Setting & managing target contracts

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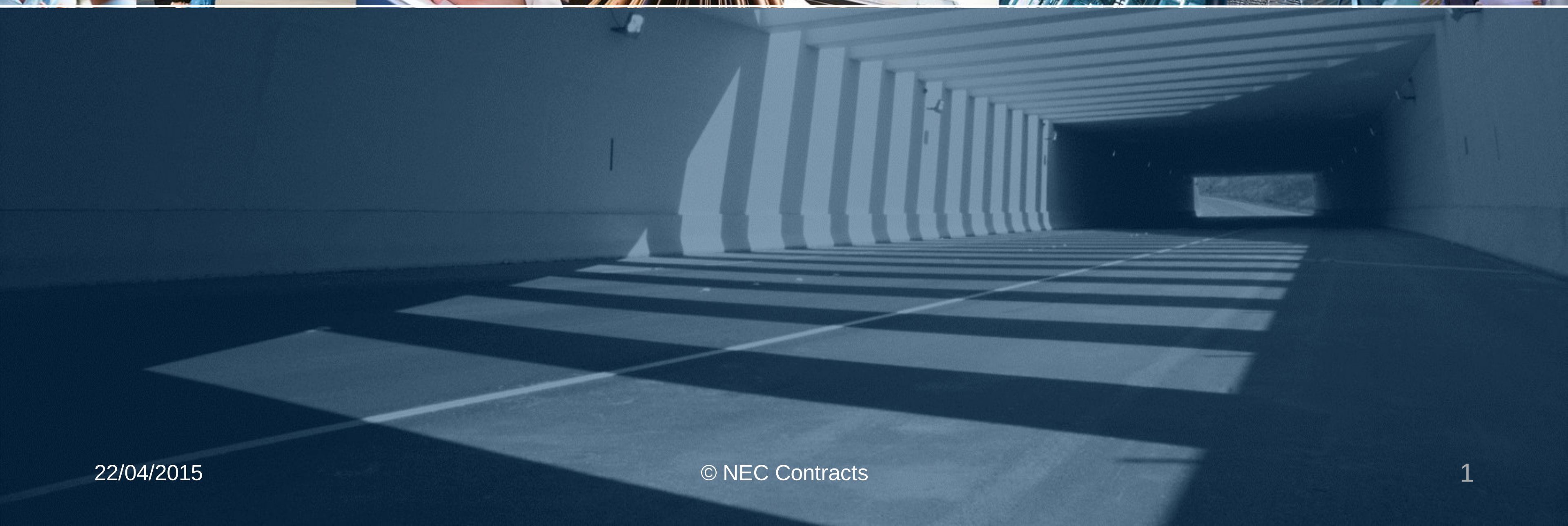


Setting & managing target contracts

- Through research, the NEC recognise that greater clarity is needed about this concept and it's practical application

- This workshop explores (in the 2 hours we have):
  - The key terminology & concepts
  - Common pitfalls in practice
  - How to manage the target
  - How to manage cost

Applicable main Options

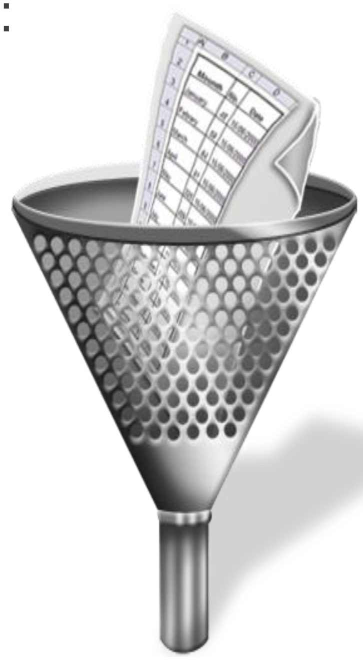
- Both main Options C & D are applicable here
- C: '**Target contract**' with activity schedule
- D: '**Target contract**' with bill of quantities
- We maintain a 'target' and compare against the PWDD (cost)
- Dependent upon the share rages, there may be a sharing of 'gain' or 'pain'
- Option C is perhaps the most popular in practice

Appropriate terminology/ clauses

- Prices (11.2(30)) & (11.2(31))
- Price for Work Done to Date (PWDD) – 11.2(29)
- Defined Cost (11.2(23))
- Disallowed Cost (11.2(25))
- Fee (11.2(8))
- Clause 52.1

