Commercial Awareness

Housing & Maintenance

July 2021

Commercial Awareness

This course covers 6 key areas:

1. Contract Awareness – risks and opportunities
2. Pricing Models
3. Understanding your costs
4. Understanding margins, overheads and profit
5. Procurement
6. Record Keeping
7. Payment Terms

Contractual Awareness

A key element of being commercially aware is first being contractually aware!

Maintenance and construction contracts come in many standard and bespoke forms. Clients will often choose a standard form that best suits the type and duration of works being undertaken, their experience and working knowledge.

Terms specific to the clients requirements will be incorporated within these standard forms of contract.

Unless otherwise amended the form of contract, and its core clauses, will dictate how the contract is to be administered, particularly around issues of the Specification, Variations, Extensions of Time, Disputes, Valuations and Payment.

The ACA and JCT forms of contracts are typically used in maintenance and refurbishment works

Contractual Awareness

A key element of being commercially aware is understanding the contract!

Generally a contract will contain some form of time, specification, scope of works, inclusions and/or exclusions, obligations and requirements on one or both parties.

In addition contracts may stipulate that one or both of the parties act in accordance with regulations, British standard, and ensure statutory compliance (even if that changes during the contract).

- ***It is therefore really important to read and understand the requirements of a contract.***

When reading a contract, you can then consider all the possible cost and value implications.

For example:

- What is the aim of the contract, what are the expectations other the other party. What have they agreed to pay or be paid?
- The scope and specification – what will you do, and how will you do it?
- Time / Programme – how long will it take you, what is the sequence of events?
- ***By understanding the contract you will start to gauge the commercial risks and opportunities***

Contractual Awareness

Key terms to be aware of:

- Company names – Ensure the contract is with the correct company & registered address (check Companies House if unsure)
- Contract Date – Check the date of the contract, this is when it takes effect
- Scope, Specification, Pricing, Numbered/Referenced Documents
- Term – When does the contract terminate? Extension clauses?
- Defects Liability Period & Retention
- Design Liability – Who's specifying the work?
- Insurances – PL, EL, PI
- Parent Company Guarantees, Performance bonds
- Penalties, LADs
- Payment Terms

Standard clauses are often amended so check all the documents!

Contractual Awareness

Design & Specification

Design and Specification

There are to two types of specification:

Prescriptive Specification Design risk 0%

Performance Specification Design Risk 100%

Example:

- Prescriptive Specification

Facing brickwork; 215mm (one brick think) in stretcher Bond; use Ibstock red engineered bricks; laid with Cement mortar 1:3 with bucket handle pointing to one side against batter earth.

- Performance Specification

Construct a retaining wall to retain the bank and associated change in ground levels.

Pricing Models

A key element of being commercially aware is understanding your price!

Only by understanding your pricing can you be sure of what its for, what's not included, and where further risks or opportunities may present themselves.

Maintenance contracts are priced in a variety of ways. Some are purposely designed to assist one party or another, some allow a lot of flexibility while others are constrained. All pose differing risks and differing opportunities for both parties.

Below are some of the typical pricing models used in housing maintenance contracts:

- **Fixed Price Contracts (e.g. Price Per Property)** – Often used to provide clients with cost certainty. Can pose significant risk if priced too low or volumes are higher than anticipated. Can provide great opportunity if the volume of work is less than anticipated. Encourages contractors focus on cost control and to do less rather than more.

- **Re-measurable contracts (e.g. Schedule of Rates)** – Often used where the scope of the works is unknown and needs measuring while in progress. Often used in conjunction with nationally recognized rates for benchmarking purposes. Provides certainty to contractors of recovery against all tasks undertaken (subject to contract adjustments).

- **Open Book / Cost Plus /Cost Reimbursable** – Often used in collaborative contracts where the client accepts risk of the outturn cost. Provides no risk on the contractor who is assured of overhead and profit recovery.

- **Agreed Maximum Price (AMP)** – re-measurable up to a ceiling maximum price. Often used where the scope of works is unknown but has budgetary restrictions.

