Appendix 1 of the Sustainable Growth and Environment Capital Scrutiny Committee Report dated 15th September 2015 - procurement options for highway contracts including fixed price and target cost contracts

There are numerous procurement routes and contract options open to the Council to buy goods and services; The Peterborough City Council Contract Rules document contains detailed information on the mandatory consultation and approvals process required for differing levels of expenditure. Generally the more expensive a project is to procure the more stringent the approvals process.

Where a suitable Framework Agreement exists, you may use the Framework if the Council is mentioned as a potential purchaser under the Framework Agreement. A framework Agreement comprises pre-assessed suppliers and therefore simplifies the tendering process and offers considerable cost reduction.

Peterborough City Council is a member of the Midlands Highways Alliance (MHA) framework. The premise of the framework is to achieve efficiencies by working collaboratively. It is the expectation that all parties, clients and contractors alike, will share experiences and innovation for the mutual benefit of the whole Framework Community, thereby providing continuous improvement. Framework contracts can realise benefits to the MHA member and the supplier by forging long-term relationships focused on delivering a specific service consistently. These include fewer procurement actions, early involvement of the contractor (if required), fostering of relationships with suppliers and their sub-suppliers, (i.e. supply chain management), shorter lead-in times, faster delivery and an opportunity to demand high standards of training and health and safety awareness.

The MHA Medium Schemes Framework 2 (MSF2) contract that we use is based upon the NEC3 Framework Contract June 2005. This has six options (labelled A to F) as follows:

- Option A – Priced contract with activity schedule
- Option B – Priced contract with bill of quantities
- Option C – Target contract with activity schedule.
- Option D – Target contract with bill of quantities.
- Option E – Cost reimbursable contract
- Option F – management contract

The most widely used variants of the NEC are options C and D, both target contracts. The main difference between a target contract and a conventional contract is the mechanism for sharing risk and opportunity. While the client retains the cost and time risk linked to contractual changes, the financial effects of cost overruns can be shared between the client, contractor and supply chain. This is often termed the gain/pain share mechanism.

Target contracts are best used on well-defined projects, where the contractor has a motivation to reduce costs, rather than on projects that are loosely defined, as changes in project definition are likely to change the value of the target price.

Using this approach, equitable risk transfer is often adopted to encourage positive behaviour. That said, as contractual share of risk and gain/pain mechanism are set by the client, it can modulate its exposure to risk.

Used effectively, target contract options give the incentive to deliver a project on time and to budget. However, if costs fall out of control, the contractor may seek to increase the target via compensation events. In this case, a greater burden of cost overrun risk may transfer to the client than intended.

Within the actual MSF2 framework, four options are available for use for each work package:

1. NEC Short Contract.
2. NEC Engineering and Construction Contract
3. NEC3 Professional Services Contract
4. HA's Asset Management Framework.

Peterborough City Council usually exercise option 2.

The Framework information contains three options for selecting a framework contractor:

- Option 1 – a direct call off short process
- Option 2 – a direct call off long process
- Option 3 – a mini competition

We generally use Option 1 although a mini tender process can be used (as was the case for the Junction 8 scheme).

It is accepted that mini-tendering may well produce a lower initial Target Price. However, this does not necessarily lead to a lowest out turn cost, as under NEC3 Option C this will be based on the actual cost of the work (the defined cost), and this is much more likely to be influenced by successful early contractor involvement (ECI).

How a fixed price contract works

Fixed price contract is not strictly correct as the final cost of a fixed price contract may exceed the tendered sum, the correct term is a Lump Sum contract.

Lump sum contracts are used on well-defined projects where changes to works are unlikely and details of required works and/or volumes of materials and resources can be accurately identified before the tender process.

A fixed price contract places minimum administrative burden on the contracting parties, but subjects the contractor to the maximum risk arising from full responsibility for all cost escalations associated with the works defined within the contractual documents.

Lump sum contracts assign a greater proportion of risk to the contractor and give the client some certainty about the likely cost of the works. Therefore a client can end up paying for risks that do not occur during the construction or implementation of a project.

