NEC 3 –
a legal and practical consideration
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Projects (Engineering & Construction) Practice
Overview

• Background and structure of the form
• Key differences between NEC and other standard forms
• Take up of the form – Hong Kong and elsewhere
• Clause review: Compensation Events, Option X12
General
Background

• Launched in the UK in the early 1990s
• Timing: construction industry being pushed to be less adversarial
• Now in its 3rd edition
• Hong Kong government has now endorsed its use
Structure: an integrated suite

- Engineering and Construction Contract – focus on this today
- Engineering and Construction Subcontract
- Professional Services Contract
- Term Service Contract
- Short Forms
  - Engineering and Construction Contract
  - Subcontract
  - Term Service
- Framework Contract
- Adjudicator's Contract
Structure: building the ECC Contract

- 9 core clauses
- 6 main option clauses
  - Option A – priced with activity of schedule
  - Option B – priced with bill of quantities
  - Option C – target contract with activity of schedule
  - Option D – target with bill of quantities
  - Option E - cost reimbursable
  - Option F – management contract
- 20 secondary option clauses
- Option to insert bespoke clauses ('Z' clauses)
- Contract Data, Works Information, Site Information
Key personalities

• Employer
• Contractor
• Project manager – contract administration
• Supervisor – quality of work and defects
Key differences with other standard forms
Co-operation

Clause 10.1:
"The Employer, the Contractor, the Project Manager and the Supervisor shall act as stated in this contract and in a spirit of mutual trust and co-operation."
Philosophy of risk allocation

NEC:
"Risks belong with those who are best able to evaluate, control, bear the cost and benefit from their assumption."

• Risk – parties over amend the form
Use of clear plain English

• Non legal terms, use of present tense to impose obligations, italics for definitions

• For example:

  – 20.1 The *Contractor* Provides the Works in accordance with the Works Information.

  – 21.1 The *Contractor* designs the parts of the works which the Works Information states he is to design.
Flexibility

• The modular ease to use different pricing options (priced, reimbursable, target cost etc) whilst maintaining the same rigour and provision for project management

• NB predominant importance of the Works Information
Strong programme provisions

- The usual way: programme of peripheral importance
- Common mindset for employers: contractor's end date
- Common mindset for contractors: time can be made up one way or another
- Result: employer faces costs of delay, contractor faces liquidated damages
- The NEC way: programme the corner stone of the contract eg key dates, compensation events lever off it
- IGNORE AT YOUR PERIL (and use the best programming software you can get)
Early warning system

• Must be given in a party becomes aware of any matter that could:
  – Increase price
  – Delay completion
  – Delay meeting a key date
  – Impair performance of the works in use

• Sanction on contractor: assessment of compensation event cannot be any higher than it would have been, had the early warning been given

• Sanction on employer: breach of contract (damages or compensation event) if it or project manager fails to give
Compensation Events

• The time and cost impact of Compensation Events is normally to be the result of Quotations by the Contractor, once accepted not to be revisited.

• No final account
NEC projects in the UK

• Civil Engineering
  – British Airports Authority
  – UK Water Companies
  – Environment Agency
  – Highways Agency
  – Rail eg Crossrail
  – Power
NEC projects in the UK

• UK Office of Government Commerce recommends the use of the NEC 3rd edition
  – Central and Local Government
  – London 2012 Olympics

• Other
  – BBC – 5 year framework contracts for professional services and construction, across the BBC's property portfolio
NEC projects elsewhere

- NEC say it can be used internationally
  - South Africa
  - New Zealand
  - Australia
  - Middle East
  - ... and Hong Kong
NEC projects in Hong Kong - Government

• Drainage Services Department
  – 2009: Improvement works to the Fuk Man Road Nullah in Sai Kung (ECC Option C Target)
  – Happy Valley Underground Stormwater Storage Scheme (ECC Option C Target), DSD's largest contract to be designed and managed in-house: $678m contract awarded to Chun Wo 3/9/12. Due to complete 2018
  – Village sewerage in Yuen Long Kau Hui and Shap Pat Heung: $145m contract awarded to Kwan On Construction 5/9/12. Due to complete 2016
NEC projects in Hong Kong - Government

• Architectural Services Department
  – advisory stage: design and build of new Tin Shui Wai Hospital
  – 2011, for 10 years: Total Facility Management Service for graded historic buildings and declared monuments (Term Service Contract)

