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Insights

JCT TARGET COST CONTRACT, 2024 EDITION: FIRST IMPRESSIONS

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SUMMARY

In this Insight, first published in PLC, Partner Shy Jackson considers the JCT's Target Cost Contract, 2024 Edition (TCC 2024), a new addition to its 2024 Edition contract suite that reflects the wider industry trend towards collaborative contracting. Thr article explores how the TCC 2024, based on the JCT Design and Build Contract 2024 (DB 2024), seeks to align the commercial interests of employers and contractors through the target cost mechanism. It examines the key new concepts of Allowable Cost, the Contract Fee, and the Adjusted Target Cost and how these elements combine to calculate the Difference Share, the pain/gain mechanism that incentivises collaboration and cost efficiency. It explores the various choices parties must make regarding the contract's operation, such as the timing of the Difference Share calculation and the potential use of the associated Target Cost Sub-Contract, 2024 Edition (TCCSub 2024) and highlights the practical implications for parties, such as the need for open-book accounting and robust record-keeping. Further, it contrasts the TCC 2024 with the equivalent target cost option under the NEC suite of contracts.

The rise in the use of collaborative contracting is an international trend, reflected by the UK government's Construction Playbook as well as the soon to be launched FIDIC collaborative form of contract, building on the increasing use of the NEC suite of contracts. Collaboration used to refer to various types of arrangements, but there is a recognition that collaboration works best where there is an alignment of commercial interests or, in other words, the contractor (and the employer) has a financial incentive to collaborate.

TARGET COST CONTRACT, 2024 EDITION

This is the context for the recent publication by the Joint Contracts Tribunal (JCT) of its new Target Cost family of contracts (TCC 2024). In its introductory note, the JCT states that:

> *"The ethos of this form is risk sharing. This conceptually is apposite for the current difficult marketplace. The parties can both benefit from their joint efforts in ensuring the project has a*

successful financial outcome."

This will be a familiar concept for anyone who uses NEC4, where Options C and D of the ECC form of contract (as well as other forms of contract within the NEC suite) provide a target cost option. That form (NEC4) has been used on major projects and provides a useful comparison to the TCC 2024. For parties not familiar with NEC4, it should be noted that the TCC 2024 is based on the JCT's Design and Build Contract, 2024 Edition (DB 2024) and is aimed at larger projects, both private and public sector, where the contractor is required to complete the design as well as carry out the works.

In simple terms, the main difference from DB 2024 is in the allocation of risk where the aim of TCC 2024 is to align the parties' commercial interests so that they have an incentive to collaborate in improving delivery and reducing the cost of the works. This operates on the basis that the contractor is paid its actual costs plus a fee that is then compared to a target cost, which is adjusted in the same way as the Contract Sum is adjusted under DB 2024. If there are savings, these are shared between the parties and similarly, any overspend is also shared.

This is commonly known as the pain/gain share and is best explained by using examples and contrasting it with the position under DB 2024. By way of example, under DB 2024 the contactor retains any savings it can achieve through its design process or supply chain procurement and the employer has no incentive to cooperate in achieving such savings. Under a target cost contract, the employer receives a share of any such savings and is therefore more willing to agree to a different design or materials. Where the employer instructs a "change", under a target cost contract the value may be agreed ahead of carrying out the change and both parties benefit if that can be undertaken for a lower cost. In terms of risk sharing, where the actual costs are higher than expected because productivity is less than expected or a supplier or sub-contractor goes into insolvency, that will usually be a shared risk with both parties having an incentive to reduce the impact of such an event by collaborating to find the most efficient solution.

This is therefore undertaken by comparing the actual cost of the works, plus a fee (to represent overhead and profit) against the target cost as adjusted for employer's risks or changes. Any savings or overspend are shared in pre-agreed proportions. How this mechanism is implemented can be quite complex, and this article considers how these elements are reflected in the TCC 2024.

ALLOWABLE COST - THE BASIS FOR PAYMENT DURING THE WORKS

During the course of the works, payment is based on actual cost plus a fee. This is set out in article 3 and clause 4.4 of TCC 2024 and is based on three elements:

- Allowable Cost.
- Contract Fee.
- Any sum payable in respect of the Difference Share.

