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NEC Users' Group Workshop – Defined Cost

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making the **difference**

Introduction

- Practicalities in assessing of Defined Cost & Disallowed Cost
- Assumption that you have a basic understanding of Defined Cost and the Schedule of Cost Components
- Focus particularly on it being the method for reimbursing the Contractor under Options C, D & E of ECC3
- Defined Cost in the assessment of compensation events under Options A, B, C, D & E
- Interactive workshop
 - Share experiences / issues / knowledge
 - Ask questions, debate, challenge

Defined Cost

- Defined Cost - Definition changes between Main Options
- Serves 2 purposes
 - Under all Main Options basis for assessing the financial impact of compensation events
 - Under Main Options C, D, & E it is also the basis for reimbursing the Contractor for the Price for Work Done to Date



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Defined Cost as the basis for Payment of the PWDD

Defined Cost = Actual Cost?

- Under cost reimbursable contracts Contractor is paid their “actual cost”?
- What is actual cost?
- Cost reimbursable contracts do not pay real actual cost
- It is very difficult / impossible to work out the actual cost
- Many costs are not project specific and are shared over many projects
- Cost reimbursable contracts contain a set of rules over what “costs” can be claimed and how
- “Cost” needs to be clearly and completely defined in the Contract
- ECC – Defined Cost that defines what “costs” can be recovered and how

Defined Cost - Definition

- ECC - Options C, D & E, 11.2 (23) Defined Cost is
 - the amount of payments due to Subcontractors for work which is 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 and
 - 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 any Disallowed Cost

Schedule of Cost Components

- There are two Schedules of Cost Components
- Shorter Schedule of Cost Components
 - used with Options A & B (and if agreed options C-E)
 - only used to assess compensation events
- Schedule of Cost Components
 - used with C-E
 - used to assess compensation events and
 - determine the Price for Work Done to Date
- The schedules are a set of rules to define those components of the Contractor's cost which are included in Defined Cost
- Linked to Contract Data Part 2

Schedule of Cost Components

- Subcontractors – Direct Cost
- Your experiences / issues?
- Common issues
 - Value for money tests
 - Value is achieved by driving efficiency in the Contractor and their supply chain
 - How do you ensure value for money achieved?
 - Works undertaken by internal or affiliated companies

Schedule of Cost Components

- ECC approach
 - Amounts included in Defined Cost are
 - at open market or competitively tendered prices
 - with deductions for all discounts, rebates and taxes which can be recovered
- Competitive testing of prices or
- Open market prices - benchmarking
- Additional requirements to enforce competitive tendering?
- Quality v price
- VFM should be driven by pain / gain mechanism?

Schedule of Cost Components

- Contactor's "other" costs
 - Schedule of Cost Components is split into the following sections
 1. People
 2. Equipment
 3. Plant and Materials
 4. Charges
 5. Manufacture and fabrication
 6. Design
 7. Insurance

People

- Costs incurred in the “Working Area”
 - Definition?
 - Who determines the Working Areas?
 - Can it change?

People

- Direct costs of employment of the staff and labour engaged by the Contactor to deliver the works
- Your experiences / issues?
- Common issues
 - True cost of staff or salary costing rate?
 - Key to understand the basis of the rate
 - Total hours divided by annual costs – holidays / sick days / training etc.
 - Overtime
 - Benefits in kind – phone / car / fuel card / expenses
 - Pay rises, bonuses and redundancy costs

Equipment & Plant

- Costs incurred in the Working Areas
- Direct cost for hired Equipment
- Agreed schedule of rates for Contractor's own Equipment
- Additional Equipment – at notional external hire rates
- Equipment purchased - a payment for the difference in value between purchase price and open market sale price for Equipment bought specifically for the works
- Your experiences / issues?
- Common issues
 - Ability to benchmark – discount agreement
 - What if internal costs are higher but quality / performance is better – VFM

Materials

- Direct costs incurred in purchasing the Plant and Materials
- Your experiences / issues?
- Common issues
 - Volume / annual company wide discounts – how are these accounted for?
 - Do they still exist?
 - Should they be shared with the Employer

Charges

- Direct costs of water, gas and electricity used in the Working Areas
- Direct costs of payments to authorities and listed items
- Application of a Working Areas overhead percentage to the total cost of People to cover for a list of overhead costs incurred within the Working Areas
- Your experiences / issues?
- Common issues with Working Areas Overhead
 - Purpose
 - Coverage
 - Pricing

Manufacture and Fabrication & Design

- Costs incurred outside the Working Areas
- Shared facilities
- Difficult to allocate the actual costs of the shared facility to the project
- Pre-agreed schedule of hourly rates
- Plus pre-agreed percentage for overheads
- Your experiences / issues?
- Commons issues
 - Ensure this information is completed as part of Contract Data Part 2
 - Design by the Contractor's own staff – sub-consultant would be a Subcontractor under the ECC

Insurance

- Deducted from Defined Costs
- The costs of events which the Contractor has to insure
- Other costs paid to the Contractor by insurers
- Your experiences / issues?
- Common issues
 - › Identifying and valuing insurable events
 - › Insurance excesses – borne by the party who carries the risk
 - › Insurance provided by Employer but risk carried by Contractor?

