TARGET COST CONTRACTS

The use of target cost contracts has increased in recent years as employers have sought means to incentivise contractors to bring in projects within cost budgets. With this aim in mind, these contracts typically provide for a pain/gain share mechanism. In this newsletter we consider the main elements of a target cost contract and look at how they are treated in a range of standard forms.

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The Target Price

Target Price Contracts are based on a cost reimbursable mechanism in which the contractor is reimbursed his costs (on an actual cost basis) subject to the application at the end of the project of a formula which allows the contractor to share any savings made and to contribute towards overspend.

In the first place, a target cost will be agreed which will be for a scope of work defined to a greater or lesser extent. The target cost will be adjustable in certain circumstances, most commonly for variations.

The target cost will be made up of three elements, of which two are “visible”. These are, first, the base cost which will largely be made up of subcontractor costs as well as necessary items such as plant hire and utility bills. Secondly, the target cost will also include the contractor's overheads, profits and other head office elements which are referred to as his “Fee”. The Fee may be a percentage of the actual cost or target cost or, in some cases, a fixed sum. The third element will be the contractor's price for his risk, but this will be subsumed in the Fee.

The target cost is usually arrived at through a tender process followed by negotiation. It should represent a genuine pre-estimate of the most likely outturn cost. The intention is that the contractor will be incentivised by the pain/gain mechanism (see below) to minimise his actual cost through creating efficiencies leading to savings. If properly constituted, the target cost should represent a middle way between a tender which is too low (but may win the work) and an inflated figure which may serve to discourage the contractor from seeking efficiencies.

1 FIDIC has not yet produced a target cost contract form.
The Pain/Gain Mechanism

This is the essential feature of the target cost contract which differentiates it from other types of payment mechanism. The mechanism is based on a formula which may either be part of the contractor's tender, or specified by the employer, or agreed post tender.

A common method used for the mechanism is to divide overspend or underspend into "bands" on a percentage basis. One way of doing this would be for the parties to agree a 50/50 split of all over- and underspend. Alternatively, a sliding scale of percentages may be adopted: for example, the first 10% of any over- or underspend may be split equally, but above this figure the employer is required to bear a greater share of the pain; against this, the contractor's benefit from any underspend may be increased once a figure below 90% of the target cost is reached.

Such an approach would be based on the premise that larger employers are better able to carry the financial risk of overspends; if the contractor was required to bear the risk, he might inflate his target cost accordingly. Decreasing the employer's benefit from any underspend may motivate the contractor to limit costs and create efficiencies to obtain a greater benefit. However, the reverse approach is also encountered.

A mechanism requiring the contractor to meet 100% of cost above a certain share range will effectively guarantee the employer a maximum price for the contract. Setting the contractor's requirement to meet cost at zero above a certain share range may persuade the contractor to reduce his Fee.

Approaches to Calculating the Contractor's Fee

The contractor's Fee covers both head office and profit elements. Should the contractor carry out works himself (as opposed to employing subcontractors) this will normally be treated as part of his actual cost, which in turn is subject to the Fee. Costs incurred by the contractor on site, such as site huts and provision of resident staff will also form part of the actual cost.

Contractor's design work may be placed in either category but it is more likely to form part of actual cost where the scope of works is not clearly defined at the outset and calculation of a fixed percentage Fee may be difficult. A staged approach may be appropriate, perhaps incorporating a bonus for early completion of the design element.

The Treatment of Target Cost and Standard Forms

A number of standard form producing bodies have brought out target cost contracts and we consider below the attributes of the payment mechanisms concerned.

New Engineering Contract 2013 ("NEC Form")

NEC Form Options C and D provide for a target cost approach. Option C is a lump sum contract used with an activity schedule setting out a description of the work. Option D (the less commonly encountered) is used where bills of quantity are adopted and the contractor is paid on a re-measurement basis.

The target price is tendered by the contractor in the form of his estimate of Prices on the basis of an activity schedule or bills of quantity. The contractor will seek payment of his estimate of Defined (actual) Cost and his Fee as a percentage of the Defined Cost. During the course of the contract, the contractor is paid Defined Cost on a cost reimbursable basis (which excludes any disallowed cost) plus the Fee which are together defined as the Price for Work Done to Date ("PWDD"). The Prices may be adjusted for the effects of Compensation Events and also by re-measurement in the case of option D.

The pain or gain share adjustment is made at the end of the contract by comparing the final total of the Prices (as adjusted throughout the contract term) and the final PWDD applying the formula stated in the Contract Data. This will set out a pain/gain share mechanism. The contractor's share is paid provisionally at completion on the basis of the project manager's forecast and
corrected on final assessment which should take place within four weeks after the issue of the defects certificate. It is to be noted that the contractor's share is not paid or deducted on an interim basis so that there is a risk of under or over payment of the contractor's share, especially towards the end of the contract period.