The Allowable Cost and Contract Fee are the equivalent of the Price for Work Done to Date under NEC4.

Allowable Cost

Allowable Cost (Defined Cost under NEC4) is set out in clause 4.5, which refers to the detailed provisions contained in schedule 2 (which itself comprises seven parts). While the principle is that payment is based on the actual cost incurred by the contractor, there is an option to use lump sums, all in rates or maximum amounts, which are identified in the Contract Particulars (and deemed to be the actual cost). The Target Cost Contract Guide 2024 (TCC/G 2024) explains that this simplifies the calculation of Allowable Cost and requires less administration. However, by moving away from actual cost and using a fixed price approach or a cap where maximum amounts are listed, this detracts from the incentive to collaborate.

Allowable Cost is made up of the following elements:

- Sub-Contract work, addressed in part 2. This refers to any costs which are due and payable under sub-contracts, but costs which are due to contractor default are excluded. This is a wide term and the Court of Appeal decision in ABC v Network Rail [2020] EWCA Civ 1645, which concerned an Infrastructure Conditions of Contract (ICC) target cost contract, shows how using the term "default" can result in more risk being allocated to the contractor.

- Contractor's management and design staff, addressed in part 3. The contractor is expected to provide a list of directly employed management and design staff, including the relevant terms and conditions of employment, as payments in respect of salaries and items such as bonuses and contributions to pension scheme are Allowable Costs. This will require substantial disclosure by the contractor of information that would be regarded as confidential and subject to data protection obligations. In addition, issues may arise in relation to bonuses that are allocated on an annual basis when an employee has only spent part of it on a project; similarly, where pension contributions relate to a longer period than the time an employee has spent on site. Overall, payments must be in accordance with a company's "normal terms and conditions of employment". However, that may not be easy to ascertain for large companies that are unlikely to have a uniform set of such terms.

- Contractor's direct workforce, addressed in part 4. This refers to other staff, based on numbers and trades so they are not identified individually. However, it is also necessary to identify the relevant terms and conditions of employment and payment, including salaries and other items, as for management and design staff. The employer's authorisation is needed for out of hours working, which is paid at basic rates with percentage additions and is deemed to include bonuses and similar allowances. This seems likely to result in complex calculations when such staff are paid for working out of hours.

- Materials and goods, addressed in part 5. This is based on actual costs, net of any trade discounts, or current market prices that were provided by the contractor.
- Plant, services and consumable stores, addressed in part 6. This is based on net prices, or, where owned by the contractor or its parent or associated company, on agreed rates or rates not exceeding market rates where there is no such agreement.
- Sundry costs, addressed in part 7. This is a catch all provision, listing items such as charges incurred in respect of Statutory Providers or utilities, postage or courier charges for correspondence sent from site, costs of preparing Acceleration Quotations and costs of progress photographs. This also covers any payments for exercising the statutory right to suspend under clause 4.15, due to the employer's failure to make payment.

All of the above costs must be reasonably and properly incurred otherwise they will not be recoverable. In addition, while NEC4 has a concept known as disallowed costs, the TCC 2024 does not have such a separate concept. The same result is achieved by excluding certain items in parts 2 to 7 of schedule 2 as noted above as well as excluding the following costs from Allowable Cost:

- Costs which cannot be reasonably substantiated by the contractor's accounts and records. This is similar to the NEC provisions and highlights the need to have full and accurate cost records.
- Costs of remedying defects in the rectification period, as well as the cost of making good defects, shrinkages and other faults that become apparent or are notified by the employer before practical completion. Under NEC4 only the cost of remedying defects after completion is disallowed, while under TCC 2024 the contractor bears the risk of remedying defects during the course of the works, an amendment sometimes made to NEC4.
- Costs incurred by the contactor due to failure to comply with clauses 3.3 and 3.4 (and Supplemental Provision 1 where it applies). This refers to a breach of the requirements that apply to sub-contracting, which are similar to the equivalent provisions under DB 2024.
- Costs incurred in the preparation or conduct of adjudication or other legal proceedings. This makes it clear that such costs are irrecoverable as Allowable Cost, but a court still has its discretionary power to award certain costs in court proceedings (and the same will apply in arbitration).
- For any period of default in completion after the relevant Completion Date, costs are limited to amounts applicable directly before the Completion Date or, if less, the actual amount. This appears to limit recovery during any period of culpable delay, presumably to stop the contractor recovering any more than what is referred to as the "actual amount" or, at most, at rates applicable at the Completion Date. How this will be applied in practice remains to be seen.

