

## PRACTICE

# Differences between defined and disallowed cost in NEC3 and NEC4



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## KEY POINTS

- 'Defined Cost' is used in most NEC3 and NEC4 contract forms for assessing amount due for payment, for assessing compensation events and for assessing the amount due on termination.
- In main options A and B defined cost is calculated using the short schedule of cost components while options C, D and E use the schedule of cost components and deduct 'Disallowed Cost'.
- NEC4 changes over NEC3 include allowing the defined cost of preparing quotations for compensation events. Other changes and new provisions help to provide clarity and conciseness.

'Defined Cost' is a defined term used in all NEC3 and NEC4 forms except the Framework Contract (FC) and Dispute Resolution Service Contract (DRSC). Where a contract form such as the Engineering and Construction Contract (ECC) has main options, defined cost has an option-specific definition and is included in the contract clauses applicable to each main option clause.

Defined cost is used for assessing the amount due for payment under certain main options, assessing the change to the prices for a compensation event quotation, and assessing the amount due on termination.

Under the priced main option A (priced contract with activity schedule) and option B (priced contract with bill of quantities) contracts, defined cost is calculated using the short ('shorter' in NEC3) schedule of cost components. Interim valuation for monthly payment to the contractor is dealt with under these options as reimbursement for completed activities contained within the activity schedule or units of work within the bill of quantities.

The definition of defined cost under the reimbursable main options C (target contract with activity schedule), D (target contract with bill of quantities), E (cost reimbursable contract) and F (management contract) is different to priced options A and B as it is also used to calculate the defined 'Price for Work Done to Date' (PWDD). This is used by the contractor to calculate the sums for interim payments in accordance with clause 5. Under reimbursable contracts therefore, defined cost is used for calculating interim payments and evaluation of compensation events. The reimbursable options use a more detailed method to calculate the defined cost using the schedule of cost components.

The definition of defined cost in the reimbursable options C, D and E (and Option F, although rather different) includes the defined term 'Disallowed Cost', which is only included and defined to calculate the PWDD for interim payments. These options contain similar definitions for both defined and disallowed cost and operate in a similar manner.

## Changes between NEC3 and NEC4

Under NEC4 priced main options A and B, the definition of defined cost is similar to the NEC3 forms but NEC4 removes the restriction which excluded the defined cost associated with preparation of quotations for compensation events. This exclusion was in NEC3 priced main options A and B, meaning that tenderers had to include parts of the cost for managing change within the tendered prices. Defined cost can now include the cost of preparing quotations

for compensation events under all of the main options in NEC4.

The definition of defined cost within NEC4 has also been simplified by removing the five possible amounts to be deducted from the defined cost calculation relating to payments to subcontractors in NEC3. Subcontract costs, including allowances for retention, are now addressed as a component in the schedule and short schedule of cost components, and deductions for payments to the client arising from the contractor's failure to meet a condition stated for a key date are no longer dealt with under the definition of defined cost.

Circumstances where payments are to be made from the contractor to the client in relation to missing a key date are defined under NEC4 clause 25.3. This combined with clause 25.2 provides a more detailed description of the circumstances under which the contractor will make payments to the client. The mechanism for making these transactions is included under clause 50.3 bullet point 3.

There is no fundamental change arising from the removal of retention from NEC3 clause 11.2(23) as this will be administered under the defined cost calculation for subcontractors within the schedule of cost components, which minimises the risk for the client paying or retaining an amount twice.

A significant change within the NEC4 definition of defined cost is the removal of reference to working areas overhead, which is no longer applicable or contained within NEC4 contracts. They need to be allowed for in the prices and are generally recoverable as equipment in the schedule of cost components.

## NEC4 provisions

The NEC4 main options C, D, E and F include a provision for widening the definition of disallowed cost to include the costs of preparing for and conducting an adjudication or tribunal between the contractor and a subcontractor or supplier, where the contractor did not provide notification of such to the project manager. However, the effect or reasoning for notifying the project manager, and the resulting sanction for non-adherence, is not obvious.

The costs associated with payments to a member of the dispute avoidance board (option W3) are also disallowed under NEC4 alongside payments associated with adjudication or a tribunal.

Clause 50.9 in NEC4 main options C, D, E and F allows the contractor to notify the project manager when a part of the defined cost has been finalised and to present this part to the project manager for acceptance. The project manager may accept the part of the defined cost presented as correct, or notify the contractor that further information is needed, or notify the contractor of errors in the assessment.

Stated timescales for notification and responses are included within the process described in the clause. A default in responding within the timescales, most likely occurring through a lack of response from the project manager, may lead to the contractor's assessment being treated as correct.

## Benefits of NEC4

The general movement of the changes between NEC3 and NEC4 is to provide clarity and conciseness to the contract processes. Possibilities for subjectiveness in operation of the contract are also addressed, for example, the revised definition of disallowed cost in NEC4 removed the text 'which the *Project Manager* decides' from the description, thereby modifying the use of this term.

The NEC4 provision included for finalising parts of the defined cost can be used to mitigate the risks associated with cost audits occurring late in a project. These audits may cause unnecessary hardship for contractors in answering questions as the turnover of staff on a long-term project may lead to difficulties in substantiating costs which have been incurred and reimbursed for long periods. ○

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