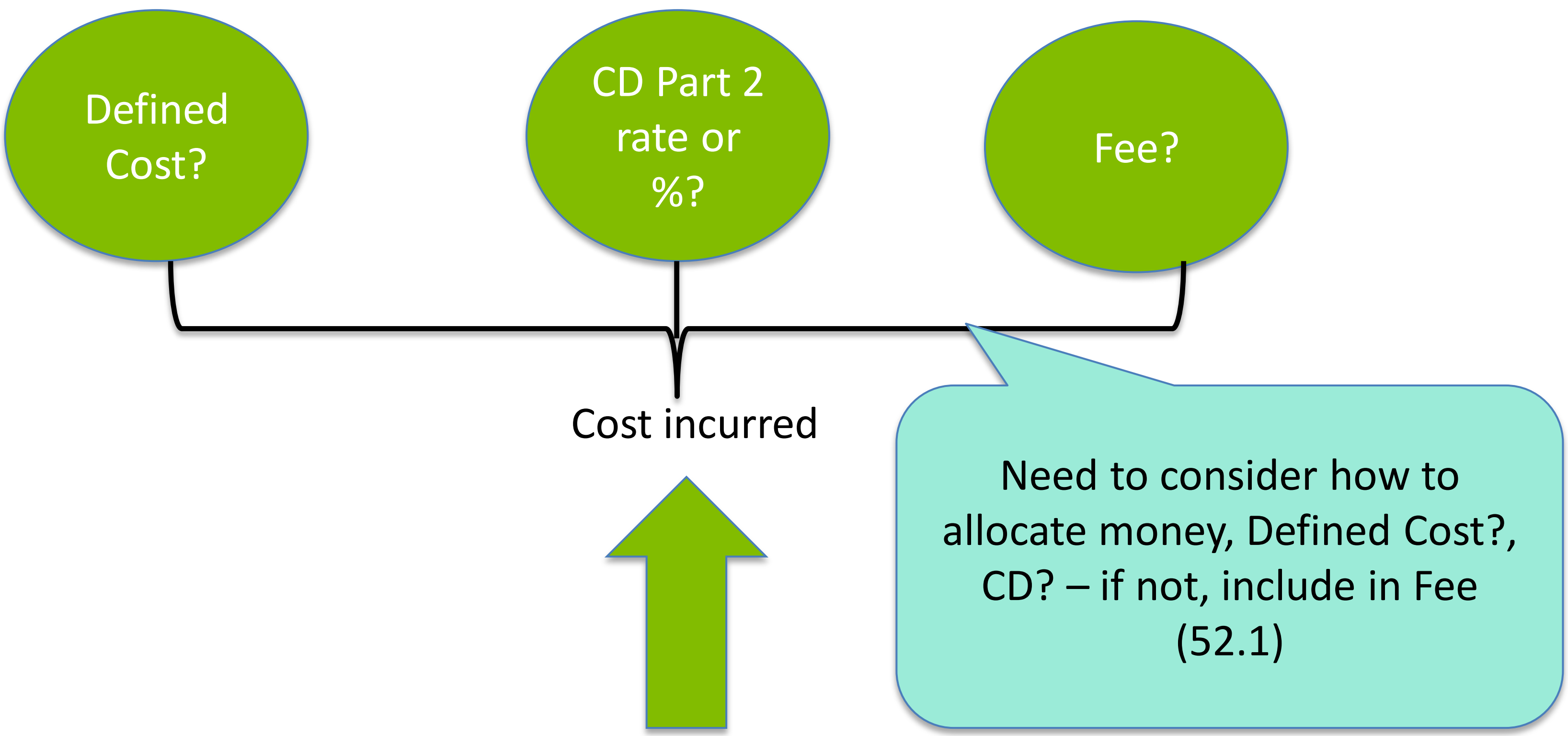
Disallowed Cost – what is it?

- Under Options C,D, E & F the *Contractor* is paid Defined Cost
- Disallowed Cost provides a 'filter' against certain costs which are seen as unreasonable for the *Employer* to pay for
- Disallowed costs may be broadly categorised into the following:
  - Costs which cannot be justified
  - Costs incurred as a result of failing to follow contract procedures
  - Costs incurred as a result of failing to follow Works Information procedures
  - Correcting Defects after Completion
  - Excessive waste/ poor management of resource
  - Costs incurred in preparing for an adjudication



Disallowed Cost – relationship with other clauses?

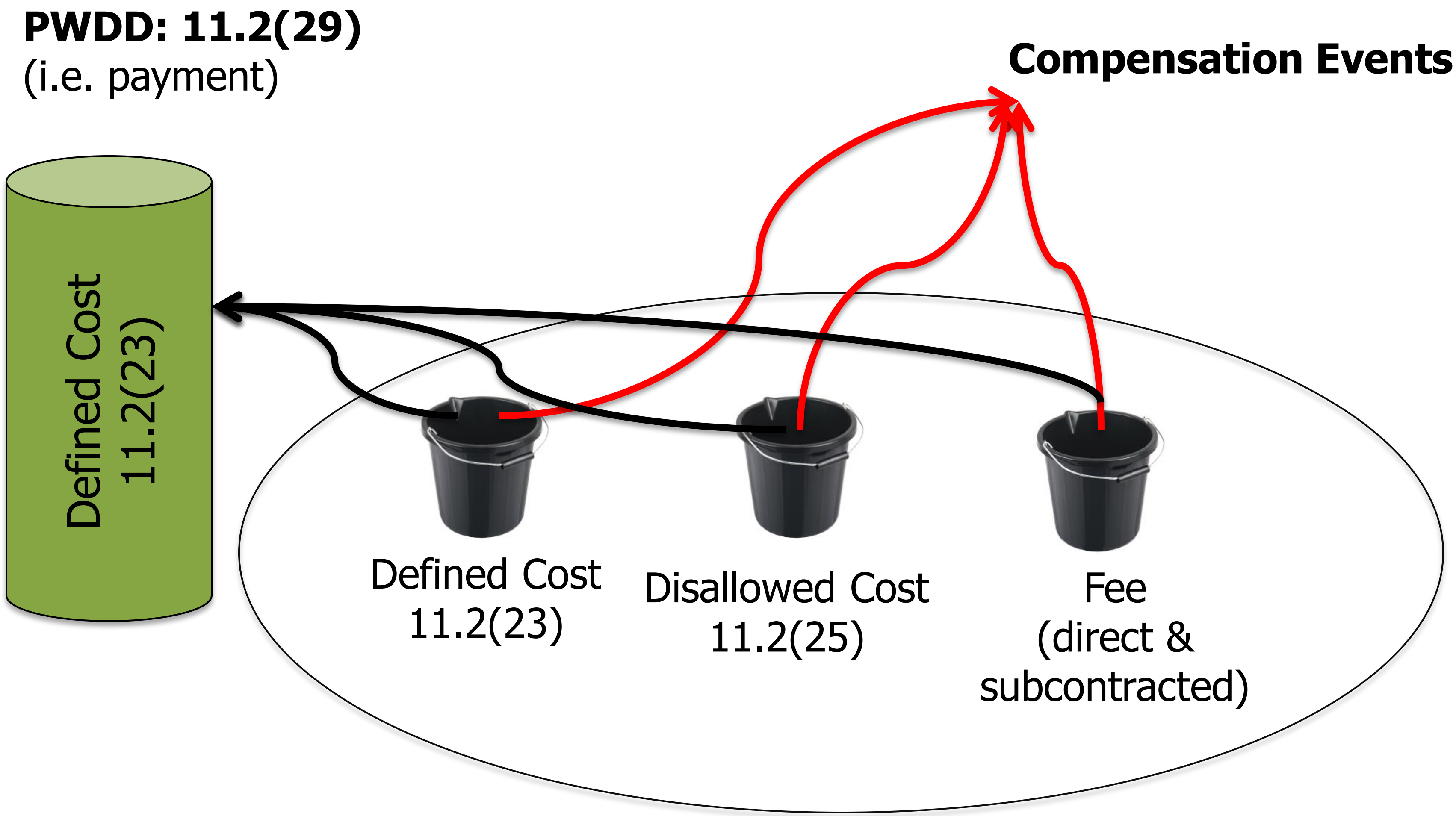
- A clear understanding is required at tender stage:



