Project Controls EXPO

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Project Controls Expo 2015

Making Target Cost Contracts Work, under NEC3

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Objectives

- Making Target Cost Contracts Work, under NEC3
- Review the principles of how target cost contracts are set up and operated
- Consider key risks / issues that can exist under Target Cost arrangements
- How these risks can be mitigated
- Deliver the benefits of Target Cost contracts

- NEC3 ECC Main Options C & D used as a basis
- Issues are consistent across all forms of Target Cost contract

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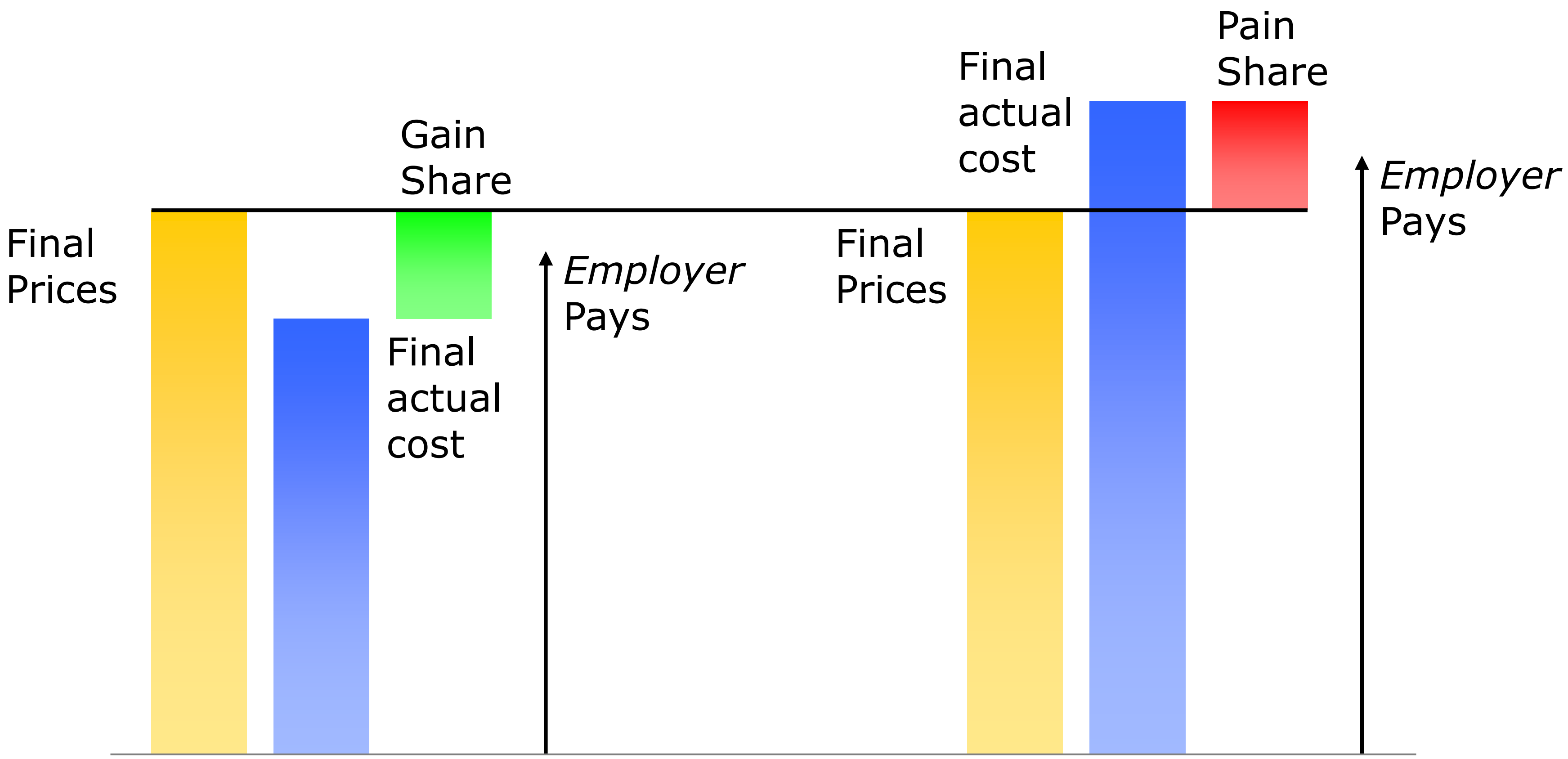
What is a Target Cost

How do Target Cost Work

- Target Cost is set
- Target Cost is subject to change via compensation events (+ / -)
- Contractor paid on a cost reimbursable basis
- Payments claimed on the basis of the Contractors accounts and records
- Client given full access to these accounts – open book
- At the end of the Project compare final Target Cost (Original Target Cost + changes - variations) to final actual cost
- Determine pain / gain figures
- Share pain / gain figures based on the pre-agreed split in the Contract

