

# MDA CONSULTING



## FIRST AID FOR CONTRACTS



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### **NEC: OPINION ON THE APPLICATION OF *SUBCONTRACTED FEE PERCENTAGE* UNDER THE NEW ENGINEERING CONTRACT (3RD EDITION) ENGINEERING CONSTRUCTION CONTRACT.**

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**We have recently been asked by a client to provide an opinion with regards to the application of the *subcontracted fee percentage* under the New Engineering Contract (3rd Edition) Engineering Construction Contract (ECC3) and views expressed by the employer in relation thereto.**

It was evident from the request for providing this opinion that there is a common confusion among ECC3 users as to precisely how the Subcontractor's resources are to be treated in the Shorter Schedule of Cost Components under Main Option A and Main Option B. The purpose of this article is to provide our opinion (and insight) in relation thereto and to equip the reader with a better understanding of the application of the subcontracted fee percentage.

#### Why a 'subcontracted fee percentage'?

The NEC Managing Reality Book 1 - Introduction to Engineering and Construction provides that the subcontracted fee percentage was introduced in the ECC3 "to overcome the issue regarding declaration at the time of tender by the Contractor of one fee percentage to cover his own and the work of his subcontractors. This caused a few headaches especially on options A and B for price based contracts where the one fee percentage was deemed to cover both the Contractor's direct work and the work of his Subcontractors"<sup>1</sup>.

The inclusion of the subcontracted fee percentage in the Contract Data enables the Contractor to recover that portion of the costs which are not accounted for by application of the Shorter Schedule of Cost Components such as profit, head office charges and overheads, finance charges, the cost of performance bonds and/or sureties, insurance premiums, advertising and recruitment costs etc. in relation to the subcontract works carried out in consequence of a compensation event.

The reason for Contractors possibly losing money or realising a break even where a compensation event involves Subcontractor resources has nothing whatsoever to do with the subcontracted fee percentage being lower than the direct fee percentage but rather, as stated in the Practical Guide to the NEC 3 Engineering and Construction Contract, *“stems from a common confusion among ECC3 users as to precisely how the Subcontractor’s resources are to be treated in the Shorter Schedule of Cost Components”*<sup>2</sup>.

The relationship between Defined Cost, Subcontractors and the Schedule of Cost Components (or the Shorter Schedule of Cost Components) under the ECC3 is managed differently depending on the selection of an applicable Main Option. *“It is this variation in the way in which the Shorter Schedule of Cost Components applies that causes confusion”*<sup>3</sup>.

To determine exactly how the Schedule of Cost Components or the Shorter Schedule of Cost Components applies to Subcontractors under each Main Option proper consideration should be given to:

- the second sentence of clause 26.1 of ECC3;
- the definition of Defined Cost under the specific Main Option used; and
- the definition of Fee.

#### Clause 26.1 of the ECC3

Clause 26.1 provides that *“if the Contractor subcontracts work, he is responsible for Providing the Works as if he had not subcontracted. This contract applies as if a Subcontractors employees and equipment were the Contractors”* (emphasis added).

The first part of clause 26.1 categorically provides that the *“Contractor retains responsibility for providing the works notwithstanding that any part of it may have been subcontracted”*<sup>4</sup>.

The second part of clause 26.1 in fact goes beyond the effect of the first part by expressly making “this contract”, i.e. the contract persisting between the Employer and Contractor apply as if a Subcontractors employees and equipment were the Contractors. Included in “this contract” are the unique procedures for dealing with compensation events including the mechanisms for determining the cost effects of compensation events involving Subcontractors’ employees and equipment.

### Defined Cost

“Defined Cost” is defined in both Main Option A and Main Option B in clause 11.2 (22) in precisely the same words and prescribes that *“Defined Cost is the cost of the components in the Shorter Schedule of Cost Components whether work is subcontracted or not excluding the cost of preparing quotations for compensation events”* (emphasis added). This position accords with the second part of clause 26.1 which stipulates that the contract, in this instance specifically clause 11.2 (22) of the contract, applies *“as if a Subcontractors employees and equipment were the Contractors”*.