- **'Basket Rates' / Composite Rates** – Fixed pricing for repetitive works which include risk and reward e.g. kitchen renewals, external decorations.

Pricing Models

Contracts may also include other forms of payment. Typically these may be linked the actual performance in delivering the contract to incentive or penalize either party.

Examples may include:

- Liquidated Ascertained Damages (LAD'S) – These are effectively the additional costs or loss of revenue the client will incur as a direct of the contractor's delay in completing the works. These should be fixed sums (typically per day, week or month) stated within the contract. These should be reasonable but the client does not have to justify these.
    - LADs can be avoided where a valid Extension of Time (EOT) is granted. As examples, an EOT may be granted where additional works have been instructed that can not be completed within the agreed timescale, failure by a 'nominated' sub-contractor or force majeure ('an act of god').
- Penalties – Often linked to the performance of the contract. Often against specific event failures or Key Performance Indicators (KPI's) stipulated in the contract.
- Bonus – Also often linked to the performance of the contract. Often against Key Performance Indicators (KPI's) stipulated in the contract.
- Variable Profit – This may be a proportion of the specified profit sum within the contract that is 'ring-fenced' outside of the pricing model that is only payable on the delivery of key tasks or achieving key performance targets or KPI targets.
- Fluctuations – Often referred to as inflationary adjustments. Often long term contracts may include a provision to allow the contract prices to be adjusted annually for inflation (usually on or around each anniversary of the start date, or financial year). How these are calculated will be specified in the contract. Typically will refer the to nationally recognized inflation indexes, e.g. Retail Price Index, Consumer Price Index, etc.

Always read the contract carefully to understand the risks and opportunities of the all commercial models.

Understanding your costs

A key element of being commercially aware is understanding your costs!

Costs are typically categorised into one of the following: Labour, Materials, Plant, Sub-contract, Overhead.

Labour costs – often based on a monthly, weekly, daily or hourly rates, however can also be based on fixed rates per task (subject to prior agreement), overtime and bonuses.

Note the cost of direct labour is not solely the productive time. You must also consider the non-productive time and the associated additional cost to any business of direct PAYE labour, such as Employers National Insurance and Pension contributions, Travel & Phone costs. Also note many PAYE operatives will have other associated overhead cost, such as Vans, Fuel, PPE, etc.

Material costs – the supply of goods or services. Typically based on unit prices.

Plant cost – cost of equipment used to carry out a task. Often hired on a weekly or monthly basis but can also be purchased (if more cost effective). Also consider carriage and collection charges.

Sub-contract cost – the cost of another company's provision of labour and materials (or labour only). Should always be based on pre-agreed pricing, specifications and payment terms.

Overhead costs – also know as the indirect costs – are often further categorised into Preliminary or Site Overheads (specific to the delivery of a contract) or Central Overheads being those central to the business functions e.g. Finance, HR, etc. Costs are typically categorized even further into office based staff, office costs, fleet, stationary, etc, etc.

Understanding your costs

Similar to the pricing models its important to understand the basis of your costs.

- Sub-contract Quotations / Estimates
  - Fixed price
  - Re-measureable
  - Fixed term (how long they will hold their price)
  - Estimates do not mean a fixed price
  - Are they quoting for what you (or your client) have actually specified
  - Are they allowing for the correct materials, brand, make, model and specification
  - Payment terms

- Offer and Acceptance is deemed a contract
  - In the absence of any formal contract the agreement to a sub-contractors price on their terms (verbally or in writing) would constitute a binding contract.
  - Any agreement to a sub-contractors price should be on our terms so be sure to offer these back!
  - Is it fair? Is it value for money? Is it competitive?
  - Remember – a legally binding contract can be formed merely by conduct.

Understanding margins, overheads and profit

Markup vs Margin, they are not the same thing!

