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The construction &
energy law specialists

Issue 98 - September 2024

Insight

Insight provides practical information on topical issues affecting the building, engineering and energy sectors.

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Forecast or fantasy: Where is the NEC dividing line?

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Forecast or fantasy: Where is the NEC dividing line?[1]

The NEC4 form of contract emphasises "*collaborative working requiring the early identification of problems and proactive approach to addressing problems*". This means, amongst other things, notifying compensation events promptly and forecasting their effects based on the rules laid down in the contract. The rationale for this approach is that it encourages the parties to actively manage the risk that has been identified. This in turn reduces its impact on the project and increases the chances that the project will prove successful.

By definition, a forecast involves an element of educated guesswork in not only preparing quotations, but also in deciding whether to accept them. If both parties act sensibly (and in the mandated spirit of mutual trust and cooperation[2]), then the process works well. After all, a party may achieve what turns out to be a very good commercial resolution in respect of one compensation event, once the actual costs of it are assessed, but do less well on the next. This "*sort it and move on*" approach is one of the reasons that the NEC form is so popular domestically and, increasingly, internationally. The advantages include not only the efficient management of risk, but also a reduction in the chances of having a final account dispute.

However, problems do arise when the parties fail to adhere to the rules associated with quotations for compensation events. This is particularly the case where the forecasts are exaggerated either deliberately or due to a misunderstanding as to how the contract is intended to operate.[3]

In this *Insight*, we take an in-depth look at the rules governing forecasting the costs associated with a compensation event in a quotation submitted pursuant to the NEC4 Engineering and Construction Contract (ECC) (the "**NEC4**"). In that context, we examine the guidance available on navigating the hotly debated issue of prospective versus retrospective assessments for compensation events. We also analyse what protections are available both pursuant to the NEC4 itself, and at common law, to protect against exaggerated forecasts (and claims).

The basics

The starting point for how compensation events should be assessed under the NEC4 is found in Clauses 63 and 64. Clause 63.1 states:

> "*The change to the Prices is assessed as the effect of the compensation event upon*
>
> - *the actual Defined Cost of the work done by the dividing date,*
> - *the forecast Defined Cost of the work not done by the dividing date and*
> - *the resulting Fee.*
>
> *For a compensation event that arises from the Project Manager or the Supervisor giving an instruction or notification, issuing a certificate or changing an earlier decision, the dividing date is the date of that communication.*
>
> *For other compensation events,* ***the dividing date is the date of the notification of the compensation event***" [Emphasis added].

The phrase "*dividing date*" was introduced for the first time by the NEC4 in order to clarify where a quotation should switch from using actual Defined Costs and delays (if applicable) to forecast Defined Costs and delays.[4] The wording found in the NEC3 had the same concept present but is less specific about how the concept should be applied.[5] It is crucial to note that "*Defined Costs*" is a defined term; whether actual Defined Costs or forecast Defined Costs are being included within a quotation, the rules governing what they are (and what they are not) must be applied.

The NEC4 also provides that the parties may agree rates or lump sums to assess the change to the Prices.[6] This gives the parties a degree of flexibility that was not available in the NEC3. It is also made plain that the Prices can reduce as well as increase in specific circumstances.[7] Likewise, a risk allowance is allowed both for cost and time for matters "*which have a* ***significant*** *chance of occurring and are not compensation events*" [Emphasis added].[8] Obviously, determining what has a significant chance of occurring is a matter of opinion and, if there is a difference in that opinion, it may be sensible for the parties to agree that a quotation is based on assumptions.[9] This is permitted under Clause 6.1.5 where the effects of a compensation event are "*too uncertain to be forecast reasonably*" but the instruction to do this (and the nature of the assumptions) is within the discretion of the Project Manager alone.[10]

Finally, in making an assessment the Project Manager can assume that the Contractor "*reacts competently and promptly to the event and that any Defined Costs and time due to the event are reasonably incurred*".[11] This assumption is important as it can be used both historically (i.e. in relation to actual Defined Cost and delay) and in the context of a forecast, to reduce the amounts claimed. Therefore, it is not open to a Contractor to stand back and wait to see what transpires in relation to a compensation event. They must try to mitigate their losses. As a matter of good practise Contractors may want to proactively show how they are going to act promptly and competently to a compensation event and demonstrate that this is already factored into any quotation they produce. This may reduce the chance that a Project Manager challenges a quotation on the ground it has failed to take their Clause 63.9 duties into account.

