LEGAL & BUSINESS GUIDANCE NOTE

Inflation: Prime Cost, Cost Reimbursable and Target Cost Contracts (Guidance)

This guidance note explains how Members can engage on works using a prime cost contract under the JCT standard forms or a cost reimbursable contract under the NEC standard forms to mitigate against inflationary and materials costs risks.

- What are prime cost/cost reimbursable contracts?
- When should prime cost contracts be used?
- Prime cost contracts under the JCT standard form
- Cost reimbursable contracts under the NEC standard form
- What are provisional sums and target costs as an alternative to prime cost or cost reimbursable contracts?

ECA has a number of other key guidance notes dealing with pricing under construction and maintenance contracts which will also enable Members to consider how to share, spread and collaborate on risks in pricing allowing parties to move away from the fixed lump sum pricing model that has dominated the industry.

1. What are prime cost/cost reimbursable contracts?

Prime cost contracts, or cost reimbursable contracts, as they are known within the NEC suite of contracts, are an alternative to the traditional lump sum (fixed price) pricing model used in the majority of construction contracts. For ease of reference, this guidance shall generally refer to this pricing model as prime costs, with contractual distinctions between prime costs under JCT and cost reimbursable contracts under NEC being outlined further below.

Prime costs are one way in which Members can leverage a fairer allocation of risk between the parties and have flexibility on price during the life cycle of a project.

In a lump sum contract, parties agree at the outset of the project the price that is to be paid to the contractor/sub-contractor for the works (i.e. the contract sum), with limited mechanisms in place to adjust elements of the fixed price.

On the other hand, a contract which is agreed to be on a prime cost basis reimburses a contractor/sub-contractor for cost of the works as those works progress, allowing a greater degree of flexibility on being able to recover within the price for the actual labour and materials costs, as well as being paid an additional fee to cover its overheads and profits.

2. When should prime cost contracts be used?

Members should consider using prime cost contracts on projects where the remit of the scope of works is likely to be varied during the course of the project or where Members may find it difficult to accurately price materials or goods at the tender stage, either because of the duration of the project or fluctuating market conditions, or both.

The advantages of this approach are that it creates a fairer pricing model for Members to contract on and it means that a client/main contractor cannot hold a Member hostage to an out of date lump sum fixed price. Given the sharp rise of inflation in 2022, Members who are party to prime cost contracts can, to some extent, combat inflationary risk by having the contractual mechanism to reprice for materials to mirror the going market rate.

It can also bypass some of the contractual issues that can arise when the scope of works is changed, by way of variation, as a Member will be able to price any additional works without having to seek an entitlement to money or time.

Finally, prime cost can be a pragmatic contractual solution for projects where a Member is required to rapidly deploy its labour force and have boots on the ground to start work on site as soon as possible, before all the necessary design information or scope of works may have been defined.

This should be pitched as an attractive contractual arrangement to clients/main contractors as they will be given the opportunity to employ Members at short notice on building projects or be able to effect urgent repair works on management projects.

However, it is important to note that a potential disadvantage of contracting on a prime cost basis is that since is a much less widely used form of contract it may create some uncertainty on contractual arrangements between the parties. Members may also find that they are having to a significantly greater degree of bookkeeping and transparency of their costs than they would usually have to do, or are comfortable with, when working on a lump sum basis, As Members' costs will be compartmentalised and transparent, they may find that they do not have the opportunity to make the same level of savings/profit on costs as they may usually have had under a lump sum contract.

3. Prime cost contracts under the JCT standard form

For Members who are looking to engage on works under the JCT suite of contracts, the JCT PCC 2016 edition offers contract pricing on the prime cost basis, whilst retaining many of the boilerplate provisions relating to materials, possession, defects, insurance and dispute resolution that parties would expect to see under more commonly used JCT standard forms.

The architect/contract administrator has significant control over sub-contracting under the JCT PCC and the main contractor needs to obtain the consent of the architect/contract administrator to enter into a sub-contract with a sub-contractor.