How do Target Cost Work

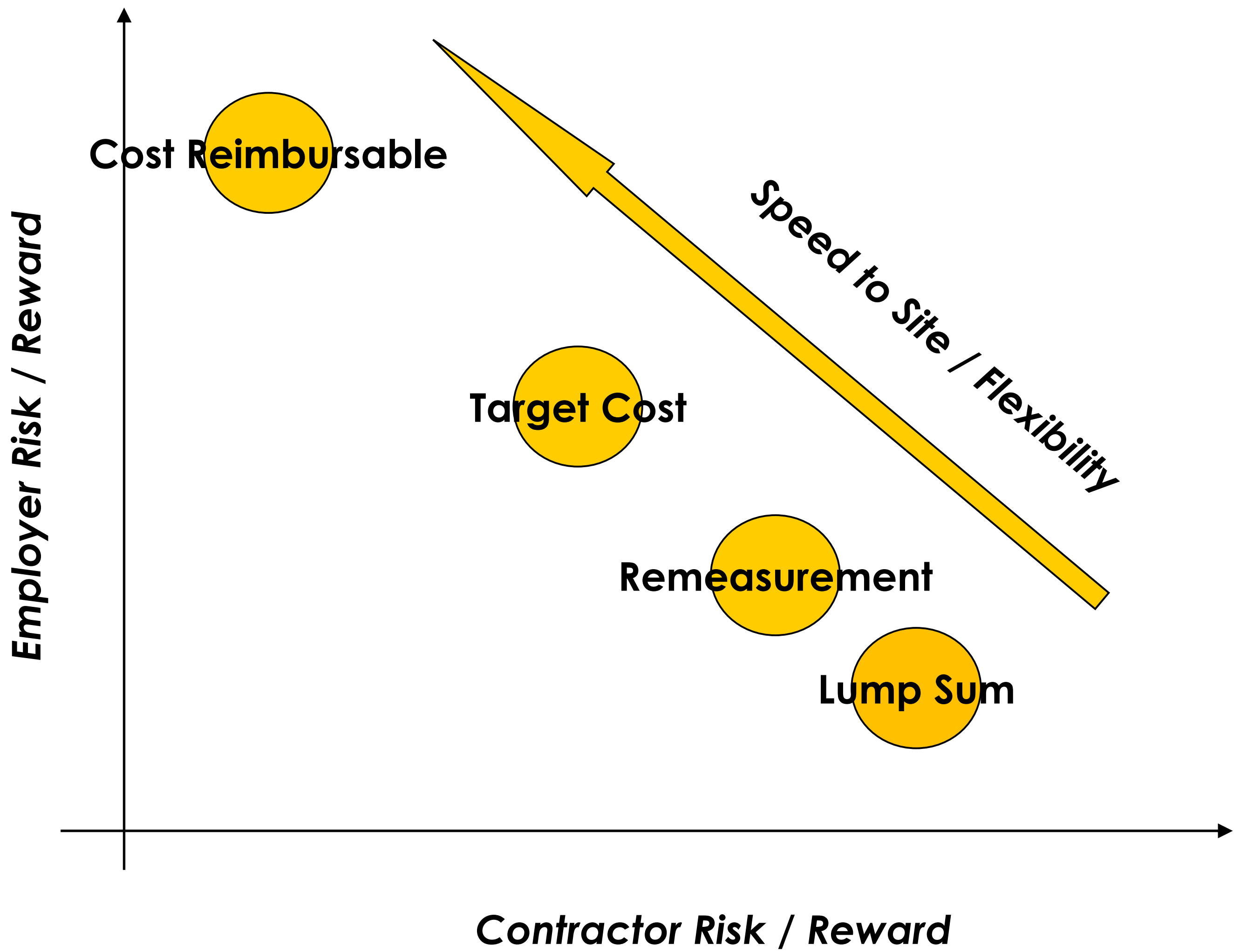


- Proportion of saving / overspend received / paid by Contractor is determined by the Employer

Why Use Target Cost Arrangements

- Align the Parties objectives - helps create a partnering environment
- Both parties encouraged to control costs through sharing the risk of over / under spend
- Suitable for projects that have a high degree of risk and uncertainty
- Greater flexibility for the employer to develop the project post award
- Earlier start on site
- Open book approach creates trust and assists in the pricing of change
- Reduced incentive for the Contractor to try to generate additional profit through inflated claims
- Potential for claims / disputes reduced