• Highways Department
  – Tender recently closed: Pok Oi Interchange

Why not watch the HK Government's YouTube video on its experience using NEC!

http://www.youtube.com/watch?v=fDwbzFQXxeI
NEC projects in Hong Kong - private

• CLP Power
  – 2010: Castle Peak Power Station maintenance services (NEC3 Framework Contract (5 years) and Term Service Contract (Option C Target)

• HK Academy (completion mid-2013)

• Commitment from MTR Corporation to use NEC3 on an upcoming project
Clause review
Compensation Events

Wide number of triggers:

- Breach of contract by the employer
- "Physical conditions" which the contractor encounters (term wider than "ground conditions")
- "Prevention" wider than typical force majeure
- Changes to the Works Information

Compensation Events deal with time AND money

The time and cost impact of Compensation Events are the result of quotations by Contractor, once accepted not to be revisited. No final account!

Time consuming rules = PRESSURE!
Compensation Procedure

Notification of compensation event
- PM notification, with instruction (61.1)
- Contractor notification 8 weeks from “becoming aware” (61.3)
  (Contractor can notify before it happens)
- Must be a separate notice (13.7)

Replies & Assessment
- PM reply within 2 weeks of submission (62.3) - options for reply (revise, accept, make own assessment)
- PM assesses (64.1) if:
  - Failure to submit quote or programme;
  - Quote assessed wrongly;
  - Programme not submitted or rejected for permitted reasons (64.2)

Response
- By PM within 1 week or longer if agreed (61.4)
- If no reply, 2 weeks notice, then deemed compensation event
- Project Manager’s decision – early warning not complied with (61.5)

Quotations (fully inclusive)
- Within 3 weeks of instruction (62.3)
- Include alterations to programme if affected by compensation event (62.2)
Option X12 Partnering

• Partnering: early formation of team that will deliver the project (client, contractor, designer, project manager) who sign up to early overarching partnering agreement
• NEC is a collaborative contract … but probably not a partnering contract
• Option X12 attempts to bridge the gap:
  – If partner fails to implement decision of Core Group under its own contract … then breach its own contract plus compensation event
  – Incentive payments to each partner based on key performance indicators
Option X12 Partnering

• But…
  – Still no early contractor involvement
  – Not a multi-party contract: clause 12.2(6): "This option does not create a legal partnership between the Partners who are not one of the Parties in this contract."

• Partnering breakdown?
  – NEC guidance notes: "final sanction against any Partner … is for the Partner who employed them not to invite them to partner again."
  – Risk: move back towards adversarial contracting.
Option Z: Additional conditions of contract

• NEC guidance notes: "only when absolutely necessary"
• My experience: lots!
Legal case review

• Just a handful of cases have involved NEC contracts
  – Costain v Bechtel [2005] EWHC 1018 (TCC) – obiter, arguable that when assessing sums payable to contractor, project manager must act impartially between employer and contractor
  – Anglian Water v Laing O'Rourke [2010] EWHC 1529 (TCC) – NEC style of drafting "a triumph of form over substance".
  – Compass Group v Mid Essex Hospital [2012] EWHC 781 (QB) -
• NEC: claims to be a form people don't litigate over
• NEC's use coincided with statutory adjudication in UK, and rise in other forms of alternative dispute resolution
Conclusion

• If you choose to use NEC, embrace the NEC approach but be aware of its most sensitive areas
General Background

Background:

- Now 3rd Edition of NEC contracts issued 2005
- Variety of projects such as airports, power plants, highways etc.
- Extensive global coverage with success (e.g. UK, India, HK, UAE etc.)
- Partnering contract requiring collaboration
General Background

Background:

- Distinct lack of case laws involving NEC
- Successful implementation dependent on people’s behaviour
- Philosophy is to reduce conflicts through collaborative partnering

- Nevertheless, key practical issues often encountered on projects provide useful lessons learnt and further improvements
Common Pitfalls of Using NEC

- Contract Documentation
- Works Information
- Risk Register
- Programme
- Assessing the Amount Due
- Subcontractors / Suppliers
- Time Bar / Sanctions
Contract Documentation

Potential Pitfalls

The ECC uses plain English which can place it at odds with common industry terminology used in other forms of contract.

