

Issue No : 15
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Author : Roger Trett
Title : Introduction - Construction Industry 9.5% of GNP - Where in The World

Construction Industry 9.55% of GNP

Where in the World?

- 1) The total construction output for the 1980's reached approximately £147 billion, exceeding that of the previous 3 decades.
- 2) The total floor area of the urban and rural residential buildings completed in the 1980's amounts to 1.28 billion square meters, being nearly twice that attained in the previous 3 decades.
- 3) The output value of the construction industry increased annually by an average 10.8%.
- 4) 1,109 large and medium industrial projects were completed and put into use during the same period.
- 5) The construction industry employs the greatest share of the workforce. Employing a total of 102.2 million people in 1980, the numbers have nearly tripled to 270.2 million in 1992.
- 6) The output of the construction industry reached 9.5% of GNP

Where? Obviously not the UK but China, where the construction industry now plays a significant role in the PRC's national economy.

The above figures are included in a paper entitled 'The Economic Structure of the PRC Construction Industry' prepared by Professor Lu of Tsinghua University, Beijing and Honorary Professor of Shenzhen University, Shenzhen, PRC. It shows the substantial growth of the construction industry in China since the introduction of the open door policy in 1979.

I have just spent a week in the PRC meeting various people and have concluded that China offers an opportunity that should be considered seriously. Whilst the construction industry has grown at such a pace most of it has been achieved through the control of the contractor by the various ministries. It is evident from my discussions that a recognition exists that to sustain such growth and to become cost effective, the construction industry has to be properly structured along Western lines.

This offers an opportunity for a number of Western consultants to assist in bringing China to international level. Whilst they have the manpower in abundance (mechanisation is not necessarily an area that they are in a hurry to catch up with), there is a need to understand and develop the financial controls and management of the industry. There is, I believe, considerable potential for UK contractors to sell their experience to China - specialist management expertise in particular and specialist sub-contractor work.

One of the problems perceived with China at the moment is the uncertainty of the Law. (I was asked whether commissioning problems on a fertilizer plant constituted a criminal offence !!). VAT fraud is considered a major offence which may, in certain circumstances, carry the death penalty. The law is in a constant state of development to allow China to deal with the West and it is necessary to give Western contractors some confidence to deal with them. The Chinese are prepared to enter into international contracts with dispute resolution by arbitration

external to China and China is party to the New York convention for the enforcement of arbitral awards.

The training of Chinese staff takes on board Western practices and they do understand what a Quantity Surveyor is (perhaps not so inspiring after all!).

In pursuing these opportunities, Trett Contract Services has entered into a Co-operation Agreement with the Kang Da Law Agency with offices in Beijing, Shanghai and Shenzhen. The Co-operation Agreement is for Trett to provide advice on commercial, contractual and financial/QS matters on international contracting to Chinese construction companies working internationally or procuring internationally for work in China. Similarly Kang Da Law Agency will provide legal advice for Western companies wishing to work in China.

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Author : M Kenyon
Title : The Winning Formula

The Winning Formula

Mike Kenyon examines contractor's claims for loss of contribution to head office overheads.

Contractor's claims for the reimbursement of loss and/or expenses arising from prolongation frequently provide for the recovery of loss of contribution to head office overheads.

Head office overheads, by definition, include those costs of the contractor's business that cannot be charged to a particular contract without the need to employ costly and complex accounting procedures. Items forming the head office overhead typically include:-

- Head office maintenance and running costs
- Mortgage or rent and rates of offices, plant and yards
- Wages of head office supervisory, estimating, surveying, administrative and accounting staff
- Depreciation costs
- Legal Fees
- Interest

It is common practice to distribute head office overhead costs to all contracts in progress. The overhead is ascertained from company accounts and adjusted for the forthcoming year. The contractor will estimate his turnover for the year and determine what percentage of turnover is required to contribute to the head office overhead cost. From this the estimator will be able to establish that percentage which must be added to the estimated cost of a contract to cover the head office overhead contribution. This percentage contribution is typically spread across all items in a contractor's tender submission. Despite being common estimating practice this process does fail to recognise that head office overhead is as much a function of time as it is of cost.