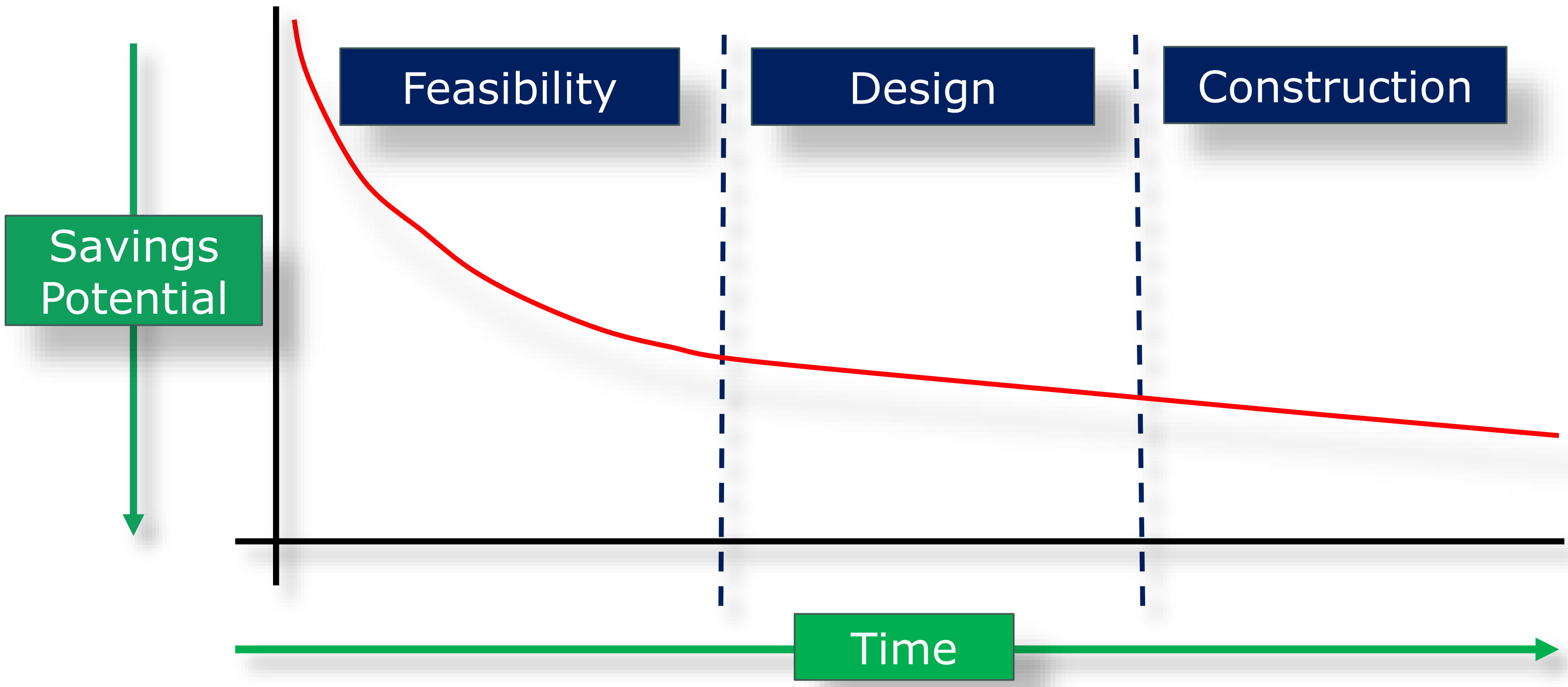
Risk / Reward – Post Contract



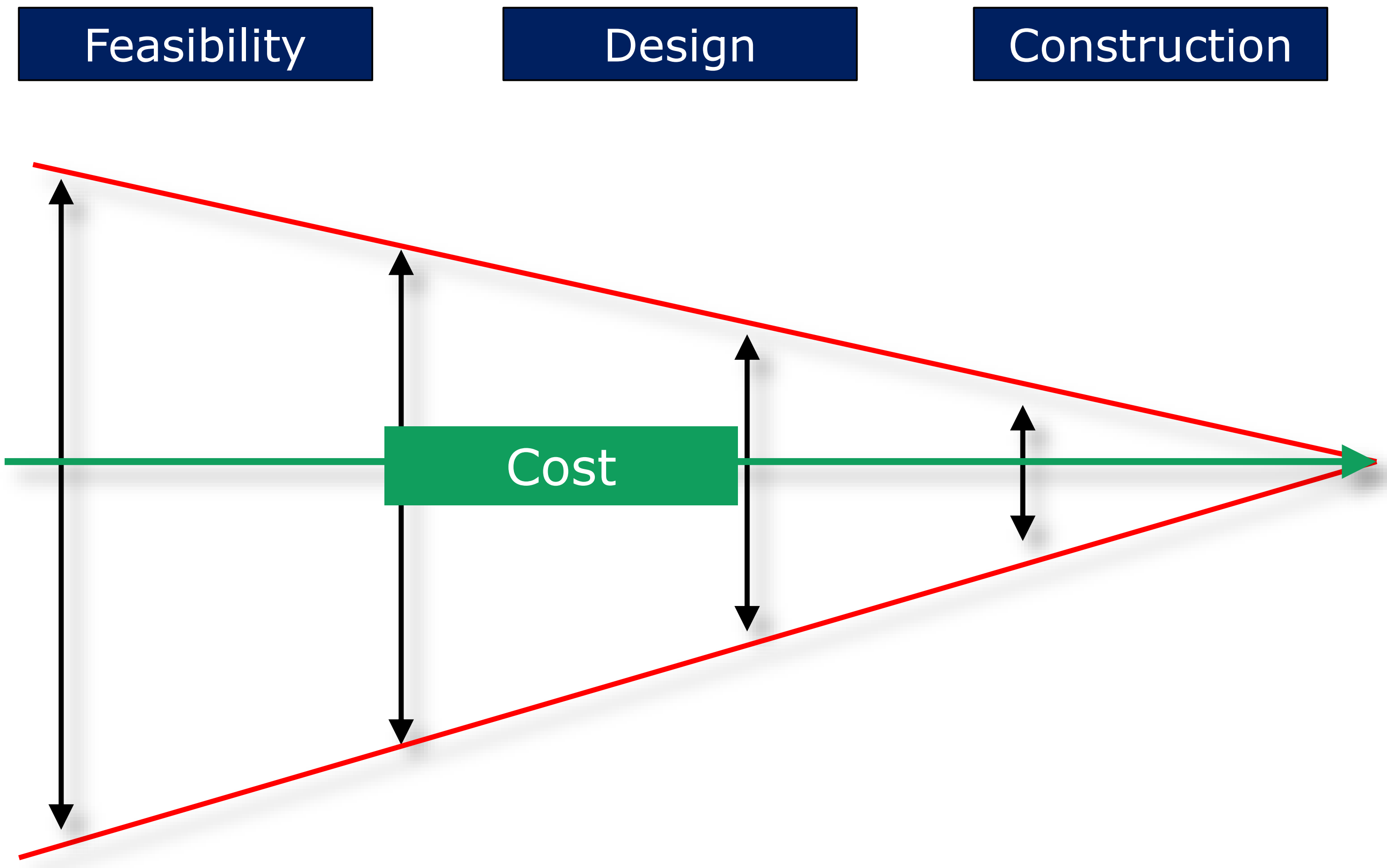
Setting a Target Cost

When to Set a Target Cost

- No right answer
- The earlier it is done the greater the uncertainty but the greater the potential for savings