Incorporated into the contract as part of the Works Information or BoQ.

The terms Preliminaries, Preambles, Provisional Sums or Prime Cost Sums do not appear in the ECC.

Extensive amendments or additional conditions.
Possible Solutions

Provisional Sums etc, may be accommodated by including an assumed scope of works in the Works Information for the Contractor to price and include a time allowance.

When the scope of the works is defined, a compensation event is issued changing the Works Information leading to a revised cost and time.

Clear and accurate Works Information reduces the need for amendments, especially when core clauses aim to set out general obligations.
Works Information

- Key document – provides the contract with the flexibility it does by leaving the finer detail to be prescribed within the Works Information.

- Is more than just a specification and drawings and is cross-referenced throughout the core clauses, examples:

  11.2(2) Completion is when the Contractor has done all the work which the Works Information states he is to do…

  11.2(25) Disallowed Cost is cost which … was incurred only because the Contractor did not follow … an acceptance or procurement procedure stated in the Works Information

  21.1 The Contractor designs the parts of the works which the Works Information states he is to design

  27.4 The Contractor acts in accordance with the health and safety requirements stated in the Works Information

  40.1 Tests and inspections required by the Works Information…
Works Information

Potential Pitfalls

- Incomplete in terms of coverage, with a lack of clarity
- Included as *addition conditions of contract* (Z clauses)
- Duplication with the contract provisions
- Often based on standard documentation taken from previous projects which were not ECC based, conflicts in terminology and referencing
Works Information

Possible Solutions

- Put sufficient time and team effort into drafting accurate and complete Works Information
- Ensure that all the Works Information requirements have been covered
- Ensure that there is no duplication with other contract provisions
- Check for the use of terminology and referencing that is not compatible with the ECC
- Review the ECC to identify each clause that refers to Works Information
- Responsibility for design is to be identified in Works Information
The Risk Register is a register of the risks which are listed in the Contract Data and the risks which the Project Manager or the Contractor has notified as an early warning matter. It includes a description of the risk and description of the actions which are to be taken to avoid or reduce the risk.
Risk Register

Cl. 16

- The Contractor and the Project Manager give an early warning by notifying the other as soon as either becomes aware of any matter that could
  - increase the total of the Prices,
  - delay Completion
  - Delay meeting a Key Date or
  - Impair the performance of the works in use.

- The Contractor may give an early warning by notifying the Project Manager of any matter which could increase his total cost. The Project Manager enters early warning matters in the Risk Register.
Risk Register

Potential Pitfalls

- The “contractual” Risk Register is in effect for information only
- Misunderstand that this allows the reallocation of risk or the quantification of risk values or probabilities
- Some people use the project risk register* as the “contractual” Risk Register
Risk Register

Possible Solutions

- Do not use the project risk register as the “contractual” Risk Register

- Must not contain owners of risk or values this is covered by the contract

- Ensure that the Risk Register only contains the two columns stated in the contract – a description of the risk and the measures to be taken to reduce the risk

- Risk transfer done by choice of options and amending the standard contract through Z Clauses
Programme

Cl. 31.2 The Contractor shows on each programme:

- the starting date, access dates, Key Dates and Completion Date,
- planned Completion,
- the order and timing of the operations,
- the dates when the Contractor plans to meet each Condition stated for the Key Dates and to complete other work needed to allow the Employer and Others to do their work,
- provisions for float, time risk allowances, health and safety requirements and the procedures set out in this contract
- the dates when the Contractor will need
  - access to a part of the Site if later than its access date,
  - acceptances,
  - Plant and Materials and other things to be provided by the Employer and Information from Others
- for each operation, a statement of how the Contractor plans to do the work
- Other information which the Works Information requires
Programme

Potential Pitfalls

The ECC promotes best practice, through extensive programme requirements

Substantial resources required to continually update programme

Project Manager has to proactively drive and accept the programme

A pragmatic approach is taken to a lower level of information and to less frequent updates of the programme

ECC does not ask for a critical path and logic linked programme
Programme

Possible Solutions

- Request critical path and logic linked programmes in the Works Information
- Contract is amended to simplify programme requirements
- Balance the costs expended against the benefits provided
- Need to decide the approach to a particular project
- Open dialogue, challenge & joint production of the programme
- Project Manager and Contractor meet at the earliest opportunity

