Nuclear decommissioning contracts: the legal and commercial issues

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A fundamental aspect of the UK Programme of Decommissioning and Waste Management is the desire of the Nuclear Decommissioning Authority to achieve more for less. This requires the use of ‘incentives’ and target-cost arrangements. This paper examines the role and use of the NEC3 Engineering and Construction Contract and the Institution of Chemical Engineers Burgundy-Book conditions of contract. Questions are now arising about how incentives-based contracts/target-cost contracts actually work in practice. How do they provide an incentive and allocate the risk of cost/time overrun? What are the problems that are leading to disputes? These questions are addressed, as well as exploring the specific areas that contracting parties should now consider before signing up to an incentives-based or target-cost contract. The paper concludes by examining the desire in the industry to use ‘hybrid contracts’ that incorporate elements of fixed price, or longer-term target plus fee (for workstreams or sites where analysis of risks is required or where work needs to be better understood and characterised).

1. Introduction

A fundamental aspect of the UK Programme of Decommissioning and Waste Management is the desire of the Nuclear Decommissioning Authority (NDA) to achieve more for less. This requires the use of ‘incentives’: incentives that seek to reward innovative efficient management and construction and engineering methods, workmanship and standards. Naturally, this philosophy needs to be enshrined (consistently) in the various contracts and subcontracts (typically referred to as tier 1, 2, 3 and 4 contracts).

This paper examines the various methods that contracting parties can use to incentivise the decommissioning obligations. In particular it will consider the role and use of the NEC3 Engineering and Construction Contract (ECC) (NEC, 2005) and the Institution of Chemical Engineers Burgundy Book (IChemE, 2007) conditions of contract. The paper focuses on complex contractual provisions including the use of key performance indicators (KPIs); bonuses for early completion; liquidated damages; and target-cost contracting.

The paper also seeks to explain the interrelationship and inter-dependency between the commercial imperatives and the legal terms in the contracts. Further, that ‘incentives-based contracting’ necessitates robust and often complex legal provisions in the decommissioning contracts. Poor/incomplete incentives can lead to on-site problems such that tier 1, 2, 3 and 4 contracts effectively ‘become’ cost-reimbursable arrangements with no (real) incentives thus defeating the NDA objectives.

Given that the NDA and contractors appear to be content that incentives-based contracts are both necessary and an ideal mechanism for the decommissioning sector, questions are now arising about how incentives-based contracts/target-cost contracts actually work in practice. How do they provide an incentive and allocate the risk of cost/time overrun? What are the problems that are leading to disputes? These questions are addressed, as well as exploring the specific areas that contracting parties should now consider before signing up to an incentives-based or target-cost contract. There is growing concern in the supply chain that incentives-based contracts are needed, but that contracts that base payment partly on fixed price, partly on cost reimbursement and partly on target cost are more applicable where the scope of work or waste characterisation is not so complete, conclusive or sufficiently accurate.

This paper is in three parts: Section 2 examines incentives-based contracting; Section 3 looks at how incentives-based contracts work in practice; and Section 4 reviews the areas, risks and contractual terms that commonly give rise to disputes.

2. Incentives-based contracting

2.1 The NDA ‘targets’

The NDA was established on 1 April 2005 to ensure the safe and efficient clean-up of the UK’s first generation of public sector nuclear facilities. As at December 2007, 14 facilities had already shut down and were in the process of being decommissioned. It is a non-departmental public body sponsored by the
Department for Energy and Climate Change (DECC) which approves its strategy, plans and budgets. The NDA also reports to the Scottish ministers who agree its strategy and plans for Scottish sites. This means that DECC and the Scottish government are involved in the governance of the NDA. The NDA owns a varied and ageing portfolio of sites including Magnox nuclear power stations; research sites, including Dounreay; and the fuel-handling, recycling and production facilities at Sellafield. At its inception the NDA had full ownership of 18 sites and has a lease agreement with the United Kingdom Atomic Energy Authority for that part of the Harwell site which was designated to it under the Energy Act 2004 and requires decommissioning and clean-up.

