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NEC: DEFINED COST UNDER THE NEC3 ENGINEERING AND CONSTRUCTION CONTRACT

Clause 52.1 of the core clauses in the NEC3 Engineering and Construction Contract states:

“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.”

And there, ladies and gentlemen, is your iceberg, bobbing along serenely on the murky waters of the NEC3.

But, as everyone knows, barring perhaps the Captain of the Titanic, what we see on the surface is only, well, the tip of the iceberg.

Clause 52.1 is, in fact, a deeming provision.

All of the Contractor’s costs, not included in the Defined Cost, are deemed to be included in the Fee.

But what is the Fee? And what, for that matter, is the Defined Cost?

The definition of the Fee may be found in the core clauses, more specifically at Clause 11.2(8), which

reads:

“The Fee is the sum of the amounts calculated by applying the subcontracted fee percentage to the Defined Cost of subcontracted work and the direct fee percentage to the Defined Cost of other work.”

ICEBERG AHEAD!
**(DEFINED COST UNDER THE
NEC3 ENGINEERING AND
CONSTRUCTION
CONTRACT)**

The words “*subcontracted fee percentage*” and “*direct fee percentage*” appear in italics. This is an indication that these terms will be found in the Contract Data. Part 2 of the Contract Data to be precise.

These are percentages that must be stipulated by the Contractor in the Contract Data, the subcontracted fee percentage being applicable to work that is subcontracted and the direct fee percentage being applicable to all other work.¹

So what then is this Defined Cost, which we are constantly being referred to? It does not appear in the Identified and Defined Terms in the core clauses.

It does, however, appear in the main option clauses for each of the Options A to F.

The reason for this is, that Defined Cost has a different meaning, depending on which Option is selected by the parties.

Options A and B define Defined Cost at Clause 11.2(22) as:

“the cost of the components in the Shorter Schedule of Cost Components whether work is subcontracted or

¹ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 19.

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not excluding the cost of preparing quotations for compensation events.”

Options C to E define Defined Cost at Clause 11.2(23) as:

“

- 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.”

Options C to E define Disallowed Cost at Clause 11.2(25) as:

“cost which the *Project Manager* decides

- is not justified by the *Contractor*'s accounts and records,
- should not have been paid to a Subcontractor or supplier in accordance with his contract,
- was incurred only because the *Contractor* did not
 - follow an acceptance or procurement procedure stated in the Works Information or
 - give an early warning which this contract required him to give

and the cost of

- correcting Defects after Completion,
- correcting Defects caused by the *Contractor* not complying with a constraint on how he is to Provide the Works stated in the Works Information,
- Plant and Materials not used to Provide the Works (after allowing for reasonable wastage) unless resulting from a change to the Works Information,
- resources not used to Provide the Works (after allowing for reasonable availability and utilisation) or not taken away from the Working Areas when the *Project Manager* requested and
- preparation for and conduct of an adjudication or proceedings of the *tribunal*.”

Option F defines Defined Cost at Clause 11.2(24) as:

“

- 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,
 - the supply of equipment, supplies and services included in the charge for overhead cost within the Working Areas in this contract

and

- the *prices* for work done by the *Contractor* himself
- less Disallowed Cost.”

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Option F defines Disallowed Cost at Clause 11.2(26) as:

“cost which the *Project Manager* decides

- is not justified by the accounts and records provided by the *Contractor*,
- should not have been paid to a Subcontractor or supplier in accordance with his Contract,
- was incurred only because the *Contractor* did not
 - follow an acceptance or procurement procedure stated in the Works Information or
 - give an early warning which this contract required him to give or
- is a payment to a Subcontractor for work which the Contract Data states that the *Contractor* will do himself or the *Contractor's* management.”

Phew! Once we have waded through all of those definitions, we are left with this: Defined Cost may be ascertained:

- Options A and B – from a reading of Clause 11.2(22), with the Shorter Schedule of Cost Components;
- Options C to E – from a reading of Clauses 11.2(23) and 11.2(25), with the Schedule of Cost Components; and
- Option F – from a reading of Clauses 11.2(24) and 11.2(26), with the prices.

Note the requirement of the deduction of the Disallowed Cost from the Defined Cost, for Options C to F, which is an important part of this calculation.

As the word “*prices*” is in italics, we know that they may be found in the Contract Data, but what of the Shorter Schedule of Cost Components and Schedule of Cost Components?

These two schedules list the elements which form part of the Defined Cost, falling under seven (7) headings, being, people, equipment, plant and materials, charges, manufacture and fabrication, design and insurance².

The function of these schedules, however, will differ depending on which Option is in use.

Firstly, and in order to get it out of the way, it can be seen from the definition of Defined Cost above, that neither of the schedules has any application to Option F³.

The Shorter Schedule of Cost Components has application to Options A through to E, however, the Schedule of Cost Components has application to only Options C to E⁴.

Option A is a priced contract with activity schedule, meaning that it is a lump sum contract with the lump sum being comprised of a number of smaller lump sums each of which relates to an activity referred to in the Activity Schedule. The Contractor is paid in accordance with the activities, which have been completed at each assessment date⁵.

Accordingly, The Price for Work Done to Date is defined, for Option A, at Clause 11.2(27) as:

“the total of the Prices for

- each group of completed activities and
- each completed activity which is not in a group.

² D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 196.

³ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 196.

⁴ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 196.

⁵ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 2.

A completed activity is one which is without Defects which would either delay or be covered by immediately following work.”