- Markup is how much you increase a cost.
  - For Example:
    - A sub-contractors cost is £100
    - You agree to markup by 30%
    - Your marked up price = £130
- Margin is the % of the price you get to keep!
  - For Example:
    - Your sub-contractors cost is £100
    - Your marked up price to the client is £130
    - Your gross profit (assuming no other direct costs) = £30
    - £30 divided by £130 = 0.2308..... x 100 = 23.08%

Remember percentages are a measure of 100 so you may need to multiple by 100 to derive your percentage (%). Profit is a % of the value, not the cost!

When preparing a price for the client be careful how you markup your costs to achieve your expected margin!

Understanding margins, overheads and profit

Overheads are typically a businesses fixed costs

- For example: Office rent, Support staff (e.g. HR, Finance), Insurance, Vehicles, IT equipment.

Overheads can also be variable costs

- For example: Temporary staff, Fuel, Temporary Accommodation, Workwear, Waste.

Within the construction sector Overheads are typically categorised as;

- Site Overheads (also know as ‘Preliminaries’)
- Central Overheads (typically the Indirect Costs).

The recovery of these Overhead costs will depend on the Cost Model within your contract but must be factored in when pricing for works.

If not, you may think you’ve made a great gross profit on the works but if that gross profit doesn’t include the direct or indirect overheads you may ultimately make a loss!

Understanding margins, overheads and profit

Each business will have its own rules and policies as to how ‘profit’ is derived.

For many businesses its may be as simples as Sales less Costs = Profit.

In the construction sector, profit can typically be claimed on the work that has been completed (which may not yet have been invoiced).

What is the difference between ‘Gross profit’ and ‘Net profit’?

- Again, the answer will depend on the business rules but generally (in Construction) your ‘Gross Profit will be:

  Sales (Works invoiced + Works completed but not invoiced) LESS Direct Costs = GROSS PROFIT

  Nb: Other construction businesses may calculate gross profit after direct and indirect costs (or only site overhead costs).

- Net Profit, is typically calculated after all costs have been factored in. This will be the profit a company is then taxed on by the HMRC for Corporation tax. This is sometimes referred to at the “PBT” (Profit before tax).

  Sales (Works invoiced + Works completed but not invoiced) LESS Direct and Indirect Costs (inc. all central overheads) = NET PROFIT

Stakeholders and shareholders may also insist on some contingencies to ensure a business doesn’t over report its profit e.g. cost accruals, aged write off, bad debt provisions, etc.

Procurement

"Procurement is the acquisition of the materials, supplies or services needed to successfully operate a business or complete a project. In construction, this refers to the goods and services needed to successfully complete a build from start to finish".

Procurement needs to be approached in a strategic way to maximise the efficiency on each project.

- Speed
- Cost
- Quality
- Risks and opportunities
- Budget and financing
- Specific constraints on the project / terms & conditions / inclusions
- Authority / Competition

Record Keeping

It is essential to keep good records on your construction project.

- Contract Management
- Site Attendance, Site Inductions
- Health & Safety Forms, Accident Reports,
- Variations, Contract Instructions & CVIs
- Quotations, Purchase Orders, Sub-contract Orders, Work Orders, Delivery Notes
- Applications for Payment & Payment Notices
- Default Notices, Practical Completion, Defects Liability
- Dayworks
- Certificates of Handover/Conformity

