NEC4 X22: more contractor incentive in two-stage contracts?

The X22 provision in NEC4 aims to provide more commercial incentives for contractors in two-stage tenders. Chrystele Kan considers its likely impact.

The NEC introduced early contractor involvement provisions under its third edition in November 2015, and a new secondary option X22 – only used with options C or D – under its fourth edition. This is a significant change from standard construction contracts where clients require contract amendments or a separate pre-construction services agreement to implement a two-stage process.

Two-stage tenders can weaken the client's commercial position because there is no other competition when the price is agreed after the first stage. The X22 option in NEC4 attempts to provide a solution to this – but will it?

The provision has the following features to incentivise the contractor to provide a competitive price. It introduces two new definitions:

- 'Project cost', which includes the final prices for work done to date and the costs incurred by the client to other parties; and
- 'Budget', which is an estimated project cost and is agreed at the outset of the contract.

At the end of the project, if the project cost is less than the budget, the contractor can earn a portion of such a saving – this is the 'budget incentive. At completion, the contractor gets a pain or gain share based on the total price and the price for work done to date.

This commercial arrangement is intended to get the contractor involved in design innovation at an early planning stage and to manage all the project costs incurred by the client. The contractor is incentivised to do so by earning two types of incentive bonuses when it beats the budget as well as the total price.

Contractor pricing considerations

In considering the effectiveness of the incentive mechanism, it is important to understand the factors being considered by the contractor when determining the budget and the prices for stage two. They are:

- The likelihood of achieving a budget saving;
- The level of attractiveness of the budget incentive; and
- The extent of risks that it is likely to take in stage one and stage two.

The earlier the contractor is involved, the higher level of risk there could be, and the less accurate the budget is likely to be. To achieve a budget saving, the contractor will have to allow for all or most of the probable risks in the budget, so the budget could be unrealistically high. In which case, it could be too easy for the contractor to earn a budget incentive, and the client would not get the full benefits of early contractor involvement.

As stage one progresses, the contractor may identify more risks than it expected. Or, the other parties' costs which are not within the contractor's control may become higher than was estimated at the outset of the contract. Then, the contractor is less likely to achieve a budget saving. Having weighed out the project risks and the profit return, the contractor may decide to forgo the budget incentive and focuses on getting the total price right to maximise its profit margin.

The incentive mechanism under X22 has sensible logic. However, it appears that the commercial risk of an over-budget target price at stage two remains. Clients may amend this clause significantly to suit their commercial incentivisation models.

If you have any questions on this topic, you can get in contact with Quigg Golden's team at ***Dublin@QuiggGolden.com*** *or visit* ***QuiggGolden.com***