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IMBALANCE OF CONTRACTUAL RELATIONS IN CONSTRUCTION FOR SMALL-SCALE PUBLIC CONTRACTS IN CZECHIA

Abstract:

Small-scale public contracts in Czechia have imbalanced contractual relations, especially when we compare big and small enterprises. Small enterprises often face “take it or leave it” situations, because they either can not compete with the big enterprises, they can not fulfill the expectations of the investor, or they simply are not ready for the higher risks. This paper is split into several parts - in the first part we define what public contracts even are and how they work in Czechia specifically. The second part is about the risks and difficulties small enterprises face when competing with the big ones for contracts. In the final part of this paper we will learn about the current situation in Czechia, how the market changed in recent years, and what should be done in order to make the contract more fair and worthwhile for both sides.

Keywords:

public contract, contractual relation, construction, Czechia, risks, difficulties, LCC

JEL Classification: L74, D24

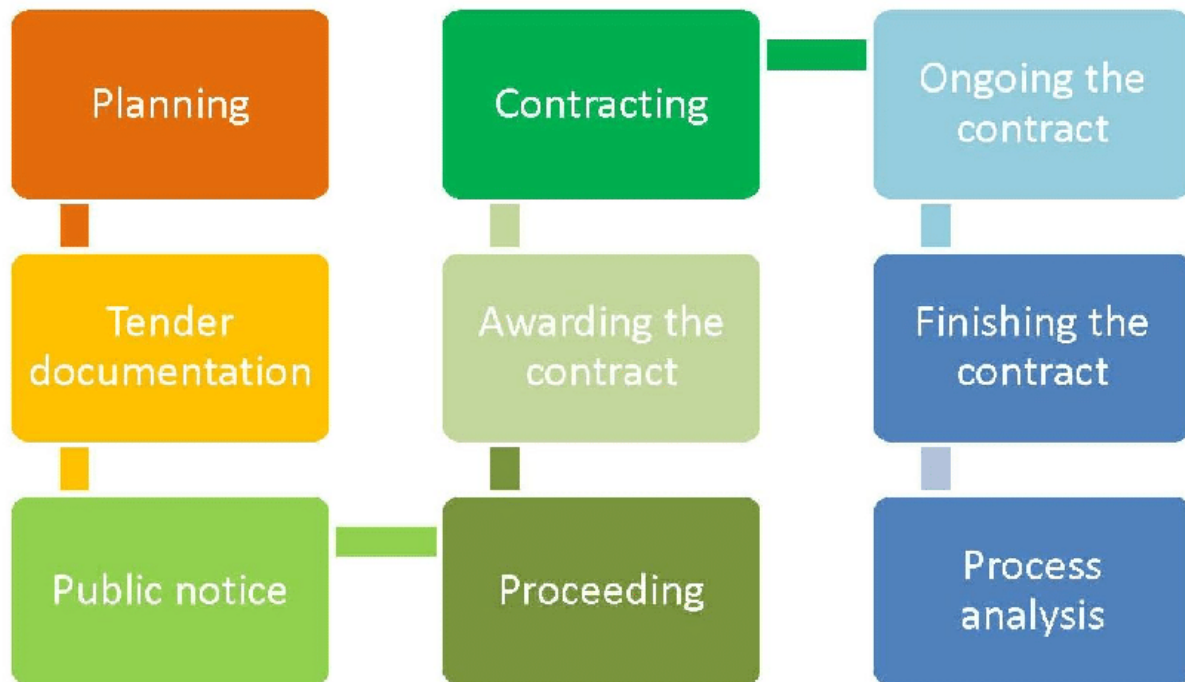
Introduction

Small enterprises face many risks and difficulties when it comes to competing for public contracts. They are often faced with “take it or leave it” situations, where their only option is to either compete – in that case they might invest a lot into the project and not even be awarded, therefore losing resources with nothing to show for it, or they do not compete at all. We will take a look at what is the cause of this imbalance, what are the problems and risks, and how we could improve upon the current situation.

