



Target Cost Contract

A new generation of contract

Target Cost Contract becoming more familiar in major infrastructure projects across the world. This article sets out to examine the benefits and drawbacks of a Target Cost Contract and how does it achieve its objectives.

The traditional fixed-price lump-sum contract showed mediocre performance, inadequate collaboration, and no trust; there were no incentives, and contractual objectives were often unmatched. Target Cost Contracts (TCCs) were subsequently introduced as a cost management tool to reduce the cost of construction projects and stimulate further and better cooperation between the parties. TCCs have been used on several significant projects to date, such as Heathrow Airport "T5" (UK), the London 2012 Olympics and on many parts of Crossrail – Elizabeth Line including procurement and supply chain. The popularity of the TCC (Target Cost Contracts) form of contract has now been adopted by New Engineering Contract 2013 ("NEC Form"), ICC Target Cost Contract 2011 and the Institution of Chemical Engineers (I Chem E) Burgundy Book 2013



Fundamentally, TCC's are a contractual approach for parties to agree on a final estimated price or target cost. A "Target Cost" is the best estimation of the final cost of carrying out the required contractual scope. What makes this contractual method stand out, is it is designed to drive cost savings for both parties from start to finish. If the contracts complete below the agreed estimated budget, it allows both parties to distribute additional cost savings and earn incentives. This is sometimes also known as "pain/gain contracts mechanism." The distribution of the pain gain split between the client and the contractor is very much part of the negotiations prior to the contract execution and makes this suitable for longer durations and higher value contracts where there may be opportunities to benefit from continuous cost improvement through value engineering.

It is not uncommon for TCC's to be developed with a combination of individual objectives and incentives placed strategically throughout the contract programme, these are sometimes also known as Key Date or Milestone Incentives payments, this enables the client to apply several different strategies simultaneously to achieve key completion goals as well as ensure progression moves at the correct pace. There can be differentiations of TCC's, however, all must include a target cost, a target fee which is the amount of fee payable if actual costs ultimately equal the target cost and an agreed pain share/gains share percentage split.

A Target Cost Incentive fee (TCIF) is used in competitive and non-competitive tenders. This contractual approach provides incentives for the contractor to reduce the estimated costs and final prices as well as ensure a realistic cost outturn accompanied with a suitable profit. Target cost Incentive fee percentage can also adjust project delivery behaviours and change cultures; it aims to improve the way contractor and client work together to deliver both major infrastructure and smaller projects.

The Pain/Gain Mechanism of the contract is often formulated and either submitted within the contractor's tender or stipulated by the client. The most common approach of pain/gain share is to divide overspend or underspend into groups on a percentage basis. For example, the parties agree a 50/50 split of all over- and underspend. Alternatively, a scale of percentages may be adopted. For instance, the first 30% of any over- or underspend may be split equally; however, should this go above 30% the employer may take a greater element of the pain, simply due to an organisation ability to hold such significant risk without it being a threat to their entire company; furthermore, the contractor's benefit from any underspend may be increased once a figure below 90% of the target cost is reached. Decreasing the employer's benefit from any underspend may motivate the contractor to create better and further efficiencies to obtain a greater underspend.

Where can it go wrong?



Whilst this type of contract looks attractive with its incentives and lower risk, it comes with several challenges.

TCC contracts are preferred on the high value long timeframe projects as it gives more time and opportunities for value engineering. So, what happens when the Contractor recognises early into the project, they are unable to achieve targets and incentives? What incentive do they have to complete and keep cost to a minimum? Essentially none. It may therefore be important to assess the probability of this failure prior to the execution of the contract and include this probability within the risk analysis. Is the target cost correct or wildly loaded with risk? Furthermore,

- Should achieving the target cost or incentives be a considerable risk or potentially incorrect, it may be prudent to periodically insert the incentives into monthly target payments. For example, January to February incentive/ targets for the contractor in place and achieved through completion of certain works and cost management, however, March may not be met due

to a fault of the contractor, and therefore, no payment incentive is paid. However, April to December is fully achieved, and so on, to the end of the contract. This contract arrangement will ensure the incentive is consistent from start to finish and continue the contractors drive to reduce cost and meet target throughout the project. However, failure to put this in place will be detrimental to the entire project.