Clause 64.1 provides that the Project Manager can assess the compensation event in four specific circumstances rather than relying on the Contractor's quotation. Project Managers can sometimes be keen to take on this power, particularly if they feel the quotations are exaggerated or not prepared as required under the terms of the contract. The specific circumstances in which they can exercise this power are, however, only as follows:

- *"if the Contractor has not submitted the quotation and details of its assessment within the time allowed,*
- *if the Project Manager decides that the Contractor has not assessed the compensation event correctly in the quotation and has not instructed the Contractor submit a revised quotation,*
- *if, when the Contractor submits quotations for the compensation event, it has not submitted a programme or alterations to a programme which the contract requires it to submit or*
- *if, when the Contractor submits quotations for the compensation event, the Project Manager has not accepted the Contractor's latest programme for one of the reasons stated in the contract."*

The dividing date should, many would argue, remain the same when the Project Manager carries out an assessment. However, given the time that may have passed before this occurs, this can raise issues regarding to what extent they can take into account actual events that have occurred since the Contractor's original quotation. The case law addressing this is discussed further below. Debates can also arise as to whether the Project Manager's right to carry out an assessment has actually arisen (albeit that does not necessarily speak to the merits of the underlying assessment).

Key issues

With that outline in mind, we will now highlight some of the issues that can arise when debating what should be a forecast and what should be based on actual Defined Cost.

Defined Cost

Defined Cost (whether actual or forecast) is a defined term under the NEC4. For Option C, Defined Cost is the *"cost of the components in the Schedule of Cost Components less Disallowed Cost"*.[12] The Schedule of Cost Components (the "**SCC**") lays down strict rules for people, equipment, plant and materials, subcontractor, charges, manufacture and fabrication, design and insurance costs. The rules in the SCC all need to be followed and quotations checked for compliance with them. *"Forecast"* Defined Cost is regulated by strict rules – it is not a carte blanche to higher rates or to overblown claims.

If costs are not Defined Cost or Disallowed Cost,[13] then they are deemed to form part of the Fee (essentially profit and overheads). No additional monies will then be payable for them specifically. Unfortunately, disputes do arise where the rules are not followed. This can sometimes be the case where it was not realised what was (or could be) deemed to be in the Fee at the time of entering the Contract.

When do we forecast from?

One issue that commonly arises where compensation events are not agreed contemporaneously is whether the parties should stick to using a now *"artificial"* forecast from a dividing date which is in the past. This debate can get particularly heated if the actual costs are far higher than any forecast made earlier or, alternatively, if the forecast made contemporaneously (but not agreed or implemented) was too high.

The *NEC Guide* discusses the dividing date below:[14]

> *"On the* ***rare occasions when some or all the work arising from a compensation event has already been done, Defined Cost should be readily assessable from records. Forecasting future Defined Cost is less straightforward.*** *Estimates of resources are required as well as productivity rates for Equipment and labour. For Options C, D and E, pricing of the various components of Defined Cost is normally based on the Schedule of Cost Components with the associated percentages tendered in the Contract Data part two. The Short Schedule of Cost Components is used with Options A and B. The Fee is calculated in accordance with clause 11.2(10).*
>
> *Clause 63.1 pinpoints the date when there is a switch from recorded costs to forecast costs included in a quotation. This is called the 'dividing date'.* ***This prevents the practice of a Project Manager making a retrospective and selective choice between a quotation and the final recorded costs of dealing with a comparison event. This practice was never intended to be allowed because it clearly disadvantages the Contractor and, if adopted, will inevitably lead to adversarialism and game playing.***
>
> *The dividing date has been set in clause 63.1:*
>
> ***'For compensation events that arise from the Project Manager or the Supervisor giving an instruction or notification, issuing a certificate or changing an earlier decision, the dividing date is the date of that communication.***
>
> ***For other compensation events, the dividing date is the date of the notification of the compensation event.'***
>
> *This supports the intention of the NEC that assessments will usually be forecasts of the cost of work yet to be done. Where work has had to start before the quotation*

> *has been submitted or even before the instruction to submit was given it is inevitable that the forecast component of quotation will be influenced by the cost already incurred.* ***Nevertheless, for most cases, the inclusion in the clause of a dividing date set early in the assessment process reinforces the point that compensation events are not cost-reimbursable but are assessed on forecasts with the Contractor taking some risk*** *…"* [Emphasis added].

The problem is that by the time a quotation is received (and large quotations can take time to produce), it may be that the position has changed when compared to the forecast position from a month or more ago. For example, a substantial risk allowance may very reasonably have been included for a risk which did not then materialise or, vice versa, a risk was not priced for when (with the benefit of hindsight) it should have been. As noted in *Keating on NEC*: "*the question then arises as to whether the Project Manager is entitled to make their own assessment to take account of the later information or alternatively instruct the contractor to submit a further quotation*".