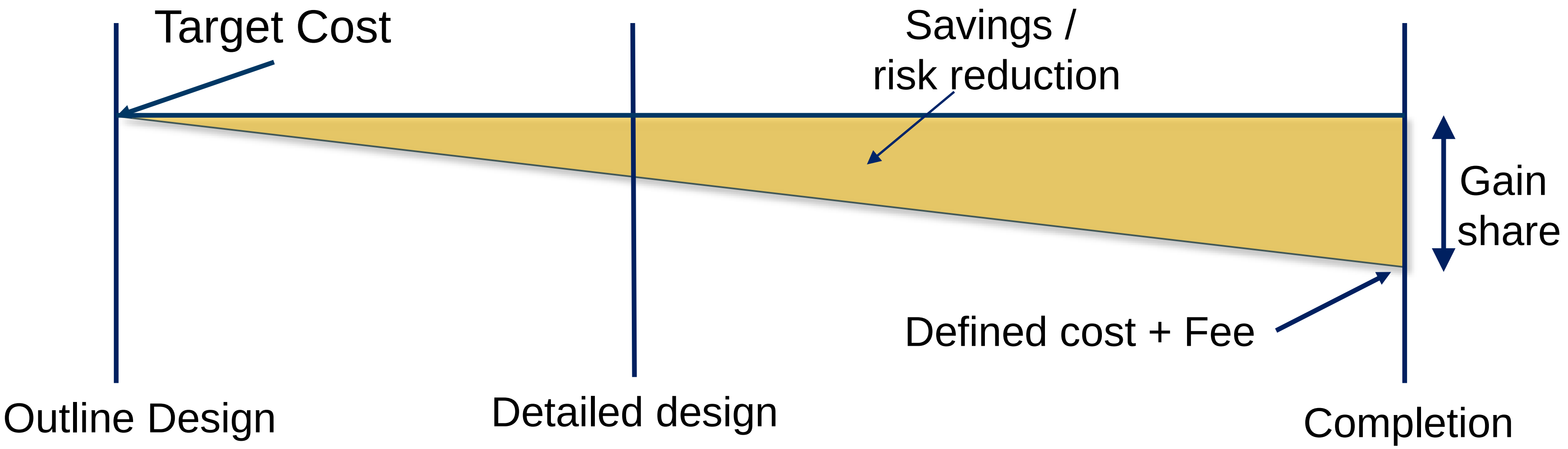


When to Set a Target Cost



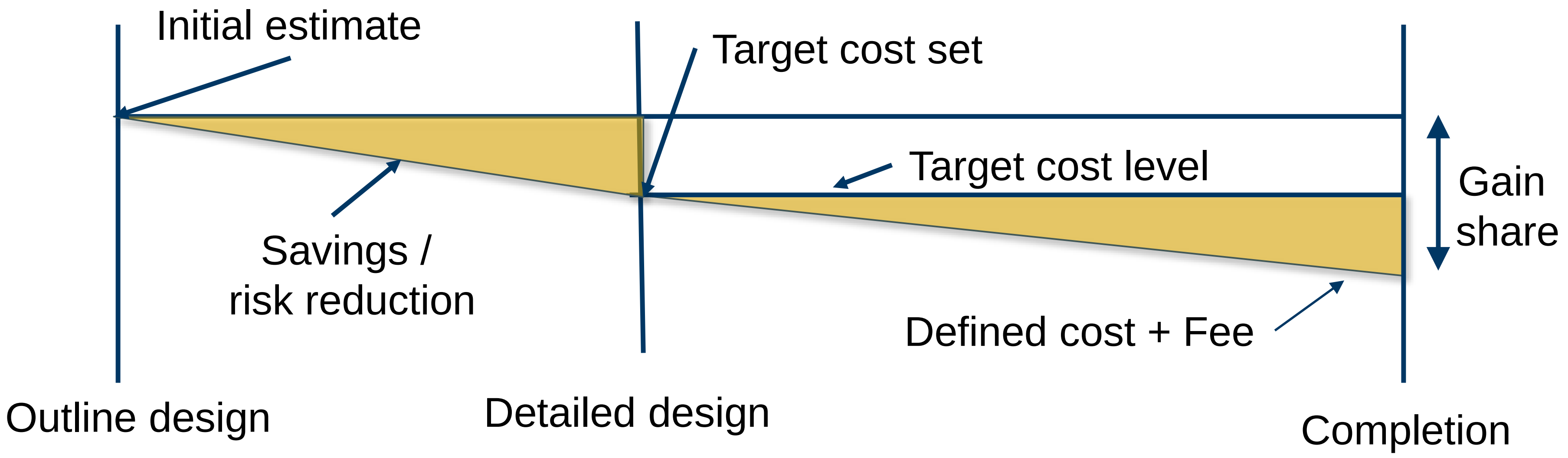
Single Stage Approach

- Need to be able to set a robust target cost at the earliest possible state
- Only possible for certain types of work
- Programme approach



2 Stage Approach