And The Prices are defined, for Option A, at Clause 11.2(30) as:

“the lump sum prices for each of the activities on the Activity Schedule unless later changed in accordance with this contract.”

Option B is a priced contract with bill of quantities, meaning that this is a re-measurement contract, which will be paid based on the actual quantities of work performed as per the rates set out in the bill of quantities⁶.

Accordingly, The Price for Work Done to Date is defined, for Option B, at Clause 11.2(28) as:

“the total of:

- the quantity of the work which the *Contractor* has completed for each item in the Bill of Quantities multiplied by the rate and
- a proportion of each lump sum which is the proportion of the work covered by the item which the *Contractor* has completed.

Completed work is work without Defects which would either delay or be covered by immediately following work.”

And The Prices are defined, for Option B, at Clause 11.2(31) as:

“the lump sums and the amounts obtained by multiplying the rates by the quantities for the items in the Bill of Quantities.”

No need for the Shorter Schedule of Cost Components in calculating payments due to the contractor under Options A and B then. So what is its purpose?

The answer is found in Clause 63 of the core clauses, which is titled “Assessing compensation events”.

Clause 63.1 states:

“The changes to the Prices are assessed as the effect of the compensation event upon

- the actual Defined Cost of the work already done,
- the forecast Defined Cost of the work not yet done and
- the resulting fee.”

The Shorter Schedule of Cost Components is used for assessing compensation events in Options A and B⁷.

Option C is a target cost contract with activity schedule. The Activity Schedule, which is, again, made up of the various lump sums referred to under Option A, is used to establish the target cost. The Activity Schedule is not actually used for calculating payments to the contractor, however, and the contractor is paid on the basis of his Defined Cost. At the end of the project, of course, this being a target cost contract, the contractor will also receive his agree share of the saving against the target, or be obliged to pay his agree share of the excess over the target⁸.

The Prices, for Option C, have the same definition as that ascribed to them in Option A, and which appears in Clause 11.2(30).

⁶ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 2.

⁷ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 196.

⁸ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 3.

Option D is a target cost contract with bill of quantities, with the target price being established by reference to the bill of quantities. The bill of quantities is not actually used for calculating payments to the contractor, however, and the contractor is paid on the basis of his Defined Cost. At the end of the project, of course, this being a target cost contract, the contractor will also receive his agreed share of the saving against the target, or be obliged to pay his agreed share of the excess over the target⁹.

The Prices, for Option D, have the same definition as that ascribed to them in Option B, and which appears in Clause 11.2(31).

Option D also adds Clause 11.2(33), which states:

“The Total of the Prices is the total of

- the quantity of the work which the *Contractor* has completed for each item in the Bill of Quantities multiplied by the rate and
- a proportion of each lump sum which is the proportion of the work covered by the item which the *Contractor* has completed.

Completed work is work without Defects which would either delay or be covered by immediately following work.”

This addition permits the Prices to be re-measured to reflect the actual quantities of work done for the purposes of calculating the share of the saving or excess payable to or by the contractor¹⁰.

Option E is a cost reimbursable contract simply meaning that the contractor is reimbursed for the cost he incurs in carrying out the work¹¹.

The Prices are defined, for Option E, at Clause 11.2(32) as:

“The Prices are the Defined Cost plus the Fee.”

The Price for Work Done to Date is defined, for Options C to E, at Clause 11.2(29) as:

“the total Defined Cost which the Project Manager forecasts will have been paid by the Contractor before the next assessment date plus the Fee.”

It is the Schedule of Cost Components, which is used in determining the Defined Cost in Options C to E, which is, in turn, used to determine the amount to be paid to the contractor for work done.

But what of the Shorter Schedule of Cost Components? No mention is made of it in the definition of Defined Cost, for Options C to E, at Clause 11.2(23).

The answer to this is found in the introductory paragraph to the Shorter Schedule of Cost Components, which states:

“When Option C, D or E is used, this schedule is used by agreement for assessing compensation events.”

Now you will remember that Clause 63.1 of the core clauses states that compensation events are assessed using the Defined Cost, which in Options C to E means the Schedule of Cost Components, however, Clause 63.15 found in Options C to E provides the following alternative:

⁹ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 3.

¹⁰ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 3.

¹¹ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 3.

“If the Project Manager and the Contractor agree, the Contractor assesses a compensation event using the Shorter Schedule of Cost Components. The Project Manager may make his own assessments using the Shorter Schedule of Cost Components.”

In order to fulfil their function, both of these schedules must be read with the rates, percentages, items and sundry information entered into Part 2 of the Contract Data¹².

Remember that iceberg? What happens if, due to an oversight or because an item was not foreseen as necessary for the provision of the works at tender stage, an item, rate or percentage, required by the schedules, is not included in the Contract Data?¹³

In terms of Clause 52.1, costs, which are not included in the Defined Cost are deemed to be included in the Fee.

It may be open to a Contractor to argue that if no rate or percentage has been agreed, a reasonable one should be implied, but the success of this argument remains to be proven¹⁴.

The lesson for a contractor pricing a tender in terms of the NEC3 Engineering and Construction contract:

- 1. Make sure that all of the items in the Contract Data are thoroughly considered and completed; and**
- 2. Consider carefully which cost components are not found in the Defined Cost and make allowance for these in the fee percentage¹⁵.**

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¹² D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 196 – 197.

¹³ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 197.

¹⁴ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 197.

¹⁵ D Thomas QC, Keating on NEC3 (First Edition), Sweet & Maxwell, 2012, pg 20.

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