

## NEC4 – Clause 11.2(26) – Disallowed Cost (Options C, D & E)



### Understanding "Disallowed Cost" under Clause 11.2(26) in Option C of the NEC4 Engineering and Construction Contract

The NEC4 Engineering and Construction Contract (ECC) is a widely utilised framework in the construction industry, prized for its clarity, flexibility, and emphasis on collaboration. In Option C (Target Contract with Activity Schedule), "Disallowed Cost" under Clause 11.2(26) is a critical concept that refines the *Contractor's* cost reimbursement, ensuring only justifiable expenses are paid. This article explores the meaning of "Disallowed Cost" in Option C, its contractual significance, the clauses that govern its use, and relevant legal perspectives from court judgments in England, Scotland, and Northern Ireland. Legal insights are incorporated to provide practical and legal context.

### What is "Disallowed Cost" under Clause 11.2(26) in Option C?

Clause 11.2(26) of the NEC4 ECC defines "Disallowed Cost" for Option C as:

(26) Disallowed Cost is cost which

- is not justified by the *Contractor's* accounts and records,
- should not have been paid to a Subcontractor or supplier in accordance with its contract,
- was incurred only because the *Contractor* did not
  - follow an acceptance or procurement procedure stated in the Scope,
  - give an early warning which the contract required it to give or
  - give notification to the *Project Manager* of the preparation for and conduct of an adjudication or proceedings of a tribunal between the *Contractor* and a Subcontractor or supplier

and the cost of

- correcting Defects after Completion,
- correcting Defects caused by the *Contractor* not complying with a constraint on how it is to Provide the Works stated in the Scope,
- Plant and Materials not used to Provide the Works (after allowing for reasonable wastage) unless resulting from a change to the Scope,
- resources not used to Provide the Works (after allowing for reasonable availability and utilisation) or not taken away from the Working Areas when the *Project Manager* requested and
- preparation for and conduct of an adjudication, or payments to a member of the Dispute Avoidance Board or proceedings of the *tribunal* between the Parties.

In Option C, a target cost contract, the *Contractor* is reimbursed its "Defined Cost" (Clause 11.2(24)), actual costs per the Schedule of Cost Components (SCC), plus a Fee, with the final cost compared to the target (Activity Schedule Prices) for a pain/gain share (Clause 54). "Disallowed Cost" is subtracted from "Defined Cost," reducing the Price for Work Done to Date (PWDD, Clause 11.2(31)). It targets costs (pun intended!) deemed unjustifiable, inefficient, or non-compliant with contract procedures, such as inadequate records, failure to issue early warnings, or post-Completion Defect corrections. This mechanism encourages *Contractor* diligence and efficiency, aligning with NEC4's collaborative risk-sharing ethos by ensuring the *Client* does not bear "unreasonable" costs.

For options A & B there is no such definition of Disallowed Cost. As explained in previous articles, under Options A & B, the *Contractor* is being paid in accordance with the Activity Schedule or Bill of Quantities respectively, rather than being paid their justifiable costs.

As clauses 11.2(26) states, disallowed cost is costs which are;

*"not justified by the Contractor's accounts and records"*: If the *Contractor* cannot demonstrate that a cost has been incurred by providing satisfactory records such as invoices, etc, then cannot be reimbursed. This process provides a useful audit of the robustness of the

*Contractors* accounts processes in terms verifying and filing cost data. In this respect the accounts process of 3 stage approval is essential. The data is usually sample spot checked each period by the *Project Manager's* team. It is important to establish a manageable audit process from the outset.

*"should not have been paid to a Subcontractor or supplier in accordance with its contract"*: Any payments made to a Subcontractor which are not justified on an examination of the subcontract, would be disallowed. For example, the payment relates to unforeseen ground conditions but under the subcontract this is the Subcontractor's risk, e.g. under an amended NEC subcontract.

*"was incurred only because the Contractor did not follow an acceptance or procurement procedure stated in the Scope"*: For example, if there were processes identified within the Scope for procuring materials, that was not followed correctly, e.g. by a certain date to avoid increases in cost, any incurred cost increases could be disallowed.

*"was incurred only because the Contractor did not give an early warning which this contract required it to give"*: For example, further to Clause 63.7, if an early warning had not been given by the *Contractor* and the *Project Manager* was of the opinion that additional costs were incurred as a result, these costs could be disallowed. This is a good reason to remember to issue early warnings!

*"the cost of correcting Defects after Completion"*: Costs incurred correcting defects after Completion are disallowed. Therefore, costs incurred correcting defects BEFORE Completion are allowed. Consequently, and one of my goals when managing any Option C projects was, ensure that all defects are corrected before Completion. A defects free handover will never disappoint a client!

*"the cost of correcting Defects caused by the Contractor not complying with a constraint on how it is to Provide the Works stated in the Scope"*: For example, if there were specific constraints identified in the Scope on how surfaces should be treated or protected during curing, etc, and the Contractor did not follow same, any costs incurred addressing or correcting that issue would be disallowed.