The NDA’s core objective is to ensure that the civil public sector nuclear sites are decommissioned and cleaned up safely, securely and cost-effectively and in ways that protect the environment for the benefit of current and future generations. The Energy Act 2004 imposed these duties on the NDA. The Act left the statutory responsibilities of site operators, and their relationship with health, safety, security and environmental regulators, unchanged. This is very important in the context of incentives and KPIs since the legal responsibility for determining compliance with the regulatory requirements rests with the site licensees.

The NDA Business Plan 2010–2013 shows that the NDA has additional responsibilities for implementing government policy on the long-term management of low-level and higher-activity wastes, and providing oversight to the British Energy Nuclear Liabilities Fund. The NDA is also required to operate openly and transparently; to promote competition; to secure value for money and promote best practice. Of considerable commercial importance, the NDA is also required to operate existing commercial plant efficiently, effectively and in accordance with the current contracts with third parties. This ‘operational’ aspect not only interfaces with the practical site issues but also generates income that is part of the decommissioning and clean-up budget (e.g. Thermal Oxide Reprocessing Plant – THORP). It follows that any inefficiency in the ‘operational’ aspects will have a detrimental impact on the rate of decommissioning.

Of fundamental importance in the present context, in July 2004 the government agreed in parallel with the comprehensive spending review settlement

(a) a public service agreement target that requires the NDA to reduce the UK aggregate nuclear liabilities by 10% by March 2011 (relative to 2008 levels)
(b) to deliver 2% annual UK aggregate net efficiency gains (after performance payments) against budget from 2006–2007.

The NDA income comes from a mix of grant-in-aid from DECC and revenue generated from commercial activities including power generation and fuel processing. (The NDA’s commercial income arises mainly from the power generated from the Authority’s two remaining operational Magnox reactors, the production and reprocessing of fuel for British Energy and overseas customers and the international transport of nuclear materials.) The NDA Business Plan 2010–2013 states that the total planned expenditure for 2010/2011 is £2840 million, of which £1690 million will be funded by the government and £1150 million by income from commercial operations.

The NDA discharges its primary obligations and responsibilities for decommissioning through management and operation contracts with the site licence companies who in turn manage the sites (which includes preparing site decommissioning plans, performing and subcontracting work to the supply chain).

The government’s aim is that all the site licensees will be wholly owned by private sector parent bodies. As at April 2010 the parent bodies are: Nuclear Management Partners Ltd (for Sellafield Ltd); Reactor Sites Management Company Ltd (for Magnox North Ltd and Magnox South Ltd); UKAEA Ltd, now owned by Babcock International Group plc (for Dounreay Site Restoration Ltd and Research Site Restoration Ltd); UK Nuclear Waste Management Ltd (for Low Level Waste Repository Ltd) and Westinghouse Electric UK Ltd (for Springfields Fuels Ltd). At the centre of this strategy lies the concept that a competitive private sector will bring ‘more for less’. The ‘parent body contracts’ are expected to run for an initial period of 5 years, extendable for a total of 12 further years over three periods, subject to performance. It is important to note that the primary contract is between the NDA and the site licence company with the parent body organisation providing a parent company guarantee for the benefit of the NDA.

2.2 Incentives in the maintenance and operation contracts

The maintenance and operation (M&O) contracts between the NDA and site operators are typically on a cost-reimbursable basis. The problem has been that reliance on detailed short-term work plans that are evolving and changing has made the existence of a testing incentive regime impractical and of limited use. The NAO report states

In our view, in their current form, the [M&O] contracts are unlikely to encourage sites to deliver long-term value for money as they do not provide strong incentives to contractors to control lifetime costs through, for example, innovation and efficiency improvements. (NDA, 2008)

The NAO recommends that the NDA should develop incentives by
Incentives-based contracts, typically target-cost contracts, have been used over a period of many years and are ordinarily viewed to be advantageous for complex, uncertain construction projects. This is clear from the 1982 National Economic Development Office Report *Target Cost Contracts – a Worth-while Alternative* (NEDO, 1982).