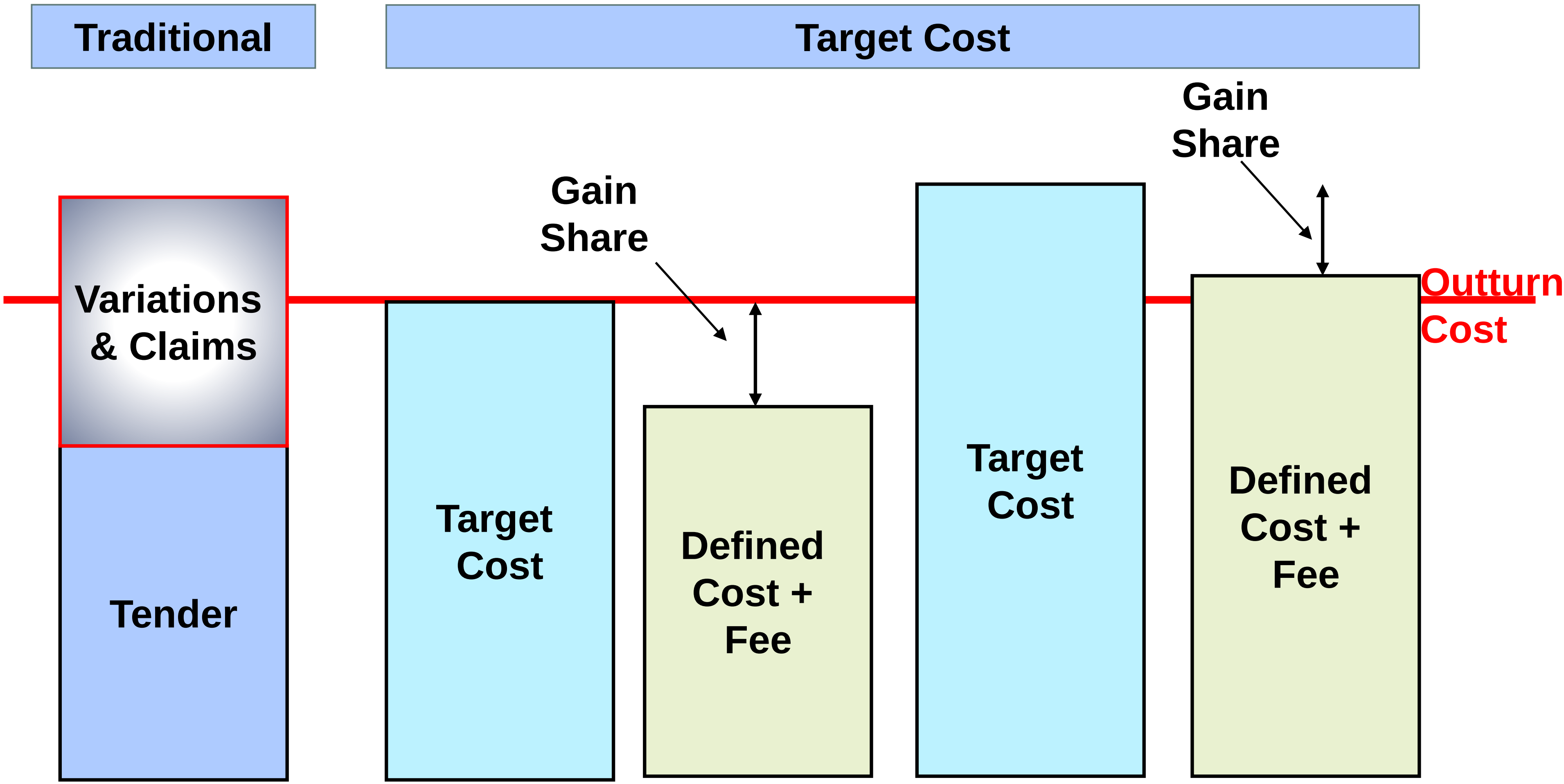
- Early contractor involvement – PSC or ECC Option E
- Convert to Target Cost once sufficient detail available
- Challenge in agreeing a robust Target Cost – engage more than 1 contractor
- Contractor withholds innovation/savings until after Target Cost set