The cost of the components in the Shorter Schedule of Cost Components determines Defined Cost whether the work necessitated by the compensation event is performed by the Contractor or the Subcontractor as if a Subcontractors employees and equipment were the Contractors.

“Defined Cost” is further explained in both Main Option A and Main Option B in clause 52.1 as *“All the Contractor’s costs which are not included in the Defined Cost are treated as included in the Fee. 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 discounts, rebates and taxes which can be recovered”* (emphasis added).

Clause 52.1 expressly restricts the determination of Defined Cost to only amounts calculated using rates and percentages stated in the Contract Data and other amounts at open market or competitively tendered prices. Keating on NEC3 states that *“In the assessment of Defined Cost the Project Manager must apply the amounts and rates stated in the Contract Data to the relevant components listed in the schedule”*<sup>5</sup>. The Project Manager therefore has no authority (under Main Option A and Main Option B) to determine the Defined Cost by applying any amounts or rates located elsewhere, for example in a Subcontractor’s invoice to a Contractor.

Under clause 52.1 all the Contractor’s costs which are not included in the Defined Cost are deemed to be included in the Fee. The NEC3 guidance notes provide a non-exhaustive list of cost components that are not included in the Schedules which include most head office costs, insurance premiums, corporation tax, advertising and recruitment costs, sureties and guarantees, financing charges, some indirect payments to employees and the Contractors profit.

Clause 11.2 (8) in both Main Option A and Main Option B defines the Fee: *“The Fee is the sum of the amounts calculated by applying the subcontracted fee percentage to the Defined Cost of subcontracted work and the direct fee percentage to the Defined Cost of other work”* (emphasis added).

It is therefore necessary under ECC3 to determine the Defined cost of subcontracted work as a separate exercise. Defined Cost (of both subcontracted work and other work) under Main Option A and Main Option B is the cost of the components in the Shorter Schedule of Cost Components or Schedule of Cost Components (as the case may be) irrespective of whether or not the work is subcontracted.

### The Fee

The Fee has two components; one in relation to Defined Cost for other work and the other for Defined Cost for work undertaken by the Subcontractor, i.e. subcontracted work.

The cost effect of a compensation event involving subcontracted work is Defined Cost (determined by application of the Shorter Schedule of Cost Components to both the Contractor's work in relation to the subcontracted work and the Subcontractor's own work) plus the Fee (which is the sum of the subcontracted fee percentage multiplied Defined Cost of subcontracted work plus the direct fee percentage multiplied by the Defined Cost of other works).

Dependent upon the Main Option applicable the Subcontractor's resources are either treated as if they are the Contractor's and included in the calculation of the cost of the compensation event under Shorter Schedule of Cost Components, or the Subcontractor's resources are excluded from that calculation and treated at the amount paid to the Subcontractor for them by the Contractor.

In the Practical Guide to the NEC 3 Engineering and Construction Contract Rowlinson concludes that *"for Main Option A and Main Option B the former of these two situations applies, that is the Subcontractor's resources are treated as if they are the Contractor's and included in the calculation of the cost under the Shorter Schedule. This treatment is determined by the definition of Defined Cost at clause 11.2 (22) which includes the phrase "whether work is subcontracted or not"7.*

In compiling a quotation for a compensation event involving subcontracted works under Main Option A and Main Option B the Contractor therefore calculates the Defined Cost for subcontracted works using rates and percentages stated in the Contractor's Contract Data Part Two (i.e. data for the Shorter Schedule of Cost Components) and other amounts at open market or competitively tendered prices with deductions for discounts, rebates and taxes which can be recovered. The Subcontractors invoiced costs to the Contractor are simply not relevant to the determination of Defined Cost of subcontracted work under Main Option A and Main Option B.

