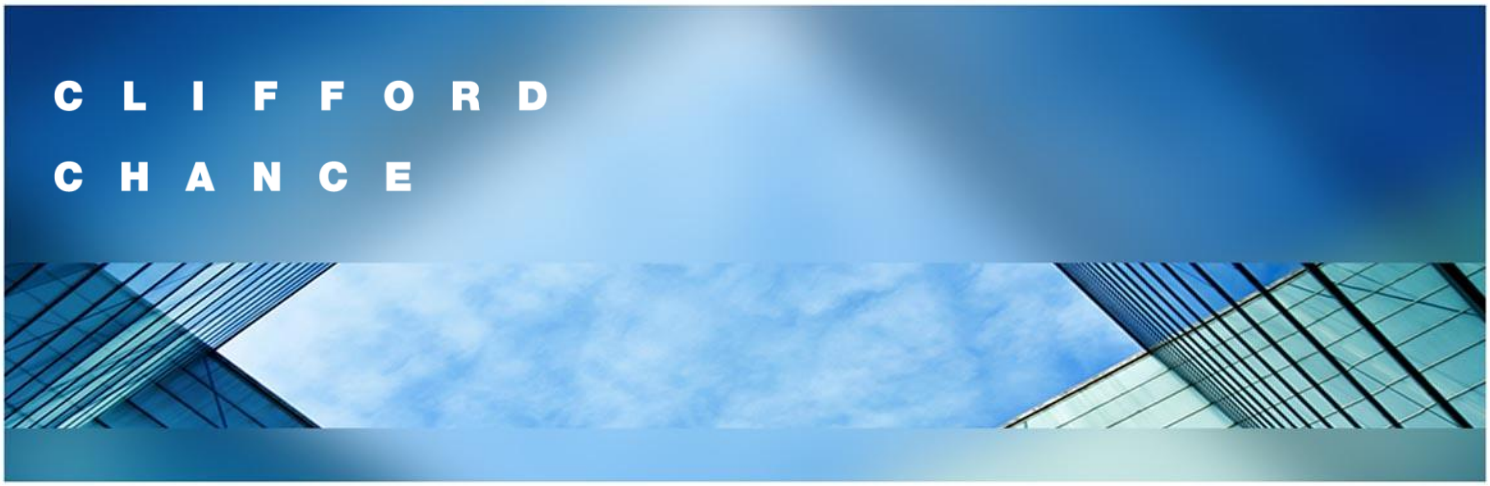

MUCH TO GAIN FROM THE PAIN? JCT'S TARGET COST CONTRACT

JCT has recently published its Target Cost Contract (TCC). Naturally, it has attracted much attention from commentators. So, for the purposes of this briefing, we assume anyone sufficiently interested in an overview of the TCC's general terms has now satisfied their curiosity.

EFFORT AND REWARD?

Rather, this briefing asks whether the TCC will find a worthwhile role in UK construction procurement, particularly in the private development sector. Our wager is that it will struggle to do so.

The attraction and availability of more conventional (lump sum) models, a degree of caution and unfamiliarity among the TCC's potential customer base and their lenders, the availability of established rival target cost standard forms with a track record of use in sectors more open to what target cost contracting involves, as well as the timing of its launch, may all hamper the TCC's hopes in life.

Of course, the effort in producing any contract form deserves acknowledgement. And there is little wrong with the TCC, as far as the basic target mechanism goes.

Rather, it's a question of whether the effort (or pain) in producing the TCC will lead to any gain for its possible users..

SOME PLUSES

It's only fair to say the TCC has some features that may, at least in principle, make it more palatable to developer clients when compared to some other target models. These include the following (incidentally, all points of contrast with NEC Option C):

- *Fixed fees*: the TCC allows for the fee to be a fixed amount, rather than simply a percentage of the contractor's "actual" or "allowable" cost in carrying out the works. This addresses one concern with target models, where the contractor is (subject to any painshare) paid a fee that increases with the cost incurred (regardless of cost overruns).
- *Lump sums can still be used*: the TCC permits parts of the work to be paid for on a lump sum basis, in place of allowable cost. This will provide some more certainty as to outturn cost under the TCC.

