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Incentive Contracts

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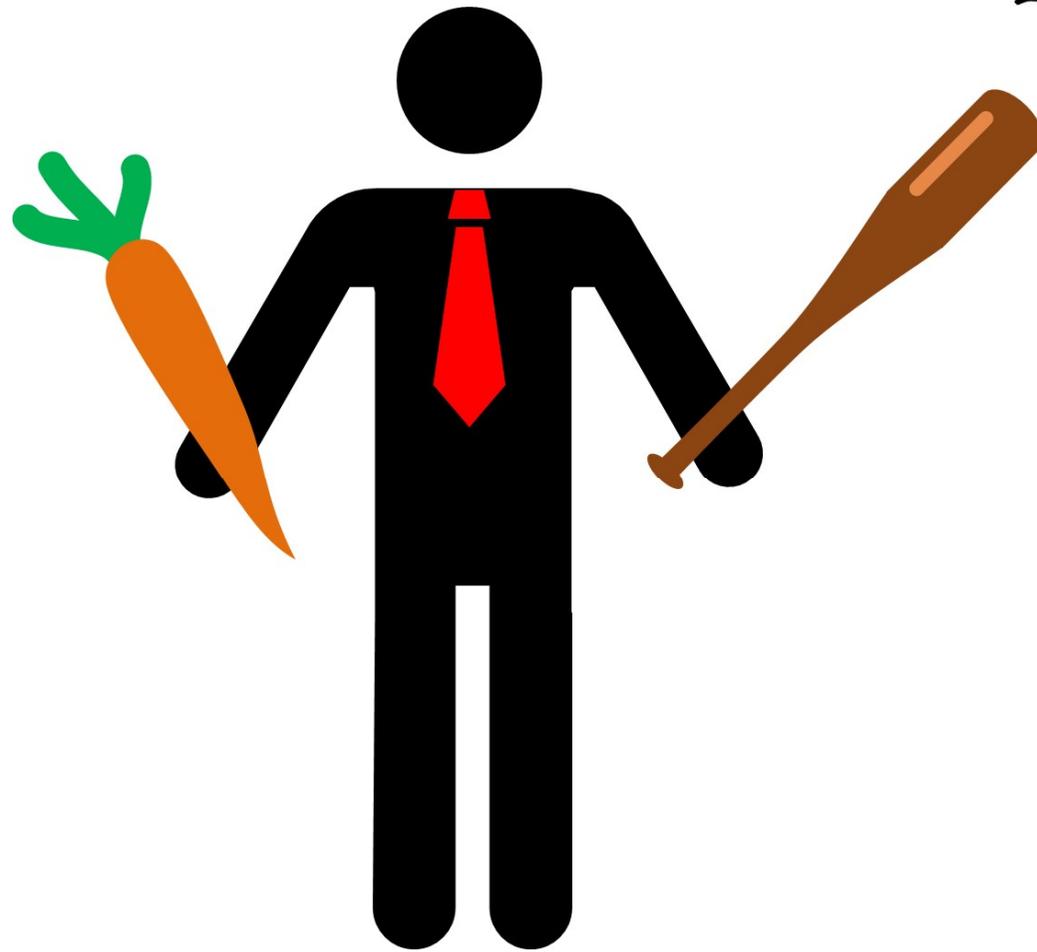
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Incentive Contracts



- How can incentive contracts help you secure VFM in new procurements?
- What can and should procurers do?

Or...



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Or for those in
the
construction
world



What is an Incentive Contract?



One that requires;

“...an owner to make an additional compensation to a contractor based on the contractor’s execution performance of cost, schedule, quality, and safety according to the contract terms and conditions.”

www.theprojectdefinition.com

What contractual sticks do we use?



- Liquidated and ascertained damages
- Unliquidated damages
- KPIs
- Low Performance Damages
- Availability and performance deductions
- Notice of default leading to termination
- Exclusion from further procurements

Why use a Carrot?



- That is a far bigger question than I intend to cover today
- Some say punishment better than reward to improve performance
- Some say reward better than punishment to improve performance
- Some say reward and punishment together are best, and that both can be classed as incentives

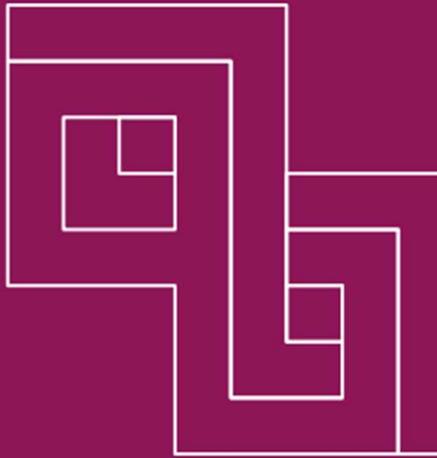


HM Government

THE CONSTRUCTION PLAYBOOK

Government Guidance

on sourcing and contracting public works projects and programmes



Version 1.0
December 2020

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The Construction Playbook

- *Create sustainable, win-win contracting arrangements that incentivise better outcomes*
- *With the right KPIs in place, it should follow that contracts are designed to incentivise delivery of the things that matter, minimise perverse or unintended incentives and promote good relationships*
- *Contracts should create positive relationships and processes designed to integrate and align multiple parties' commercial objectives and incentives.*