As the Subcontractor's resources are treated in exactly the same way as those provided directly by the Contractor for purposes of determining the cost effect of compensation event (s) employing Subcontractor resources, it follows that the Contractor will need access to sufficient resource utilisation and cost information from the Subcontractor to enable the Contractor to compile a quotation.

The Fee comprises two elements, one each for subcontracted work and direct work carried out by the Contractor. The Subcontractor's resources that are treated as if they are the Contractor's, and costed under the Shorter Schedule of Cost Components for this purpose under Main Option A and Main Option B, should be detailed separately from other resources so that the appropriate fee percentage can be applied to each.

The Practical Guide to the NEC 3 Engineering and Construction Contract states that there is *"nothing in these Main Options or the definition of Fee to say that only the direct fee percentage should apply to all costs under the Shorter Schedule. The Contractor can apply the subcontracted fee percentage to the element of the costs assessed under the Shorter Schedule of Cost Components that results from the employment of resources actually employed by the Subcontractor. This allows him the facility to price for the fees he will have to pay his Subcontractors by means of the difference between the two fee percentages he is required to insert in Contract Data Part Two"*<sup>8</sup>.

By contrast under Main Options C, D, E and F, the definition of Defined Cost at clause 11.2 (23) or 11.2 (24) (whichever is applicable) makes it quite clear that payments made to Subcontractors are treated separately from payments for work done directly by the Contractor. In these four Main Options, the resources employed by Subcontractors are not considered when applying the rules from the Schedule of Cost Components.

Clause 11.2 (23) provides that:

Defined Cost is

- the amount of payments due to Subcontractors for work which is subcontracted without taking account of amounts deducted for
  - retention,
  - payment to the *Employer* as a result of the Subcontractor failing to meet a Key Date,
  - the correction of Defects after Completion,
  - payments to Others and
  - the supply of equipment, supplies and services included in the charge of overhead cost within Working areas in this contract

and

- the cost of components in the Schedule of Cost Components for other work less Disallowed Cost (emphasis added).

Clause 11.2 (24) provides that:

Defined Cost is

- the amount of payments due to Subcontractors for work which is subcontracted without taking account of amounts deducted for
  - retention,
  - payment to the *Employer* as a result of the Subcontractor failing to meet a Key Date,
  - the correction of Defects after Completion,

- payments to Others and
- the supply of equipment, supplies and services included in the charge of overhead cost within Working areas in this contract

and

- the prices for other work done by the Contractor himself less Disallowed Cost” (emphasis added).

In the matter on which we were requested to provide an opinion, the Employer was of the view that the Project Manager, in considering whether to accept the proposed conditions of subcontract (should these be other than the NEC 3) in accordance with clause 26.3 *“needs to be able to identify the cost components and make sure the Employer does not pay a Fee on top of a Fee (Simply put)”* is patently incorrect for two reasons:

- a. Firstly under Main Option A and Main Option B the “cost components” utilised in determining the Defined Cost of subcontracted work are by virtue of the definition of Defined Cost at clause 11.2 (22) (which includes the phrase ‘whether work is subcontracted or not’) read together with the second sentence of clause 26.1 exactly the same as those applicable to the Contractor under the Shorter Schedule of Cost Components i.e. for purposes of determining Defined Cost the Subcontractors resources are treated as if they are the Contractors.

There is no need whatsoever for any enquiry into the proposed subcontract conditions to

identify the “cost components” and make sure the Employer does not “pay a Fee on top of a Fee” as for purposes of determining Defined Cost the Subcontractors resources are treated as if they are the Contractors.

The fact that the Employer believes that there is a need for such an enquiry betrays the Employer’s own confusion as to precisely how the Subcontractor’s resources are treated in the Shorter Schedule of Cost Components under Main Option A and Main Option B.