Indeed, contractors have embraced this principle. For example, the written evidence submitted by Washington E & C Ltd to the House of Commons Select Committee on Trade and Industry states:

Washington Group believes that the significant improvement in cleanup performance in the US DOE-EM complex coincided with the clearly stated objective of site closure and the use of incentive contracts, focused on results rather than programmatic compliance. Contractors were given significant rewards for delivering cleanup at below cost targets and on early completion. Delivery below the cost target enabled the US DOE to save on the overhead and indirect costs associated with a longer duration contract and enabled other work programmes to be initiated and completed early.

The contractor concluded ‘this type of motivation results in contractor innovation and performance that generates major reduction in site cleanup costs for the Government. We recommend this incentivised contract model to the NDA’.

The NDA states that contractor performance will be ‘controlled’ by sets of metrics that measure performance effectively in the areas of:

(a) nuclear safety  
(b) industrial health and safety  
(c) security  
(d) environmental protection.

The metrics are to be monitored by an ‘independent oversight and assurance team’ that reports to the Nuclear Safety, Security and Environment Director. The NDA can terminate contracts for poor performance and so the setting, measuring, monitoring and scoring of performance can become contentious.

### 2.4 Definition of target-cost contracts

In short, the main difference between an incentives-based/target-cost contract and a fixed-price contract is the mechanism for sharing risk and opportunity. In lump sum or fixed-price contracts, the price is fixed and subject to change only if the employer makes changes to its requirements. In this type of contract, the contractor takes the risk of cost overrun and only benefits if the work can be done at a cost lower than the fixed price. From a contractor’s perspective, fixed-price contracts are typically viewed as ‘high risk’ and ‘high profit’.

At the other end of the cost overrun risk spectrum, there are cost-reimbursable contracts. Here the employer agrees to pay the contractor for work carried out on either an agreed daily rate or time/cost basis. The important point is that, while the employer maintains flexibility in how and what works are carried out, the contractor is much more certain of making a profit at the end of the contract. This form of contract is generally viewed as ‘low risk’ and ‘low profit’ for the contractor.

Employers, however, perceive cost-reimbursable contracts to be comparatively high risk. This is because the cost to the employer of a reimbursable contract is less certain than a fixed-price contract and the employer bears the full risk of cost and time overrun (subject to arguments about variations and changes). Employers are also expected to provide a higher level of project management and to carry higher financial and technical risks than they would under a fixed-price contract, because the contractor does not price for risk in the cost-reimbursable environment in the same way that he can under a fixed-price contract.

Target-cost contracts are essentially hybrids of the fixed-price and cost-reimbursable contracts. The *Burgundy Book* defines target-cost contracts as (IChemE, 2007)

… a particular type of cost reimbursable contract in which the contractor is reimbursed his costs subject to the application of a formula which allows the contractor to share in savings made often called ‘gainshare’ or to contribute towards additional costs incurred called ‘painshare’, according to how well the parties are able to manage the cost of the works.

However, contractors, typically, are not prepared to accept an open-ended ‘painshare’ liability and so will insist that their ‘painshare’ liability is capped. This cap can be a specified figure or a percentage of the target cost. The target cost concept also resonates with the NDA desire to frame contracts around ‘outputs’ and required end states. The ‘what’ not ‘how’ driver is important. For example, the NDA cites the example of the development of the waste cementation plant at Winfrith. The contract required the production of a given number of drums of waste. It did not seek tenders from contractors to design, build, commission and operate a cementation plant.
‘gainshare’ and ‘painshare’? Should the contractor’s financial liability be capped? If yes, at what figure? The parties also need to consider the following, less obvious, points.