- Like all good partnerships, there is compromise; it will be the contractor doing all the work; creating the saving benefits and construction efficiencies for client's budget. Any saving made will, require the contractor to share the savings made with the client. To share the saving will mean potential profit made by the contractor will be reduced. However, this works both ways, the client will be open to the risk incurred from the contractor and the construction process which may require the client to bare the overspend. Therefore, gaining the contractors value engineering plans prior to agreeing the target cost may limit this risk and ensuring a reputable and experienced contractor is selected.
- Failing to meet target cost means the client and the contractor will hold the additional costs. Based on the usual percentage swing within the pain/gain mechanism, it is likely to be worse for the client. The importance on



administering a full and detailed risk analysis prior to agreeing the target cost is significant. Should the risks of the project not be fully recognised the client may save on not paying

incentives because the contractor has failed, but then again should the cost increase be considerable, it may end up exceeding the client's overall budgets including the incentives budget. Again, this works both ways. Whilst the contractor may have forecast for an incentive payment, they may end up completing their contract obligation for actual cost, lump sum cost plus fee only with no further saving or value engineering.

- Another common pitfall is all contracts will have an expectation or requirement for quality. The TCC contractor may try to use products that are cheaper with reduced quality to increase profit, signifying they have fulfilled the contract scope but not fulfilling the client's expectations for quality. Should the quality not be established at the beginning it may lead to later disagreements, essentially defeating the object of the contract, which is to change behaviours and create better contractual co-ordination. High spec projects will also be exceedingly difficult to value engineer and find further cost savings due to their bespoke nature.

- Like all projects, scope change may occur between the contractor and the client, if changes arise during the project due to client driven change or external influences, this will increase the cost, the fee, and in turn the incentive which will be a significant percentage increase of final cost. Cost increase will arise in 3 forms.



- Most parties who enter contracts with one another come with mutual trust and co-operation. Not all clients are construction industry clients, such as developers or government entities, there lies a risk, that should the contractor be working for a naïve client they may submit an over inflated bid to ensure they meet target and incentive payments, which in turn would de-risk their part of the contract and increase the client's overall cost unnecessarily.
- With cost reimbursable contracts, the requirement for substantiation and evidence of cost is greater than any other type of standard contract, and with the many cost components on a major infrastructure project additional administrative costs for both the contractor and the client. If you add an incentive, the paperwork to provide evidence of completion will require additional engineering administration. This will alone increase the contract prelim.
- The importance of getting the target cost estimate as accurate as possible is the key to getting this contract right, this however takes time, requires substantial time to price, and negotiate. The contractor and the client will be keen to make sure this is the best price they can produce and therefore take more time and due diligence to get this right. Another downside to this will be the tender period timeframe. Generally, the period to price and submit cost does not reflect the requirement for additional due diligence and submission which means the target price estimate is submitted quickly and incorrectly.
- It can change the contractor's priority of the contract. For example, when the incentives are the focus of the project this can mean the rest of the project i.e., time, quality and cost for the remainder works not linked to the incentive lose attention to detail.
- With incentives that are linked to a particular completion of works, more so a complex piece of the works, may increase the risk of dispute. Multiply this by several incentives throughout the contract programme and this may lead to major disputes very early on which may jeopardise the entire success of the project.

What makes this so desirable?

With all TCC agreements, the most essential part of ensuring its success and to guarantee it sets out what it is intended to do, i.e., reduce the cost of construction projects and stimulate further and better cooperation between the parties; is getting the target cost estimate as accurate as possible at the beginning. By successfully establishing the target cost the positives attributes of this contract will be seen.

