rates was a desirable option for assessing People costs, with the results split 50/50. Coupled with the majority of respondents agreeing that the philosophies of the SCC promote the spirit of mutual trust, it could be argued that whilst some adaptations may be required, to abandon the principles of the SCC in favour of rate based methods would be a victory for the resistance to change brigade and not embracing the spirit of the contract.

Charges

The cost of utilities, payments to authorities, cancellation charges, inspections and the like are covered in components 41, 42 and 43 of the SCC. However it is item 44 that - although basic in concept - can cause some confusion.

Item 44 provides for a charge for overhead costs incurred in the Working Areas, calculated by applying the percentage for Working Areas overhead in the Contract Data to the total of the people items 11, 12, 13 and 14. The charge excludes accommodation but includes such items as catering, recreation, sanitation, security, computing and hand tools not powered by compressed air: items that may generally be considered 'preliminaries', except that supervision is reimbursed under the cost component for people. The Contractor must assess, at the time of tender, the estimated people costs and the estimated cost of the items covered by the charge for Working Area Overheads, which is then expressed as a percentage in Part Two of the Contract Data.

I asked survey participants to assess the commonality of contractors applying for payment for items which should have been included in the charge for Working Area Overheads, with 85% answering either 'Common' or 'Very Common'. This could be a consequence of the *Contractor* applying for these items for ease and having the *Project Manager* deduct them in his assessment. Consider this scenario at the start of a contract: the *Contractor* needs to procure some timber for formwork, a circular saw, PPE, some padlocks and some cleaning products for the site compound. The *Contractor*'s buyer goes directly to the local builder's merchant who can deliver the items the next day. One purchaser order is raised and one invoiced received. Even assuming the *Contractor* understands the SCC and has appropriate cost coding systems, the reality is a difficult administrative exercise to allocate the costs to the correct component and exclude those covered the by percentage for Working Area overheads.

The aim of the percentage for Working Area overheads is twofold: to reduce the administrative burden and place the risk of excessive wastage of hand tools and the like on the *Contractor*. I would question whether administration really is greatly reduced and in terms of wastage and utilisation, there certainly seems a conflict with the general philosophy of the contract where the risk of reasonable resource utilisation, Plant and Materials wastage and defects before Completion are shared by the Parties.

What needs to change?

The objectives of the SCC align with the contract and are generally considered positive progression from current practices, with 80% of my survey respondents supporting the open book approach of Option C, yet evidently more needs to be done to improve understanding of how costs are to be reimbursed to the Contractor. The real question is what needs to change, the contract or the users?

Distinction must be drawn between an absence of clarity and an absence of knowledge: the former being an issue with the contract and the latter a characteristic of the users. Whilst the relationship between knowledge and understanding of participants was outside of the scope of my research, I'm not sure if those having problems have genuinely taken the time to acquire the knowledge necessary to apply the SCC in practice. If it isn't working the easy option is to blame the contract, but as the old saying goes 'a bad workman always blames his tools'!

NEC3 generally requires changes in philosophies, attitudes, working methods, systems and procedures, as well as education and training. If users make the effort to acquire the knowledge but cannot develop the necessary understanding to operate the contract effectively, then the objective of clarity has failed. However, until we can be sure they have, it is impossible to conclude what needs to change.

The recent publication of a number of new reference books and guides to NEC3 perhaps suggests that it is more commonly acknowledged that the problem lies in the user's understanding and application of the contract in practice, rather than in the contract itself.

Some suggestions from the results of my research that may be useful to consider going forward are set out below.

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Suggested Improvements to Schedule of Cost Components

Suggestion	Implication	How it could be achieved
1 Clear and Thorough Guidance Notes	• Aids knowledge development and understanding from the outset • Single point of reference for clear understanding	• Via NEC User Group and Healthcheck Service • More practical worked examples • Standard reporting and application proforma and templates
2 Training of Personnel in line with roles and responsibilities under the contract	• Reduces errors, misunderstandings and disputes • Promotes co-operative management approach • Enables teams to retain knowledge and embed good practice on future contracts	• Contract start up workshops to establish understanding and procedures • NEC accredited training with commensurate qualification for all members of the project team
3 Appointment of Independent Auditor/ Advisor	• Able to act as facilitator between Employer, Contractor and Subcontractors • Able to improve cross party communications and take independent view on most effective risk reduction measures • Fair and reasonable procedures established early in the contract avoids potential for disputes and irons out any misunderstandings at an early stage • Promotes learning and good practice for all parties	• Employer and Contractor appoint Auditor/Advisor in same manner as Adjudicator may be agreed and named in contract • Stipulate fair and reasonable audit procedures in the contract • Agree sensible timing and frequency of audits
4 Use of a single Schedule	• Achieves consistency across all options and supports a common approach • Promotes greater clarity and understanding for all parties	• Amendments to the conditions of contract by the Employer • Review by the NEC drafting panel for 4th edition
5 Schedule of Rates for People	• Gives Employer improved cost certainty and aids effective tender evaluation • Reduces administrative burden post contract	• Amendments to the conditions of contract by the Employer • Set out templates to be pre-audited and ensure rates are reflective of anticipated cost
6 Collaborative Supply Chain Management	• Employer and Contractor ensuring the supply chain understand how costs are to be reimbursed and how the Contract Data should be completed • Key personnel and understanding of contract procedures known pre-contract	• Tender workshops • NEC facilitators to work with supply chain in compiling and completing tender documentation

The way forward

There is concerning lack of understanding of the contractual provisions for the reimbursement of cost under Option C, often resulting in an inaccurate target before the works have even started.

For me, one of the more significant changes from the second edition of the ECC to the third clearly hasn't resonated through the industry in the way in which it was intended: the change in definition from 'Actual Cost' to 'Defined Cost' to underline that the Contractor isn't simply reimbursed amounts paid.

Despite these misunderstandings, it is unlikely that wholesale changes to the contract will be made, certainly not any time soon. It is here perhaps that the *Employer* must optimise the flexibility of the NEC3 and work collaboratively with the *Contractor*. If you don't think the SCC will work practically on your project, by all means amend it; but do it properly, with clarity, common sense and with the true objectives of the contract in mind.

By John Rossiter - Service Delivery Director

References

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Rowlinson, M. (2006, August). NEC3 – Revisions to the Schedules of Cost Components and the Fee in the ECC. *NEC Users Group Newsletter Issue 36*, pp. 4-5.