

PRACTICE

NEC4 ECC compensation event assessment – a worked example



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KEY POINTS

- Use of defined cost is the primary method for assessing compensation events for all main options in the NEC4 ECC.
- It is important to note that defined cost is not the same as actual cost.
- The intent of a compensation event is to ‘compensate’ a contractor, putting it back in the cost position it would have been in but for the event.

Assessing compensation events under the NEC4 Engineering and Construction Contract (ECC) is a vital part of contract administration. Compensation events are events that, under the NEC4 ECC, entitle a contractor to a change to the prices, completion date or key dates. Incorrect assessment of a compensation event could result in a contractor not recovering its full entitlement. Once a compensation event is implemented (other than by the use of ‘assumptions’, which would be a new compensation event), it cannot be re-opened.

Defined cost is the primary method for assessing compensation events for all main options in the NEC4 ECC. It is important to note that defined cost is not the same as actual cost: defined cost is a defined term. In accordance with the dividing date (the rule that governs whether assessment is retrospective or prospective in nature), defined cost can be either actual defined cost or forecast defined cost.

In NEC4 ECC priced Options A and B, defined cost refers to the short schedule of cost components (SSCC), whereas in cost-reimbursable Options C, D and E, it refers to the schedule of cost components (SCC). This is simplified when compared with the NEC3 ECC as, under Options C, D and E, the SSCC could be used instead of the SCC for assessing compensation events, but only by agreement. Note in the management contract Option F there is neither an SSCC or SCC and a different form of assessment applies.

Worked example

Say a contractor is building a new library under NEC4 ECC Option A (priced contract with activity schedule). The client’s scope includes a new storage room specifying type A shelving. The tendered price in the activity schedule to supply and install this shelving is £60,000.

Six months into the project the project manager instructs a change to the scope, deleting the type A shelving and replacing it with type B shelving. For completeness, it is given that the project manager has correctly notified a compensation event and instructed quotations without an agreement to use rates or lump sums (clause 63.2).

There are various clauses that, at this stage, become most relevant and should be considered. These are core clauses 14.3, 20.1, 27.3, 60.1(1), 61.1, 61.2, 62.1, 62.2, 63.1, 63.2, 63.5, 63.8 and 63.9, and Option A clauses 55.1 and 63.14.

After speaking to subcontractors and suppliers, the forecast defined cost to supply and install the type B shelving is £80,000. No additional building work is required, and the contractor determines that the programme for remaining work is not altered by the compensation event.

The relevant information for an assessment now available is:

- type A shelving activity schedule price is £60,000
- fee percentage is 10%
- forecast defined cost of type B shelving is £80,000
- type B shelving is assumed to take the same amount of resource to install as type A
- secondary option X1 on price adjustment for inflation has not been selected.

It may be considered that the above information is sufficient information to enable the compensation event to be assessed. Using only this information, however, would result in an incorrect assessment, as shown by the following calculations.

INCORRECT ASSESSMENT #1

Forecast defined cost (a)	80,000
Current price (b)	60,000

a-b	20,000
Add fee (10%)	2,000
(c)	22,000
Revised activity price (b+c)	82,000

INCORRECT ASSESSMENT #2

Forecast defined cost	80,000
Add fee (10%)	8,000
Revised activity price	88,000

Both the above assessments are incorrect as they have not followed what the contract requires.

Effect on forecast defined cost

Clause 63.1 requires an assessment of the effect of the compensation event upon defined cost. This involves establishing the defined cost of the work both before the event (type A) and after the event (type B), with this difference being the effect described by clause 63.1. It is not the difference between price of type A shelving (as per the activity schedule) and forecast defined cost of type B shelving.

Currently, there is insufficient information to correctly assess the compensation event as the forecast defined cost of type A shelving has not been ascertained and is not known. For the purposes of this example, two possible correct scenarios are considered based on different quotes for the forecast defined cost of type A shelving.

Scenario 1: forecast defined cost of type A shelving is £50,000

CORRECT ASSESSMENT #1

Forecast defined cost type A shelving (a)	50,000	
Forecast defined cost type B shelving (b)	80,000	
b-a	30,000	The impact of the compensation event is to increase the defined cost by £30,000
Add fee (10%)	3,000	

Continued on page 9 >>

>> Continued from page 8

(c)	33,000	Including the fee, the compensation event is assessed at £33,000
Changed activity price	93,000	The changed activity schedule price is £60,000 + £30,000 + £3,000 = £93,000

Without the compensation event, the contractor would have made £10k on this activity compared with its tender (defined cost type A £50k, activity £60k). This position is maintained.

Scenario 2: forecast defined cost of type A shelving is £70,000

CORRECT ASSESSMENT #2

Forecast defined cost type A shelving (a)	70,000	
Forecast defined cost type B shelving (b)	80,000	
b-a	10,000	The impact of the compensation event is to increase the defined cost by £10,000
Add fee (10%)	1,000	

(c)	11,000	Including the fee, the compensation event is assessed at £11,000
Changed activity price	71,000	The changed activity schedule price is £60,000 + £10,000 + £1,000 = £71,000

Initially it may seem that in scenario 2 the contractor will lose out as it will not recover the cost to deliver the works. However, the same principle as before applies as, without the compensation event, the contractor would have also lost £10k compared with its tender (defined cost type A £70k, activity £60k). Again, this position is maintained. The same principle will apply if the assessment results in a negative value.

Other considerations

In the above scenarios, the prospective pricing of risk allowances for cost and time matters which have a significant chance of occurring (clause 63.8) have not been included. However, should the risk profile of undertaking the work encompassed by the instruction in scope differ, the forecast effect on the defined cost would need to be included in an assessment. Examples of changes in the risk profile could include matters like disruption to productivity due to other trades causing workflow inefficiencies, access constraints, or even changes in the weather

such as working in winter instead of autumn.

Under NEC4 ECC, quotations for compensation events should detail how much additional money the contractor should be compensated as well as how much additional time it is entitled to, which in either case could be zero or, in the case of cost, could be negative. There is often a misconception that compensation events only deal with cost because that is what is generally associated with the terms ‘compensate’ and ‘quotation’. However, unlike other forms of contract, including other NEC4 contracts, compensation events under NEC4 ECC deal with both time and money.

The above worked example only deals with money so the quotation should also detail that no additional time is assessed. Where the compensation event has an effect on time, it would be necessary to follow the procedure set out under clause 63.5 and provide details of the additional time assessed.

Conclusion

The key point to note when assessing compensation events is that the intent of a compensation event is to broadly compensate the contractor by putting them back in the cost position that they would have been in, but for the event. A compensation event is not an opportunity for either party to gain by either potentially wiping out a tendered advantage, or to gain and recover from a poor tender price. The process isolates the impact of change upon cost.