- b. Secondly the Employer can never “pay a Fee on top of a Fee” if the Contractors quotation is compiled strictly on the basis detailed above. The Contractor’s quotation should separate the cost components constituting the Defined Cost for the Subcontractors work in relation to the compensation event from the Contractors Defined Cost (if any) for the Contractors work in relation to the compensation event. The subcontracted fee percentage is then applied strictly (and exclusively) to the Subcontractors Defined Cost and the direct fee percentage is then applied to the Contractors Defined Cost. The totals of both are then added together to determine the Fee. There can only ever be a single Fee.

The fact that the Employer believes that it is possible for the Employer to “pay a Fee on top of a Fee” betrays the Employer’s own confusion as to precisely how the Subcontractor’s resources are treated in the Shorter Schedule of Cost Components under Main Option A and Main Option B and how exactly the Fee is to be determined by application of the plain unambiguous wording of clause 11.2 (8) in compensation events involving Subcontractor resources.

In determining the subcontracted fee percentage exactly the same considerations which apply in determining the direct fee percentage must be utilised. It is incumbent upon the Contractor to ensure that the subcontracted fee percentage is thoroughly interrogated and properly calculated.

The subcontracted fee percentage itself will never change once it has been incorporated into the Contractors Contract Data Part Two unless the Employer and Contractor expressly agree to such change by way of amendment. The Fee (not the subcontracted fee percentage) however necessarily differs in each instance as the Fee is determined by multiplying the subcontracted fee percentage with the Defined Cost of the subcontracted work, which Defined Cost will necessarily be different in relation to each compensation event.

Once the subcontracted fee percentage is incorporated into the Contractors Contract Data

Part Two the Contractor has no legitimate right or ability (contractual or otherwise) to force the Subcontractor to “lowering their Fee percentages”. The singular subcontracted fee percentage necessarily remains constant for duration of the contract unless varied by subsequent agreement between the Parties in accordance with the applicable conditions of contract.

Any loss suffered or break even realised by the Contractor through a compensation event involving subcontracted work accordingly has nothing whatsoever to do with the subcontracted fee percentage. The loss suffered or break even realised is inter alia a consequence of the Project Manager, Contractor and Subcontractors confusion as to precisely how the Subcontractor’s resources are treated in the Shorter Schedule of Cost Components under Main Option A and Main Option B.

Whether or not the conditions of subcontract contain either a Shorter Schedule for Cost Components or fee percentage applicable under the subcontract is irrelevant for purposes of determining the cost effect of the compensation event involving subcontracted work as for purposes of determining Defined Cost the Subcontractors resources are treated as if they are the *Contractors* under Main Option A and Main Option B.

The Contractor may however suffer a loss or realise a break even if the cost effect of the compensation event determined in accordance with the ECC3 is different from the compensation due to the Subcontractor as determined under the applicable conditions of subcontract. In most instances, however the conditions of subcontract limit the Subcontractors entitlement to the amount payable by the Employer to the Contractor. Again, the potential loss suffered or break even realised in these circumstances has nothing whatsoever to do with the subcontracted fee percentage.

The problem did not start with the Contractor tendering a subcontracted fee percentage without actually first finding out what the Fees from its Subcontractor's will be. The problem arose as a direct consequence of a common confusion among ECC3 users as to precisely how the Subcontractor's resources are to be treated in the Shorter Schedule of Cost Components under Main Option A and Main Option B.

We trust this article provides the reader with a better understanding in determining the cost effect of compensation events involving subcontracted works according to the specific provisions of the ECC3.

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<sup>1</sup> Mitchell B and Trebes B, NEC Managing Reality Book 1 Introduction to the Engineering and Construction, page 51

<sup>2</sup> Rowlinson, M, Practical Guide to the NEC 3 Engineering and Construction Contract, page 159

<sup>3</sup> Refer note 2 above at page 159

<sup>4</sup> Thomas D QC, Keating on NEC 3, page 85.

<sup>5</sup> Refer note 4 above at page 197.

<sup>6</sup> NEC 3 Guidance Notes, page 128.

<sup>7</sup> Refer to note 2 above at page 160.

<sup>8</sup> Refer to note 2 above at page 160.