Setting the Target Cost

- A Target Cost may be set via a competitive tender process, direct negotiation or set by the Client
- The Target Cost needs to be set at level which offers VFM for the Client and is achievable by the Contactor but where gain share has to be earned by efficiencies and is not already built in
- This can be a particular challenge when the target is negotiated with a single source supplier
- A challenging Target Cost is the key to making these arrangements work!

Setting the Target Cost



Setting the Target Cost

- The ECC only comes into effect upon agreement (as all contracts) and does not cover pre contract processes
- There are no contractual provisions on how to set and agree the Prices
- Employers will have to set out a process for agreement particularly where the Target Cost is negotiated
- Guidance can be taken from the ECC and the accompanying guidance notes

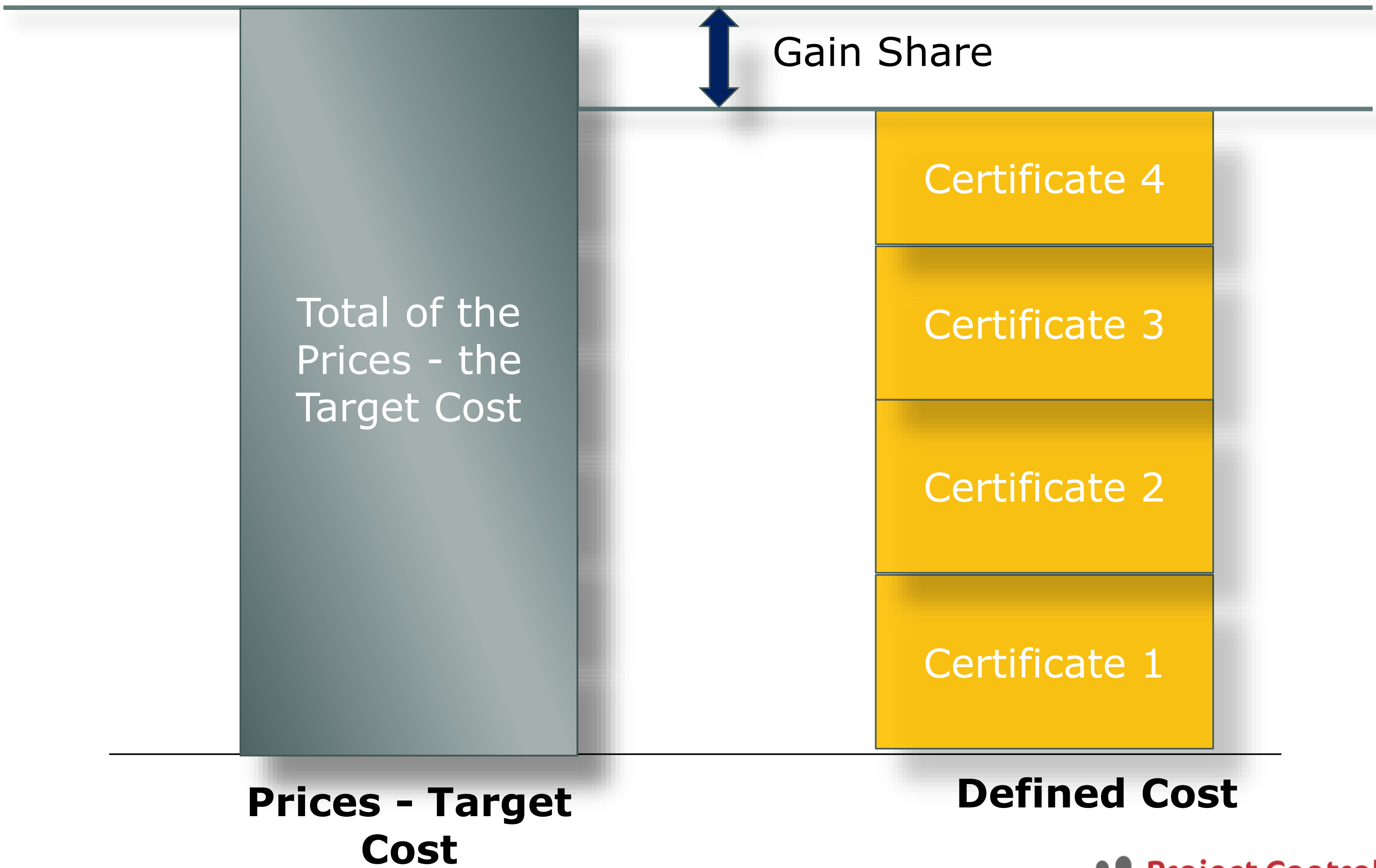
Definition of Target Cost

- No definition of Target Cost in NEC3 ECC, in fact the term is not used!
- Option C & D – Target Cost is the total of the Prices
  - Option C = Activity Schedule
  - Option D = Bill of Quantities