*"the cost of Plant and Materials not used to Provide the Works (after allowing for reasonable wastage) unless resulting from a change to the Scope"*: This to ensure that the *Contractor* minimises material waste. Large material volumes should be monitored almost daily, e.g. Stone & Concrete volumes on a Windfarm project. This is a good opportunity to use your KPIs and Lean Tools!

*"the cost of resources not used to Provide the Works (after allowing for reasonable availability and utilisation) or not taken away from the Working Areas when the Project Manager requested"*: for example, to prevent the Contractor merely using the Site as a "car park" for

his Equipment and expecting to be paid for it, as I have had a lot of experience of! Trackers on excavators, etc can be useful to demonstrate or defend this.

### **Clauses Relevant to "Disallowed Cost" in Option C**

Several clauses in the NEC4 ECC interact with Clause 11.2(26) in Option C, governing its application:

#### **1. Clause 11.2(24) – Defined Cost**

- "Defined Cost" is effectively the SCC cost minus "Disallowed Cost," forming the basis for PWDD. Clause 11.2(24) directly shapes what qualifies as reimbursable.

#### **2. Clause 50.3 – Assessing the Amount Due**

- The PWDD is the forecast "Defined Cost" (less "Disallowed Cost") plus Fee. The *Project Manager's* role in identifying "Disallowed Cost" under Clause 11.2(26) ensures payments reflect compliant costs.

#### **3. Clause 15.1 – Early Warning**

- Costs incurred due to not giving an early warning are disallowed, incentivising proactive risk notification to mitigate impacts on cost, time, or quality.

#### **4. Clause 52.2 – Keeping Records**

- The *Contractor* must maintain detailed accounts and records (e.g., payroll, invoices) for "Defined Cost." Clause 11.2(26) disallows costs not substantiated by these, emphasising record-keeping rigor.

#### **5. Clause 63.1 – Assessing Compensation Events**

- Changes to Prices use "Defined Cost" plus Fee, with "Disallowed Cost" exclusions (e.g., inefficient resources) ensuring fair adjustments based on SCC.

#### **6. Clause 54 – The *Contractor's* Share**

- The final PWDD (including "Disallowed Cost" deductions) versus the target determines the pain/gain share. "Disallowed Cost" reduces *Contractor* reimbursement and affects share calculations.

#### **7. Clause 46 – Uncorrected Defects**

- Costs of correcting Defects after Completion are disallowed, shifting post-Completion risk to the *Contractor* unless *Client*-caused (Clause 80.1).

## Legal Insights

"NEC Contracts: How Not To Amend Them" (July 2, 2017) warns that Z clauses expanding "Disallowed Cost" (e.g., "not properly incurred") can disrupt Option C's pain/gain balance, shifting risk unfairly. "Understanding Defined Cost in NEC3 ECC and Its Simplification in NEC4 ECC" (November 9, 2021) notes NEC4's removal of "*Project Manager* decides" from Clause 11.2(26), making disallowance objective, not discretionary, enhancing clarity. "Disallowed Cost and the Cost of Subcontractor Disputes in NEC4 ECC" (January 30, 2023) (attached) highlights the new disallowance for unreported Subcontractor adjudications, encouraging proactive notification to avoid cost rejection.

## Practical Implications

"Disallowed Cost" under Clause 11.2(26) in Option C ensures the *Contractor's* reimbursement reflects efficient, compliant performance, requiring robust records (Clause 52.2) and early warnings (Clause 15.1) to avoid deductions. *Contractors* must train teams to understand disallowable categories (e.g., unused resources, post-Completion Defects) to maximise payment. *Clients* gain cost control, but overzealous disallowance risks disputes, as courts favour evidence-based assessments.

## Conclusion

Clause 11.2(26) defines "Disallowed Cost" as a filter for Option C's cost-reimbursable framework, supported by clauses like 11.2(24), 50.3, and 63.7, ensuring only justifiable costs impact the pain/gain share. For Option C users, mastering "Disallowed Cost" enhances financial discipline, dispute avoidance, and project success, aligning with NEC4's proactive and cooperative principles.

*If you have any further questions or need more detailed information about the article, feel free to ask!*



## Key Points

- In **NEC3 ECC**, disallowed cost includes all costs of preparing for and conducting adjudications and tribunals.
- **NEC4 ECC** clarifies this as costs for disputes between the parties.
- Costs for disputes between contractors and their suppliers can be allowed provided the project manager had been notified.
- But clients, project managers and contractors all need to take a proactive and pragmatic approach to reducing the costs of such disputes.

NEC3 ECC clause 11.2(25) states, 'Disallowed Cost is... ..the cost of preparation for and conduct of an adjudication or proceedings of the *tribunal*.'

Project managers and contractors had differing interpretations of what this clause covered, with some considering it included adjudication with subcontractors too.

Nothing limits it to disputes between the parties, except that the '*tribunal*' is identified in the contract data. At the time, Thomas (2012) in *Keating on NEC3* noted this was a new but probably unnecessary provision introduced in NEC3.