However, it is important to note that a lump sum contract does not give all the project risk to the contractor and therefore the price of a lump sum contract can change. Mechanisms for varying the lump sum include:

- Changes to works instructions, given by the client

- Relevant events, for example failure by the client to provide information by certain deadlines, neutral events such as exceptionally bad weather.
- Risks not allocated to the contractor at the time of tender and agreement of contract

Advantages

- A good level of cost certainty for well-defined schemes where changes to works and volumes are unlikely
- Appropriate for schemes where risk to client is minimal
- Risks are owned by and within control of the contractor

Disadvantages

- Client can end up paying for risks that do not occur
- Changes to works instructions are not included in the lump sum and will be additional cost to the client
- The costs of risks not identified on the project risk register are borne by the client and will additional to the lump sum submission

How a target cost contract works

Under a target contract, a contractor is reimbursed for the cost of the works, including those of subcontractors, some elements of establishing the site and the fee for the items listed in the contract as actual or defined costs. These include management costs, overheads and profit.

The contractor is contractually committed to meeting the target cost, which comprises the cost of the works described in the works information, activity schedule or bill of quantity, plus a fixed percentage fee.

The target cost and the contractor's reimbursement are not linked until the end of the project, when the gain/pain share mechanism is applied. What the contractor recovers through regular payments is the actual cost incurred, along with the percentage fee.

While the contractor is paid in accordance with a combination of lump-sum and actual costs incurred, the incentive mechanism and commitment to deliver the project on time are fixed. However, should any allowable compensation events occur that result in a change to cost or programme, the target will be adjusted by the actual cost incurred or by a lump sum, depending on how the contractor and project manager agree them?

After the project is completed, payments made to the contractor are compared to the revised target cost. Depending on the outcome, the gain/pain share mechanism agreed in the contract will come in to play.

Typically, the gain share involves splitting the amount of money saved, that is, the difference between the target cost and the actual expenditure, between the client and contractor.

If the project's costs exceed the target cost, the pain option is exercised. This could involve the contractor taking 100% of the liability and, as such, suffering the loss. Alternatively, the client may shoulder part of the loss.

The contractor would ideally meet the target cost, in which case it would receive full remuneration. Savings against the target would be shared with the client. The worst outcome for the client is the contractor being paid more than the revised target cost.

The difference between the target cost and the actual cost is, of course, fundamental to the incentive model. However, the lack of a direct link during construction means there is a risk that the project team could lose sight of its target and incentive. Therefore:

- The target cost should be realistic, based on a fully set of works information. Target cost contracts are sometimes misunderstood as being incentivised develop-and-construct approaches, where a project team is encouraged to work from an outline concept to deliver a solution focused on a client's needs. Unfortunately, a project let without well-defined works information resulting from incomplete design development is highly likely to require substantial changes and result in compensation events and amendments to the target cost. In reality, the documentation required to support the contract will be as detailed as a lump-sum contract.
- It should be set at a level that acts as an incentive. Too low, and the contractor will recover costs by other means. Too high, and inefficient working may be rewarded.
- It should be based on a detailed programme. The target cost mechanism cannot be properly administered without considering the impact of compensation events. Without this, it is not possible to assess the responsibility for delay.
- The client must understand that it is not a lump-sum contract and should co-operate with the project manager in administering the contract. Failing to comply with timescales can lead to a client creating liabilities for itself under the NEC.
- It is important for the contractor to keep track of costs incurred relative to the adjusted cost, so its own commercial position is protected. In some cases, where subcontractors are also incentivised, this may involve the project manager and contractor in the audit of material supply invoices and labour returns, to confirm levels of expenditure.

Advantages

- Provides contractors and subcontractors with an incentive to improve performance and enables the client to secure a share of the benefits of a well-managed project
- Encourages active and equitable risk sharing, based on a clearly defined allocation of risk agreed at the outset of the project.
- Can incorporate lump-sum and prime-cost subcontracts under a single target price
- Target costs provide incentive for the timely administration of change control mechanisms
- Provides an accountable mechanism to enable public sector clients to use incentives.
- Provides an incentive for the effective management of prime cost contracts.

Disadvantages

- Requires contractor to share savings derived from improved performance with the client and other members of the supply chain
- Client and contractor must share gain and pain if the full benefits are to be secured. The client may have greater exposure to cost risk
- Potential for failure on insufficiently defined projects owing to misunderstandings of the operation of the incentive mechanism
- Complex target price, gain/pain share and change controls may not be understood by all

- Separation of target and actual costs before completion creates the potential for loss of control
- Relies on administration best practice and a competent project manager.

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