



Guest contributor, Christopher Ennis guides us through some features of the NEC 3 contracts that are relevant to claims for additional reimbursement. He points towards some aspects of the contracts worth taking note of when a dispute might arise.

This article outlines features in the NEC 3 suite of contracts relevant to claims for additional reimbursement; it does not address prolongation or time-related issues. There is presently a dearth of judicial authority for some of the propositions discussed here. For a more detailed discussion of the background with some authority from more learned commentators, please refer to Ennis, C., "Financial Claims under NEC 3 Contracts: An Overview."¹

The inter-relationship and differences between the various NEC 3 forms is as follows:

Based on Lump Sum

Based on Cost Reimbursement

Options A and B

Options C and D	: Target Cost
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Options E and F	:
Cost Plus Fee	

Priced contract with activity schedule (A)

Priced contract with bills of quantities (B)

Target contract with activity schedule (C)

Target contract with bills of quantities (D)

Cost reimbursable contract (E)

Management contract (F)

Particular features of NEC 3 relevant to claims for additional reimbursement and common areas where disputes tend to arise include:

- Evaluation of Compensation Events, and the effect of Early Warning Notices, Risk Review Meetings, Risk Registers and notice periods;
- Interpretation of definition of Defined Cost and Disallowable Cost in the cost reimbursement Options;
- The effect of these on the pain/gain share mechanisms in the target Options (C and D).

In the lump sum Options (A and B) payment is governed by the contract price, as set out in the Schedule of Cost Components or the Bills of Quantities, and thus represents the price rather than the cost of work done to date. For these options, this is the “Defined Cost” described at Clause 11.2(22). Additional payments are governed by the rules relating to Compensation Events.

In the cost reimbursement Options (C, D, E and F) the “Defined Cost” payable according to Clause 11.2(23) relates to costs incurred. These, of course, include additional costs whether or not they are the subject of Compensation Events, but they are subject to deduction of “Disallowed Cost” defined at Clause 11.2(25). These definitions provide fertile scope for dispute.

The term “target cost” is not used other than in the titles of the Option C and D contracts, but this is a convenient label used for the total of the lump sum contract prices adjusted by Compensation Events, to be compared with actual costs (again, this is not the term used). The pain/gain share mechanism in these Options provides that the Contractor and Employer share, in pre-defined proportions:

- Savings arising from actual costs turning out to be lower than target, or
- Excess cost arising from actual costs exceeding target.

Whilst incentivising the Contractor to achieve savings in actual cost against target, this may lead to claims for larger adjustment of Prices (and thus an increased target) through recognition of Compensation Events at the highest possible value, thus creating a more comfortable margin between cost and target from which the Contractor will earn gain share and avoid pain share.

So far as financial claims are concerned:

- In Options A and B there is – to some extent – a traditional approach to recovery of additional costs. The Contractor must prove an entitlement to additional payment, whether through variations or showing loss and/or expense, although these have different nomenclature in NEC 3.
- In contrast, for Options C, D, E, and to some extent F, the contractor is reimbursed all “legitimate” costs, i.e., subject to admissibility – and the onus transfers to the employer to show inadmissibility. The chief difference between the target Options C and D and reimbursement Option E is that in C and D issues such as Early Warnings and Compensation Events take on greater relevance, because they will impinge upon pain and gain share through their influence on adjustment of the target cost.

It might be considered that the reason why there are so few apparent “claims” under NEC 3 is that they emerge under the less pejorative label of Compensation Events. One obvious group of Compensation Events are variations in design, specification or quantity defined by the Employer’s Requirements. Others are matters that would normally give rise to “claims” in

conventional forms of contract, such as access difficulties, suspension, failures in employer obligations whether by the employer or its consultants, and exceptional weather. The word “claims” suggests a focus on claims by the Contractor against the Employer for additional payment. Under the cost reimbursement Options the financial initiative is effectively reversed, and it is claims by the Employer against the Contractor for resisting payment of costs incurred that are likely to arise, and not only on account of (for example) delay damages and similar financial deductions. Typical areas for dispute include:

- The requirements for notice. With certain exceptions, the Contractor must notify the Project Manager within eight weeks of becoming aware of an event that it considers to constitute a Compensation Event. If the Contractor fails to do so, it may not be entitled to a change in price (Clause 61.3), or if the Project Manager decides that costs were incurred – whether pursuant to a Compensation Event or otherwise – only because the Contractor failed to give an Early Warning Notice (“EWN”) required under the contract, then those costs become Disallowed Costs (Clause 11.2(25)).
- EWNs, the Risk Register and risk reduction meetings are apparently formal requirements that do not appear in more conventional forms of contract. Whilst no automatic sanctions apply in the event that these provisions are not followed, proper observance may affect evaluation of Defined and Disallowed Cost. For example, the Project Manager may assess a lower changed Price arising from a Compensation Event if it can be shown that, had an EWN been given, a lower cost would have resulted (Clauses 63.5 and 63.7).
- The regime requiring the Contractor to provide quotations for Compensation Events has its own complications in terms of notice, timing of submission of quotations, and responses by the Project Manager. There is deemed acceptance of a quotation absent a reply by the Project Manager within two weeks of expiry of the original time for response, upon notice. On a busy project such issues pile up, in terms of notifications, dealing with quotations, and confirming or refusing Compensation Events. Where voluminous requests for Compensation Events and/or quotations are issued at the same time, but just within programme, these create heavy administrative burdens for the Project Management team. Disputes can arise as to whether it is reasonable to deem the Employer to have accepted quotations in these circumstances, quite apart from whether such matters should be deemed to constitute Compensation Events at all.

Assessments of Defined Cost and Disallowed Costs are often disputed; the provision in Clause 11.2(25) for disallowing “...cost which the Project Manager decides... is not justified by the Contractor’s accounts and records” is a particularly fertile area.

- The contract seems to require the Contractor to maintain auditable records, but there may be a presumption that monthly examination of records is no more than an interim and approximate measure, and that final audit or validation will be carried out when all records are available at the end of the job. The monthly assessment will also be carried out – usually –

without the benefit of concluded technical assessment of Compensation Event requests.

Partnering clauses – Clauses 10.1 and Option

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– may be cited in protest at attempts to make later downward revision of interim assessments.

- Even if invoices capable of satisfying the average accountant auditor that payments have been made, is there enough detail to show that such expenditure has been properly incurred from a quantity surveying perspective – i.e., has appropriate value been obtained without undue wastage/inefficiency? The more that the primary expenditure is located at a lower contractual tier, the greater the difficulty for audit. Many subcontract accounts are settled in negotiation. The level of detail available to justify many such “deals” is often sparse.

- Records may be inadequate when first inspected, but capable of augmentation later. Issues may arise as to whether, and just how reliably, records can be augmented by witness statement, or some other ex-post facto justification of expenditure not otherwise adequately justified by contemporaneous records.

- Defined Costs may, arguably, be related to some concept of “reasonable costs”. NEC 3 eschews constructs such as “fair” and “reasonable”, and it may not be enough to say – in the case of Options C and D – that such adjustments are catered for in the pain/gain share mechanism, which provides an incentive to avoid inefficiency. However, in Option E there is no such incentive at all.

¹Paper D117, Society of Construction Law, December 2010.

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