Claims for loss of contribution to head office overheads are frequently contested in principle and continue to be the subject of much debate. Despite this, such claims have found favour with the courts. The case of **J F Finnegan V Sheffield City Council (1988) 43 BLR 124** is one instance. Sir William Stabb QC sitting as Official Referee stated;

"It is generally accepted that, on principle, a contractor who is delayed in completing a contract due to the default of his employee; may properly have a claim for head office or off-site overheads during the period of delay, on the basis that the work-force, but for the delay, might have had the opportunity of being employed on another contract which would have had the effect of funding the overheads during the overrun period."

On this point Sir William Stabb QC also referred to the unreported case of **Whittal Builders Company Limited V Chester-le-Street District Council (1985)**, Mr Recorder Percival QC in passing judgement said

"...I come to overheads and profit. What has to be calculated here is the contribution to off-site overheads and profit which the contractor might reasonably have expected to earn with these resources if not deprived of them."

At this point it is worth stressing that claims for loss of contribution to overhead are not the same as claims seeking to recover the actual overhead expended by the contractor in relation to the contract during the prolongation period.

If a contractor is to make a successful claim for lost overhead contribution, then in common with other prolongation claims, it is necessary to establish that the period of prolongation for which the loss of contribution is claimed arose as a consequence of those relevant events provided for under the contract. It must not be forgotten that the principle behind loss of contribution claims is, that but for the delay the contractor would have generated overhead contributing turnover on other contracts. As a consequence, the contractor must establish that other work was available which, but for the delay, would have been secured. The contractor must also quantify the actual loss of contribution.

Contractors frequently adopt a formula approach to quantify of claims for loss of contribution to head office overheads. The formula approach is subject to considerable criticism, not least that it fails to recognise the actual loss. Despite this, the formula approach has found favour with the courts. Judgements in both *Finnegan* and *Whittal Builders* accepted, or were prepared to apply, a formula approach to quantifying the lost contribution. Three formula methods are in common usage Hudson, Emden and Eichleay. However, it is only Emden that has met with judicial approval.

The Hudson formula, is expressed as follows;

$$\text{H.O. profit percentage}/100 \times \text{contract sum}/\text{contract period (weeks)} \times \text{delay (weeks)}$$

The head office/profit percentage applied is that percentage to cover both head office overheads and profit as built into the tender. A proper appraisal of the formula does reveal flaws and the following points are worthy of note when considering its application: -

It provides for overhead and profit on a contract sum that already includes for overhead and profit

- It assumes that the overhead and profit percentage was capable of being earned by the contractor elsewhere
- The formula links together overheads and profit which in reality are separate issues
- That the overhead and profit percentage was reasonable
- The percentage is based on a tender estimated that may not have been achieved in reality

The Emden formula is similar to Hudson. However, the Emden formula provides for a percentage to be applied in respect of overhead only. This percentage is derived by dividing the total overhead cost of the organisation by the total turnover. This is more realistic than the approach adopted by Hudson as it is based upon an actual percentage achieved and will at least be supported by audited accounts. Despite this benefit the Emden formula should be used with similar caution to Hudson.

A flaw common to both is that they do not take into account any additional overhead that may have been recovered through additional works in the period of prolongation. They also work on the premise that overhead is purely a function of time, which is not necessarily correct. Furthermore, too liberal an application of both Hudson and Emden can lead to a situation where the overhead contribution claimed exceeds the actual overhead cost recorded in the company accounts.

The Eichleay, judicially recognised in the USA, corrects the flaw in Hudson and Emden in that it makes allowance for the recovery of overheads that may have arisen from the execution of additional works. Eichleay also overcomes some of the other concerns of the above methods, not least that when used correctly the overhead claimed will not exceed the actual total company overhead. The Eichleay formula is as follows:

1. $\text{Contract turnover}/\text{total company turnover} \times \text{company H.O. overhead} = \text{allocable overhead}$
2. $\text{Allocable overhead}/\text{contract duration} = \text{daily overhead allocable to contract}$

3. Daily overhead x prolongation period = loss of contribution to H.O. overhead

Overhead

Eichleay, though recognising additional works contribute to overhead, does not consider the timing of such works (in that it averages out the overhead contribution from the additional works over the full contract period).

Accordingly, the Eichleay will in many instances inaccurately state the lost contribution during the period of prolongation.