Inappropriate terminology

- Target cost
- GMP
- AMP
- …..using lay terminology becomes confusing – people then start to get ‘target’ and ‘cost’ mixed up
- We use **Prices** (target/ contract sum) and **Price for Work Done to Date** (Defined Cost plus Fee) i.e. cost

Relevance of Defined Cost, Disallowed Cost & Fee for different main Options: Option C & D



Defined Cost: Clause 52.1

- All the *Contractor's* costs which are not included in the Defined Cost are treated as included in the Fee. Defined Cost includes only amounts calculated using rates and percentages stated in the Contract Data and other amounts at open market or competitively tendered prices with deductions for all discounts, rebates and taxes which can be recovered.

Common pitfalls: Risk allocation

- Many projects and frameworks attempt to allocate risk via a risk register. However:

- Definition of the Risk Register (11.2(14)):

  - Register of risks listed in the Contract Data, and;
  - Risks which the *Project Manager* or the *Contractor* has notified as an early warning matter

- It includes:

  - A description of the risk
  - A description of the actions which are to be taken to avoid or reduce the risk

CD part 1 & 2 – where risk management begins:

- In Contract Data part 1 & 2 (as part of the tender process) both parties list the matters to be included in the Risk Register
- This does not change the risk allocation!
- It merely provides the initial building blocks of a post-contract risk register which is then supplemented by early warnings

Risks identified in Contract Data part 1 & 2 (headed 'risks to be included in the Risk Register') do not change the risk allocation – their purpose is to support post-contract risk management

CD part 1 & 2 – where risk management begins:

- As an optional statement in Contract Data part 1 there is a list of potential additional *Employer's* risks

- These and Z clauses do change the risk allocation

Common pitfalls: Works Information

- Often with negotiated target contracts the Works Information prepared by the *Contractor* for his design can develop away from that of the *Employer* (often referred to as derogations)

- If this is done in agreement then the *Employer*'s Works Information needs amending

- If not, the Employer's Works Information remains dominant (clause 60.1(1)), second bullet).

Common pitfalls: Working Areas

- A legitimate Working Area is necessary for Providing the Works and used only for work in this contract (11.2(18))
- Regional or head office therefore will not apply!
- How the project will be serviced needs to be carefully considered at tender stage and reflected in the pricing strategy

Common pitfalls: Rates and percentages

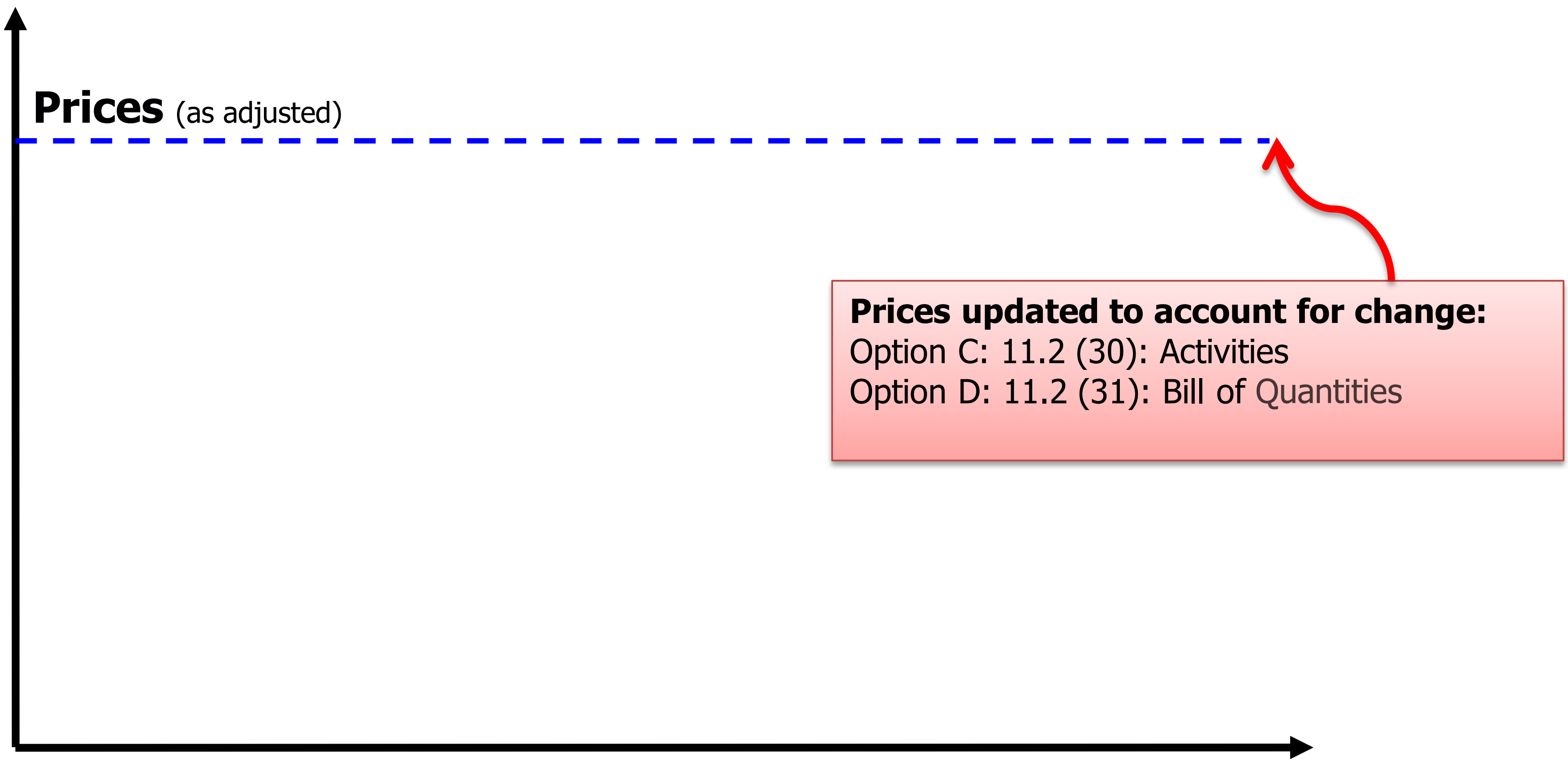
- Very often, it is not fully appreciated how the rates and percentages in Contract Data part two are used in terms of the Price for Work Done to Date and for compensation events
- Common misconceptions:
  - *"I've not included a subcontracted fee as I don't intend to subcontract any work"*
  - *"The fee percentages should not be used for negative compensation events"*
  - *"If the rates are wrong we can agree to change"*