1. Public contracts and their criteria

In order to talk about public contracts in the construction industry, we must first at least briefly define what a public contract is. Public contracts are divided into services, supplies, and construction works. Public contracts are also divided according to the expected price range: small-scale commissions, sub-limit and over-limit commissions. There is also a fourth category, significant commissions (over CZK 300 million).

Figure 1: Public procurement process



Source: https://www.researchgate.net/figure/Public-procurement-process-until-05-25-2016_fig1_315846311

1.1 Public contracts in Czechia

Act No. 137/2006 Coll., on public contracts § 7 (Zákon o veřejných zakázkách č. 137/2006) defines public contracts:

(1) A public contract is a contract implemented on the basis of a contract between the contracting authority and one or more suppliers, the subject of which is the gratuitous provision of supplies or services or this Act, must be implemented on the basis of a written contract.

(2) According to the subject, public contracts are divided into public contracts for supplies, public contracts for services and public contracts for construction works.

(3) According to the amount of their expected value, public contracts are divided into above-limit public contracts, below-limit public contracts and small-scale public contracts. This includes not only the construction work itself, but also all design and engineering activities related to them and the supplies and services necessary to complete the contract.

Public procurement of construction works in the Czech Republic carries many problems. According to the CEEC Research survey, the satisfaction of construction companies with public contracts, specifically with the course of the tender process, is very low - 4.9/10 points, which is almost a 33% lower satisfaction compared to the course of tenders for a private investor. The problems already arise at the point of tendering for a public contract, where many companies decide not to submit a tender for a public contract at all due to competition only on price, which is very common today. Other criteria are then omitted, such as the quality of the construction, references, qualifications, etc.

2. Risks and difficulties of competing

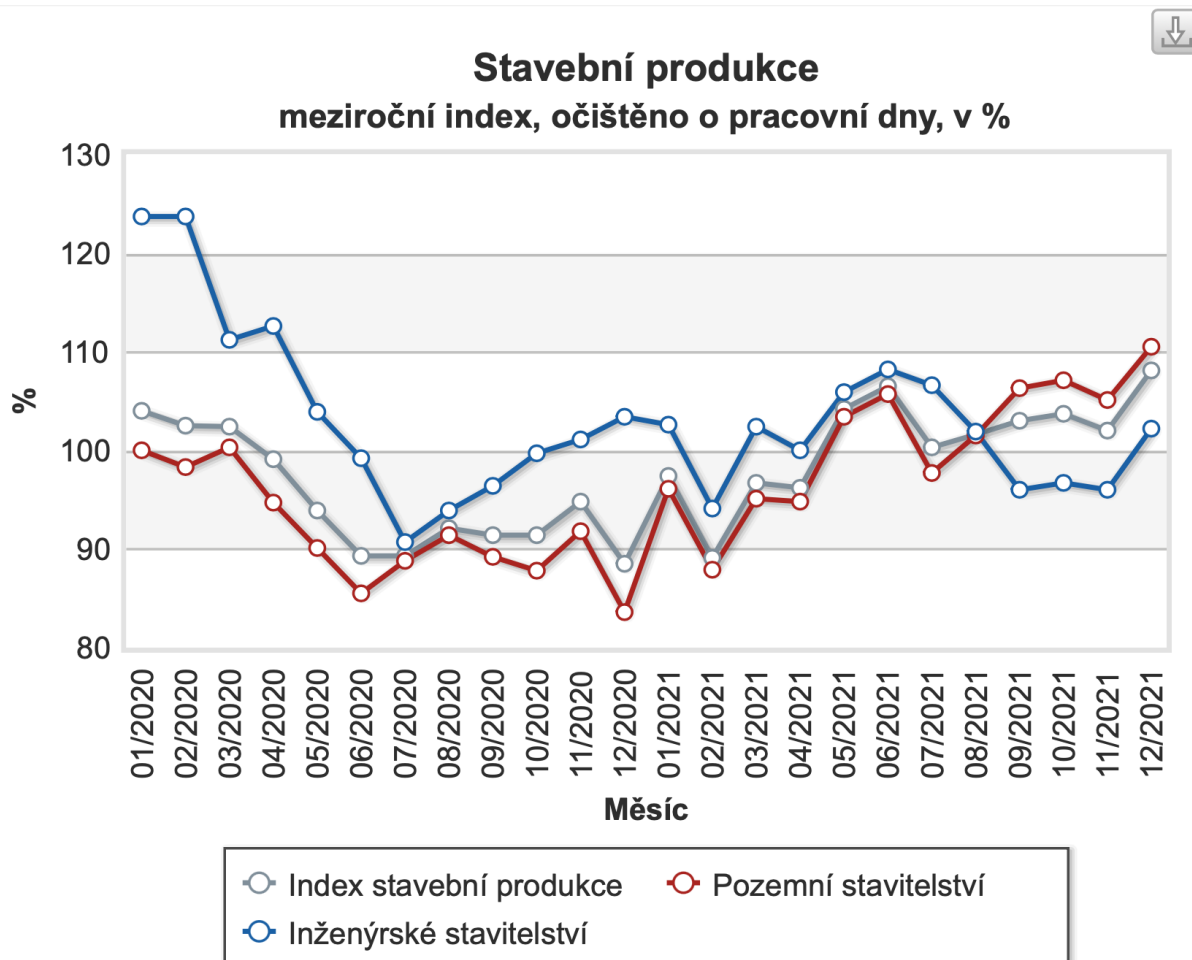
Participation in the selection procedure is often very expensive and complicated for the applicants. In order to participate in the competition, a detailed project proposal must be developed, which is then assessed by the investor and used in the event of a contract being awarded. *The first step to drawing up an offer is to receive documents from the contractor. Since the offer must usually be processed in a very short amount of time, multiple employees cooperate on its creation. Based on these documents, the company carries out a number of activities that lead to forwarding the created offer to the investor (Tománková, Čápková, 2013). The construction project proposal includes the entire complex of activities that must be planned, organized, financed, controlled and evaluated, i.e. managed throughout the entire life cycle of the building (Tománková, Čápková, Měšťanová, 2008).* In the case of smaller companies, competitiveness is worse precisely because of the time and financial demands of preparations.