Key points

- Is the effort in producing the TCC worthwhile? In particular, will it readily find adopters among commercial developers? We are doubtful.
- While the TCC contains features that may make it more attractive to commercial developers compared to NEC's Target Contracts, the TCC's approach to risk-sharing may still be unattractive to developers (and funders).
- In particular, certain dynamics and features of commercial development appear to militate against wide uptake. These include the desire for a higher level of outturn cost certainty, the difficulty of setting "realistic" targets and the level to which design is often progressed before main contract award. The latter point may mean some of the residual risks and opportunities that could justify a target cost approach will be materially reduced in commercial development projects.
- There may be a case for using the TCC/a target mechanism on occasion. For example, in relation to developments which retain complex or difficult-to-manage infrastructure interfaces with public sector bodies. But we envisage such contracts being let on a hybrid basis, with pricing covered by lump sums wherever practicable.

- *No payment on basis of forecast cost:* the TCC does not provide for payment to the contractor on a cash-neutral basis. Instead, the allowable cost payable is that incurred up to the current valuation date, with no payment of a forecast of the allowable cost that will be incurred up to the next valuation date.
- *Avoiding the need to "clawback" painshare from contractor*: the TCC gives an option to calculate and pay the employer's and the contractor's respective shares of any saving or overrun, on a monthly basis, calculated against a proportion of the target. This is in contrast to waiting until practical completion of the works and finalisation of the adjusted target. It should prevent the employer paying sums due to a contractor that later have to be refunded, once the contractor's painshare is finally calculated. But, equally, the option will require the employer to pay gainshare to the contractor, where the monthly calculation indicates a saving against the relevant proportion of the target. Developers and lenders may not be amenable to that.
- *Grounds for increasing the target*: the TCC's range of grounds entitling the contractor to an increase in the target is narrower than the list of compensation events in NEC Option C. But, as noted below, this is an area on which contractors are likely to focus when agreeing contracts based on the TCC.

WHO MIGHT USE TARGET CONTRACTING AND WHEN?

It's worth recalling when target cost contracting may be most suitably used. Situations that may lead to its adoption include where:

- the project is particularly complex or innovative;
- significant areas of detailed design will require to be carried out after the commencement of construction;
- the project involves risks for which a main contractor cannot, or will not, offer acceptable fixed prices;
- there is material scope for the contractor to innovate and achieve efficiencies during the construction phase; and
- the client is willing and able to play a proactive and collaborative role in driving efficient project delivery, recognising that it too will share in savings realised against the target, and has, or will engage, the resources and experience to monitor sub-contract procurement and cost accrual. (We touch more on some of this below.)

These factors could, of course, also be used to justify the use of other contracting strategies, e.g. construction management (which, of course, raises its own issues, such as increased interface risk borne by the developer).

THE REALITY OF COMMERCIAL CONSTRUCTION PROJECTS?

But how many of these factors will apply so forcefully, in the context of large UK commercial development projects, as to prompt a switch from a single lump sum contracting approach to something approaching a full target model?

What developers need

From a developer's viewpoint the answer, we suspect, is likely to be "almost never" or "rarely (at best)". Given that protecting a project's financial viability and achieving, or bettering, projected internal rates of return are core developer concerns, a target cost model that envisages the sharing of cost overruns, as well as cost savings, between employer and contractor is unlikely to be attractive. (A caveat to this would be where the developer has confidence that a material gainshare will be realised. But that may simply indicate the target is being set too high in the first place.)

By contrast, a lump sum price, with a built-in contingency for project risk allocated to the contractor, at least superficially provides a developer with more project cost certainty. In principle, a lump sum should also help to reduce the level of project contingency a developer needs to maintain for the project.

There are other issues too. A developer contemplating a target approach may think the target should be stretching - in other words, set at a level preventing a contractor earning a windfall payment without having achieved some genuine innovation or efficiency in project delivery. But how can that be done, without taking at least a step towards the level of project risk analysis that would enable much in the way of pricing to be covered by credible lump sums?

Indeed, would the time involved in negotiating and setting such a target, intended to deliver the benefits a developer seeks, be much less than that required to fix a credible overall lump sum price subject to some limited and usual exceptions?

What contractors may require

Equally, contractors may well push for broad grounds entitling them to an increase in the target, especially where they perceive the scope to earn gain, and so avoid pain, is limited.

There is, of course, a core rationale to that: target incentive models will break down if significant risk, not priced in a target's build-up, crystallises but doesn't result in a commensurate uplift to the target. But one may wonder if requests for grounds for adjustment to the target may include some of the expanding list of relief events one sometimes sees suggested in the quite different context of lump sum contracting.

That attitude may be boosted where the optional mechanism to account for painshare on an interim basis is adopted. It seems plausible the risk of making such payments will encourage contractors to seek ways of increasing the target, by way of a broader category of relief events and through a more intent focus on making claims (of whatever merit) as soon as possible. If so, that outcome could well be at the expense of contractors looking proactively for ways to reduce cost overruns.