Completing Contract Data part two: Option C or D

- Option C and D require the following to be completed:

Description	Rate	Percentage
direct fee %		✔
subcontracted fee %		✔
SCC: List of Equipment purchased for the contract	✔	
Rates of special Equipment	✔	
Working Areas overheads %		✔
Hourly rates for manufacture & fabrication outside the Working Areas	✔	
Manufacture and fabrication overhead		✔
Hourly rates for Defined Cost of design outside the Working Areas	✔	
Percentage for design overheads		✔
Categories of design employees whose travelling expenses are included as a cost of design done outside the Working Areas	✔	
People overheads %		✔
Published list of Equipment	✔	
Percentage adjustment		✔
Rates for other Equipment	✔	

Managing the target: Both Options require the Prices to be updated



Reporting requirements under the ECC:

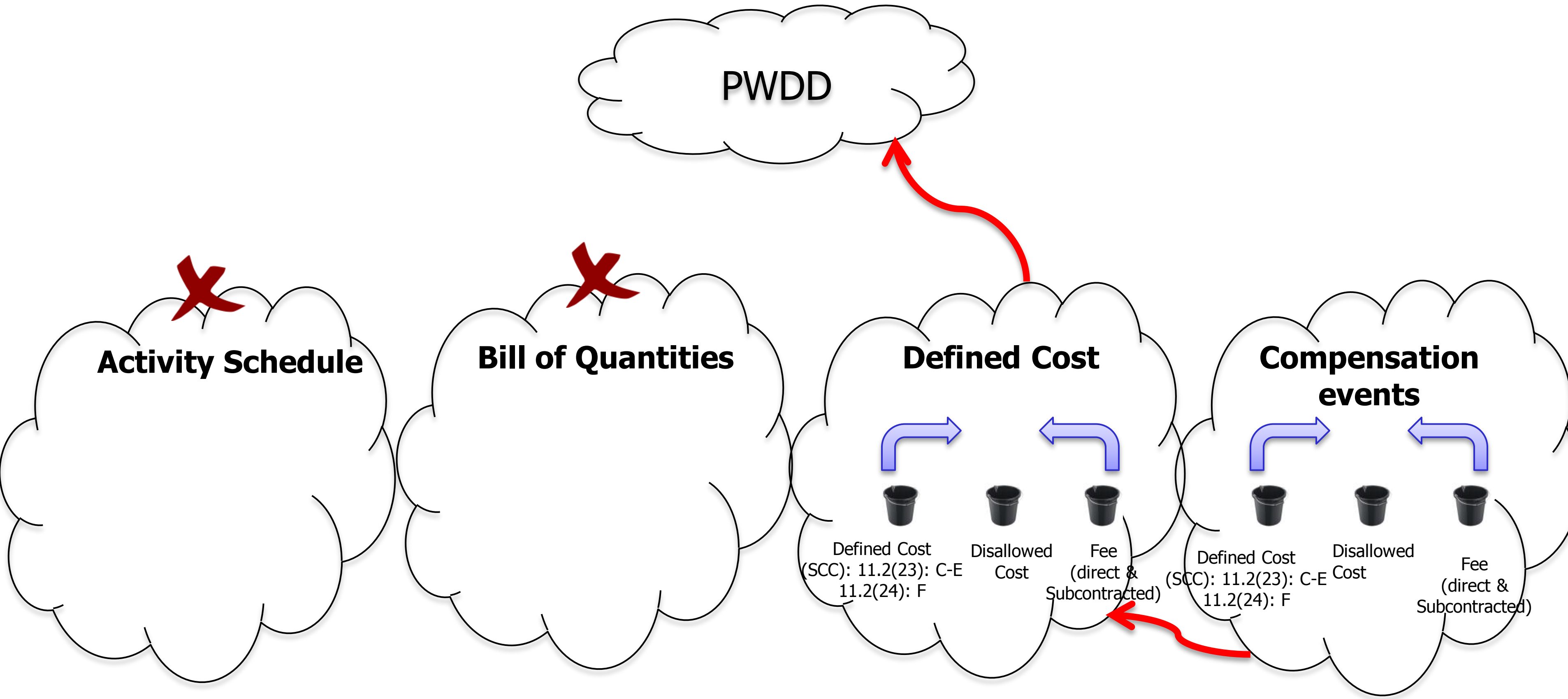
- We therefore have an updated assessment of the Prices i.e. the outturn ‘value’ of the project.