While no formula is ideal for quantifying the actual lost head office overhead contribution they do have a part to play, not least as a first stage tool in quantifying a potential loss of contribution. Contractors relying on nothing else, other than a formula to support lost contribution of head office overheads, must accept that such claims will meet with little chance of success if put to strict proof. Contractors should at the very least expect to provide accounts, tender breakdowns, internal head office and job records. This information should cover the whole period of the contract in dispute and not just the period of prolongation. Further and in addition to the above, the contractor must prove that he would have secured other work in the period of prolongation.

Those in receipt of claims supported in this way, while not representing the actual loss, should not dismiss them totally out of hand, should give serious consideration to making some contingent allowance in the event that such a loss of contribution can be ascertained.

Proving the actual loss of contribution is difficult and will necessarily involve a wholesale review of the contractor's trading position over the duration of the contract. The success of any review will be dependent upon the quality and accuracy of the contractor's records and accounts. An overhead formula will be no substitute for the hard work required to prove the actual loss of contribution.

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Article No : 3
Author : Alan Lumley
Title : International Experience 7 - To Russia With Lumley

To Russia With Lumley

"Dear Mr Lumley " read the letter in pidgin English received by fax from Ross, Byelorussia (where the hell is Byelorussia?) " ... We are building in Ross a military town financed by Germany for military men's families withdrawn from East Germany ... Please make us an offer to prepare a claim awaiting your offer by fax tomorrow, up to 1pm British time. Yours sincerely ... "

Is this somebody setting me up I wonder?

A couple of days and a few phone calls later to Byelorussia (which turned out to be in the west of what was Russia, now Belarus, near Minsk), I had it cracked!

The project was one of about 40 military camps being built by international joint venture contractors (this one being German/ Finnish/Russian) from £5,000 million given by Germany to Russia under an agreement made in 1990, (under seal I hope), between Herr Kohl and Mr Gorbachev, whereby Russia was to remove its army of 400,000 men plus families and 2.6 million tonnes of tanks, planes, helicopters, artillery, combat vehicles and equipment, from East Germany and relocate it to new military camps throughout Russia.

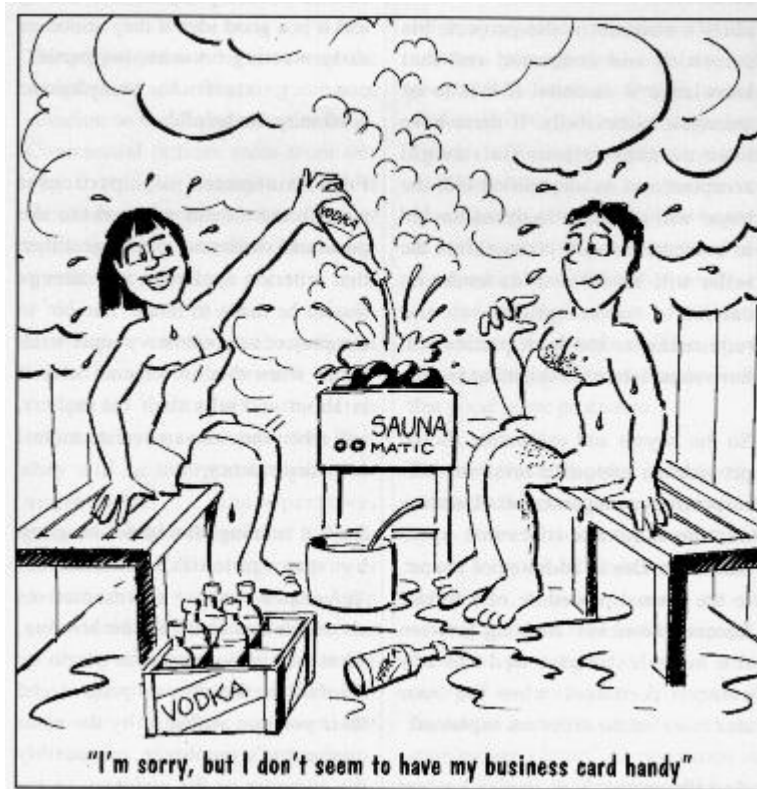
Four years later, by September 1994, the transfer of the army was complete and the last of the military camps, including this one, was fast approaching completion.

The construction contract for the camp at Ross was straightforward. The Contract was between the Russian Government and the Joint Venture Contractor and worth approximately £58 million at straightforward Druk exchange rates. But, as the Russian Contractors' workmen were paid only about £27 per month, the equivalent contract value at European construction rates was probably about £200 million.