Similarly, it seems doubtful that many contractors on major projects will be likely to agree expressly to absorb a share of cost overruns beyond, at most, their declared OHP. That too may cause commercial developers to consider their interests are better served by looking at other pricing models.

As an aside, these supply chain attitudes may well diminish the chances of the TCC finding a role as a guaranteed maximum price contract (under which the contractor would bear all cost overrun risk).

MANAGING RISK IN PROCURING MAJOR COMMERCIAL CONSTRUCTION PROJECTS

The underlying challenge with target contracting is, it seems, setting a target that has just the right level of risk or opportunity pricing built into it. But the pricing of risk is a notoriously difficult thing to do.

In fact, one of the larger themes in commercial construction procurement, over the last decade and more, has been a general shift to identify and mitigate project risk better prior to signing the building contract. That has been exemplified by the increasing use of two-stage tendering or early contractor involvement. This can cover a range of activities, including buildability advice, design review and development, site investigation, and supply chain engagement and package pricing.

Done well, all of these will serve to reduce risk pricing and enable robust lump sum package prices to be obtained. Some developers may focus on improving that model, rather than exploring alternatives. Indeed, it may be doubted whether a developer procuring (say) a prime office development, to be let to a single contractor, would countenance entering into a single building contract where significant detailed design decisions remained to be taken (other than in relation to some fairly typical areas, such as building services).

But, if a developer is not inclined to enter into a main contract at an early point, prior to design and other risks being more fully mitigated, on what basis could a meaningful risk or opportunity fund be generated to include as "headroom" within the contract's target?

The utility of target contracting is even further reduced, it seems, in the residential sector. In particular, the extent of design development now required to satisfy the higher risk building gateway 2 regime will result in design packages being progressed to a stage that can be robustly priced.

It may be that JCT tacitly acknowledges some of these dynamics: after all, it provides for allowable cost to be replaced (to whatever extent) by lump sum prices. The question may be, on many projects, just what would be left to warrant a residual target mechanism.

PRACTICAL CHALLENGES TO ADOPTING A TARGET MODEL

In addition to these more structural issues, there are some practical and resourcing issues that weigh against commercial developers selecting a target model. These include:

- *Management resource*: The cost and effort of administering a target cost contract (especially the assessment of allowable cost) will inevitably be greater than that required for a lump sum model. Will many commercial developers be inclined to pay for that?
- *Skills and ways of working*: Even if the answer is "yes", it may take contract and cost managers some time to adapt their processes and ways of working to a target cost contract environment. Admittedly, some may be able to lever their previous experience of working with target contracts based on NEC Option C. But, inevitably, there will be some lag as

professionals adapt to the TCC. This could be another reason for a developer not to opt for its project to be a trial for the TCC.

Similarly, one of the potential pluses of the TCC - the optional mechanism intended to avoid the need to clawback painshare - may prove too difficult or time-consuming to apply in practice.

The TCC's light-touch approach to the approval of sub-contracts (particularly pricing information) may also be a hindrance to using it, at least in unamended form. For example, it doesn't recognise that non-arm's length sub-contractors affiliated to the contractor might more appropriately be paid on the basis of their actual cost (not sub-contract prices), so as to prevent "overpayment" to some parts of the supply chain.

FINAL THOUGHTS

The TCC may be an example of a perfectly serviceable product that will nevertheless struggle to find buyers from among a brand's (here, the JCT's) usual customer base.

Those clients - for example, in the infrastructure, energy or utilities sectors - strongly inclined to use target contracting will likely already have a wealth of experience of using NEC Option C or IChemE's Burgundy Book. The TCC may struggle to gain followers among them.

In the commercial construction sphere, user (and lender) caution, together with a lack of commercial fit to developer needs, may leave the TCC largely languishing on bookshelves. A potential exception may be where it is used as the basis of a hybrid contract, with most of the pricing covered by lump sums, but with some target pricing for uncertain parts of the scope which the contractor is able to influence and manage. Examples of such projects could be complex urban regenerations, with infrastructure elements relating to transport undertakers.

At a different point in the construction cycle, the TCC could, in something like its pure form, appear more attractive on larger and more complex projects. Even so, clients may still be more attracted by other options: rather than gazing through a glass darkly to compute a target cost, the stronger impulse may be to press for a lump sum (with some caveats for risk that cannot be sensibly borne by the contractor) or to own and manage risk more clearly and fully on the basis of a management model.

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