

Fair Payment under NEC 3 Construction Contracts

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Introduction

Public construction projects now have special payment requirements. This commentary here focusses on how to set up and operate in practice the NEC3 contract document family once chosen for your procurement route¹. The special requirements come from the “Office of Government Commerce” (OGC)². These are on top of the soon to come into force new payment rules in what we call the “Construction Act”. Put more formally, the payment rules in the Housing Grants, Construction and Regeneration Act (the 1996 Act) are soon to give way to Part 8 of the Local Democracy Economic Development Act 2009 including the revised “Scheme for Construction Contracts”. The Scheme has completed its consultation phase; the Dept. for Business Innovation and Skills is now reporting to Parliament. This paper however deals with what is said in the new parent act together with what the OGC requires of the NEC contract document.

The NEC 3

The NEC is properly called the “Engineering, Construction Contract”. It is commonly used for the appointment of a contractor for engineering and construction work including, if required, any level of design responsibility. NEC stands for the “New Engineering Contract”. The first edition was in 1993. The second edition was 1995 (NEC2) and the third edition was released in June 2005 (NEC3). There have been amendments to NEC3 since. It springs from the Institution of Civil Engineering (ICE) through its wholly owned subsidiary Thomas Telford Ltd. Until July 2010 the family of NEC ran in parallel with the long established ICE Conditions of Contract. But, the ICE has decided that it is now withdrawing the popular ICE forms to solely to include NEC 3 suite of contracts. The re-alignment has period of grace of 12 months (there are those in industry who prefer the clear and precise drafting of ICE conditions over the NEC form). During that time the new payment provisions will be introduced to NEC 3. It is worth also noting that CECA (Civil Engineering Contractors Association) intend to amend their Blue forms of subcontract to bring in the new payment provisions including OGC requirements.

Bear in mind that NEC 3 comes as options (Primary options)

- Option A: Priced contract with activity schedule.
- Option B: Priced contract with Bill of Quantities
- Option C: Target contract with activity schedule.
- Option D: Target contract with Bill of Quantities.
- Option E: Cost reimbursable contract.
- Option F: Management contract

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¹ Option procurement is via JCT or PPC2000

² Soon to be absorbed into another government department

- Short contract for small and simple contracts.
- Framework contract
- Subcontracts for use with options A-F and the short contract.
- Professional services contract.
- Adjudicator contract.

Each of the Primary Option contracts require you to then select “secondary options” at the tendering, bid and negotiation stage so as to eventually crystallise the contract terms. Some of this is important for payment provisions.

The broad requirements of the Construction Act 2010 for NEC

This is an overview of the contractual intentions. Bear in mind that this is what the Construction Act requires of the contract document. If the document does not comply in part or whole then “The Scheme” makes good the noncompliant parts, meaning it is imported by law to correct the express but wrongful term in the contract. The key requirements:

1. The contract shall contain an “adequate mechanism” showing how stage payments and final account are to be calculated and when payment is to be made.
2. There shall be a requirement to issue a “Payment Notice” saying what is payable and when (the notified sum).
3. Then, if it is intended to reduce the sum in the “Payment Notice” there shall be issued a “payless notice” (a withholding notice).
4. All this is to be put into effect before the “Final date of payment”.

The broad requirements of OGC

This is an overview of HMG as payment for services such as public procurement construction projects. The intention is that public bodies will pay main contracts within 10 working days and contractors will pay the subcontractor also in super fast time. This policy is rooted in the “Fair payment in Construction Initiative” launched by OGC in January 2008. It contained “recommendations” that all public construction clients and their principle contractors and their subcontractors, even sub sub contractors formally adopt the Principle of Fair Payment in all new contracts from 1st January 2008.

By Autumn 2008 these recommendations were supported by the department for Business Innovation and Skills (BIS) “Prompt Payment Code” designed to improve cash flow during challenging times at that date.

By late 2009 the recommendations and code had not had uniform adoption so it was announced in March 2010 that it would become mandatory for all government departments, agencies, non-departmental public bodies (and the bodies over which they have direct control) to include a contract condition in their contracts for works, goods or services requiring their contractors to pay their subcontractors within special time limits. The effect:

- The NEC contract shall include the principles set out in the fair payment charter
- The NEC contract shall provide KPI monitoring and reporting about payment periods and payment mode
- There be a 10 day payment pledge
- There is to be an obligation in the main contract that the fair payment period will be included in the subcontracts and promise in all subcontracts that the fair payment period will be in sub-subcontracts.