**ICC Target Cost Contract 2011**

The ICC suite of contracts was formerly published by the UK Institution of Civil Engineers and includes a target cost form in its suite. Unlike the NEC Form, the contractor's fee percentage is based on the target cost of the project. Each monthly statement produced by the contractor shows the estimated target cost value of works up to the end of the month and the forecast total cost for the completed works.

A proportion of the fee is certified each month calculated by reference to the target cost value of the works carried out to the end of that month as assessed by the Engineer. If total cost (calculated on a cost reimbursable basis) at any time exceeds the current target cost for the whole of the works, then the appropriate adjustment is made to total cost to reflect the contractor's pain share. ICC consider that this will protect the employer's position by avoiding overpayment to the contractor and will incentivise him to keep costs down.

**Institution of Chemical Engineers (I Chem E) Burgundy Book 2013**

I Chem E publish forms of contract for process plant work and their stated aim is to produce forms of contract which are result orientated rather than work orientated. To this end elaborate procedures for takeover and performance testing are included. The Burgundy (Target Cost) Book is the counterpart to those produced by NEC and ICC for this payment mechanism. The overall approach is that the contractor is reimbursed for his work on the basis of actual cost. This cost is calculated in accordance with a schedule completed by the parties. This may be on the basis of actual cost plus profit or a unit rate for each item of work.

The parties may agree the target cost in advance or during the period stated in a schedule. The target cost may be adjusted where variation orders are issued.

The share ranges applicable to the actual (as compared to the target) cost are also set out in a schedule to the contract. Interim payments of actual cost are made during the course of the contract and compared with the target cost. The contractor's final request for payment must include provision for his gain share where actual cost is less than target cost.

Conversely, where, in the project manager's opinion, the actual cost is at any time expected to be greater than the final value of the target cost, interim certificates are adjusted so as to ensure that there is no overpayment to the contractor. As such certificates are based on the project manager's estimates, there is a provision to the effect that, if they are found later to be wrong, then a correcting certificate may be issued. Therefore, the employer's position is protected by avoiding overpayment to the contractor.

**Recent Case Law on Target Cost Contracts**

In *AMEC v Secretary of State for Defence* (2013), the parties had agreed a guaranteed maximum price clause by which the contractor was liable for excess costs up to a cap of £50 million if costs exceeded the agreed maximum price up to that figure. Sharing arrangements applied from a target cost up to the maximum price. The contract did not make it clear what was to happen if the cost overrun exceeded the cap of £50 million.

The English High Court considered a Disputes Review Board's decision on this point and concluded that it was "plainly right". The Board had concluded that the contractor would recover additional costs in excess of the cap since the contract stated that his liability for additional costs over the maximum price was not to exceed this figure. However, the calculation of actual cost above the cap would not reimburse the contractor for costs unreasonably or improperly incurred as this would be a departure from the approach to payment adopted throughout the contract.

**Conclusion**

The target price contract is a particular type of cost reimbursable contract where a contractor is paid his actual cost but at the end of the project a formula is applied which may lead to a pain or gain share for the contractor. The risk to the employer of a pure cost reimbursable contract is therefore mitigated as the contractor should be incentivised to seek savings so that he brings in the total cost below the target cost and therefore he derives benefit from the share ranges applicable to any underspend.

It is important that the target cost is a proper pre-estimate of the most likely outturn cost. Some contracts (such as I Chem E) envisage that the parties may continue to work up the target cost in the initial stages of the contract as provisional sums are finalised and subcontractor's prices "firmed up".

If this exercise is properly undertaken the contractor should be reassured that the target cost will be sufficient to carry out the works and should be motivated to seek efficiencies leading to savings which in turn will bring him into gain share.
A target cost figure which is set too low may incentivise the contractor to seek its enhancement by virtue of compensation events. By contrast; a target cost figure which is set too high is likely to give the contractor no incentives to make efficiencies since he knows that he will be able to deliver the project at the (lower) outturn level.

Employers may prefer to adopt the position found in the ICC and I Chem E forms where an interim pain share payment can be certified so that there is no likelihood of overpayment during the course of the contract, thereby avoiding placing the risk of the contractor's insolvency on the employer.

As for contracts based on a cost-plus formula, record keeping must be transparent in order to enable the employer to check that the costs being claimed by the contractor are valid. A suitable audit clause should therefore be inserted into the contract.

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