Managing cost

- Understanding the Price for Work Done to Date (PWDD)
- Understanding Defined Cost
- Open-book audit
- Cost forecasting

Group working: understanding cost

PWDD: Option C & D



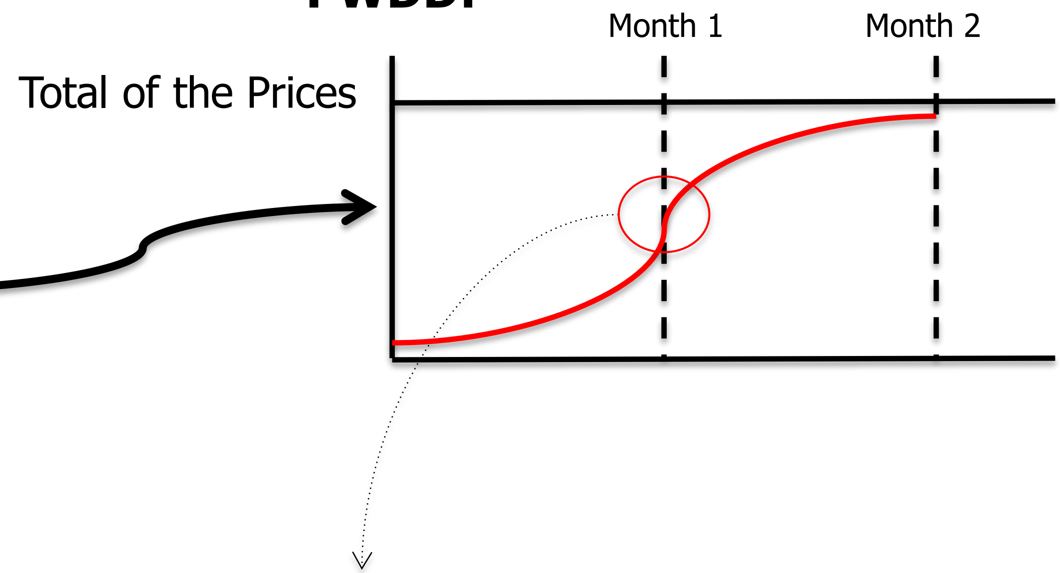
(29) The Price for Work Done to Date is the total Defined Cost which the *Project Manager* forecasts will have been paid by the *Contractor* before the next assessment date plus the Fee.

PWDD: Option C: Worked example

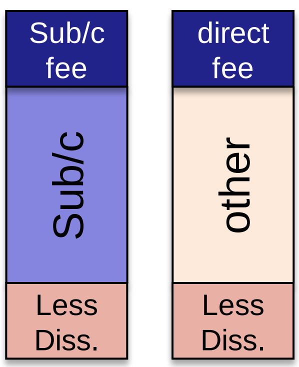
Activity Schedule:

Activity nr	Description	Unit	Price (£)
1	Earthworks as per WI 1.1	Sum	£10
2	Drainage as per WI 2.1	Sum	£10
3	Concrete as per WI 3.1	Sum	£10
4	Steelwork as per WI 5.1	Sum	£10
		Total of the Prices	**£40**

PWDD:



Defined Cost:

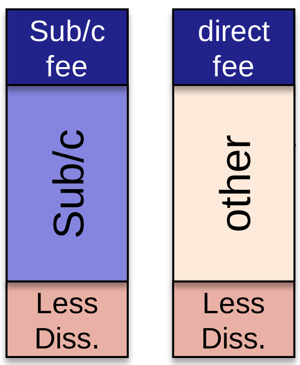


See overleaf

PWDD: Option C: Worked example

From last slide

Defined Cost:



Defined Cost (forecast before next assessment: 11.2(29)):

SCC (other):			
1. People	£1	10 % (WAO)	£1.10
2. Equipment	£1		£1.00
3. Plant & Materials	£1		£1.00
4. Charges	£1		£1.00
5. Manufacture & fabrication	£1	10 %	£1.10
6. Design	£1	10 %	£1.10
		Subtotal	£6.30
		Plus direct fee%	10 %
		Total (other)	**£6.93**
Sub/c:		Sub/c total	£6 +
		Sub/c fee%	10 %
		Total (sub/c)	**£6.60** =
		PWDD = (other) + (Sub/c)	**£13.53**

Schedule of Cost Components (SCC):

- Used under Options C, D & E (11.2(24)) under F (the prices for work done by the *Contractor* himself).

- The SCC relates to the *Contractors'* own costs.

(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 Disallowed Cost.

Schedule of Cost Components (SCC): People 1

- Normal place of working is the Working Areas.
- Not their normal place of working but within the Working Areas.
- 14: allows consultants or agency staff to be paid.
- Note the ability to specify Working Areas in CD part two.
- Also these can be added to under Clause 15.1.

Clause 15.1 (last sentence) states that a reason for not accepting is that the area is used for work not on this contract.   It must be exclusively for the contract/ cordoned off

Schedule of Cost Components (SCC): Equipment 2

- 21: allows hired Equipment but recall Clause 52.1 (‘competitive & open market’).
- 22: this allows a hire rate to be used for internal Equipment.
- 23: allows purchased Equipment to be written-down over the contract.
- 24: specialist Equipment (as these may be difficult to obtain open market prices for).

Schedule of Cost Components (SCC): Plant & Materials 3

- 31: straightforward provision.
- 32: credit for disposal.

Schedule of Cost Components (SCC): Charges 4

- 41: cost of water, gas & electric.
- 42: these may include planning/ Building Control.
- 43: lists a number of payments that are allowable.
- 44: a charge for the items a) - j) which is applied to the people items 11, 12, 13 and 14.