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Assessing the Amount Due

Cl. 50

- The *Project Manager* assesses the amount due at each assessment date (Cl. 50.1)

- In assessing the amount due, the *Project Manager* considers any application for payment the *Contractor* has submitted on or before the assessment date (Clause 50.4).
Assessing the Amount Due

Potential Pitfalls

- No requirement for the *Contractor* to submit an application
- The *Project Manager* has to make assessment even if the *Contractor* does not submit an application
- Failure to certify by the due date will lead to potential claims for interest on late payment and possible enforcement notices
Assessing the Amount Due

Potential Pitfalls – Default NEC Payment Timeline

Assessment Date

Project Manager issues payment certificate; Contractor submits invoices

Within 7 days

Within 21 days

Final date of payment: payment takes place
Assessing the Amount Due

**Possible Solutions** – Amended NEC Payment Timeline

- **Assessment Date**
  - *Project Manager* issues payment certificate;
  - *Contractor* submits invoices
  - Within 14 days

- **No later than 5 days before**
  - *Contractor* submits payment application

- **Within 21 days**
  - Final date of payment: payment takes place

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Assessing the Amount Due

Possible Solutions

- Amend the contract to make the submission of an application a condition precedent for payment
- Amend the contract to set the period for certification as 14 days after the Assessment Date
Subcontractors and Suppliers

Cl. 26

- Sets out the general conditions against which subcontractors shall be procured.
- Procedures governing subcontract procurement.

Cl. 52.1

- Defined Cost includes only amounts calculated using rates and percentages stated in the Contract Data and other amounts at open market or competitively tendered prices with deductions for all discounts, rebates and taxes which can be recovered.
Subcontractors and Suppliers

Potential Pitfalls

- Cl. 52.1 imposes a general obligation to seek competitive quotes, but also allow the Contractor to use open market prices as an alternative.
- This has led to debate with the Contractor as to what level of competitive tendering is required and what constitutes open market rates.
- Payments from Main Contractor to Subcontractors need to be transparent and clearly linked to the respective Subcontract works.
Subcontractors and Suppliers

Possible Solutions

- Additional clauses to make competitive tendering a mandatory requirement
- *Employer’s* approval over *Contractor’s* supply chain processes
- Ensure target cost is competitive in the first instance ensuring *Contractor* has to effectively manage the supply chain
- Financial threshold for obtaining 3 quotes
- Regular review of the key Subcontractors (IPA’s etc.)
The procedure relating to compensation event follows a logical chain as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notification</td>
<td>(8 weeks)</td>
</tr>
<tr>
<td>Decision on Validity / Instruction to Quote</td>
<td>(1 week)</td>
</tr>
<tr>
<td>Quotation</td>
<td>(3 weeks)</td>
</tr>
<tr>
<td>Reply</td>
<td>(2 weeks)</td>
</tr>
</tbody>
</table>

Cl. 61.3 *Contractor* notification tests – 8 weeks time bar

Cl. 61.4 Default acceptance of compensation event if no response from the Project Manager within the timescales (1 week + 2 weeks)

Cl. 62.6 Default acceptance of quotation if no response from the Project Manager within the timescales (2 weeks + 2 weeks)
## Time bar / Sanctions

<table>
<thead>
<tr>
<th>Possible Pitfalls</th>
<th>Possible Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal procedures not aligned with contractual timescales</td>
<td>Understand and comply with the contractual timescales</td>
</tr>
<tr>
<td>Sanctions apply to both the Contractor and the Project Manager – potential for either party to suffer loss if the sanctions are enforced</td>
<td>Commit sufficient resources; otherwise amend the contract to extend timescales</td>
</tr>
<tr>
<td>Mix up of early warning notice and compensation event notice</td>
<td>Need a clear, quick and accountable decision making process in client organisations</td>
</tr>
<tr>
<td></td>
<td>Keep compensation event notices from other communications</td>
</tr>
</tbody>
</table>
Summary

- In order to deliver its benefits users must understand the NEC is a fundamentally different form of contract requiring intensive management and a different approach by the parties in terms of both documentation and management requirements.
- Users must understand these issues and invest the time and resources required to overcome these potential problems and deliver the benefits the contract can offer.
- It is the people who ultimately drive the success of a project – whichever contract form is adopted.
- NEC helps by providing a framework against which people should behave.