Commentators, in fact, remain divided as to what a Project Manager can take into account if their assessment is taking place some time after the compensation event itself notwithstanding the including of the dividing date concept in the NEC4.

In relation to NEC3, which does not have the concept of a dividing date, *Keating on NEC* opines that the Project Manager is entitled to take into account later events when assessing the effect of the compensation event on the forecast Defined Cost. They state:

> *"After that date, the assessment is of the effect on forecast Defined Cost of work not yet done at that date. However, it is significant that what clause 63.1 requires is an assessment of the effect of the compensation event on the forecast Defined Cost of the work not yet done at the time the quotation was (or should have been) instructed. While in reality this may simply be a forecast of the costs that will be caused by the event, the clause does not require assessment on the basis of a forecast made as at that date.* ***There is nothing to exclude the consideration of later information available at the date of assessment. The deeming provision determines what has to be assessed, not how or the date as at which it is to be assessed.***
>
> ***Common sense also suggests that it would be wrong to ignore any actual costs that have been incurred or avoided by the time of the quotation or later assessment by the Project Manager. This would not result in a reasonable assessment and would be inconsistent with general principles applied in assessing damages****"*[15] [Emphasis added].

Whilst the authors of *Keating on NEC* acknowledge the addition of the words "*dividing date*" in NEC4, in fact, it seems that the concept and the timings of the divide between actual and forecast Defined Cost remains as set out in the NEC3. Accordingly, their commentary remains pertinent.

Case law also suggests that actual costs may be looked at in this context which is explored further below.

Risk allowance

In the context of forecasting Defined Cost resulting from a compensation event, it makes sense to price in the risk of an event occurring which may impact on how great a cost is incurred. The *NEC Guide* notes as follows in relation to this:

> *"Allowances for risk must be included in forecasts of Defined Cost and Completion* ***in the same way that the Contractor should allow for risks when pricing its tender.*** *The value of the allowance is greater when the work is uncertain and there is a high chance of a Contractor's risk happening. It is least when the uncertainties are small and when the work is to be done by resources already on Site whose output rates can be predicted relatively accurately"* [Emphasis added].

Some parties who are new to the NEC environment can feel uncomfortable with risk being included in Quotations in this way. After all, in contract forms such as FIDIC, the guiding principle in relation to claims is repaying the Contractor actual damages flowing from the claim not forecasting their effects. However, as emphasised by the *NEC Guide*, a Contractor's Quotation is akin to a tender in relation to any costs that are forecast. The probability of events occurring therefore needs to be calculated and the (potential) costs associated with that risk need to be included within the Quotation.

Clause 66.1 – implementation

Issues can also occur as to whether a compensation event has been "*implemented*" such that it cannot be rowed back on or reopened. In this respect, the steps a Contractor will need to take to make it clear that they "*dispute*" a compensation event are not perhaps as clear as they could be. This can result in one party claiming a compensation event quotation is implemented and cannot be reopened and another believing it is very much still open for negotiation.

Clause 66 which deals with "*implementation*" provides as follows:

> *"66.1 A compensation event is implemented when*
>
> - *the Project Manager notifies acceptance of the Contractor's quotation,*
> - *the Project Manager notifies the Contractor of an assessment made by the Project Manager or*
> - *a Contractor's quotation is treated as having been accepted by the Project Manager.*
>
> *66.2 When a compensation event is implemented the Prices, the Completion Date and the Key Dates are changed accordingly.*

> *66.3 The assessment of an implemented compensation event is not revised except as stated in these conditions of contract".*

Going back to basic principles, what has been "*agreed*" (or not) is essentially a question of fact. If both parties have accepted a quotation and/or assessment, then it is agreed and cannot be reopened even if subsequent events show that the forecast was wildly wrong. This applies whether or not the Quotation from the Contractor was accepted or the Project Manager made their own assessment.

Indeed, this was confirmed by Deeny J in the Northern Irish case of *Healthy Buildings*[16] in which he observed the following (in the context of an NEC3 Professional Services Contract):

> "*[41] It seems to me that the language of the clause is somewhat unclear but that it is straining that language to say the process now before the court is one of implementing the compensation event. If one looks at 65.1 and 65.2 together it seems to me that what it means is that if there is an employer's assessment, and assessment is by the employer not the consultant, which is based on a forecast, i.e. from the consultant,* ***the employer cannot subsequently revise the assessment if it turns out that they had accepted a forecast from the consultant which was unduly pessimistic, even "wrong", because in fact the consultant was put to less trouble and expense than it had forecast.*** *That is to achieve a meaning consistent with business common sense for this clause. But that is not the situation here ...*" [Emphasis added].