The issues, including a dispute about a dispute on a major infrastructure project, were reflected on by the NEC drafting team and the clause was amended for the NEC4 ECC in 2017. NEC4 ECC clause 11.2(26) currently states,

'Disallowed Cost is cost which

- was incurred only because the *Contractor* did not
  - give notification to the *Project Manager* of the preparation for and conduct of an adjudication or proceedings of a tribunal between the *Contractor* and a Subcontractor or supplier

and the cost of

- preparation for and conduct of an adjudication, payments to a member of the Dispute Avoidance Board or proceedings of the *tribunal* between the Parties.'

The second part of this amendment has certainly clarified the position insofar as it clearly now only deals with disputes between the parties. Therefore, it can be concluded the costs incurred in disputes with subcontractors should escape disallowed cost. But it is not quite as simple as that.

## Challenges for contractors

The addition of the first new sub-clause suggests that certain costs associated with adjudications and tribunals with subcontractors or suppliers can now be disallowed but only under certain circumstances. The new clause is intended to encourage the contractor to make the project manager aware of disputes and issues at lower levels of the supply chain. The intent is supported by Gerrard (2017), in which he states, 'This

gives the project manager an opportunity to attempt to resolve the issue on behalf of the client’.

So, if the adjudication or tribunal costs could have been mitigated by notifying the project manager of the dispute, they will be disallowed. If notification is not given, the project manager must assess the extent of disallowed cost as a direct result of a failure to notify. This is quite a rigid test, and it might be an unenviable job demonstrating that the adjudication or some part of the dispute could have been avoided if the contractor had notified the project manager of its existence.

Thomas (2022) picked up on the lack of any express obligation to notify. However, under clause 15.1 on early warnings, he noted the contractor would be obliged to do so if the anticipated adjudication or tribunal could delay completion or meeting a key date. This is equally applicable in the NEC4 Engineering and Construction Subcontract (ECS), with subcontractors having to notify the contractor about any potential disputes with sub-subcontractors or suppliers and the disallowed cost provision working in the same way.

Also, there is limited guidance on how to operate the additional disallowed cost clause, which may lead to subjectivity and differences of opinion. Thomas (2022) notes the assessment of the extent of disallowed cost and its proximity to the failure to notify ‘may be difficult to show in practice’.

Challenges may also arise from quantifying the costs incurred and what should be disallowed. It should be easy to identify adjudicator fees, legal costs and dispute consultant costs, but it may be more difficult to identify a thickening of project team resources or existing project team members contributing to the preparation and conduct of the dispute.

## **Challenges for clients**

Certainly in a cost-reimbursable contract, funding a contractor’s dispute can be beneficial to the client, such as resulting in a lower assessment of a subcontractor’s

compensation event. In this scenario, it appears logically and morally right to reimburse the costs subject to the contractor taking a reasonable position in the dispute.

However, Rowlinson (2019) warns it is in the client's interest to ensure that the money spent does not exceed the benefit it receives in the form of a reduced defined cost. In this scenario, getting a proactive project manager involved who understands the implication of the contractor losing the adjudication or tribunal will mean that the client may incur both the sum in dispute and the preparation costs may help the parties avoid the dispute altogether.

As Waterhouse (2021) states, 'the considerable expense of adjudication, arbitration or litigation often exceeds the costs of a sensible compromise'. This is undoubtedly the intent of the drafting, stimulating good management and hopefully mitigating protracted disputes and the associated costs wherever possible.

Nazzini and Kalisz (2023) note that 'smash-and-grab' is now the most common form of claim adjudicated in the UK. So, in a situation where the contractor has failed to issue a valid payment or pay less notice to a subcontractor, should clients stump up the bill if the defence is on shaky ground? In such cases it does not feel logically or morally right, and it is unlikely the project manager will be able to contribute much to mitigate that type of dispute.

Adjudication can be a costly process: professionals involved may include barristers, solicitors, claim consultants, quantity surveyors, forensic planners, expert witnesses, and the project team. If such costs are allowable, this might encourage a contractor to launch a 'kitchen sink' defence where otherwise it may be more minded to settle using a cheaper form of alternative dispute resolution, noting the client's obligation to pay these costs may be lessened by any pain share apportionment under a target price form of contract depending on individual project performance. This does little to promote the mutual trust and co-operation which underpins NEC.

Clients should also be very wary of the continuing escalation of cost when a contractor loses an adjudication and wishes to take the matter to a tribunal given the potentially high legal costs inevitably involved.

# Conclusion and recommendations

Clause 11.2(26) puts the onus on NEC4 ECC project managers to prove that adjudication and tribunal costs for disputes between contractors and their subcontractors and suppliers could have been avoided if they had been notified about the situation.

For contractors and subcontractors alike, it will be important to ensure compliant notifications are provided to avoid another potential dispute between the parties, for which it can be said with clarity, the preparation of an adjudication will be a disallowed cost.

Although the intent of the additional disallowed cost clause in NEC4 ECC is clear, meaning users are in a better position, the practical application still presents challenges. The parties should be aware of this amended disallowed cost provision, how they intend to use it, and the behaviour it is trying to encourage.

Whether you are the client, project manager, contractor or subcontractor, a proactive and pragmatic attitude to managing and mitigating project disputes will help keep the costs for all to a minimum.

## References

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