The work was managed by Finns and Germans, the Engineer was a purpose made consortium of German consulting engineers, the Conditions of Contract were FIDIC, oh... .and the language of the contract, including of course all the documents and correspondence etc, was in Russian and German.

So no problem!

After several very interesting telephone conferences through Svetlana, a very enthusiastic, skilled young Russian lady, who translated my broken English into Russian for another translator to interpret into Finnish for the project manager and, having received the answer about 10 minutes later, I immediately offered to go to this far off place on the basis that they would provide an inexhaustible supply of the best Russian vodka, make payment of an enormous sum of money into an account of my own choosing and pay Trett afew bob' as well.



The client promised to do most of these things and so off I went, departing by taxi from Trett's Christmas party, at (I think) two thirty in the morning, thermals and all. I had, however, been especially cunning and took with me a QS colleague, fluent (so he said) in German, having lived and worked for two years recently in Berlin. If all else failed and we couldn't make head nor tail of it all, I would simply blame him, come home and keep mum.

But we did make sense of it.

With the help of the Contractor's German and Russian staff, plus a little discipline imposed by the ever understanding Svetlana and with the help of the Resident Engineer who, professionally, on behalf of the Engineer and, nationally, on behalf of Germany as a whole, also wanted to honour obligations at a domestic and international level, we put together the framework of a design and build FIDIC based claim.

It was the usual stuff; failure to give timely possession of the site, the late approval of the Contractor's design, imposed additional requirements constituting variations, winter working and Clause 12 different/worse ground conditions (they had to rip out the frozen ground with D8's and load the iced lumps!), plus variations generally and their impact on construction and specific breaches which forced the Contractor to suspend much of the work for the best part of 6 months.

So, my English draft claim, was translated into Russian by the great Svetlana and into German by the equally professional Rachel and the document was duly submitted in both tongues to the Engineer and Employer in Moscow.

Subsequent monthly visits to Moscow, from January to April, for meetings with the Engineer and Employer resulted in settlement of some of the claims. However, a large proportion remains unresolved and it looks like matters may proceed to ICC Arbitration in Vienna - watch this space!

On my visits, I found the long days of work passed quickly. This was no doubt helped by the long nights of enforced R and R, sessions at the saunas (mixed), mega buckets of vodka and

brandy, sausages and suckling pigs, dinner parties, music and dancing, all of which left me brain dead (what's new?) on arrival back at Heathrow.

I must, in closing, express sincerest thanks to my colleague Bob, Managing Director of a German Contractor's UK operation who, when asked by his Weisbaden head office if he knew of any Great British claims consultants who could do a job for a mate of a mate in Russia, gave them my name.

Thanks Bob!

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Author : P Harvey
Title : Fair Warning

Fair Warning

"The first few days of a construction project are more critical to the outcome than the last few months - discuss"

And it should be, by all concerned. Transfer of the action from the buyers and estimators to the project managers is crucial, and warrants more care and attention, and possibly a broader approach, that it often receives.

Both parties must give priority to the fulfilment of any and all immediate commitments made to the other. When an order is being negotiated various undertakings are often given by both buyer and seller - to visit a works, supply additional drawings, furnish alternative prices, and so on - which are not necessarily contractual requirements. It is essential that these obligations are advised to the project personnel and implemented at once. Nothing sours a relationship more quickly than failing to do what you said you would do. Nothing encourages and builds a constructive relationship quicker than doing it promptly with good grace.

The same attitude must apply to initial requirements specified in the contract (provision of programmes, drawings etc), so the first duty on the buyers and estimators in handing over the project is to advise what all these immediate requirements are. The first duty on the project staff is to carry them out. It makes sound contractual and commercial sense too - it gets the project off to a good start to everyone's benefit.

Having cleared the priority, the next essential is to ensure project staff on both sides know their own background to the order. Managers must know the reasons behind the order if they are to understand and implement it properly.

Knowledge of the negotiations provides forewarning to the other party's attitude to the project, his priorities and concerns, and that knowledge is essential if it is to be managed successfully. If there have been no negotiations (ie straight acceptance of an unqualified bid) the buyer will still have analysed the bid in comparison with competitors, the seller will have based his tender on certain assumptions and requirements, and both parties still have some internal explaining to do.