- Discounts received by the contractor or other payments or credits received by the contractor. This is simply intended to ensure the employer shares the benefit of such discounts, but issues could arise where there is a single annual discount which relates to several projects and where some apportionment may be required.

As this makes clear, the ascertainment of Allowable Cost must be based on open book accounting. Paragraph 1.3 of schedule 2 sets out the requirements in respect of record keeping and the rights of the employer and employer's agent to inspect and request such records. This is something both parties will need to allow for, with contractors having to implement good record keeping systems and employers, or in most cases the employer's agent, being able to verify such costs as required. Keeping good records has always been essential and good practice, and this is all the more so in a target cost contract.

In projects using the NEC form of contract this has sometimes resulted in external companies being appointed to undertake a cost audit to verify any costs claimed and while this should be carried out by the employer's agent, it is possible that similar services will be offered in projects using the TCC 2024. Indeed, paragraph 1.3.3 refers expressly to "an appropriately qualified person authorised by the Employer" undertaking the audit.

Contract Fee

The Contract Fee is intended to generally represent the overhead and profit element that is not captured in the Allowable Cost element. While NEC provides for this to be expressed as a percentage, so that it reflects the level of cost incurred, JCT provides two options: a percentage fee or a fixed sum. Where the Contract Fee is fixed, it is adjusted (unless otherwise stated) to take into account the difference between the original Target Cost and the final Adjusted Target Cost, based on a pre-agreed percentage-based threshold, calculated in accordance with a formula set out in schedule 3. If the parties don't agree the percentage threshold, the default position is zero percent, which means that the Contract Fee is adjusted based on the same proportion as the Target Cost adjustment.

TCC/G 2024 does not comment on when a fixed sum should be used as opposed to a percentage. It is not clear what benefit there is in using a fixed sum or why this second option is needed, albeit this could be used to limit the Contract Fee payable to the contractor. In addition, where this is applied to interim payments, the Contract Fee must be apportioned every month. Using a percentage fee is likely to be much simpler in practice.

Bearing in mind that the definition of the Contract Fee (clause 1.1) makes it clear it is intended to cover all costs and expenses not covered by the Allowable Cost, agreeing the Contract Fee will be a key commercial issue in any contract negotiation.

ADJUSTING THE TARGET COST

The Target Cost (the Total of the Prices under NEC4) is set out in article 2, replacing the "Contract Sum" under DB 2024. It is adjusted in accordance with the contract conditions and is referred to as the Adjusted Target Cost. TCC 2024 also requires a Target Cost Analysis to be provided (which is used to determine the Adjusted Target Cost Value of Work Completed under clause 4.16.1).

The basis for adjustment can be found in schedule 1. Paragraph 1 lists the circumstances that allow for adjustment, as well as a catch all provision in paragraph 1.1.8. This is the equivalent of the list of compensation events in the NEC suite, but these matters are identified in TCC 2024 by cross referencing to other parts of the contract. The two main areas for adjustment are "changes" and "loss and expense".

In respect of changes, part 2 of schedule 1 sets out the methodology for assessing the value of changes, which is based on the standard JCT approach. It refers to measurable work, day work and change of conditions.

Part 3 of schedule 1 deals with loss and expense. Paragraphs 3.1 and 3.2 of schedule 1 are the equivalent of clauses 4.19 and 4.20 of DB 2024 and operate in the same way. Paragraph 3.3 deals with Relevant Matters, mirroring clause 4.21 of DB 2024. The same arguments as to whether the notification obligations amount to a condition precedent to recovery will therefore also apply to TCC 2024.

