

WHAT IS INCLUDED IN THE CONTRACTOR'S MARGIN?

Barry Tozer, Consulting
Construction Engineer &
Arbitrator

Tozer & Associates, Sydney

INTRODUCTION

The question would seem to be a straightforward enquiry. When asked recently whether certain site indirect costs could be included in the valuation of a variation as part of the cost of performing work, I replied that, in my opinion, all extra costs incurred as a result of performing the variation should be included in the pricing. I was surprised to be told that such costs were part of the contractor's margin for the variation work and that only the direct cost of performing that work could be recovered. My response to this was to suggest that the enquirer provide me with a copy of the valuation clause where this was stated. This technical note is the result of my further examination of the question.

THE COMMON DEFINITION

The ordinary meaning of the term, 'contractor's margin', may readily be ascertained by consulting a good dictionary. For example, the common meaning of the word 'margin' as used in commerce and finance is the difference between the cost and the selling price.¹ It is unlikely there would be any disagreement that the word 'contractor' generally means someone who contracts to furnish supplies or perform work at a certain price or rate.² From these words, the term 'contractor's margin' could reasonably be defined as the difference between the price paid to a contractor for performing services and the cost to the contractor of undertaking that work.

THE COST OF UNDERTAKING WORK

The direct cost of undertaking any building or engineering work task is usually subdivided into various categories of expenditure for estimating, cost control and accounting purposes. The customary

component costs are various classes of labour, construction plant and equipment, temporary and permanent materials and subcontracts. The cost of a particular work task will include one or more of these directly identified categories of cost.

In addition to the direct costs which are incurred in performing individual work tasks, it is generally accepted,³ that there are associated supporting or indirect costs that are shared among many different work activities and not readily costed to individual work tasks. Among these indirect costs are non-recurring costs associated with the establishment of the project site, removal and restoration on completion, insurances and other fixed charges related to the total cost of the work and recurrent costs, which are time-dependent, such as supervision, attendance, site administration, general plant and equipment, operation and maintenance of site services and amenities, general supplies, planning, surveys, testing, materials handling and storage.

These indirect costs are variously described in the technical literature as establishment costs,⁴ project overhead,⁵ 'site overheads'⁶ or builder's preliminaries.⁷ Quantity surveyors often refer to these indirect costs as 'preliminaries and general' costs and allow separately for inclusion of some or all of these items in a bill of quantities.

It should be noted that these indirect costs cover the cost of providing site management and equipment required for the execution of the project. Indirect recurring and non-recurring costs would not be incurred by the contractor unless the project was undertaken.

OTHER CONTRACTOR COSTS

The cost of running the contractor's business includes head office charges, estimating costs, accountancy and consulting fees, director's fees and expenses. These costs are referred to in the technical literature as head office overheads,⁸ general overhead,⁹ off-site overhead,¹⁰ company overhead¹¹ or simply, overheads.¹² By contrast with indirect costs, overheads are those items of cost that not incurred specifically for a particular contract.

It is those costs that are commonly described as 'overheads' in the established standard form General Conditions of Contract¹³ that have been used for many years.

Overhead costs assigned to a particular contract are usually based on a percentage of expected annual turnover,¹⁴ the total amount to be earned from work completed during that year. The required figure is usually derived from accounting records for previous years and may be added as a percentage of the total cost of undertaking the work.¹⁵

PROFIT

Net profit is the difference between the price paid to the contractor for performing the work and the cost to the contractor of performing the work and running the business. There is a minimum amount of profit that which must be provided for credit stability.¹⁶ Some funds are required for dividends, reserves, maintaining the real value of working capital and taxation.

MARK-UP AND MARGIN

When pricing tenders and variations, a contractor adds a 'mark-up' or margin to the estimated or expected cost of performing that work. The mark-up, either a lump sum amount or a percentage of the

cost, consists of three elements, an allowance for company overheads, an allowance for risk and an allowance for profit.¹⁷ If the work has been completed and the actual cost is known and recoverable under the contract, there is no need for inclusion of a risk allowance. The mark-up then becomes the margin which the contractor should recover, being the difference between the cost to the contractor and the price to be paid for the work.

THE CONTRACT IN QUESTION

Whilst the foregoing summary may appear to have been a little long-winded, the explanation is required to better understand the following definition which appears in the GC21 (edition 1) General Conditions of Contract.¹⁸

Contractor's Margin

An amount or proportion added for profit and additional overhead costs (including administration, supervision, establishment and attendance costs) incurred solely as a result of a variation, but not including any overhead costs relating to delay, disruption or interference caused by the variation.

The definition has, of course, adopted the broadest possible meaning of the word 'overheads' to include all indirect costs of performing the work. As previously noted, the common definition of a 'margin' does not include any costs of performing the work.