Schedule of Cost Components (SCC): Manufacture & Fabrication 5

- This covers bespoke manufacture or fabrication, examples may include:
    - Artwork
    - A one-off architectural feature
- If applicable, an overhead is also applied.

Schedule of Cost Components (SCC): Design 6

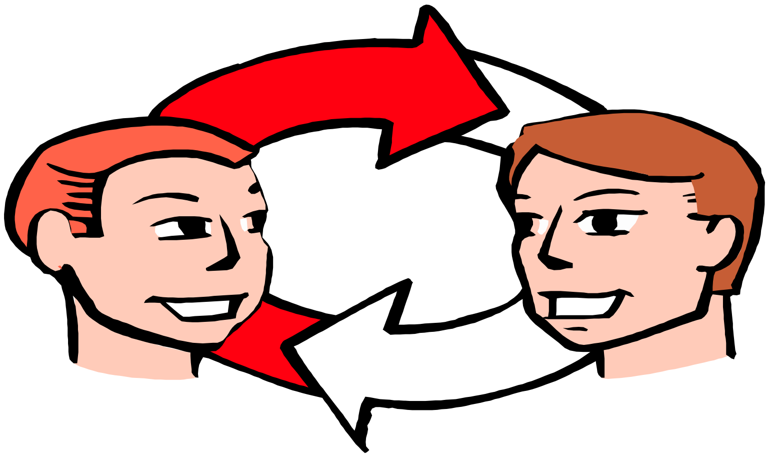
- This covers the cost of design of the *works* and Equipment outside the Working Areas e.g. architectural/ structural.
- If applicable, an overhead is also applied.

Carrying out open-book audit:

- It is in both parties interest to ensure that the commercial management is robust and agreement is obtained on the Defined Cost.
- Open-book audit does not suggest mistrust, rather, a need for good governance.
- The following is a suggested methodology for consideration to help a team understand Defined Cost, the *Contractor's* accounts system and how the audits may be conducted pragmatically with appropriate resource and minimal disruption.

Skills required for open-book accounting

Mixture of:



Quantity Surveying/ Commercial Management:

- **Contractual understanding (ECC)**
- **Understanding of Defined Cost, Disallowed Cost & Fee**
- **Knowledge of the construction industry**

+

Accounting:

- **Audit skills**
- **Detailed understanding of accounting procedures: accruals, payroll uplifts etc**

Stages to successful open book accounting: Prior to start on-site/costs being incurred

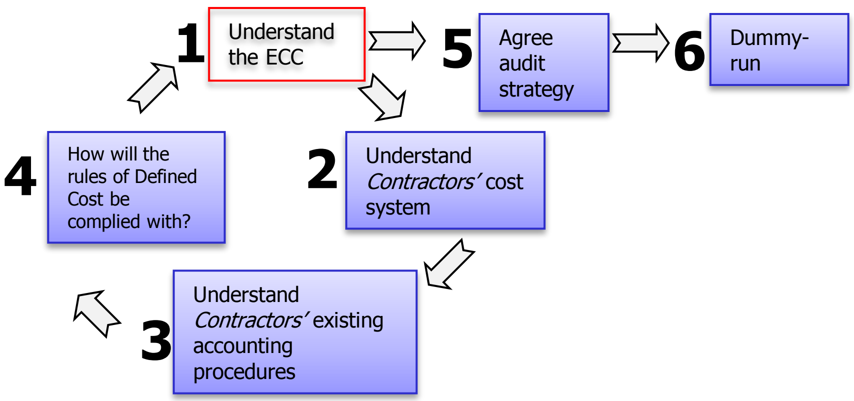
1. **Understand the ECC**
2. **Understand *Contractors'* cost system**
3. **Understand *Contractors'* existing accounting procedures**
4. **How will the rules of Defined Cost be complied with?**
5. **Agree audit strategy**
6. **Dummy-run**

Tip:

- ***Comprehensively deal with each stage before proceeding to the next.***

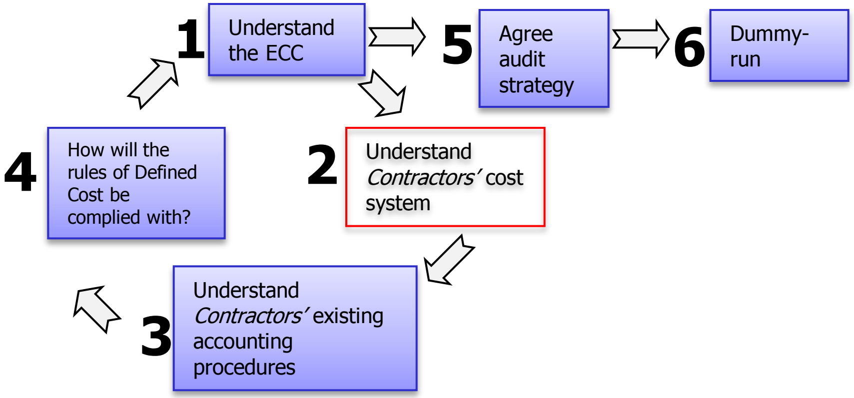
1: Understand the ECC

- Gain a joint understanding of Defined Cost, Disallowed Cost and Fee.
- Gain a joint understanding of what is included in the rates & percentages.
- Gain a joint understanding of how Defined Cost, Disallowed Cost and Fee relate to the main Option.



