TARGET COST CONTRACTS - THE DEVIL'S IN THE DETAIL

By Brad Woodroffe and Stephen Fitzpatrick

A recent TCC decision illustrates the importance of paying close attention to the detailed mechanics of target cost contracts. In this case, a small amendment to include contractor "default" in the definition of Disallowed Cost resulted in over £13m in deductions being made by the employer on account of delays and inefficient working alleged against the contractor. The court upheld such an interpretation despite arguments by the contractor that it would deprive the contract of its commercial rationale as a target cost contract.

Target Cost contracts in brief

Target Price contracts are a form of cost reimbursable contract under which the contractor is paid the "Total Cost" it incurs in carrying out the works plus a fee, subject to a "Target Cost" agreed by the parties at the beginning of the project. Upon completion, the parties ascertain whether savings were made and the project delivered for less than the Target Cost; or whether costs overran and the cost of delivery was above the Target Cost. Any saving or overrun is then allocated according to a predetermined formula commonly known as a "pain/gain share" mechanism. If the costs of the project exceed the Target Cost the excess, or "pain", is allocated between the employer and the contractor, and if the project comes in under cost then the "gain" is allocated. The philosophy behind such contracts is to actively encourage both parties to work together to manage the costs of the works.

Network Rail Infrastructure Ltd v ABC Electrification Ltd

Network Rail contracted ABC under an amended ICE Target Cost Contract (1st Edition, 2006) to undertake works on the West Coast Mainline. ABC delayed in completing the works and overran the completion date significantly, a fact that was not disputed. What was disputed was whether the additional cost of this delay should be included in the Total Cost calculation under the contract.

Clause 1(1)(x) of the Contract stated: "*Total cost means all cost (excluding Disallowed Cost and items covered by the Fee) incurred by the Contractor for the carrying out of the Works...*".

Clause 1(1)(j)(iii) defined Disallowed Cost as "*any cost due to negligence **or default** on the part of the Contractor in his compliance with any of his obligations under the Contract **and/or due to any negligence or default on the part of the Contractor's employees, agents, sub-Contractors or suppliers in their compliance with any of their respective obligations under their contracts with the Contractor**.*" The wording in bold shows Network Rail's own amendments from the standard ICE form.

Network Rail commenced Part 8 proceedings seeking declarations as to the interpretation of the above provisions. Network Rail argued that the significant delay to the works amounted to a "*default*" of ABC's obligations under the contract, and therefore any costs associated with this delay could not be added to the Total Cost and should be borne by ABC alone. ABC argued that "*default*" should be interpreted to mean only a wilful or deliberate failure to comply with ABC's obligations.

The TCC found in favour of Network Rail and applied the natural and ordinary meaning of the word "default", being a failure to fulfil a legal requirement or obligation. There was no justification for importing any element of wilfulness or intentionality. Such an interpretation was said by ABC to negate the pain/gain share mechanism inherent in the target cost philosophy of the contract, given that it would allow Network Rail to escape all risk of increased costs resulting from a failure to carry out the works in an economic and efficient manner. However, such observations were not able to overcome the clear amendments made to the Disallowed Cost definition.

Conclusion and implications

What is interesting about this case is less the verdict, which on one view is unsurprising, and more the impact that a small change in the drafting of a target cost contract can have on the financial outcome for the parties. The standard Target Cost ICE Conditions of Contract (now known as the ICC Conditions of Contract) do not include "default" by the contractor within the definition of Disallowed Cost, although negligence is referred to. It is also interesting to note the Target Cost editions of the NEC and IChemE forms of contract likewise make no mention of "default" (or, indeed, negligence) in calculating Disallowed Cost.

Had the standard ICE Conditions been retained on this project, National Rail would have been required to prove negligence on the part of ABC before the costs of delay and inefficient working could be excluded as Disallowed Cost. By including the reference to "default", National Rail was able to rely simply on the fact of delay by ABC as justifying the exclusion of costs. Such delays may not have been within ABC's control, something which ABC felt undermined the whole target cost philosophy of the contract.

Target cost contracts are intended to be a way to share risk between parties, but the amendments made by Network Rail in this case illustrate the potential for small amendments to dramatically shift the balance of risk from one party to the other. Parties considering entering into target cost contracts should not assume any particular form of target cost logic will apply. This decision shows that the precise wording used in the mechanics of a target cost contract will be given effect even if it deprives the contract of much of its target cost rationale.

References:

Network Rail Infrastructure Ltd v ABC Electrification Ltd [2019] EWHC 1769 (TCC).

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