Under this contract,¹⁹ if there was no agreement between the contractor and the principal on the value of a variation, the adjustment to the contract price was to be determined in accordance with the principles of valuation by an independent valuer. The relevant principles of valuation are set out in Schedule 5, clause 3.1 of the contract as follows:

3.1 If a variation involves additional or increased work, the valuer must determine its value as the sum of the following:

1. the additional reasonable direct labour, material and plant costs of the contractor;
2. the additional reasonable costs to the contractor of subcontract and consultant work involved in carrying out the variation; and
3. the additional amount calculated as the percentage in contract Information item 48 of the total of the costs under clauses 3.1.1 and 3.1.2 of this agreement, which allows for the contractor's margin.'

In case there was any doubt of the intent of the valuation principles to be applied, the valuer is reminded at clause 3.1.3 as follows:

3.1.3 The valuer must not include any contractor's margin in the costs determined under clauses 3.1.1 and 3.1.2 of this agreement.

The allowance for the contractor's margin as set out in item 48 of the contract Information in the contract reviewed was 10%. Whilst, 10% is often considered to be an adequate margin to be applied to the cost of the work for 'overhead and profit' as normally defined,²⁰ it is difficult to see how such a percentage would be adequate recovery for the indirect costs of performing the work as well as these allowances.

DAYWORK

An alternative method of valuation of variations, based on the actual cost of performing the direct work, is included in many contracts. Clause 53.4.2 of GC21 provides for valuation of a variation as daywork where that method is instructed by the principal. Daywork is defined in the contract as follows:

Work for a variation carried out by the contractor for which payment is made on the basis of daily job time and cost records for workmen, constructional plant, materials, services and other cost-related work as provided in Schedule 9 (Principles for Valuing Daywork Variation).

Schedule 9 of the contract provided a procedure for valuation and determination of the amount to be paid having regard to the amount of wages, allowances (subclause 1.1.1) and statutory imposts (sub-clause 1.1.2) paid by the contractor, the amount of hire charges for construction plant (sub-clause 1.1.3), amounts paid for services, subcontracts and professional fees (sub-clause 1.1.4), the reasonable actual cost of materials supplied and required for the work (sub-clause 1.1.5) and a charge calculated as specified in clause 2.2 (sub-clause 1.1.6) or as otherwise agreed between the principal and the contractor.

The charge is added to cover 'overheads, administrative costs, site supervision, establishment costs, attendance and profit'. Significantly, the wording of the list of items covered in this charge is very similar to the wording of the items in the definition of contractor's margin, namely profit and overheads including administration, supervision, establishment and attendance costs. The charge is not however described as the contractor's margin, nor should it be.

Under clause 2.2 (of Schedule 9), the amount payable to the contractor for the things described in 1.1.6 above is:

1. for daywork carried out by the contractor, 27% of the total of the amounts calculated for 1.1.1 to 1.1.3 above inclusive; and
2. for daywork carried out by a subcontractor, supplier or

consultant 12% of the total of the amounts calculated for 1.1.4 and 1.1.5 above.

Thus, the average charge to be paid to a contractor under this provision will depend on the relative proportions of labour, construction plant, materials and subcontracts required to perform the variation. Typically, for an engineering contract, the charge might amount to 22.5% of the direct cost of the work. This percentage is in stark contrast to the 10% payable as the contractor's margin under the primary principles of valuation included in subclause 3.1 of Schedule 5 for essentially the same categories of cost or entitlement.

CONCLUSION

As a result of the investigation described in the paragraphs above, my recommendation, not surprisingly, was to suggest to the contractor, that the principal should be persuaded to value all the disputed variations as daywork.

There would appear to be some confusion in the building and construction industry about the structure of prices and amounts tendered by contractors for building and construction work.

Whilst indirect costs associated with contract performance may vary from 5–15% depending on the nature of the contract,²¹ 10% is the usual reasonable minimum addition²² for overhead and profit.

Building and engineering contractors will not remain viable if the total recovery for indirect costs, overheads and margin is only 10% on significant contract variations.

REFERENCES

1. Macquarie Concise Dictionary (4th ed.) 2006
2. Ibid
3. Antill's Engineering Management (3rd ed.) J M Antill & B E Farmer, McGraw Hill 1991; Construction Contracting (6th ed.) R H Clough & G A Sears, Wiley 1994
4. Estimating for Building and Civil Engineering Works, Spence Geddes (5th ed.) (SI), Butterworths 1971
5. See note 4
6. Effective Contract Administration for Road, Bridge and General Civil Engineering Works, R Valentine, ECAT Publications, Melbourne 1995
7. Rawlinsons Construction Handbook (25th ed.) Rawlhouse 2007
8. Understanding Tendering and Estimating, A A Kwakye, Gower 1994
9. See note 4
10. See note 7
11. Estimating and Tendering for Civil Engineering Works, R McCaffer & A Baldwin, Granada 1984
12. See note 3
13. For example, AS2124, NPWC-3
14. See note 9
15. See note 3
16. Ibid
17. See note 12
18. GC21 (edition 1) NSW Construction Agency Coordination Committee, July 2003
19. Ibid at clause 52
20. See note 3 at 267
21. See note 4 at 108 and n 7 at 174
22. See note 3 at 267