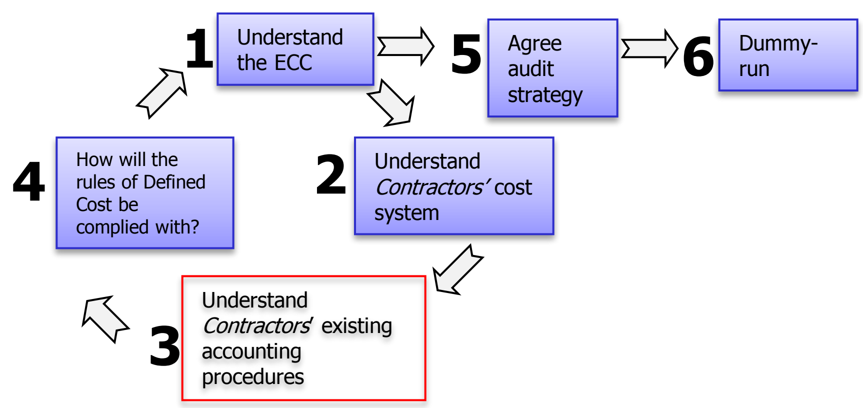
2: Understand the *Contractor's* cost system (site → office procedures)

- What is the job numbering system/hierarchy?
- How are costs recorded on site?
- Work through examples by resource.
- Become familiar with the *Contractor's* pro-formas.
- What value is typically subcontracted? How are they valued and paid? What are the terms of contract?
- Visit a site and see it working in practice.



3: Understand the *Contractor's* existing accounting procedures (office procedures)

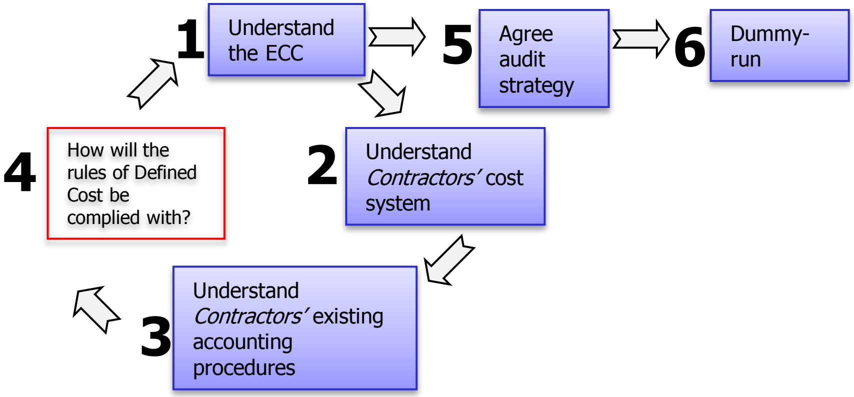
- How are discounts credited e.g. materials and subcontractors?
- How are national agreements allocated?
- Reporting frequency/key dates?
- How are accruals dealt with?
- How are internal company transfers managed?



4: How will the rules of Defined Cost be complied with?

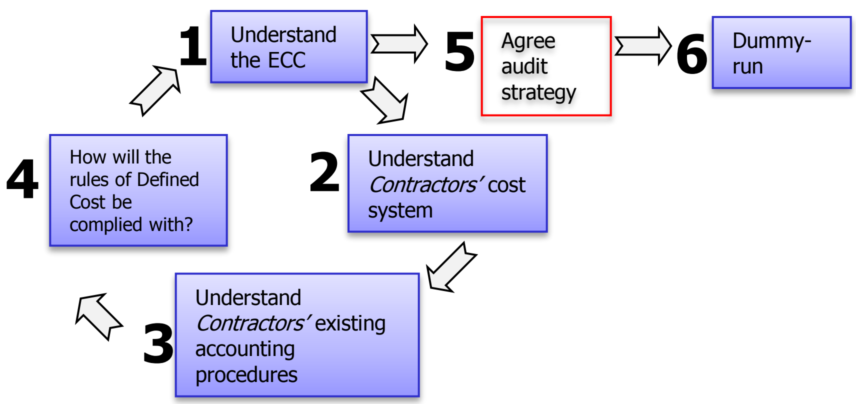
- Any ‘gaps’ (areas where the existing system does not comply) should be evident from stages 1, 2 & 3 (Defined Cost, costing system and accounting procedures).

- If the system doesn’t fully comply:
  - Jointly agree a practical solution.



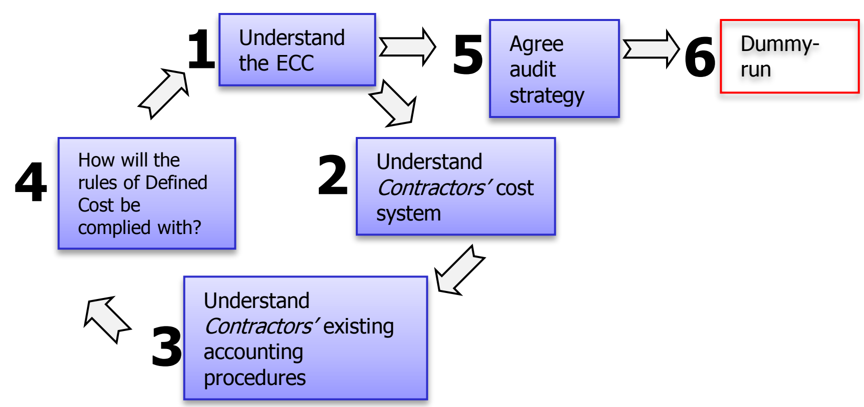
5: Agree an audit strategy

- Agree an audit strategy that deals with two elements:
    1. That stated procedures at site level are complied with.
    2. That accounting procedures are correctly applied (at office level).
- Develop a table/pro-forma outlining what will be audited, by whom, when and what information is required. Be very specific about the information required. What questions will be asked?
- Some elements of the audit strategy may need to remain random.



6: Have a 'dummy-run'

- No matter how comprehensively you have dealt with stages 1-5, issues may still occur.
- A dummy-run will enable key players to understand what is required from them and to meet up (before the pressures of the first application).
- Expect questions to be raised and some issues to emerge.
- Work-up a dummy payment certificate.
- Review the process – do key personnel need to understand stages 1-5 more clearly?
- Is the audit strategy correct?
- Should it be revised?