The process for the employer to notify and ascertain loss and expense is similar to DB 2024; within 28 days of receipt of the initial assessment and 14 days of each subsequent update. This means loss and expense claims are unlikely to be resolved within the monthly payment cycle, which means the Target Cost could lag behind the Allowable Cost and result in a deduction based on the Difference Share. Supplemental Provision 3 (loss and expense – contractor's estimates) modifies part 3 of schedule 1 where an amount in respect of loss and/or expense is to be added to the Target Cost. It sets out a procedure for estimates of the addition to the Target Cost to be issued by the contractor when it submits its interim payment application, which the employer may accept, chose to negotiate or apply paragraphs 3.1 and 3.2 of schedule 1. Where an estimate is accepted or agreed, the amount is added to the Target Cost and no further adjustment is made. This seems similar to the prospective assessment under NEC contracts which is not subsequently changed based on the actual costs incurred and therefore in effect provides a mini Target Cost against which a saving can be achieved. Paragraph 3.6 of Supplemental Provision 3 sets a sanction for non-compliance, which is assessment under paragraphs 3.1 and 3.2 of schedule 1.

Experience with NEC4 has shown that it is important to ensure that the Target Cost is realistic and to avoid a situation where due to commercial pressure the Target Cost is set too low. This would mean that a pain share would be present from the very start, which may focus attention on seeking ways to adjust the Target Cost, rather than creating the collaborative environment that target cost contracting seeks to achieve. This is not dissimilar to the risk of agreeing an unrealistic Contract

Sum under DB 2024. Therefore, an employer using TCC 2024 equally needs to consider in detail any tenders received.

Once the works commence, parties to a TCC 2024 will need to recognise that adjustments to the Target Cost are a separate process that operates in parallel to the ascertainment of Allowable Cost, which is the basis for payment. Both will need to recognise that the actual payments made will be subject to the Difference Share calculation following completion and possibly during the works. This makes it more complex for both parties to identify the true costs of the works, but parties should not lose sight of the purpose of this mechanism, which is to provide an incentive for better delivery and collaboration.

CALCULATING THE DIFFERENCE SHARE

The Difference Share (the Contractor's Share under NEC4) determines how any savings, or overspend, are shared between the parties. That is what is commonly referred to as the pain/gain share and the aim is for the parties to collaborate to avoid overspend and a "pain" and increase savings and therefore "gain". It is necessary to agree in advance how the parties' shares will be allocated and when this calculation will take place.

Allocating the Difference Share

As with the Contract Fee, under TCC 2024 it is possible to allocate the Difference Share by using bands that are based on percentages or fixed amounts. The former is more flexible and will ensure consistency as the Target Cost is adjusted, while agreeing fixed amounts for the bands may result in the risk allocation changing where costs increase.

In addition to agreeing the bands, it is necessary to agree the employer's and contractor's respective percentages that are applied in any band. It is therefore possible to agree different percentages for each band. Helpfully, however, TCC 2024 states that where no percentages are stated the percentage is 50/50. Such a split is appropriate where the parties want to share risk equally and avoids more complex graduated allocations or agreeing that one party is allocated 100%, which would bring the contract closer to a fixed lump sum contract. That makes it easier for both parties to identify the Difference Share that may apply at any given time, recognising that the Allowable Cost and Target Cost will fluctuate as the works progress.

When to apply the Difference Share

As to when the Difference Share is applied, again TCC 2024 provides a choice. Like NEC4, the Difference Share is calculated and applied on completion (or termination) once the full costs are known and the Adjusted Target Cost is known. This is done under clause 4.7.2 by comparing the sum of the Allowable Cost and Contract Fee with the Adjusted Target Cost and applying the agreed allocation. In terms of timing, this is calculated following practical completion as part of the Final Statement under clause 4.21.2.4.

In addition, it is also possible to provide for the Difference Share to be calculated and applied on a monthly basis as part of each interim payment by choosing to apply clause 4.7.1 (which applies as a default). This is done by comparing the Adjusted Target Cost Value of Work Completed (which is a proportion of the Adjusted Target Cost based on the value of work calculated by reference to the Target Cost Analysis) against the sum of the Allowable Cost and an instalment of the Contract Fee (which is based on either the percentage or a proportion of the agreed amount). Unless the Adjusted Target Cost closely tracks the Allowable Cost, this is likely to result in a further sum being paid every month by either party.