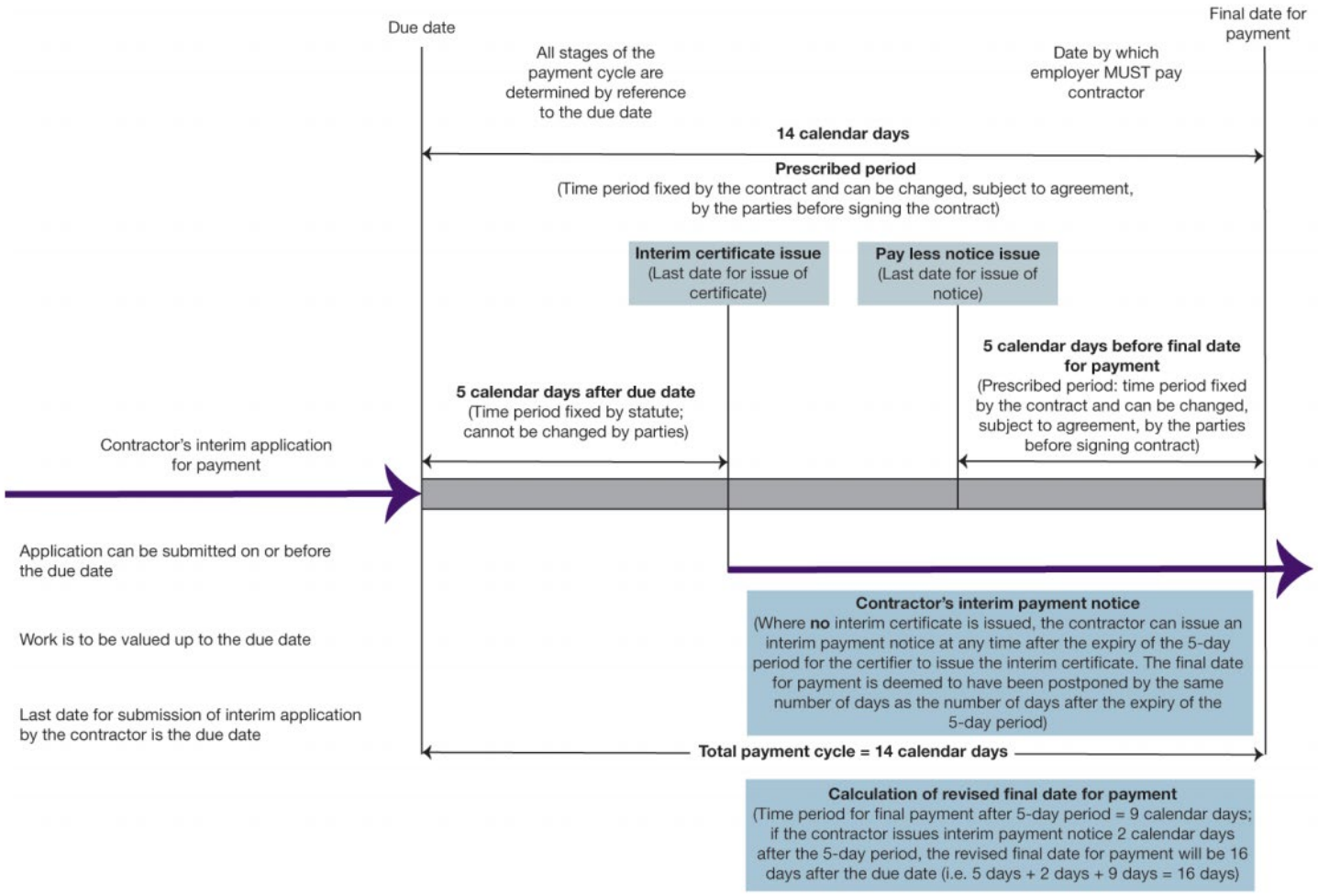
Payment Terms

The Scheme for Construction Contracts 1998 ("Construction Act") provides a default position where a construction contract does not include the necessary payment provisions (that is, sections 109, 110 and 111) of the Construction Act 1996

- Payment Notice (Section 110A)
  - The payment notice must be issued within 5 days of the **payment due date**
  - Must identify the 'notified sum' and how its assessed.
- Default Payment Notice (Section 110B)
  - If the payment notice is not served within 5 days of the **payment due date** the application for payment (if valid) becomes the default payment notice, which must be paid on or before the **final date for payment**
- Payless Notice (Section 111)
  - No longer referred to as the withholding notice
  - The pay less notice should be issued not less than 7 days before the final date for payment and state the revised 'notified sum' the payee will pay.

Payment Terms – JCT Design and Build Contract 2011

Interim payment



Questions?