PM consultation role in forecasting the total Defined Cost:

- This directly requests consultation with the *Project Manager*

Option C, Clause 20.4

20.4	The *Contractor* prepares forecasts of the total Defined Cost for the whole of the *works* in consultation with the *Project Manager* and submits them to the *Project Manager*. Forecasts are prepared at the intervals stated in the Contract Data from the *starting date* until Completion of the whole of the *works*. An explanation of the changes made since the previous forecast is submitted with each forecast.

- Agree dates in the diary when this will take place

Reporting requirements under the ECC:

- Under Options C & D an additional requirement to report forecasts of Defined Cost exists (Clause 20.4).

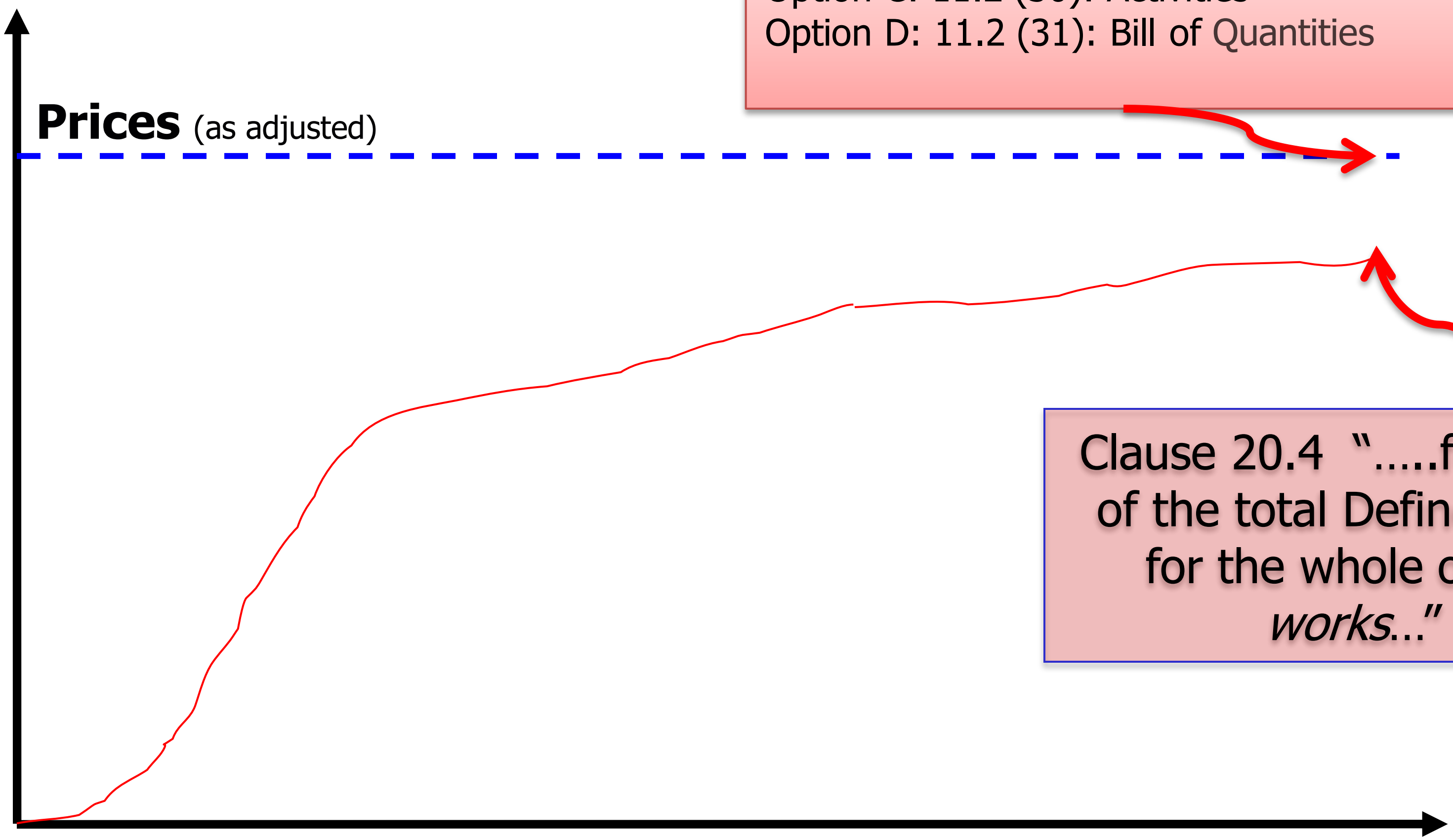
Option C, Clause 20.4

20.4 The *Contractor* prepares forecasts of the total Defined Cost for the whole of the *works* in consultation with the *Project Manager* and submits them to the *Project Manager*. Forecasts are prepared at the intervals stated in the Contract Data from the *starting date* until Completion of the whole of the *works*. An explanation of the changes made since the previous forecast is submitted with each forecast.

- Under these main Options we need to understand the Prices (‘value’) and forecast Defined Cost (‘cost’) and the relationship between the two. This is effectively a Cost/ Value reconciliation.

Managing the forecast: Options C & D also require forecast cost to be prepared (at intervals stated in the Contract Data)

Prices updated to account for CE's:
Option C: 11.2 (30): Activities
Option D: 11.2 (31): Bill of Quantities



Clause 20.4 "…..forecasts of the total Defined Cost for the whole of the *works*…"

Setting & managing target contracts

- Ensure the right **terminology** is adopted
- Make sure that those pricing fully **understand** the role of the Risk Register, rates & percentages, Works Information and Working Areas
- **Maintain the target** – keep on top of compensation events
- The **management of cost** causes problems in practice:
  - Ensure that a full open-book audit is undertaken early in the project (first 2 months)
  - Diary in the clause 20.4 forecasts

- **There are some great examples of target contracts delivering 'win-win' solutions**
- **Manage them well and your project will be one!!**

Any questions?