If parties agree with some parts of a quotation or assessment, but not others, it can lead to problems. As ever, making it plain whether or not you agree with something, and what remains open to negotiation, is crucial. This is especially the case if the Project Manager makes their assessment and purports to implement it. In those circumstances, it is essential that a very clear line is laid down as to precisely what is agreed and what is not.

Safeguards

So with those issues in mind, what are the safeguards available to parties where a forecast is either too difficult to make or cannot be agreed?

Clause 61.6: Using assumptions where the effects are too uncertain to forecast

The NEC provides that the Project Manager can state assumptions about a compensation event in their instruction to submit quotations if "*the effects of a compensation event are too uncertain to be forecast reasonably ...*".[17] These assumptions can then be corrected later on, and the quotation can then be revised accordingly.

Clause 61.6 does not, however, allow the Contractor to quote on the basis of assumptions it has proposed. Only the Project Manager can lay down the assumptions. However, it is sensible to speak to the Project Manager and agree the assumptions underlying any quotation if forecasting simply isn't possible. If the Project Manager does not act reasonably on the assumptions or refuses to provide them, it could be sensible to consider using the dispute escalation provisions if the compensation event in question is important enough to warrant it.

As the *NEC Guide* notes on risk allowances:

> "*If there is considerable uncertainty over the effects of a compensation event the Project Manager can decide, in consultation with Contractor where appropriate, to limit this uncertainty by stating the assumptions the Contractor is to base its quotation on (clause 61.6). In effect the Project Manager is limiting the Contractor's risk, but not necessarily removing it. Risk allowances for cost and time are still permitted in the assessment*".[18]

The dispute escalation process

Parties are often reluctant to engage the dispute resolution processes within the NEC4 until they are sufficiently high value or until the final account stage when the works are nearly complete or completed. However, if there are important points of principle that need to be resolved to allow the project to get back on track, then it may well be worth considering operating the dispute escalation procedures early on to stop the issue snowballing. Even if the matter is not sufficiently high value to warrant an adjudication, the dispute escalation provisions include Senior Representatives meetings. If the parties properly engage in this process, the Senior Representatives can provide a very useful tool for resolving issues early on before matters escalate into a more formal dispute.

Case law

As emphasised above, labels are not always correct or helpful and a security must always be analysed as a whole. Indicators that a security is of a particular type can include:

One of the potential issues with the NEC form is that, due the provisions for compulsory adjudication in W2 followed by (typically) arbitration, the amount of case law available on how the provisions should be applied is frustratingly limited. The main case law on how compensation events should be valued is a Northern Irish case (as mentioned above) called *Healthy Buildings*.[19] The judge in that case, Deeny J, went on to become Lord Justice Deeny. As such despite this being a Northern Irish case (and therefore persuasive only in England) his judgment has real weight.

This case is a useful safeguard for parties on all sides where the value of a compensation event was not agreed contemporaneously. That is the case whether or not the assessment made was far too low, or, conversely, the quotation was far too high. This is because the case provides that (on the facts in that case): (a) it is good authority that actual cost records (i.e. retrospective records) can be used to assess claims if quotations provided have not previously been agreed during the project; (b) the judge in the case was highly critical of the refusal by the consultant bringing the claim to provide their contemporaneous records.

The Northern Irish *Healthy Buildings*[20] case concerned the proper interpretation of the NEC3 Professional Services Contract but the compensation event in question was assessed retrospectively because it hadn't been agreed contemporaneously. The Consultant argued that its costs should nevertheless be assessed using a forecast despite the fact that no actual costs had been incurred as at the date it received the instruction from the Employer. This was on the basis that a Quotation should have been requested as at that date in accordance with the contract. Further, the Consultant then refused to produce their actual cost records arguing that they were essentially irrelevant. The judge was nervous about this, given the time that had passed, and felt that the Consultant's failure to produce their actual cost records was not in the spirit of mutual trust and cooperation. Deeny J held:

> "*First of all, it is a cardinal principle of contractual interpretation that one should look at the agreement overall. This particular contract begins with the agreement that the employer and the consultant shall act "in the spirit of mutual trust and co-operation"(10.1).* ***It seems to me that a refusal by the consultant to hand over his actual time sheets and records for work he did during the contract is entirely antipathetic to a spirit of mutual trust and co-operation...*** " [Emphasis added].

Deeny J then went on to state:

> "*Faced with seeking to award compensation to the consultant here for any cost to it as a result of the instruction of 10 January 2013* ***why should I shut my eyes and grope in the dark when the material is available to show what work they actually did and how much it cost them?*** " [Emphasis added].