- The ability to motivate the contractor to save money is the most obvious, how they do this, is what makes this interesting. By creating new ways to execute contract scope efficiently and cost-effectively without providing a low-quality product, not only means they are working more diligently but may use their best resources to do so and create or use newer innovations.
- For projects with greater uncertainty or higher risk brackets; the TCC provides flexibility. It allows both the contractor and the client to manage and mitigate project risk without threatening the completion of the project or

the budget or indeed their own business, which with major infrastructure projects could well do.

- Whilst we talk about incentives and the positive goal setting administered to achieve completion dates and cost target, the TCC also allows for negative incentives to be included. Most commonly in the way of LAD's -liquidated and ascertained damages. Clients could include them to protect themselves against negative results which may occur during in the construction process. Financial penalties and positive cost incentives can all be built into the same contract.
- Another obvious benefit is the client will benefit should the contractor be experienced in cost management. To deliver a project both on time and under budget provide positives reputation for both and repeat work.
- Collaboration increases with TCC contracts, the client, and the contractor work closer together to manage the cost of work for mutual benefit. The contractor will regularly seek the client's approval to key financial decisions and allow the client to have their say.
- As mentioned in my first point innovation can play a key role in cost efficiency which requires experienced and skilled professional engineers and cost managers. When the stakes are high the contractor will most likely place their top teams onto these projects which in turn may best suit for a better outcome.
- On large scale complex projects, the risk and unknowns tend to be greater. The choice of a TCC contracts creates the ability to share the risk which in turn requires a closer relationship with the client. On previous design and build lump sum contracts the client may keep a distance and trust the builder. In TCC contracts where the client is heavily involved and holding risk, the client's team and the contractor will increase lines of communication and in many cases share the decision making on risk items. This in turn creates a better line of communication and promotes greater personal discipline.



A step ahead?

On several occasions throughout this article, we mention the critical component to the TCC contract is the target cost estimate; it must be an accurate estimate of the most likely output cost. With little evidence to show that project estimates can be accurately priced at the beginning of a project means the importance placed on this is so significant that, should it be slightly off or entirely, the objective of the contract fails, making this contract very easily compromised from the beginning.

Whilst its intentions are good and, in many parts, have a positive and proactive approach to communication and relationships, the focus on experienced competent contractors taking full ownership of projects is taken away and leaves inexperienced clients exposed. This leaves an open question, why are so many contractors unable to provide large major infrastructure projects on a lump sum basis and get it right? Montreal Olympic Stadium, London Olympic Stadium, Channel Tunnel, Budapest Metro, Crossrail Elizabeth Line, The Shard, and the Jubilee Line Extension for

Transport for London to name but a few. All used a mixture of TCC contracts with cost reimbursable and lump sum incentives.

The balance between the pros and the cons is relatively equal, however, there is one consistent component to the TCC contract that is critical to its success, and that is ensuring at the tender stage the target estimated cost is correct, furthermore, all risks should be identified and managed. This is an extremely tall order and one that is very rarely achieved. The behaviour of a client with a busted budget is common worldwide, and this is, to limit any further cost exposure through contractual cost elimination.

The TCC potentially gives way to quality by putting cost before quality through excessive value management and is heavily administrative, potentially lowering the industry quality level of construction and arguably impacting safety. Politics now plays a significant role in construction, completing projects on time for political gain and public opinion is now a major factor and a major reason for the TCC selection. To achieve this, predominantly focusing on cost and time; is the industry now changing the mantra of time, quality and cost for time, cost, and political popularity?

Whilst this form of contract is essential and clear in terms of cost tracking and risk management, the external impacts of value engineering is missed from the contract terms themselves. The ability to save in this politically economically charged environment is less and less possible. How do we better buy materials when issues such as the Ukraine war and Brexit are so negatively impacting industry? Will a TCC help this or is it only good enough to highlight the risk and cost as well as mend years of failed relationships. Whilst it is acknowledged this contract is a positive step, this feels like a band aid for other major industry failures.