(a) When can the target cost move?
(b) How does the target cost interact with liquidated damages for delay to completion?
(c) Do liquidated damages even apply in a target cost arrangement?
(d) How is the contractor paid pre and post the target cost?
(e) Will the cost of rework/defects correction fall within the actual cost?
(f) If yes, is there a limit on how much rework/defects correction will fall within the actual cost?
(g) How can the contractor also be incentivised to maintain high standards of health and safety; high productivity; and to consider whole life-cycle costs and maintenance costs post end-state?

One concern will always be whether certain costs are ‘allowable’ or ‘disallowable’. The NDA view is that any such disputes should be resolved in accordance with the overarching dispute resolution provisions. This will be a question for the project manager. An interesting issue then eventuates, namely whether the project manager has a duty to act impartially or whether he can be robust and aggressive when assessing costs and target cost pain or gain share? This question, in the context of NEC2, came before the courts in Costain & Others v. Bechtel Ltd & Another (2005).

Costain was part of a consortium of contractors engaged to construct part of the Channel Tunnel Rail Link. Bechtel was the project manager. Costain became very concerned that Bechtel was deliberately adopting a policy of administering the contract in an unfair and adverse manner and so sought an interim injunction restraining the project manager. A key fact was that on 6 February 2005 the project manager issued payment certificate number 47. This showed that the total value of work carried out was approximately £264.2 million and that costs disallowed were approximately £1.4 million. Following the issue of this certificate, the project manager appeared to have adopted a stricter approach to the assessment of both actual costs and disallowed costs. In payment certificate 48, issued on 8 April 2005, the total amount of costs disallowed was £5.8 million. It can be seen that this was a substantial increase from the previous certificate. The increase followed a meeting convened by the project manager. At this meeting, according to the project manager’s witness statement, he said as follows.

5.3 I did say that Bechtel, as the largest shareholder in RLE, had most to lose if the project was not a financial success. This is because if any fee is to be earned by RLE Bechtel’s share of it is greater than the other RLE partners and if any penalties are to be paid (under the pain/gain machinery) Bechtel’s share of that is also greater than its partners in RLE. I firmly believe that it is in the best interests of all of the parties involved for the project to be a financial success.

5.4 I told those present at the meeting that there was a gap between the Target Cost and the project Outturn Cost of the project and it was important to seek to reduce this gap by adopting a stricter attitude to the administration of the relationship with URN and the Trade Contractors. In relation to the Trade Contract, I emphasised that it was RLE’s job to apply the Trade Contracts fully including the provisions for disallowing unjustified costs. I stressed that applying the Trade Contracts in accordance with the terms was what is required. At no time, either at the meeting on 15 April, or before it or after have I instructed or encouraged Bechtel or RLE staff to do anything other than operate the Trade Contracts in accordance with its terms. I do not believe that the spirit of partnering/co-operation, such as it is, necessarily ended from RLE’s perspective. I was however concerned that this approach had to be operated by all parties and that was not necessarily happening. (emphasis added).

The court, while it did not grant the injunction, held that: ‘It is, at the very least, properly arguable that when assessing sums payable to [the contractor], [the project manager’s] duty is to act impartially as between employer and contractor’ (see Costain & Others v. Bechtel Ltd & Another (2005) at paragraph 15).

3. Incentives in practice

3.1 Amending target cost

One option to restrict movement of the target cost is to ensure that it only moves if there are ‘material’ or major variations to the scope of work. In practical terms, this would mean that any small or de minimis changes would not entitle the contractor to request a change in the target cost. Another option is to state that the target cost can only move if there is a change or variation to the overall ‘design intent’ or ‘decommissioning statement’. In practical terms, this increases the threshold by which changes are treated as legal ‘variations’ so that changes that do not amount to a change in the overall ‘design intent’ do not allow a change in the target cost. Design intent is usually a high-level description of the scope of work (for example, it could refer to a floor space requirement for a building). In this sense, only changes that required a building with greater (or smaller) space requirement could lead to a change in the target cost.

The approach in the Burgundy Book is different: variation has a broad definition and means ‘any alteration to the Plant, method of working, programme of works or to the type or extent of the Works, which is an amendment, omission or addition there-to . . .’ The Burgundy Book (at clause 16.7) also allows the contractor to object to any variation ordered or proposed on the grounds that compliance would when combined with all variations previously ordered increase or decrease the target cost by more than 25% of the initial target cost. Limiting the
number of variations is not new: for example, the model forms of general conditions of contract MF/1 (Revision 4) (IMechE/ Institution of Engineering and Technology, 2000) and the Engineering Advancement Association of Japan Model Form International Contract for Power Plant Construction (ENAA, 1996) standard forms of contract do not allow variations which (independently or combined with previous variations) vary the contract price by more than 15%. Clearly, such limits need to be carefully considered by the employer.

In the ECC, changes are driven off the works information. Works information is information which either specifies and describes the works or states any constraints on how the contractor provides the works and is required to be stated in the documents, noted in the contract data or may be an instruction given in accordance with the terms of the contract. Clearly, for such movements to target cost to be limited to major changes, an express amendment to the terms dealing with compensation events is required. In the absence of such amendment the normal rules on compensation events will apply such that the target cost could move when any of the compensation events eventuate. Although this is the cooperative philosophy of the ECC it raises questions whether such an approach is ideal in incentives-based contracts.

3.2 Cost of rework and defects correction
Payment in a target-cost contract is typically a cost-reimbursable arrangement. This means that the employer is responsible for paying all of the contractor’s actual costs or defined costs. But should the employer pay (as part of the actual cost) the costs associated with defects or work that the contractor has himself failed to do properly? There are often practical on-site difficulties in distinguishing the time and cost spent carrying out remedial work from other work, so the parties may agree that it would be more beneficial at site level if such costs of remedial works were part of actual cost.

However, there is a risk that the remedial work may become excessive. The employer may therefore be advised to set a financial limit on the amount of rework that will be covered in the actual cost. If the target cost was £100 million, the employer may take the view that rework or defects correction work costing more than £3 million will not be part of actual cost. In practical terms, the contractor would now bear the financial risk of remedial works above this limit. The Burgundy Book and ECC do not make express provision for such limits. Instead, in the Burgundy Book, the cost of remedying any defect up until a year after the date of the take-over certificate is part of the actual cost.

3.3 Payment streams
The parties are free to agree exactly what the contractor is paid as part of the cost-reimbursable arrangement. Typically, the contractor will be paid his actual cost, corporate overhead and profit element in respect of the work. However, if it is clear that the contract is in pain-share or will soon enter pain-share then the question arises, should the employer continue to pay the contractor all or some of the foregoing?

The approach (in clause 37.11) of the Burgundy Book is that where the project manager considers that the total actual cost will exceed the final target cost, he can withhold all monies from the contractor. This also prevents a situation from arising where the contractor is overpaid. The ECC does not include such a provision.

This is one of the most contentious points in drafting target-cost contracts and raises significant commercial questions for the employer; for example, if the employer deprives the contractor of his actual costs, will the contractor have sufficient financial means and motivation to complete the project? If the employer believes not, and the contractor is in fact paid his actual cost and/or corporate overhead and/or profit then the employer needs to wait until completion and at the conclusion of final actual cost calculation (which may itself be the subject of dispute) before he can seek to recover the contractor’s painshare contribution. This raises further practical concerns since it may in practice take many months/years before the contractor’s painshare contribution is repaid to the employer.

Analysis (Perry and Barnes, 2000) concluded that target-cost contracts provide scope for manipulation of tenders and that suboptimal methods of tender evaluation are in use. The analysis supported the case for setting the contractor’s share of cost overrun or underrun at a value that is not less than 50%.

3.4 Additional contractor incentive
Target-cost contracts can also allow the employer to provide an incentive in areas such as health and safety, productivity, whole life-cycle costing, and quality/rework. However, the Burgundy Book and ECC do not make express provision for the reduction of payments in respect of these issues.

Employers may prefer to structure the target-cost contract so that each payment due to the contractor can be reduced if the contractor scores below a certain level on any of the KPIs described above. For example, if in a particular month the frequency of late deliveries or frequency of health and safety incidents is above a specified level, then a certain percentage of that monthly cost-reimbursable payment may either be deducted or retained by the employer. Again, the list of KPIs and the various deductions is a detailed issue and requires commercial analysis. This may involve running a number of financial models with different permutations of KPIs, deduction schemes and contractor failures. From a drafting perspective, the payment schedule (at Schedule 19 of the Burgundy Book) will need to reflect the exact incentive scheme.
3.5 Off-the-shelf incentives in ECC?
It is often stated that the advantage of incentives-based contracts/target cost lies in the incentives to the contractor to be efficient and to achieve savings. Considered wisdom tends to the view that in the case of the provision of performance-based payment, the contractor’s financial interests and those of the employer become more closely aligned and therefore it is in the financial interests of both parties to act in a cooperative manner. Indeed, cooperation lies at the heart of ECC. See for example clause 10.1 which states (ECC, 2005)

The Employer, the Contractor, the Project Manager and the Supervisor shall act as stated in this contract and in the spirit of mutual trust and co-operation.

The requirement for mutual trust and cooperation was added to the NEC on the express recommendation of the Latham Report Constructing the Team published in July 1994. This was the final report of an investigation by Sir Michael Latham into procurement and contractual arrangements in the UK construction industry. It did not necessarily focus on the nuclear sector and indeed many of its recommendations do not ordinarily apply to that sector (Latham, 1994).

Option X20 of ECC deals with KPIs. ECC does not provide a ready-made list of KPIs. Instead ECC allows the employer either to specify a detailed Incentive Schedule in the tender contract data or to set out in the instructions to tenderers the business- and project-specific objectives that are of key importance to the employer and invite tenderers to propose suitable KPIs. Clearly, the employer and the contractor will need to agree the incentive schedule before the contract date. The guiding principle of the ECC KPI scheme is that both parties should benefit when a KPI is met.

Interestingly, the KPIs in ECC are designed to encourage the contractor to meet objectives. The guidance notes for ECC state very clearly that the ‘intention of the KPIs is to encourage the contractor’s objectives’. In practical terms this means that the KPIs are used only as incentives and do not penalise. This means that the contractor is paid a bonus if the target for the KPI is achieved but will not be penalised if it is not achieved. Option X20.5 permits the employer to add new KPIs but prevents the employer from reducing or removing incentives already in the schedule.

Failure to meet KPIs and lose an incentive payment may lead to disputes or attempts to recover the loss. On this point, the compensation events may, at first instance, appear to be an ideal mechanism to recover loss; however, compensation events are designed to allow contractors to recover the cost of various events and not the loss suffered. Loss suffered is ordinarily recovered as damages and so one must query those contractors who pursue the compensation event route. KPIs and incentives will, however, become closely intertwined if the key dates are linked to the incentive schedule.

3.6 Assessment of KPIs
Perhaps the most controversial aspect of the KPI mechanism is that concerning KPIs where the employer has the sole discretion to assess whether the target for the KPI has been achieved. The problem of discretion makes it difficult, in practical terms, to challenge the decision under the various dispute resolution procedures. The real debate often concerns whether the employer is acting in the spirit of mutual trust and cooperation in exercising discretion against the contractor. In real legal and practical terms this then becomes the centre of potential disputes.

One KPI is schedule or time performance. The NDA suggests that the process for performance monitoring is simple.

(a) Create the baseline.
(b) Calculate progress against the baseline based on measurable work performed.
(c) Forecast the work quantities, costs, and schedule dates and durations.
(d) Collect actual costs against the baseline.
(e) Determine if progress and costs are consistent with the baseline.
(f) Evaluate deviations (positive and negative) from the baseline.
(g) Where appropriate, establish cost and schedule variance corrective action plans.
(h) Monitor the baseline and corrective action plans to completion.