Size or the volume of orders is almost directly proportional to the size of the construction companies that realize the constructions. Public contracts of a large scale are implemented by companies with sufficient capacities. As the scope of orders decreases, the capacity requirement for realizing companies does too. However, this also reduces the potential of construction companies to achieve balanced contractual conditions. For small-scale orders (up to 6 million), it is usual that a draft contract for the work is sent along with the documentation. This is to a large extent immutable and binding for the winner of the tender. The tender price for small-scale contracts then consists of the valuation of the items of the submitted bill of quantities and at the same time the acceptance of unequal contractual terms, which should be taken into account in the submitted tender. *The price/costs consists of 4 parts: costs for the implementation of construction activities, costs of the construction object, total cost of construction, and LCC (Schneiderová Heralová, Střelcová, Brožová, Strnad, 2013). LCC stands for Life Cycle Costs, and its comprised of costs related to the technical parameters of a building, operating costs and administrative costs (Macek, 2009).* The contractor can legally obtain the rectification of the contractual conditions, but it cannot be assumed that he will achieve the desired result that would be beneficial to him in time. In Czechia, for small-scale contracts, it is still the case that either the contractor accepts the conditions or does not apply for the contract – take it, or leave it. *The company's management must decide whether it is interested in applying for the offered project. Then, as a rule, the marketing department checks whether the company can fulfill the conditions of the investor. The company can fulfill these conditions on its own, but it is also possible to achieve them through the association of several companies. The goal of this phase is to eliminate projects that are not interesting or that are difficult for the company to implement without huge risks. For that reason, we have risk management that deals with the investigation of project risks (Prostějovská, 2008).*

Unequal contractual conditions lead to an artificial increase in the price of the work. Straightening the contractual conditions for small-scale contracts should therefore be a priority for public entities that award these contracts.

