

News, Notes & Commentary

Self-Insurance Costs

Several years ago, we wrote about what self-insurance should cost. Since we have recently run into this problem several times, we feel it might be important to discuss the subject again.

Theoretically, a contractor would only elect to be self-insured if it thought that the actual cost of claims and administration would be lower than a hard cost contract with an insurance company. Part of this decision is an estimation of when claims will be paid out and what these deferred costs are worth today. Interestingly, these same basic understandings are often ignored when a company charges a project for its self-insurance plan. We have heard many different defenses for the charged rates exceeding what one would expect to pay to an insurance company; including the extraordinary risk that the contractor is assuming and that Owners would not be willing to pay for claims in the future therefore failing to discount future payouts would be proper.

Typically we would argue that the decision to self-insure is not unlike the Construction Company making a side bet with its insurance company on the real cost of claims. This side bet should not effect the cost of insurance to the project and in no case should the Owner be required to pay costs in excess of market.

Related Party Subcontractors

You enter into a GMAX contract with a general contractor who routinely self performs millwork. You find out when the project ends that the G.C. considers the millwork shop to be a separate entity and the millwork was performed lump sum to the G.C. Seem Fair? This situation has happened to our clients twice in the last four months.

Obviously, an owner can run a risk of paying too such when a captive company is allowed to do work for a G.C. and even greater risk if such work is lump sum. Lack of arms length buying procedures or the appearance of preferential treatment may well result in an inflated price, even if the work is bid. Scrutiny of the subs change order prices may also be compromised. Before you casually allow the G.C. to self perform work consider the following:

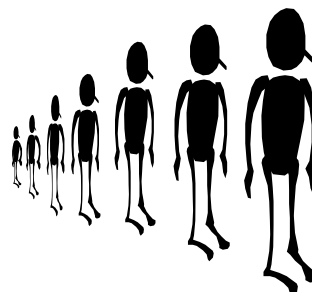
Is the captive a legitimate subcontractor or just a way for the G.C. to make more fee?

Does the sub regularly perform work for other general contractors or Owners? If not, consider not paying additional OH&P on the self performed work.

Since any bidding of the subs work can be suspect, consider making any self-performed work a "Mini-GMAX".

Don't fool yourself into thinking the G.C will negotiate in your favor with the in-house subcontractor. Plan on participating in any bid scope or pricing meetings. On a recent audit, the in-house sub was awarded a lump sum subcontract after bids were taken. The in-house sub was the highest out of five bidders. The G.C. indicated that the other bids were either incomplete or the other subs could not accomplish the schedule. Independently, we verified that neither of the two lowest subs was contacted by the G.C. after they faxed in their bids.

Beware of Crew Rates



We often encounter labor costs on change orders calculated at what can be described as an average crew rate. The following is an example of a typical crew rate calculation:

5	Journeyman at \$30 per hour	\$150.00
1	Foreman at \$35 per hour	35.00
1	General Foreman at \$40 per hour	<u>40.00</u>
		225.00
	Divided by Productive Hours	<u>5</u>
	Rate per Hour	<u>\$ 45.00</u>

Theoretically, this calculation is trying to determine the actual cost of one productive labor hour. However, the above calculation has flaws in its logic when used for pricing change orders. First, most foremen are at least 50% productive. This means that the crew cost should be divided by 5.5 productive hours rather than 5. Second, the general foreman is essentially a fixed cost. Assuming that a change order does not extend the contract schedule there should be no additional cost for a general foreman. Making the above changes adjusts the change order crew rate as follows:

5	Journeyman at \$30 per hour	\$150.00
1	Foreman at \$35 per hour	<u>35.00</u>
		185.00
	Divided by Productive Hours	<u>5.5</u>
	Rate per Hour	<u>\$ 33.64</u>

Negotiating from Strength

Recently, in a discussion with a prospective client, the topic of change orders came up. The project manager proudly exclaimed that he had negotiated \$2,500,000 of change orders on a project, and had saved his company an average of 10%. When we asked how he had accomplished this, he said that he just marked each change request down by 10%, or so, and forced the contractors to accept this new number.

While the project manager undoubtedly saved his company some money, in all likelihood he did not cut all the "fat" out of the change orders.

Our experience has shown that many contractors include a "fudge factor", or contingency, in every change request. This is especially true if the Owner has a history of arbitrarily cutting change requests. There is a good chance that the contractors had figured out the project manager's game, and had included sufficient contingency in their change requests to cover both the Owner's cut and make some extra profit.

This owner was negotiating from weakness. We suggest negotiating from strength. Many of our clients require their contractors to provide full cost estimates with all change requests. Profit, if allowed by contract, is added as a separate item. The client is then able to negotiate, or re-estimate, the contractors' material quantities and production rates; these are the areas where project managers and architects are typically the most capable and the most comfortable. They then accept the change order "subject to audit". The financial representations such as labor rates and payroll burden made in the change request can later be audited and adjusted if necessary.

This method helps produce change orders which only include the costs and profit allowed by your contract.

Contractor Accounting



Over the years, we have occasionally encountered a contractor with a deficient accounting system. Be sure that your GMAX contractor has an adequate accounting system that can report his final costs of the contract as well as documenting his change order pricing. If you have allowances or T&M change orders, make sure he can accurately track the actual cost of those, as well. Ask a few questions during your contractor selection process about how the contractor tracks his cost. If you still have doubts feel free to call us.

Free!

As always, we will be glad to review any contract you may be considering. While not a substitute for review by your legal counsel, we are in a good position to spot potential problems due to our extensive exposure to the result of different contract clauses. Please call or write for further information: