

Cutting risk is the target

Target cost contracts are growing in use, especially on large publicly funded infrastructure projects. **Nicholas Downing** and **Estelle Katsimani** of **Herbert Smith Freehills** explains how they work and looks at some recent case law.

KEY POINTS

- A target cost contract allows the parties to share in savings made and to contribute towards overspend. The aim is to align the parties' objectives and provide an incentive for the contractor to create efficiencies and to share risks
- Target cost contracts are particularly suitable for large infrastructure projects with a high degree of risk
- The target cost should represent a genuine pre-estimate of likely outturn cost to be its most effective
- Effective project management is crucial in order to monitor costs
- The choice of pain/gain mechanism should be well thought out so as to create the right incentives for the particular project. Bespoke provisions can be agreed that go beyond the traditional banded approach

Over the last years target cost contracts have increased in popularity. They tend to be preferred by employers in large scale publicly funded civil engineering projects, such as the East London Line, Channel Tunnel Rail Link and the Olympics.

A target cost contract is typically a particular type of cost reimbursable contract (other types are also in existence but not examined in this article) in which the contractor is reimbursed his costs on an actual costs basis subject to the application at the end of the project of a formula which allows the contractor to share in savings made and to contribute towards overspend. In particular:

- The parties agree a 'target cost' for a defined scope of work. The target cost is usually based on the sum of prices in a bill of quantities, schedule of rates or an activity schedule. It is adjusted in defined circumstances, for example variations and employer risk events.
- If the actual cost of the works is less than the adjusted target cost, the contractor is paid a pre-agreed share of cost savings (gain); if it is more, the contractor bears a pre-agreed share of cost overrun (pain).

As payment is made on a cost reimbursable basis, the employer will want to monitor closely the contractor's actual costs as part of the interim valuation process to ensure that they are properly due, including through audit of the contractor's financial accounts and records.

This may necessitate a high level of resource to examine large amounts of supporting documents. Further, the project manager will have a much more direct involvement in the running of the subcontracts (including the selection of sub-contractors, agreeing the subcontract terms and overseeing the administration of the subcontracts) and it will need to evaluate a higher volume of management information, such as cashflow forecasts, resource loaded programmes etc. Therefore administration best practice and a competent project manager are essential.

Standard target price contracts include *NEC3 Option C*, *NEC3 Option D*, *ICC Target Cost* and the *ICChemE: Burgundy Book*.

Target cost elements

In essence the target cost should contain the same items as a contractor would include in a traditional tender, ie:

- Base cost: costs directly incurred at site level and entirely attributable to the project.
- Overheads and profit (fee): normally pre-agreed as a percentage but sometimes as a fixed lump sum. If it is a percentage of actual cost, the contractor will be encouraged to increase the cost. For this reason, the employer may wish to agree a fixed price.
- A contingency for contractors' risk.

The target cost should represent a genuine pre-estimate of the most likely outturn cost. The parties should approach the issue in good faith so that the cost developed accurately reflects the likely costs of construction.

If the target cost is a tender figure low enough for the contractor to win the project but not sufficient to deliver the works required, the contractor will be inclined to increase the target by generating claims.

Conversely, if the target cost is inflated, the contractor will be able to achieve gain share simply by delivering the project at its expected outturn level, without any need to generate efficiencies.

In practice the parties are likely to negotiate the target cost in their own best interests, with the employer pushing for a lower and the contractor for a higher figure. The trick is how the parties arrive at the target cost, which may depend on whether the contract is negotiated or tendered. In a competitive tender environment the employer will rely on a mixture of advice from cost consultants and outcome of competitive tender. The quality of information against which the contractors are bidding is critical.

Pain/gain mechanism

This is the key driver in aligning the objectives of the contractor and employer. There is no right or wrong pain/gain mechanism and there are many different approaches depending on the particular project. The choice of model has to take into account the effect it will have on the parties' behaviour; for example, if the contractor is left to carry most of the cost overrun it may seek a significantly higher target cost to avoid the project going into pain.

The pain / gain mechanism is normally based on a percentage split of overspend or savings between the contractor and the employer, and it is often 'banded' based on the percentage of overspend or savings made compared to the target cost.

The simplest apportionment is a 50/50 split of all over/underspend (equal sharing of risk and reward). The 50/50 model is, however, sometimes varied to include a sliding scale of percentages. For example, the employer may split the first 10% of any over/underspend equally but then alter the apportionment above and below this percentage. Sometimes the employer may consider increasing the contractor's pain share percentage at a certain level above the target cost to allot to the contractor a greater share of the overspend.