Elements of a Target Cost

- A Target Cost represents the cost to the Contractor to deliver the project
- *"A Target Cost is a genuine pre-estimate of the most likely outturn cost for the Project as defined in the Contract documentation"*
- It should be built up in the same way and contain all the same items as a Contractor would include in a traditional tender
- Elements of a Target Cost
  - Base Cost
  - Fee
  - Contractors allowance for their risk under the Contract

Elements of a Target Cost



Defined Cost

- Defined Cost, principally comprises the physical works required in order to deliver the Works as defined in the Works Information
- This includes:
  - The measured work
  - All temporary works
  - Subcontracts
  - preliminaries both fixed and time related
- The base cost should be priced net of risk – or if risk allowed this should be clearly identified

Fee Percentage

- Clarity over what is in Defined Cost and what is the Fee is essential
- Contents of the Fee are not defined in the Contract
- All the Contractor's cost not included in Defined Cost are deemed to be in the Fee
- The allocation in the contract may differ to the Contractors own overhead allocation
- Principal items in the Fee are:
  - Overheads, profit and insurance

Risk

- Contractors risk allowance (Shared “Risk Pot”)
- An allowance for the Contractors risks i.e. those risks which are not Employer risks
- These risk are not grounds for compensation events should they occur
- Allowance for these items would be made by a Contractor in a traditional tender

- Clients Risk Budget THIS DOES NOT FORM PART OF THE TARGET COST and is an allowance for Employer risks i.e. compensation events

Elements of a Target Cost

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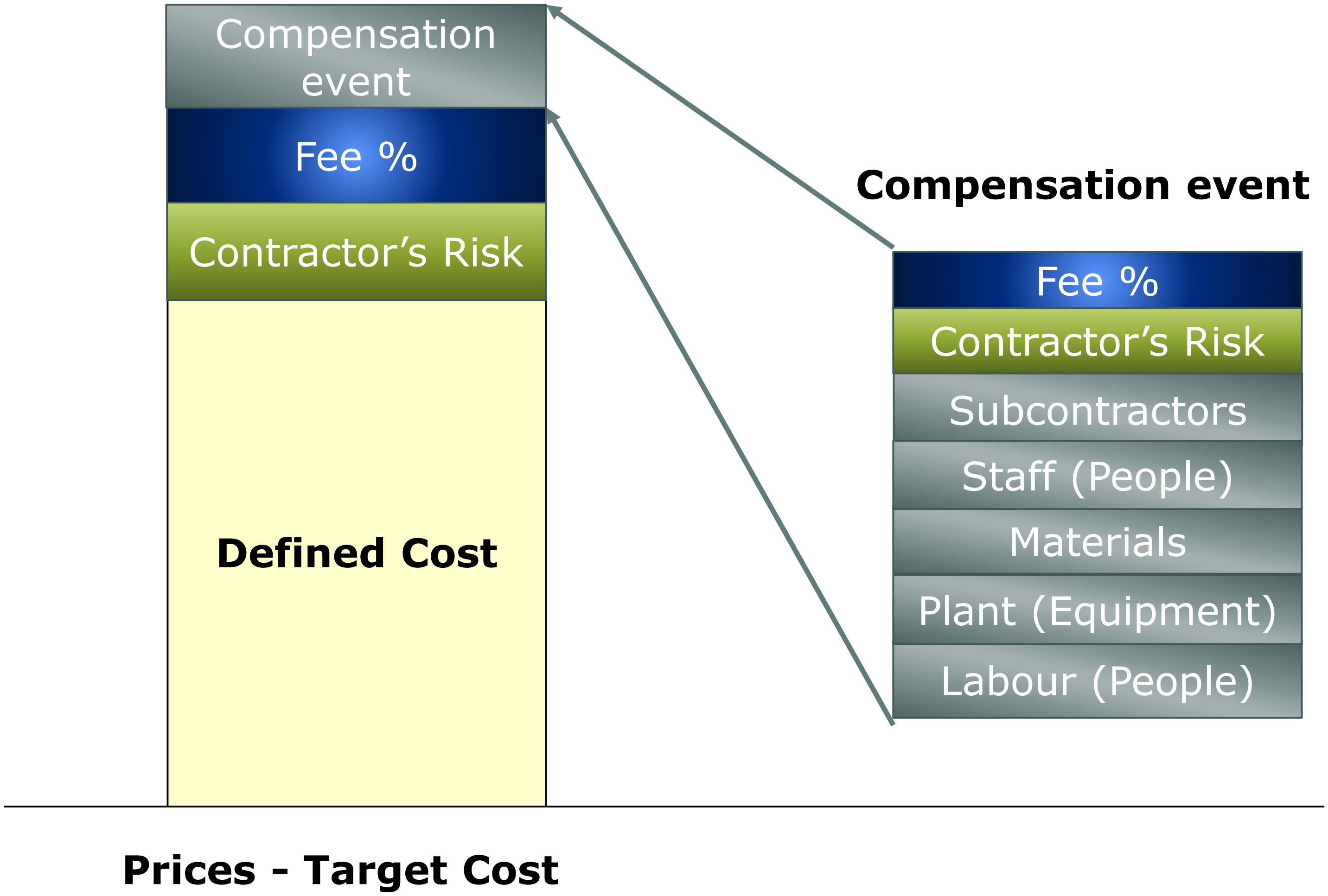
Maintaining the Target Cost