- The NEC contract be enabled to provide “Project Bank Accounts” and these be adopted in contracts “unless there are specific reasons not to do so”

NEC3 in detail

1. Is this construction project in the UK? If yes, then “Secondary option clause Y (UK) 2 applies. Currently it says HGCRA 1996 applies. That is correct until the new construction act comes into force (LDED&C 2009).
2. At Y2.2 it says the date on which payment becomes due is 7 days after the “assessment date”. That “due date” and the 7 days leading up to the due date agrees precisely with what the fair payment rules require. But the actual “Assessment Date” must hence forth be identified. The reason is that the same assessment date has to be captured not only for that reason but also as a key performance indicator (KPI) being secondary option clause x20 (KPI is explained below). Meanwhile, go to secondary option Z (the Z clauses are additional conditions of contract). They are explained at Page 40 of NEC 3 option A. They are to be written out in Page 50 “Contract provided by the employer.” Here the employer identifies
 1. The assessment date for each payment cycle shall be (e.g. last thursday in each month) for
 1. Tier 1 Main contract and same day for
 2. Tier 2 Sub contracts and same day for
 3. Tier 3 Sub sub contracts
 2. The “due date” shall be 7 days after the assessment date for all three tiers.
3. The last date for payment shall be for
 1. Tier 1 main contract 14 calendar days from the “Due Date”.
 2. Tier 2 subcontracts 19 calendar days from the “Due Date” in the main contract.
 3. Tier 3 Sub-subcontract 23 calendar days from the “Due Date” in the main contract.
4. Payment on or before the last date shall be via BACS electronic transfer.
5. And, Y(UK)2 shall apply viz.
 1. Notice of Payment in Y2.2
 2. Withholding/ Payless notice in Y2.3.

The main contractor promises in the main contract that he will insert the tier 2 payment periods into the subcontract and will require the subcontractor to insert into his tier 3 sub sub contracts the tier 3 payment periods. The Project Manager then checks this. See clause 26.3 NEC 3.

Note: the main contractor who obliges his subcontractors to give extended credit will be in breach of his main contract with the employer.

The KPI monitoring

The NEC X20 secondary option clause introduces the obligation on the Tier 1 main contractor to manage and monitor payment to all Tier 2 subcontractors so that it occurs within 19 days and Tier 3 so that it occurs within 23 days of the “Due Date” for payment in the lead contract between employer and main contractor Tier 1.

The fair payment rules do not allow an “incentive payment” to reward a contractor for paying his supply chain promptly. That means that taking a discount for payment “on time” is not allowed. It will be disapproved by the Project Manager under clause 26.3.