Another option may be to decrease the percentage gain share to the contractor below a certain level on the basis that the contractor should not be incentivised to cut costs too much in case this leads to lower quality standards or make a windfall gain because the target cost is too high.

The reverse approach is also sometimes encountered: some employers increase their exposure to pain share in the higher overspend brackets and decrease their own percentage of any underspend. The rationale in this case is that employers may be better able to carry the financial risk of overspend against the target cost and would rather carry this risk than allocate it to the contractor who may seek a higher target cost. This might apply on large or complex projects where the risks are greater. Similarly, increasing the percentage gain share to the contractor could motivate it to mitigate cost and create gain share.

Which of these approaches are appropriate depends on the intended commercial effect of the pain/gain mechanism, as well as achieving a balance between management of cost and maintaining quality standards.

Option: Guaranteed Maximum Price (GMP)

A Guaranteed Maximum Price (GMP) is a way of capping the outturn cost of a cost plus contract. Where it is used in the context of a target cost contract, it operates as a cap on the employer's potential pain share payment. At a certain level (for example, above 120 per cent of target) the employer will allocate 100 per cent of overspend to the contractor.

The GMP thus reduces the financial exposure to the employer and increases the financial risk to the contractor. It is not a collaborative arrangement

and creates a different dynamic which potentially undermines one of the key benefits of target cost arrangements, which is the aim to align the parties' interests.

A high profile example of a GMP project which went wrong for the contractor is the Millennium Stadium in Cardiff constructed by Laing who grossly underestimated the complexities of the project. This led to a substantial loss and ultimately to the sale of Laing to O'Rourke for £1 in 2001.

Bespoke mechanisms

There are lots of different variations to the traditional banded approach and the GMP option. For example, the parties may agree a buffer zone above the target price within which one of them has full liability for costs and above which the liability either reverts to the other party or is divided between the parties based on a pain/gain percentage split. An example of this arrangement can be seen in *Amec v Secretary of State for Defence [2013] EWHC 110 (TCC)*.

Amec was engaged by the government under a design and build contract to provide a facility for nuclear submarines at HMNB Clyde. There was a sharing of 75/25 for cost overruns above the target cost between the Authority and the contractor but only up to an agreed Maximum Price, beyond which the contractor was entirely liable for the excess costs up to a cap of £50m.

The case went to trial as it was not clear what would happen if the cost overrun exceeded the Maximum Price plus £50m cap. It was held that the Authority would be liable to pay the excess costs in this case, but it would only be liable for actual costs, ie costs reasonably and properly incurred under the contract, excluding amongst other things any costs incurred by AMEC by reason of any default or breach.

Another example of a buffer zone approach is the following: the contractor is paid the full outturn cost within a buffer zone of x% above target price; after the upper limit of the buffer zone has been reached there is a banded split of the overspend between the parties with the contractor's pain share being capped at the profit and overhead portion of the fee plus a small percentage of the target price.

After that cap has been reached the contractor is paid the full outturn cost. This might be combined

with a provision that once the cap has been reached and the contractor's allocation of the overspend is 0% the contractor is entitled to be paid only a percentage of site attendance costs.

Final thoughts

It is arguable that target cost contracts, being a variation of cost plus contracts, create inherently adversarial interests, in that the contractor is primarily paid for his costs while the employer is required to scrutinise these costs to ensure that they are valid.

Issues often arise as to whether the costs incurred by the contractor may be disallowed. Disallowed costs can be difficult to identify in practice, as is the case, for example, with costs which the employer perceives to have been incurred as a result of the contractor's inefficiency.

Further, there is less certainty for the employer under target cost arrangements about what the actual final cost will be: the nature of the target cost contract is such that the employer also shares in the contractor's risk.

However, for those numerous instances where some form of cost plus contract may be more appropriate (for example where a contract must be let before design development is sufficiently advanced to allow a lump-sum price to be fixed; or where the employer wishes to participate in the design; or where contractors are simply not prepared to take lump sum contracts due to the size and complexity of the project) the target cost option has clear advantages.

Incentives can work if they genuinely result in an alignment of objectives between the parties. A realistic target cost and effective project management can play an instrumental role in maximising the chances of a target cost contract delivering benefits for both parties.

Giving careful consideration to the pain/gain share mechanism and tailoring it to the particular needs of the project is also of utmost importance.

There is a wide variety of potential structures, extending beyond the traditional banded approach and GMP provision.

But as the *Amec* case demonstrates, when drafting bespoke provisions care needs to be taken over the apportionment of liability to ensure that there is absolute clarity about the exact consequences of cost overruns. **CL**