The application of the pain/gain share as part of the valuation cycle is an amendment that is sometimes added to NEC4 and is how this is undertaken under the ICC Target Cost Version, June 2018. It is seen as a way to avoid a large payment from either party following completion, which could result in a negative Final Payment if there is a large overspend. In addition, by providing for a gain share to be paid early, as opposed to after practical completion, this could be seen as improving cash flow. However, for this mechanism to operate as intended, it is necessary to ensure that the adjustment of the Target Cost is done contemporaneously, so it does not lag behind the value of the work undertaken, as this would result in a reduced payment to the contractor. All the more, where such adjustment is based on, for example, ascertaining loss and expense where the employer is required to respond within 28 days but may take longer.

The benefit of only applying the Difference Share following practical completion is that there is less pressure to seek adjustment to the Target Cost during the course of the works, which could distract from the aim of focusing on better delivery and increase the potential for disputes. This also reflects the fact that the overall saving or overspend could change during the course of the works, so looking only at the final outcome is more consistent with the aim of collaborating throughout the project for better delivery. This is something the parties will need to consider but the fact that the default option is for the Difference Share to be calculated and applied to each interim payment means that this is likely to be regarded as the standard approach.

TARGET COST SUB-CONTRACT

In its note introducing TCC 2024, the JCT acknowledged that the target cost basis may not always be suitable for use at second tier and therefore it is also possible to use the Target Cost Sub-Contract, 2024 Edition (TCCSub 2024) with or without sub-contractor design and as a lump sum or remeasurement contract. This is reflected in clause 3.4 of TCC 2024 which states that TCCSub 2024 should be used "[w]here considered appropriate".

In practice, the nature of such a contract and the added complexity of its provisions means that it may only be appropriate for use with the key sub-contract packages where there is a potential for collaboration resulting in savings, especially where there is a design element or the sub-contractor is delivering specialist elements such as the cladding system.

Where TCCSub 2024 is used, this will introduce the issues and considerations identified above into the sub-contract and even if the contractor is only using TCCSub 2024 for a small number of suppliers, this will need to be managed carefully. As TCC/G 2024 confirms, the Allowable Cost is based on what is due to the sub-contractors and this would bring the sub-contract pain/gain calculation into the calculation of the Allowable Cost under the main contract. This in turn will affect the Difference Share, so the contractor may in effect share the benefits of any savings with the relevant sub-contractor. Similarly, a sub-contractor may be liable for a pain share that would form part of the contractor's pain share. In the latter example, the impact on cash flow may not be straightforward to identify and one can see the complexity that will result when using a target cost contract at first and second tier.

While the NEC4 suite of contracts also provides a target cost option for the sub-contract terms, those type of issues mean that in practice it is common to see fixed lump sum contracts used at second tier. Experience will show whether contractors are willing to manage the target cost mechanism under the main contract as well as with their supply chain.

FINAL THOUGHTS

For users of JCT, a target cost contract is unchartered territory. As noted above, the approach to risk and ultimately payment is on a very different basis from the traditional fixed price approach parties have been used to operating under DB 2024. In addition to accepting the underlying principle of a target cost contract, TCC 2024 requires parties to make a number of choices as to how this will operate in practice. For example, choosing how to express the Contract Fee or the bands used for the Difference Share, as well as whether the Difference Share is calculated after completion or as part of the interim payment process. This brings to mind the paradox of choice, which suggests that an abundance of choice could become a problem and result in no choice being made.

In addition, regardless of the mechanism chosen, Allowable Cost means an open book approach, which requires contractors to keep good records but the employer equally needs to ensure that such costs are properly verified. The provision allowing the employer to carry out cost audits and require explanations of costs is a new provision which does not appear in DB 2024.

Nonetheless, at the very least, TCC 2024 is useful in making parties recognise that there are other options available and highlighting the need for commercial incentives to be used to encourage collaboration. In that regard, it is important to recognise that collaboration and risk sharing are not precise terms and different people understand them differently. JCT represents one way of approaching collaboration and this is also reinforced by the introduction of new article 3 (collaborative working) into the JCT 2024 suite of contracts.;

Collaboration, however, also relies on open communications and pro-active risk management and parties will also need to consider how that can be introduced and encouraged. As with any collaborative contract, it is not sufficient to just sign up to such a contract, it is also necessary to operate it with a different mindset.

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Shy Jackson

London

shy.jackson@bclplaw.com
+44 (0) 20 3400 4998