Compared to the contracting authority, the contractor faces many risks. These risks are primarily concerning negotiations with third parties and property settlements. The supplier wants to resolve the negotiations as quickly as possible, as they are a basic condition for meeting the deadlines set in advance and completing the job in the required form. However, in some unfortunate cases, the supplier is unable to meet all third party requirements – in which case responsibility must be transferred back to the client. This not only delays or even suspends the project, but also increases the bid price, so these risks must be taken into account. *Due to this, all construction companies, but especially the smaller ones, should have reserves for unpredictable costs – usually its 4 to 7% of the total cost for new constructions, 5 to 10% for reconstructions and modernizations and 13 to 18% for reconstruction of cultural monuments (Schneiderová Heralová, 2011).*

Figure 2 : Construction production in a year, in %; gray is construction production index, red is building construction and blue is civil engineering



Source: czso.cz

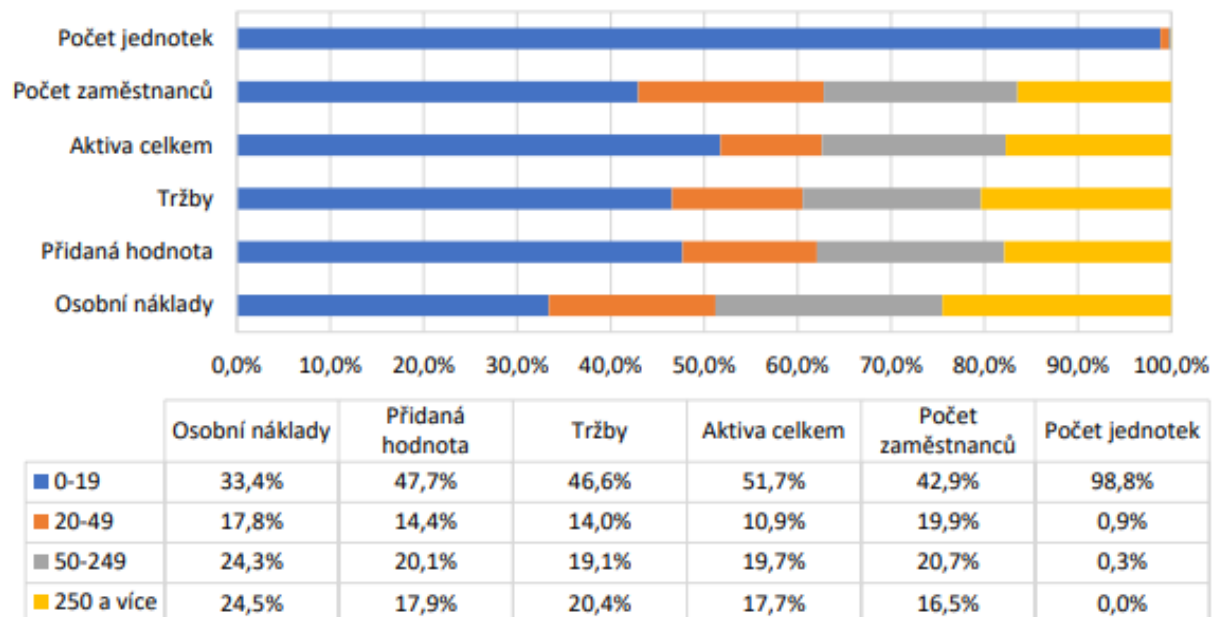
The CEEC Research survey mentioned above shows that the most important thing in the final evaluation of bids is project documentation and good references from previous construction works. Other important factors are the price and the time of construction works, while the costs of the life cycle of the construction have the smallest influence - public investor does not attach much importance to it (3.7/10), in contrast to the private investor, who is more aware of these costs. *In a lot of cases, there is higher focus on preliminary costs, rather than final costs, which are carried out after the realization of the production and show us the actual costs incurred* (Schneiderová Heralová, Kadlčáková, 2006). *The source for the actual costs after finishing the project is accounting* (Schneiderová Heralová, Brožová, Vitásek, 2018). *In order to calculate the costs, many different methods are used, such as differential calculation methods, calculation with incomplete costs and ABC analysis* (Brožová, 2021). *We should also be aware of the secondary costs, such as: construction equipment costs, various charges, area occupation costs, costs related to extreme climatic conditions, difficult traffic conditions etc.* (Schneiderová Heralová, Kremlová, Střelcová, 2008).