In terms of monitoring performance, the NDA requires a comparison of actual schedule with the target schedule to determine schedule performance in the following areas

(a) Total project/task per cent complete deviation from the baseline
(b) Movement of performance-based incentives in the current schedule
(c) Movement of the NDA regulatory or progress milestones
(d) Critical path analysis between defined milestones
(e) Activity float analysis.

The analysis of these items should be included in the schedule analysis that evaluates the project/site success in completing the schedule activities as planned. This analysis is not to be confused with the schedule variance analysis – that is, the analysis of the scheduled spend plan against the earned spend. The earned value method of performance monitoring is then used to compare the rates of planned spend against the earned and actual. The NDA has expressly warned that the data quality
must have total credibility with the users and be recognised as the accurate record of data by the site. Earned value performance monitoring evaluates performance for the current period, for the financial year to date, and at the year end. This approach provides multiple views of the site/function/task to assist in pinpointing discrepancies from the plan.

3.7 Change in procurement strategy

Given the above problems it is not at all surprising that many now question whether tier 2 contracts should separate out the design and/or waste characterisation process from the actual physical removal process. Many consider that a front end engineering design (FEED) approach would benefit all parties, not least because the tier 2 contractor has a more refined understanding of the nature of the waste and because the incentive or target cost should be more realistic. Procurement on this basis would effectively mean that the tier 2 contractors operate under a cost-reimbursable regime unless and until the scope of work and target cost can be agreed upon. Problems persist since now the argument is that the tier 2 contractor is not properly incentivised, may not innovate and may just draw out the process, causing both cost to exceed expectation and delay to the end state.

Others in the industry are exploring the role of alliancing and partnering as a means to better share risk and illustrate the existence of incentives during the FEED/waste characterisation stages. However, this is not straightforward and questions remain: how many parties will be in the alliance? Will the Parent Body Organisation (PBO)/tier 1 contractor allow the tier 3 contractors to be in the alliance? What is the measure of success or at what stage can a tier 2 target cost be fixed? What would be the respective percentages in ‘gain-share’ and ‘pain-share’?

4. The problem areas

4.1 Access to statutory adjudication

Section 105(2)(C) of the Housing Grants, Construction and Regeneration Act 1996 excludes the ‘assembly, installation or demolition of plant and machinery, or erection or demolition of steelwork for the purposes of access to plant or machinery, or demolition of plant and machinery, or the erection of steelwork and so an essential question relates to whether the particular site is being used, primarily, for nuclear processing or power generation.

It is clear that many sites no longer carry out nuclear processing or power generation as their primary activities. For example, Dounreay ceased operating in 1994; Winfrith ceased operating in 1990 and has a ‘decommissioning and termination’ status; and Bradwell ceased operating in 2002 such that it has a ‘defuelling/decommissioning and termination’ status. This then would mean that tier 2 and tier 3 contracts dealing with ‘construction operations’ would be ‘construction contracts’ under the above Act and so certain protections on payment and recourse to statutory adjudication would be afforded to the contractor and subcontractor.

On other sites, for example Sellafield, there may be nuclear processing. In such cases there may be a mismatch between the tier 2 and tier 3 contract in terms of the applicability of the Construction Act, especially if the tier 3 contract deals with works that are construction operations and not related to plant or machinery. The case in this area may not be settled although many will favour the decision of Ramsey J in North Midland Construction plc v. AE&E Lentjes UK Limited (2009). There are essentially two judicial views: the so-called narrow approach that says that the above exclusion does not apply to construction operations which are part of or preparatory to excluded operations; and the broad approach that says that the exclusion applies to construction operations whenever they are necessary to achieve the wider aims of the employer where the primary activity of the site is excluded. North Midland Construction provides further judicial support for the narrow approach. However, the judge expressly recognised that where disputes were not limited to construction operations but also included the excluded works then it will be impossible to apply, for instance, the adjudication provisions of the Act to only part of the dispute.