So the buyers and estimators should provide an adequate brief to their respective management staff setting out the sequence of events up to handover. This in addition, of course, to the normal procedure of a formal internal 'handover' meeting between the buyer/estimator and the key contract personnel, when the 'nuts and bolts' of the order are explained.

And the sooner both parties can put names to functions, faces to names, and personalities to faces the better. Since placing an order is generally a successful event for both parties the relationships between them at the point will be positive. It is the task of the buyers and estimators - the negotiators - to capitalise on this state of affairs and introduce their respective contract staff to each other in person. A 'letter of introduction', or even (as is often the case) no introduction at all are far less effective, and may even be counterproductive.

The negotiators should make it clear that they are freely available to discuss or clarify any matters arising and it is a good idea if they attend an early meeting between the parties' contract staff to emphasise continuity. Be helpful.

For contracts of particular significance (and when there are personnel dedicated to a project then that criterion applies) a real attempt should be made to relate 'our bit' to the project as a whole - people work better when they understand what it is about and why their bit matters, and when they can appreciate mutual inter-dependency.

Such a briefing should not be given by the potential contractual 'adversary', whose representatives should rather share in the briefing. Thus new sub-contractors might be briefed on the overall project and their position within it by the main contractor's employer, or possibly the engineer or the architect, in the presence of the main contractor. 'Them and us' adversarial castings are to be avoided; joint team involvement in the project should be encouraged. Sub-contractors appreciate their involvement being recognised beyond their immediate employers, which this sort of introduction engenders.

There's another thing that needs to be clearly understood from day one - the submission of notices.

Conditions of contract almost invariably include provisions for the issue of assorted notices by each party to the other. The particular requirements may vary, as do the contractual and commercial significance of the notices, their formality, and the timing and manner of their submission; but whatever form they take they are a common cause of unnecessary friction.

The purpose of notices is to warn the recipient of a forthcoming event or situation so that he can prepare for it. Contractual notices stem from our duty to mitigate damages, though it should be remembered that the duty to do so exists whether notices are specified or not.

However, even though the notice is issued for the sole benefit of the recipient, managers are often reluctant to do so because they fear they will be interpreted thereby as aggressive, uncooperative, provocative or mischievous. Such an attitude, which is not uncommon, is intended to discourage the submission of notices upon the generally erroneous conviction that if they are not submitted then the relevant damages cannot be sustained.

Both attitudes, reluctant submission and aggressive response, which most of us have experienced, are due to misunderstanding the purpose of the notices and are actually contrary to the interests of each. So, start as you mean to continue, with sensible understanding of the mutual benefit that notices afford (compliance with contract requirements and advance warning) and agreement on their uninhibited submission.

It is inhibition which usually delays the timely submission of a notice, which at an early stage may be felt to refer to a minor matter, until the matter has grown out of all proportion and a notice (now obviously overdue) would be too late either to comply with contract conditions or to have any beneficial or mitigating effect. So get the notice in early and invite discussion. It is much easier to withdraw or overlook a redundant notice than to validate one that is overdue. The New Engineering Contract emphasises that good sense procedure.

To comprise 'notice under the contract' the communication doesn't have to be written on parchment headed by an illuminated clause reference, though it must be in writing and delivered to the recipient. Proof of posting or "I gave it to George" are inadequate. However, if the notice is clearly referenced to the appropriate clause, its relevance is more likely to be appreciated by the recipient and subsequent argument, as to whether the notice was given, is less likely.

Be wary of the differences between mandatory notices (those which compromise a condition precedent) and those which are not, and that standard conditions of contract may be subtly changed in that regard. If a contract provides for notices which are mandatory then mandatory they are unless that condition is waived by both parties to the contract. The fact that the intended recipient knew of the event through other channels, or discussed it with you at length in his boardroom or in front of a shareholders meeting, is no substitute for a written notice. But be sensible; if, in the absence of a written notice, warning has been clearly given, can be

shown to have been given, and mitigating action has subsequently been taken, then you would be ill advised to ignore the consequences.

It can be a useful exercise to tabulate the notices required for a new contract, together with any time limitation relevant thereto, and to ensure that staff are fully aware of them. Who is responsible for which? Similarly, ensure incoming notices are properly heeded, that you take full advantage of the warning they give. That's what they are for. Respond to them.

Experience suggests that the success of many projects is hugely dependent upon starting on the right foot. Capitalise on and cultivate the euphoric goodwill of the order, it is the most valuable asset you share.