Maintaining the Target Cost

- Target Cost moves with changes both positively and negatively
- Evaluated in accordance with the Contract
- “Mini” Target Costs- Defined Cost + Fee + Contractor’s Risk events

Maintaining the Target Cost



Maintaining the Target Cost

- It is essential that the Target Cost is "maintained"
- Changes agreed as and when they are known / occur
- Enable the pain / gain calculation to still work
- Lose control of the target = cost reimbursable contract

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Defined Cost

making the **difference**

Defined Cost

- ECC - Options C & D
- 11.2 (23) Defined Cost is
  - the amount of payments due to Subcontractors for work which is subcontracted ....

  and

  - the cost of components in the Schedule of Cost Components for other work
  - less any Disallowed Cost

Defined Cost

- Subcontractors – Direct Cost
- 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

Verifying Defined Cost

- Need to put in place an audit process to validate Contractors costs
- Sample audit common approach or Forensic Cost Assurance
- Need to drive efficiency in Contractor and their supply chain
- Quality v price
- NEC 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
- Review resources on site and material deliveries to ensure that these are correct and not excessive
- VFM should be driven by pain / gain mechanism

Disallowed Costs

- Costs which the Contractor may have incurred and fall within the definition of actual cost **BUT**
- The costs have only been incurred due to some failure or default of the Contractor
- The Employer can reject payment
- Disallowed costs are therefore cost borne entirely by the Contractor

Disallowed Costs

Issue

	Allowed	Disallowed
Amounts not justified by the Contactors accounts and records		✓
Should not have been paid to a Subcontractor / Supplier in accordance with their contract		✓
Contractor failed to follow an acceptance or procurement procedure (WI)		✓
Contractor failed to give an early warning		✓
Plant and Materials not used to Provide the Works (reasonable wastage)		✓
Resources not used to Provide the Works (reasonable availability and utilisation)		✓

Disallowed Costs

Issue

	Allowed	Disallowed
Correcting Defects after Completion		✓
Correcting Defects prior to Completion	?✓	?
Preparation for adjudication / tribunal		✓
Contractor inefficiency	✓	
H&S incidents	✓	
Fines / charges	✓	
Contractor's negligence	✓	

Disallowed Costs

- Definition is difficult
  - Wide / subjective approach
  - Specific / objective approach
- 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”

Pain / Gain Mechanism

Pain / Gain Mechanism

- Mechanism to align the parties and drive the right behaviours
- Ensure efficiency and drive the Contractor to provide VFM
- Through the sharing the risk of over spend and under spend
- Mechanism usually defined by the Employer but can be negotiated
- Key issue to ensure pain / gain mechanism drives the right behaviours
- Various mechanisms available from simple to complex

Pain / Gain Mechanism

- Simple 50:50 split i.e. every $1 saved or overspent shared 50c to Employer 50c to Contractor
- Enhanced by a series of share ranges in which the employer allocates increasing amounts of gain share to them and increasing amounts of pain share to the supplier
- Employers cap pain share at say 120% of Target Cost value
- Cap gain share at say 80% of Target Cost

Pain / Gain Mechanism

- It may seem attractive to the employer to allocate as much pain as possible to the supplier, so as to reduce their risk, but this may result in the supplier seeking to increase the target cost or maximise changes, to avoid incurring pain

- Reducing or capping the level of gain share - the supplier may lose the motivation to try to make savings below a certain level

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Summary

Summary

- Target Cost contracts are increasing in use globally
- Allow greater alignment of objectives of the Parties to reduce costs and create savings
- Deals with risk and provides greater flexibility to the Employer
- Openness / transparency of costs leads to reduced potential for claims and disputes
- Employer needs to understand they carry much greater post contract risk than fixed price or remeasurement options
- If Target Cost is not set at a competitive level the Contractor will have reduced incentive to be efficient or to seek VFM in supply chain
- Employer will share costs caused by Contractors inefficiency / poor management through pain / gain share
- Incentivisation mechanism must drive the right behaviours in the Contractor