July 2023

CECA NEC4 Bulletin

CECA Member Briefing:

Bulletin No. 31 - Disallowed Costs

Introduction

Training and development support is a key part of CECA's core offer for its membership and working in conjunction with GMH Planning it has delivered a programme of training events around the NEC Form of Contract across several CECA UK regions.

In addition to this training, a series of monthly NEC Contract Bulletins are being produced for both Contractors and Subcontractors to improve practical awareness on key topics within the NEC. The coverage, whilst not exhaustive, is intended as a general overview on some of the contractual principles to increase a wider understanding in support of more sustainable outcomes.

For the purposes of these bulletins a contractual relationship between a "Client" and "Contractor" is assumed. The same rules/principles also apply if the contractual relationship is between a "Contractor" and a "Subcontractor" and so the term "Contractor" will be used to describe both parties.

These bulletins are based on the latest NEC4 family of contracts, but the same principles and rules would apply where parties are engaged under an NEC3 form of contract.

Coming next month:

Bulletin Nr 32 - Engineering and Construction Short Contract

Please respond to Leone Donnelly should you require any further information on the CECA NEC4 Bulletins via e-mail: leonedonnelly@cecasouth.co.uk.

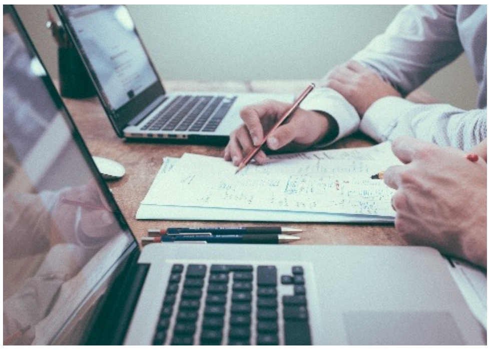
For further advice or guidance on the NEC details please visit www.gmhplanning.co.uk or contact GMH Planning Ltd by e-mail glenn@gmhplanning.co.uk.

NEC Contract focus month 31 - Disallowed Costs

Within options C, D,E & F of the NEC4 Engineering and Construction Contract (ECC), the Contractor is paid each period their Defined Cost plus fee. In simple terms this is the actual cost they can prove they have spent (or will have spent prior to the next application date) plus their fee percentage (identified in contract data 2). However, the amount paid each period will be subject to Disallowed Costs as defined within the contract. It would be easy for a Contractor to end up with a false sense of security where they know they are being paid actual cost so, they need to ensure that they are not doing anything that could be disallowed and hence limit their opportunity to make a reasonable profit on that project. For options A & B there is no such definition of Disallowed Cost, as the Contractor is being paid in accordance with their 'activity schedule' or 'bill of quantities', rather than being paid in accordance with their records and accounts.

Defined Term: Disallowed Cost is a defined term in ECC options C, D,E & F. This bulletin will consider the main elements of this definition that could have practical implications if not fully understood by the Contractor.

11.2(26) Disallowed Cost is cost which:

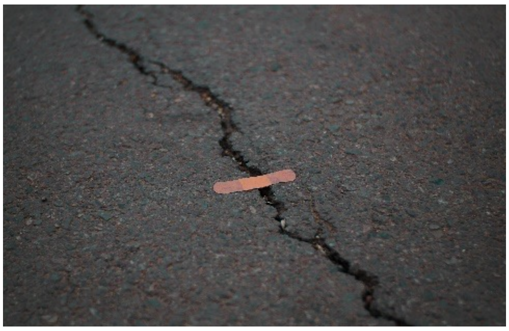


- **is not justified by the Contractor's accounts and records:** If the Contractor cannot demonstrate that a cost has been incurred via their accounts and records then it will not be paid. It is very important at tender stage and at the commencement of the project that the Contractor understands the Client's requirements and expectations as to what would need to be identified to "prove" the cost they are claiming. The Contractor would need to consider what detail and what format they are able to show the Client to meet this requirement and avoid any costs being withheld that period.

- **should not have been paid to a Subcontractor or supplier in accordance with its contract:** Any elements that have been paid that are not part of a Subcontractor's contract would be disallowed. Examples would be compensation events that should not have been paid, or for any bonuses that had been paid to a Subcontractor that were not part of their contract.