Verifying Defined Cost

- Need to put in place an audit process to validate Contractor's costs
- Contractor is required to keep these records
 - Accounts of payments of Defined Cost
 - Proof that the payment has been made - what does this mean, banking records?
 - Communications about and assessments of compensation events for Subcontractors and
 - Other records as stated in the Works Information – chance to enhance and clarify requirements
- Commonly no further requirements added and no pre-agreement over the level of information required
- Your experiences / issues?

Verifying Defined Cost

- Common issues
 - Need to understand and validate Contractor's costing system
 - On site costing system can be different to accounting software and can act more as a profit and loss account for the Project than a true record of costs incurred
 - Costs posted but not paid / journal entries
 - Allocation of costs to projects such as staff costs / equipment depreciation etc.
 - Audit of cost
 - Sample audit common approach – 10% - vertical and horizontal audit
 - Computer aided audit systems – 100% audit
 - Review resources on site and material deliveries to ensure that these are correct and not excessive



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Disallowed Cost

Disallowed Costs

- Costs that do not form part of the definition of Defined Cost - covered by the Fee – non allowable costs
- Disallowed Cost is cost the Contractor may have incurred and fall within the definition of Defined Cost, but
- The costs have only been incurred due to some failure or default of the Contractor
- The Project Manager can reject payment
- Disallowed costs are therefore cost borne entirely by the Contractor
- Have to be covered by the Fee

Disallowed Cost

- Amounts not justified by the Contactor's accounts and records
 - To what level of detail – actual records of payment via bank records
 - Accruals / liabilities / journal entries
- Should not have been paid to a Subcontractor or supplier in accordance with their contract
 - Clause 26 – Project Manager needs to see copies of subcontracts
 - Settlement agreements?

Disallowed Cost

- Costs incurred because the Contractor did not follow an acceptance or procurement procedure stated in the Works Information
 - Assessing the extra over cost due to the failure – what costs could have been saved
- Contractor failed to give an early warning which this contract required him to give
 - Gift of hindsight - assess what could have happened, what costs could have been saved
 - Disallow all costs incurred and / or add back the costs that would have been incurred – if so how?

Disallowed Cost

- Plant and Materials not used to Provide the Works (reasonable wastage)
 - What is reasonable
 - Pre-agree wastage allowances
- Resources not used to Provide the Works (reasonable availability and utilisation)
 - Standby plant?
 - Pre-agree any debateable items
- Preparation for adjudication / tribunal
 - When does commercial management become preparation for adjudication?

Disallowed Cost

- Correcting Defects after Completion
- Correcting Defects prior to Completion
 - Defect – not in accordance with the Work Information or applicable law
 - Not all Defects covered only Defects caused by the a failure to comply with a constraint on how to provide the works stated in the Works Information
 - What is a constraint on how?
 - Examples

Disallowed Cost

- Majority of Defects prior to Completion will be allowable
- There will always be Defects during construction
- Someone will have to bear the cost of correction
- ECC has drafted clauses to allocate risk but definition is difficult
- Identification and capture an issue – and cost
- Behaviours the approach creates
 - › Hiding Defects
 - › Snag free hand over
- Pay anyway as part of the Fee?
- Costain V Bechtel Ltd [2005] EWHC 1018 (TCC) – “independent certifier”



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Compensation Events

Compensation events

- Under all Main Options basis for assessing the financial impact of compensation events
- By agreement rates and lump sum prices can be used under Options C, D & E
- Option C, D & E
 - Definition as used for payment
 - Same issues apply

Option A & B

- Defined Cost – Options A & B
 - Only used for assessing compensation events
 - Defined Cost is the cost of the components of the Shorter Schedule of Cost Components whether work is subcontracted or not excluding the cost of preparing quotations for compensation events
 - Determining the cost of preparing quotations as opposed to normal commercial activities

Option A & B

- If work is Subcontracted – ignore the actual cost of the Subcontractor and price based on the Shorter SoCC
 - Lump sum quotation from Subcontractor – how do you work out man hours etc?
 - Level of breakdown required – into categories or rates for staff etc?
 - Specialist work which the Contractor does not undertake – what basis for pricing?
 - No overheads and profit allowed for Subcontractor work has to be included in the Fee - *subcontracted fee percentage*



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Summary

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- Recap of the session
 - Clarify any issues
 - Capture actions / learning points
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- **Thank You**