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Examples of Incentive Contract Terms

- NEC4
- *“Our philosophy was to produce something which cured every known ill of traditional contracts. We did not have to compromise. Everything we thought would be a good idea went in – and we could decide what to put in solely on the basis of what would stimulate all those using it to manage their contribution well”. – Martin Barnes*



NEC Option C or D

- Target is set at tender stage
- Contractor is paid
 - its actual costs
 - + or –
 - A share of the difference between actual cost and target cost
- Note the target cost is adjusted to allow for changes in scope and other compensation events
- Expensive to administer!
- Open book accounting

Example of 50/50 pain/gain

- Target cost £15,000 (ie tendered figure) and there are £1,500 of compensation events
- Adjusted Target = £16,500
- If Actual Costs = £15,500 then contractor will get
 - = £15,500 + 50%(£16,500 - £15,500) = £15,500 + £500 = £16,000
- If Actual Costs = £17,500 then contractor will get
 - = £17,500 + 50%(£16,500 - £17,500) = £17,500 + -£500 = £17,000

NEC Option X6



- Option X7 is Delay Damages
- Option X6 is Bonus for Early Completion

The Contractor is paid a bonus calculated at the rate stated in the Contract Data for each day from the earlier of Completion and the date on which the Client takes over the works until the Completion Date.



NEC X12 Multiparty Collaboration



X12.4 Incentives

- (1) A Partner is paid the amount stated in the Schedule of Partners if the target stated for a KPI is improved upon or achieved...
- (2) The Promoter may add a KPI and associated payment, but not remove one

Examples of X12.4 Incentives



- If the total cost of the project including all Client costs is less than £3,000,000, 75% of the difference is split between the Partners as follows:
 - 20% to the Contractor
 - 15% to Supplier 2, and so on.
- If the number of notified Defects is less than 100 nr each Partner receives £5,000.

- For Supplier 2, if his M&E equipment achieves the following performance levels for 98% of the time during a three month period after Completion, he receives £10,000.
- For the Project Manager, if 95% of all compensation events are assessed within the ECC timescales he receives £5,000.

Clearly, an optimum number of incentives should be strived for, enough to make a difference and not too many or of an amount that could potentially compromise the Client's objectives in any way.

© NEC procurement and contract strategies

@ Procurement



- By setting the right award criteria, a CA can drive the supply chain to offer performance that matches the CA objectives
- The incentive being the ability to win at a higher price

What do we want and are prepared to pay for?

Example

| | Quality Score out of 60 | Price | Price Score out of 40 | Overall Marks |
|----------------------------------|----------------------------|-------|--------------------------|------------------|
| Tender aligns with objectives | 55 | £11m | 36.4 | 91.4 |
| Tender does not align | 45 | £10m | 40.0 | 85.0 |

Allow Contractor to Tender Duration

- ITT for PWC in Ireland

| | | | | |
|---|------------------------|---|---|-----------|
| Contract Sum | | | | € |
| Tendered Contract Sum (Form of Tender ³) | | | | |
| Tendered Compensation Events Charges | | | | |
| € | labour | x | % adjustment (Schedule, part 2D) | |
| € | materials | x | % adjustment (Schedule, part 2D) | |
| € | plant | x | % adjustment (Schedule, part 2D) | |
| | days | x | tendered rate (Schedule, part 2D) ⁴ | |
| | | | | SUB-TOTAL |
| Tendered date for Substantial Completion (if used) | | | | |
| € | Value per calendar day | x | days in excess of the earliest date for substantial completion ⁵ | |
| | | | | SUB-TOTAL |
| | | x | | |
| | | x | | |
| | | x | | |
| TOTAL COMPARATIVE COST OF TENDER | | | | |

Pros and Cons

Pros

- It creates more ownership over the work being completed
- It incentivises innovation.
- It promotes better lines of communication
- It encourages skill-based personnel
- It allows for better management

Cons

- It creates additional administrative costs
- It requires extra negotiation time
- It can change the priority of the contract.
- It increases the risk that a dispute will occur.
- It can be difficult to determine what a fair incentive is

Final Thoughts

- Questions to ask
 - What behaviour do we want to incentivise?
 - Why?
 - How important is it?
 - Does the client know it comes at a cost?
- Should the incentive be positive, negative, or both
- How can this be achieved through the contract terms?
- How can this be achieved through the procurement?



To Recap

That's all folks!

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