Members should note that the full provisions for sub-contracting under the JCT PCC were found under the 1998 edition, and these are not used in the JCT PCC 2011 and 2016 editions. However, the main contractor has the option to select a sub-contractor from a pre-selected list in the specification, like other forms of JCT contract and additionally, the JCT Short Form of Sub-Contract can be used with the JCT PCC.

Under the JCT PCC the Member undertakes to carry out the works as 'economically as is possible' consistent with the instructions issued and having regard to all the circumstances, including the scope of works, the completion date and current prices for materials, goods and labour (clause 2.1.2). This links back to the earlier point about the greater degree of scrutiny a Member may face when contracting on a prime cost basis and the requirement for diligent and transparent bookkeeping and maintenance of accurate records.

Payment is dealt with under clause 4 of the JCT PCC - payments are made in instalments as set out in clauses 4.6 - 4.10 of the 2016 edition and clauses 4.6 - 4.11 of the 2011 edition. Members will find that the provisions are very similar to those found in the other JCT contracts in the suite regarding payment applications, payment notices and pay less notices

The prime cost payable to the Member is calculated in accordance with schedule 1 of the JCT PCC and comprises of 'reasonably and properly incurred' costs in relation to the works, labour, materials, plant, services and other sundry costs. As stated above, a Member must be mindful to ensure that the costs it incurs during the works are reasonable, to avoid them being disallowed from the prime cost.

It must also produce records to allow the prime cost to be ascertained otherwise the quantity surveyor can make its own reasonable assessment (clause 4.2.1). If for example there is any inaccurate setting out by the Member (clause 2.8)

4. Cost reimbursable contracts under the NEC standard form

Members who are contracting under the NEC suite of contracts can use the NEC Engineering and Construction Contract (ECC) to be paid on a cost reimbursable basis using pricing Options E and F.

ECC Option E is a cost reimbursable arrangement where the Member is paid the actual cost of the contract (the 'Defined Cost'), plus a percentage fee set out in the Contract Data to cover its overheads and profit (see NEC3 clause 11.2(29)/NEC4 clause 11.2(31)).

In a similar fashion to the requirement to maintain detailed and accurate bookkeeping under a JCT prime cost contract, the Member has to keep records of payments of the Defined Cost, communications regarding assessments of compensation events and any other records stated in the Works Information/Scope (clause 52.2) and has to make these available for inspection by the project manager (NEC3 clause 52.3/NEC4 clause 52.4).

Members who are acting in their capacity as a sub-contractor may find themselves engaged under ECC Option F where a main contractor manages the works but sub-contracts most, if not all, of the elements of the works. Similarly to Option E, the main contractor will expect the Member to keep clear records of the Defined Cost so that the main contractor can make them available to the project manager (NEC3 clause 52.2–52.3/NEC4 clause 52.3–52.4).

5. What are provisional sums and target cost as an alternative to prime cost or cost reimbursable contracts?

Prime cost and cost reimbursable contracts are one of several options available to Members looking to manage and mitigate their costs and risk exposure. Given the relative scarcity of use of such contracts within the industry over the last couple of decades in the context of a relatively stable economic landscape, Members can also consider alternative contractual safeguards that may yield similar protection, and in some instances, may be better suited from a commercial perspective.

One of the obvious alternative options to prime cost is provisional sums which can similarly be used on projects where there is uncertainty on the pricing of materials or the scope of the works.

Provisional sums are an amount inserted into the contract sum analysis to cover certain items of work that cannot be accurately defined, detailed or valued at the time that the tendering documents are issued by the client/main contractor.

Alternatively, a target cost contract is another type of cost reimbursable contract and is commonly used where the project is not fully designed or defined at the point the Member is expected to start on site. The parties agree upon a target cost at the start of the project, and the Member is paid the actual costs it incurred on the works, and at the end of the project the parties will apply a mechanism/formula to calculate whether savings were made, or whether costs overran and the cost of delivering the project was more than the target cost. This is commonly known as a pain/gain sharing arrangement as the parties pre-agree the split for any savings or costs overrun as part of the contract.

We would advise Members to consider all options available to them at the pre-contractual stage and to speak with ECA should they require guidance.

As always, ECA's legal team are on hand to support Members with negotiating prime cost/cost reimbursable contracts and to advise generally on the topic.

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Rev: MMYY