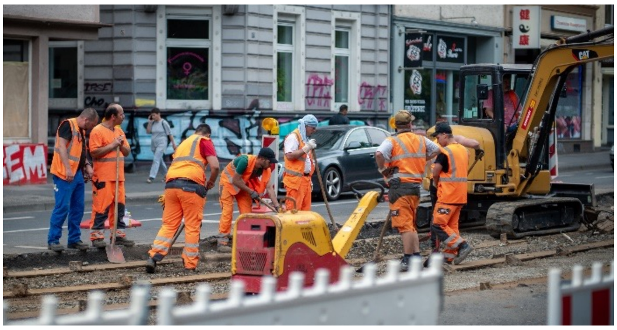
- **was incurred only because the Contractor did not follow an acceptance or procurement procedure stated in the Scope:** There could be very specific processes identified within the Scope for procuring Subcontractors or materials, or for accepting design, that needs to be understood and allowed for. If any cost was incurred by the Client due to any of these processes not being adhered to, any resultant associated costs could be disallowed.

- **was incurred only because the Contractor did not give an early warning which this contract required it to give:** If an early warning had not been given by the Contractor and it was viewed by the Project Manager that an avoidable cost was incurred as a result, this cost could be disallowed from the Contractor's application. This is likely to be subjective, and the best way to avoid this issue is to make sure that wherever possible early warnings are issued for all such eventualities.



- **the cost of correcting Defects after Completion**: Any cost in correcting defects after Completion will also be disallowed and therefore the Contractor's liability. On the flip side, it does mean that the cost of correcting defects before Completion will be payable! It is in the Contractor's interest to ensure that wherever possible they correct all defects before Completion, as at least they can then be claimed as part of Defined Cost (although it will reduce their overall share percentage).

- **the cost of correcting Defects caused by the Contractor not complying with a constraint on how it is to Provide the Works stated in the Scope:** If the Contractor has not followed a specific constraint identified in the Scope, which has then led to additional cost being incurred, the Project Manager can deduct any such amount from the Contractor's application.



- **the cost of Plant and Materials not used to Provide the Works (after allowing for reasonable wastage) unless resulting from a change to the Scope:** This element is to ensure that the Contractor optimises material use and minimises waste. Should it be viewed that they have been unnecessarily wasteful with materials, this cost can be disallowed by the Project Manager. This element does have the potential to be subjective, so the Contractor should be ready to demonstrate through their records that they have not been unnecessarily wasteful.

- **the cost of 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:** Again, another area where the Contractor has to demonstrate that they are optimising performance is by making sure excessive resources are not used, otherwise it could be argued that they were unnecessary or could have been more efficiently managed.

To prove 'disallowed costs' does mean that the Project Manager and the Client's team will have to be closely associated to the project and carrying out audits to assess if any of these potential disallowed costs have been incurred.

Z clauses to change Disallowed Cost definition: The definition of Disallowed Cost could be amended by the Client to re-word existing elements or to add additional ones. These would need to be carefully reviewed and understood by the Contractor at tender stage and any increased risk priced accordingly, or the wording negotiated and amended to a mutually agreeable risk profile prior to signing the contract.

Disallowed costs can be harder hitting to the Contractor under option E than option C: In theory the common view would be that option E is the option of lowest risk to the Contractor, but the effect of disallowed costs have the potential to hit the Contractor even harder compared to an option C or D contract. For example, under option C, if the Contractor completed a £1mil project and had £50k disallowed costs, they would be paid £950k but then earn their share on the underspend. If their share percentage was 50%, they would be paid overall £975k. For the same £1mil project but this time under option E, if the Contractor had the same £50k worth of disallowed costs, they would only be paid £950k overall.

Periodic agreement of Defined Cost: Clause 50.9 allows the agreement of Defined Cost for part of the works during the life of the project. By agreement, elements of Defined Cost can be mutually agreed and finalised so that neither party can re-open to either increase or reduce the costs for that element of the project. This is particularly useful for longer duration projects and avoids the potential for disallowed cost audits towards the end of a project potentially going back over costs from previous months or even years. It should be in both Parties' interest to know exactly where they are in terms of costs for budget purposes and in understanding their relative liability.

Summary: Disallowed Costs are one of the biggest risks to a Contractor on cost reimbursable type projects. The Contractor needs to understand what the Disallowed Costs are (including any amendments) and brief their site teams accordingly to minimise the potential of any of their applications being reduced unnecessarily.

For more information, contact CECA Southern Director David Allen on 07741 543468 or davidallen@cecasouth.co.uk
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