Whilst the *Healthy Buildings* case is often criticised by those seeking to argue a purely prospective approach should be adopted to compensation events, in the author's view, it can be a useful safeguard where an original quotation was based on flawed premises or was grossly exaggerated. As ever, the extent to which a prospective approach is of assistance will depend on the facts. However, even if a prospective valuation is being sought from the adjudicator or arbitrator in a dispute over the proper valuation, actual records can be useful evidence that the quotation was grossly exaggerated (i.e. it may support the merits of a lower assessment even if made prospectively).

Overview

The NEC's use of forecast Defined Cost for its compensation events does involve a different mindset to that needed for making and assessing claims under more traditional contract forms such as FIDIC or the JCT. However, there are strict rules governing any forecasts made in the contract as well as tools that can be utilised where the task is a difficult one. These need to be followed and utilised to ensure the smooth running of a project. If difficulties do arise, then it is important to keep in mind the dispute escalation provisions within the contract. Finally, whilst often criticised by NEC purists, the case of Healthy Buildings can provide a useful cross check when a quotation hasn't been agreed contemporaneously perhaps because its quantum was exaggerated.

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23 September 2024

Footnotes

1. By Claire King, Partner, Fenwick Elliott. With thanks to Kort Egan of Gatehouse Chambers who delivered a Fenwick Elliott webinar on the same topic with Claire King on 12 September 2024.
2. See Clause 10.2 of NEC4.
3. As research into the underlying causes of disputes has repeatedly indicated, exaggerated claims are a major source of disputes within the construction industry. See, for example, King's College's Report "*2023 Construction Adjudication in the United Kingdom: Tracing trends and guiding reform*" in which it is estimated that 30% of adjudications result from exaggerated claims.
4. The definition is also introduced for the purpose of applying for extensions of time both to Completion and to Key Dates.
5. NEC3, Clause 63.1 provides: "*The changes to the Prices are assessed as the effect of the compensation event upon:*
    - *the actual Defined Cost of the work already done,*
    - *the forecast Defined Cost of the work not yet done and*
    - *the resulting Fee*

    The date when the Project Manager instructed or should have instructed the Contractor to submit quotations divides the work already done from the work not yet done."
6. See Clause 63.2 of NEC4.
7. See Clauses 63.3 and 63.4 which allows for a reduction in the Prices where there is a change of Scope or a correction to a previous assumption for a compensation event.
8. See Clause 63.8 of NEC4. This can be a point for debate where a Project Manager is making an assessment sometime after the event occurred given that this risk may have either passed or been much worse than forecast.
9. See *Keating on NEC*, para 7-190.
10. See Clause 61.5 which provides that: "*If the effects of a compensation event are too uncertain to be forecast reasonably the Project Manager states assumptions about the compensation event in the instruction to the Contractor to submit quotations. Assessment of the event is based on these assumptions if any of them is later found to have been wrong, the Project Manager notifies a correction.*"
11. See Clause 63.9.
12. See Clause 11.2 (24).
13. For Option C, see the following: "*(26) Disallowed Cost is cost which*
    - *is not justified by the Contractor's accounts and records,*
    - *should not have been paid to a Subcontractor or supplier in accordance with its contract,*
    - *was incurred only because the Contractor did not*
      - follow an acceptance or procurement procedure stated in the Scope,
      - give an early warning which the contract required it to give or
      - give notification to the Project Manager of the preparation for and conduct of an adjudication or proceedings of a tribunal between the Contractor and a Subcontractor or supplier

    and the cost of
    - *correcting Defects after Completion,*
    - *correcting Defects caused by the Contractor not complying with a constraint on how it is to Provide the Works stated in the Scope,*
    - *Plant and Materials not used to Provide the Works (after allowing for reasonable wastage) unless resulting from a change to the Scope,*
    - *resources not used to Provide the Works (after allowing for reasonable availability and utilisation) or not taken away from the Working Areas when the Project Manager requested and*
    - *preparation for and conduct of an adjudication, payments to a member of the Dispute Avoidance Board or proceedings of the tribunal between the Parties.*"
14. See the *NEC4 User Guide*, Managing an Engineering and Construction Contract, Volume 4 (the "***NEC Guide***").
15. See *Keating on NEC*, Section 7-170.
16. See *Northern Ireland Housing Executive v Healthy Building (Irish) Limited* [2017] NIQB 43.
17. See Clause 61.6.
18. See the *NEC Guide* at page 64.
19. See *Northern Ireland Housing Executive v Healthy Building (Irish) Limited* [2017] NIQB 43.
20. Ibid.