3. Situation in Czechia

Industry and construction both grew in recent years, however, we still haven't reached the pre-pandemic values. The economy of Czechia is mostly dependent on the production of cars and spare parts for the automotive industry. Due to the lack of chips for the production of cars, the industry grew less than it theoretically could. Analysts expect that this factor will disappear in the future and we can therefore expect better numbers in this sector. In regards to the situation in the construction industry in Czechia, there has been an outflow of Ukrainian workers from the Czech construction industry due to the conflict between Ukraine and Russia, which led to a slowdown in the construction industry due to a lack of labor. There already was a shortage of labor in this sector, and the military conflict only exacerbated it.

In 2020, compared to the previous year, a greater number of public contracts for construction work were awarded, a total of 4,408, but with a smaller value of CZK 152.9 billion (price without VAT). The largest share of orders, roughly construction and renovation of buildings accounted for half, while in the previous year 2019 it was linear and engineering structures. The inertia of construction contracts can play a role, when it is reflected in the statistics completion of constructions started in previous years (Ministerstvo průmyslu a obchodu, 2021).

Figure 3 : Shares of size groups of enterprises according to the number of employees on selected indicators for the construction industry in 2020



Source: ČSÚ, MPO calculations, units with 0 or more employees

Statisticians announced that in 2021, the construction industry grew by 1.4%, but in 2020, there was a drop of 6%. So we can say that last year's construction growth of just 1.4% is disappointing, as the calculation was based on a low base of 2020, when construction fell by 6%. Land construction, which includes the construction of apartments, offices and warehouses, increased by 1.5% year-on-year last year. Transport construction, i.e. civil engineering, grew by 1% in 2021. At the end of last year, unlike industry, construction workers did well. Construction accelerated year-on-year growth to 8.1% from November's 2%. In addition, building constructions grew by 10.5% year-on-year in the last month of the year, and the construction of engineering structures rose by 2.2% (Koranda, 2022).

The number of building permits rose by 5.8% year-on-year to 90,960. The indicative value of permitted buildings reached 521.9 billion crowns, which is 33 percentage points more than in 2020. In 2021, the construction of 45,244 apartments started, and there were 28.3% more of them year-on-year. Furthermore, last year, completed apartments increased by 0.7% to 34,641. The whole of last year 2021 was marked by a significant slowdown in the construction industry. It grew by only 1.4% last year, after a decline of around 5% in 2020. The construction industry is thus still one of the most affected sectors of the economy.

Conclusion

On the basis of these findings, it can be concluded that the main problem lies in the higher final prices of the constructions compared to the original expected pricing. This price increase is caused by the neglect of construction life cycle costs by the public investor due to competition only on price and insufficient focus on other factors compared to private investors. Private investors take into account the whole process of construction work, together with the subsequent operation and costs. In contrast, the public investor is bound by many regulations, which often conflict with the selection of a quality developer for the public construction contract.

In order to improve this situation, it is necessary to set the maximum weight of the price criteria in tenders, and aim to have less competition where the main focus is the price. We should also strive for less regulations binding the public investors. This would lead to a more frequent selection of suitable candidates for public procurement construction projects, and at the same time they would become more advantageous for most companies compared to the current situation. We should also consider the possibility of paying contributions to unsuccessful applicants and thus motivate more participants to compete. It would be better to make the payment and invoicing of the work based on the progress of the given project, rather than set a fixed budget in the beginning. The most common construction procurement system is the Design-Bid-Build method. *This system is mainly used because of greater control over the project proposal and transparency regarding financing - this is especially important in the case of public contracts financed from public sources* (Tománková, Čápová, 2013). This method has its weaknesses, but even though there are other, more effective methods, they are limited by the laws of Czechia.

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