NEC Users’ Group Workshop – Defined Cost

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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
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 competed 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
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”
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*
Summary

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

- Thank You