4.2 Substantive areas of dispute

The question of whether a clause dealing with the giving of notice of a delay or compensation event is a condition precedent to entitlement has troubled, confused and had detrimental consequences for many in the (orthodox) construction sector. Most recently Education 4 Ayrshire Limited v. South Ayrshire Council (2009) (a case dealing with the PFI (private finance initiative) sector) has highlighted how such clauses can have real impact and act as a bar to entitlement. In that case a contractor was held to be too late in giving notice even though the employer was aware of certain issues that caused the delay relied upon by the contractor. In the decommissioning sector it is ECC clause 61.3 that attracts most attention where tier 2 contractors argue that clause 61.3 does not bar entitlement because the project manager ‘should have notified the event but did not’, while the tier 1 contractors seek to argue that the notice (if it is a notice) was provided outside of eight weeks of becoming aware of the event.

Perhaps the most understandable issue for dispute is the practical, commercial and legal problem that occurs when the waste actually being discovered and removed is not the same as the waste characterisation details provided by the tier 1
contractor in the site information or the works information. Tier 2 contractors do not, understandably, expressly agree to take all the risks associated with ‘unforeseen waste’ or for the accuracy of waste characterisation details. This means that adjudicators need to decide complex factual, technical and high-value disputes not just in terms of whether something is a compensation event but (typically) also in terms of the impact on the waste minimisation incentive and the overall target cost model. It is sometimes said that this is such a complex sector that it is simply not feasible to fully characterise waste and that the tier 1 contractor is therefore effectively allocating the risk of assessment, management and retrieval to the tier 2 contractor such that if it does cost more to complete the scope of work then it is the ‘specialist’ tier 2 contractor that bears that overrun. This ‘commercial context’ argument is said to be the key when interpreting tier 2 contracts. The concept of the tier 2 contractor being the specialist could be extrapolated such that some may seek to argue that the tier 2 contractor misrepresented his expertise to win the contract – the recent high-profile case of BSkyB Ltd & Anor v. HP Enterprise Services UK Ltd & Anor (2010) may provide encouragement for some tier 1 contractors.

4.3 Conclusion

Target-cost contracts can provide an excellent opportunity for an employer to deal with the risk of cost overrun and provide an incentive to the contractor to beat the cost target, so providing mutual benefits. Paradoxically, the success of a target cost arrangement requires the parties to consider key issues normally associated with failure. These key issues involve considering the implications of cost overrun including the worst-case scenario where a contractor’s financial liability may need to be capped. Questions of what constitutes a ‘variation’ or ‘change’ sufficient to allow movement of target cost also need to be addressed by the parties.

The exact nature and breakdown of elements of payments to the contractor, especially if pain-share is inevitable, is another controversial issue for commercial pre-contract discussions. The problem is compounded because, while the employer does not want to wait many months until completion of the works to recover the pre-agreed proportion of pain-share, he also does not want the situation where the contractor is financially unable to carry on and complete the works. All of these commercial balancing acts are difficult and must be fully addressed by the parties. They are the essential factors that make a target-cost contract a success. If the parties decide to use the ECC and/or the Burgundy Book then this standard form needs to be amended to reflect the commercial agreement on the above key issues.

The ideal procurement route is not the only concern. The ultimate client, the NDA, has ‘slowed’ spending and has focused most emphasis on the so-called ‘high hazard waste’. This means that those not working on high-hazard projects are now prejudiced and there is much general anxiety about funding in the future. It has been suggested that slowing the rate of decommissioning leads to an ultimate increase in the decommissioning costs paid by the public. Is it too soon to be talking of nuclear decommissioning being carried out and funded by the private sector akin to the PFI model?

The desire to use ‘hybrid contracts’ that incorporate elements of fixed-price, or longer-term target plus fee (for workstreams or sites where analysis of risks is required or where work needs to be better understood and characterised) is increasing. Initial target cost arrangements lead to disputes when the scope of work or waste characterisation information specified in the contract is at variance with the actual waste arisings.

REFERENCES


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