



Technical

Assessing Compensation Events

Date: 30 Jun 2016

Assessing Compensation Events

1. The assessment of the value or cost of change under NEC3 is fundamentally different from other standard forms of contract and requires considerable thought as to how the rules should be applied. The concept is that the Contractor should recover his costs¹ resulting from the Compensation Event, rather than risk contract rates being used as the basis of valuation.
2. The Contractor should make an assessment of his Defined Costs, as the NEC works on a prospective basis. All of the main options except Option F, rely upon the Schedule of Cost Components (“SCC”) or Shorter Schedule of Cost Components (“SSCC”) to assess Defined Cost, although only for the purposes of Compensation Events in Options A and B. There has been limited research produced reviewing this element of the Compensation Event mechanism, which arguably is the most important as it is the building blocks by which the value of Compensation Events is assessed. There is often confusion as to what is and is not included in the various elements of the SCC.

What is Defined Cost?

3. In Options A and B (Lump Sum) payment is by way of the contract price as set out in the Activity Schedule or the Bill of Quantities respectively.

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Defined Cost applies to the additional payments for Compensation Events².

4. Option C, D, E and F are cost reimbursement contracts and the 'Defined Cost' that is payable is in accordance with Clause 11.2(23) and relates to costs incurred. This includes additional costs whether or not they are subject to a Compensation Event. These costs can be subject to a deduction of 'Disallowed Costs' defined at Clause 11.2(25).
5. As can be seen the same defined term of "Defined Cost" has a different meaning depending on which option is used. For the inexperienced user of NEC, it is difficult to comprehend that the same words have two different meanings.
6. My research found that there was little understanding of what Defined Cost means under the different NEC Options. Respondents to the questionnaire did not have a good understanding of this fundamental element of the Compensation Event mechanism. The interviews conducted confirmed this general lack of understanding of the term "Defined Cost". The most striking comment was raised by the Project Manager in his interview:

*"They haven't got a clue what it means. 99% of users don't even know that the term Defined Cost exists let alone what it actually means."
(Project Manager Interview)*

Issues with Ce Quotations – What does my Research say?

7. There are two schedules which assist with valuing Defined Cost. These are the SCC and the SSCC. These schedules are a set of rules to define those components of the Contractor's cost which are included in Defined Costs. The SCC is used with Options C, D or E. The SSCC is used with Options A and B and, if agreed, with Options C to E.
8. Each schedule is split into the following sections:
 - People.
 - Equipment.
 - Plant and Materials.
 - Charges.
 - Manufacture and Fabrication.
 - Design.
 - Insurance.

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9. When respondents were asked how often they use, or see used, the SCC and SSCC for assessing compensation events 60% used them 25% or less of the time and nobody used them 100% of the time. When asked which other methods were used instead, established rates and Subcontractor/Supplier quotations were the main alternatives. When asked to rate as a percentage how often did they use, or see used resources (SCC and SSCC) when pricing Compensation Events, 62% said 50% or less.
10. This raises questions as to whether the use of these schedules for valuing Compensation Events is working in practice. The general consensus from interviews was that they were not used and could be simpler and streamlined. The Lawyer's comments seem to sum up the situation well:

"I find the ones that I've looked at, the parties have muddled through despite what's in the schedule of cost components." (Lawyer Interview)

11. The Contractor stated:

"They could make it a little easier."

12. While the Adjudicator gave the following comment:

"The SCC and SSCC are not easy to follow, particularly with someone who is new to NEC Contracts. There are not very many similar documents and people sometimes confuse it with Daywork under JCT Contracts. I really do not see the point in having two schedules of cost components."

13. The research has shown that the two schedules used for assessing Compensation Events are often not used and people in the industry refer back to the traditional use of rates and quotations, and not Defined Cost.

Practical Arguments and Issues in the use of SCC and SSCC

14. I carried out a detailed review of three NEC3 schemes which went to adjudication and identified the following practical arguments and issues in the use of the SCC and SSCC:

Schedule Element	Issues Identified
People	<ul style="list-style-type: none"> • Insistence on seeing wage slips – Data protection issues. • Self-employed people – People or sub-contract arguments? • Records of what operatives are doing and being allocated to CE's. • Average rates for operatives should not be used. Actual cost of operatives. • Arguments over who is included in people or fee. • Breaking down of number of labour hours on CE's requested. • Arguments over what is included in people costs. Different companies include for costs related to people differently (i.e. holidays, overtime, mobile phones, lodging, etc.).
Equipment	<ul style="list-style-type: none"> • Equipment rates in, say, CECA schedule being higher than the actual costs incurred. • Requests for all plant costs incurred and the allocation to CE's. • Arguments whether Equipment schedules pass down from Main Contractor to Subcontractor when contract tries to back to back (badly). • Requesting precise details of Equipment such as formwork used. • Requesting to see all Equipment invoices.

	<ul style="list-style-type: none"> • Questioning productivity of Equipment (plant) when allocated to a CE.
Plant & Materials	<ul style="list-style-type: none"> • Requesting to see all material invoices. • Directly relating invoices to elements of the works and CE's.
Charges	<ul style="list-style-type: none"> • Claiming additional quantity surveying costs in preparing documents to adjudication standard as "<i>Specialist Service Charges</i>".
Manufacture and Fabrication	<ul style="list-style-type: none"> • No arguments raised in the projects reviewed.
Design	<ul style="list-style-type: none"> • No arguments raised in the projects reviewed.
Insurance	<ul style="list-style-type: none"> • No arguments raised in the projects reviewed.

15. The review of these projects shows that the pricing of Compensation Events and the proving of Defined Cost requires considerable resources and can become a time consuming and inoperable burden if the contract is followed rigorously. It can be said that much of the burden is finding the cost and resource records from companies' existing systems.

Summary

16. The assessment of Compensation Events is governed by the use of Defined Cost. There is a general misunderstanding of this fundamental element of the Compensation Event mechanism. When asked to state

the correct meaning of Defined Cost under each of the Options, there was a high level of misunderstanding of what the term meant.

The interviews conducted confirmed this misunderstanding.

17. The SCC and SSCC assist in the valuing of Defined Costs but they are rarely used with 60% of the respondents using the schedules for assessing CE's 25% or less of the time. The traditional use of rates and subcontract quotations seems to continue.
18. A more detailed review of projects and the elements of the SCC and SSCC revealed the following fundamental issues:
 - Misunderstandings between Actual Costs and Defined Costs.
 - What is included in schedules and what is in the fee percentages?
 - Insistence on actual records to the penny.
 - An administrative burden on the Contractor to prove his Defined Cost. Not the intention of the contract, but this is how it can be interpreted and used.

Note: This article is based on the author's own research.

Footnotes

1. Note the NEC uses the term Defined Cost
2. Defined cost is used to assess the value of compensation events.

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