Specimen procurement and contract clauses - NEC contracts

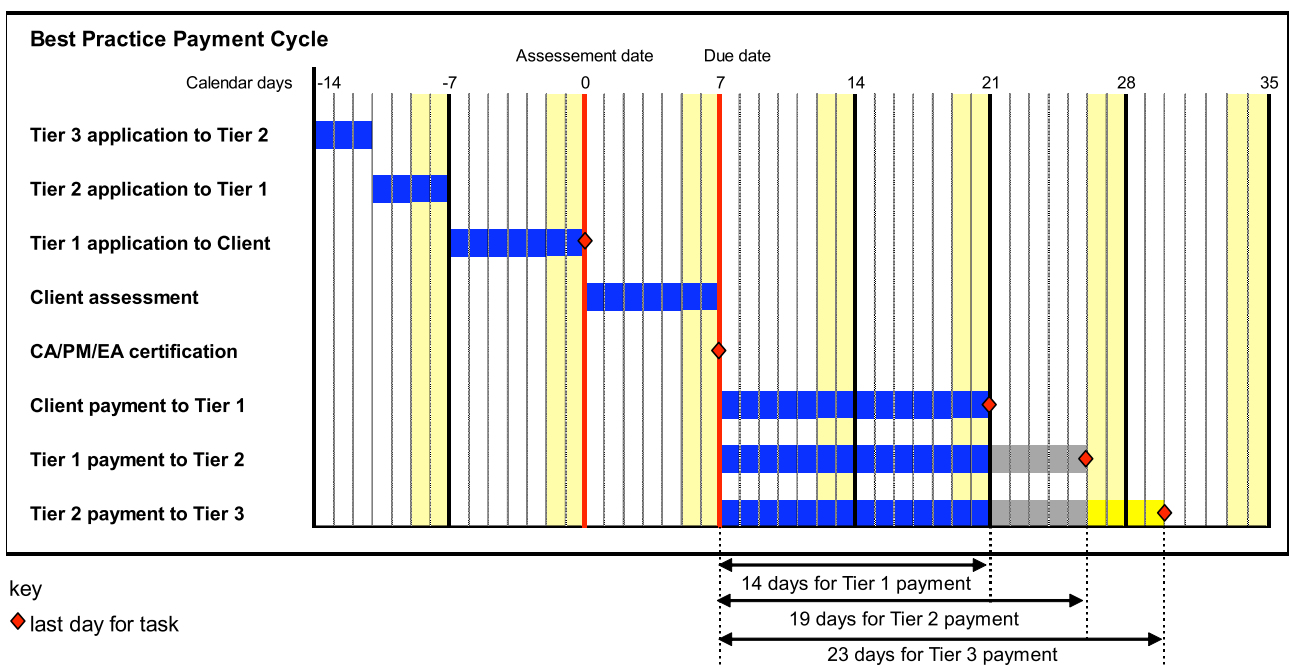
1.0 Secondary Option clause X12 or X20 Key Performance Indicator - Fair Payment

Key Performance Indicator	target	Incentive payment
Payment by the <i>Contractor</i> (Tier 1) is received by their Subcontractors (Tier 2) within 19 days and sub-subcontractors (Tier 3) within 23 days of the due date for payment (under the main contract between <i>Employer</i> and Tier 1 <i>Contractor</i>)	Tier 2 - 19 Calendar from the due date for payment Tier 3 - 23 Calendar from the due date for payment	£nil
Days are calendar days excluding Christmas Day, Good Friday and bank holidays.		

Under NEC the obligation as to obtaining the performance data rests with the Project Manager. The main contractor is to provide electronic details for the payments for subcontracts and sub-subcontracts. The simple questionnaire is to report:

- 1) Was an application for payment made by Tier 3, 2, 1
- 2) What is the assessment day/date
- 3) What is the common due date for payment
- 4) What payment was to be made?
- 5) What payless/ withholding notice was given
- 6) What sum was paid
- 7) Was it paid by the 14/19/23 day?

The Project Manager in this KPI duty is to be impartial. Reporting the KPI will influence the commercial relationship between the parties and confidence so as to reflect on trading.



Option 5 day payments where Project Bank Accounts are used

There is important enthusiasm to arrange a Project Bank Account (PBA). It will dramatically reduce the payment period down to Tier 3 to 5 calendar days! Note, this is not a pre-funding of the project by the client. The changes simply speed up the time it takes for payment to be made to the supply chain after certificate on the due date for payment.

In the standard NEC 3 system:

Employer payment is triggered by the assessment process and it takes 14 calendar days for payments to be processed and monies to be transferred into the PBA after the due date. It then takes a further 5 working days for payments to reach the recipients bank.

By introducing a number of simple changes to the payment process, this timescale could be reduced to 3 days from the due date

The process proposed is as follows:

1. Tier 1 are required to prepare an interim or milestone payment cashflow chart on all projects and update this monthly, 2 weeks prior to the next assessment date.
2. Payment of amount identified in the milestone payment cashflow chart is then processed for release into the PBA 14 calendar days before the assessment date in order that funds are available on the due date.
3. The assessment and certification process proceeds unaltered and the client certifies the actual milestone costs
4. The *Employer* and Tier 1 process the payment via the electronic banking and all recipients should receive payment within 3 days of the due date for payment. (assuming BACS)
5. If actual costs are lower than milestones costs, the surplus remains in the PBA and forms part of next milestone payment. If actual costs are higher than the milestone, the unpaid amount can either be paid separately or deferred and added to the next milestone
6. A simple reconciliation takes place monthly between the amount paid into the PBA and the certified sum.

Cashflow has always been a fundamental ingredient in construction works. These provisions help the industry to prosper and yield subsequent client benefits.

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