



## Change Order Pricing

Recently we were asked to review the cost and change orders to a contractor. During the audit we found some interesting things that might be interesting to you.

We noted that as a general rule the change order requests from the subs did not seem to be altered in any way. In other words the change requests from the subcontractor were simply passed along to the owner. The theory seems to be that if the Owner thought the amount was O.K., why should the contractor deal with it?

An audit of one of the subcontractors indicated that the labor rates in the estimates were inflated over 30%. The estimated cost of material was inflated almost 45%. The subcontractor was adding the contractual fee above the inflated cost of the change order.

We all know change orders are, as one contractor told us, "just an opportunity". However, some opportunities are more lucrative than others. In most contracts terms, whether the contract is cost plus or lump sum, the general contractor is paid a fee based on cost or estimated cost. There is every incentive to make sure the subcontractor's change orders are as costly as possible and very little incentive to make them as cost effective as possible.

Careful review of selective change order pricing could save your company substantial dollars in construction cost each year. If your Contractor is not doing a review of the cost, maybe you should consider an overhaul, starting with the contractor's management.

## General Liability Insurance and Fee

By all accounts from insurance brokers, the cost of General Liability Insurance is on the rise. This has several implications for Owners that we would like to discuss. First, while cost may go up on renewal of a contractor's policy, that doesn't mean the current cost is higher. Some contractors may attempt to pass on the future cost to you now. Additionally, with higher costs, some contractors may elect to self-insure or purchase high deductible policies, which serve the same purpose. The true cost of these types of policies may be very difficult to determine. In fact many large contractors have counted on the difficulty of insurance calculations to inflate their costs of GL Insurance for years. One contractor got so bold as to include hypothetical cost for insurance they didn't even have and called the costs "self insured". Another audit revealed an internal memo from the company president that required GL charges of .8% on GMP jobs and .3% on lump sum work. It now appears that this contractor "GL Self Insurance" trick has spread nationwide.

One way of leveling the playing field in a bid situation is to require that the contractors include the cost of GL and Umbrella insurance in their fee quote. A large contractor wanting a 2% fee and 1.1% for GL insurance somehow managed to quote only 2.5% for fee and GL when the bid was restructured. One of our clients that builds worldwide has been using this approach for 14 years and another northeast client began several years ago when cost of GL insurance seemed to be excessive in it's contractor bids. We believe that such an approach is prudent for most medium to large projects and in most areas of the country when larger contractors are included on the bid list.

## Recruitment Costs

Occasionally we run into a contractor billing recruitment costs or headhunter fees to reimbursable cost of work. We believe the trend picked up steam a couple of years ago when contractors began having a more difficult time finding and keeping employees. We hope it is obvious to most of you that personnel costs and the human resources function of a contractor are part of home office expense, and therefore, not reimbursable except in the contractor's fee. As contractors had to spend more money on recruitment they began to test the waters on larger work to see if any unsuspecting Owners would reimburse them for headhunter fees. Some of you did. Today we are seeing contractors venturing out further into the ocean of owner acceptance and billing these fees on even mid-size projects. Regardless of the need for qualified employees to build our project, do not lose site of what this recruitment cost is. It is a home office personnel expense that will benefit the contractor over the employee's entire tenure and is a substitute for the contractor's own home office employees chasing down leads for qualified candidates.

## Variable and Verifiable

If one phrase can most clearly define reimbursable costs, it is variable and verifiable. As Owners we expect to reimburse those costs that a contractor has incurred because of our project (and only our project) and are verifiable by the Owner. Costs that may be variable but are not verifiable (like persons working on our project in the home office) are not reimbursable under typical contract language. Cost that is verifiable but not variable (like fixed data processing expenses) is also not generally listed as reimbursable. Of course, costs that are not reimbursed directly by the Owner are costs that must be covered in the contractor's fee. The more of these costs that a contractor can move to reimbursable (without reducing the fee) the more of the fee can go to profit.

## “Fix the Rate, It's Too Hard to Audit”

We have heard the argument of fixing a rate because it is too hard to audit hundreds of times. Obviously, it depends on who is auditing how hard it is. Since we perform these tasks several times a week it is actually rather simple to determine with great degree of accuracy, actual expenditures for all kinds of detailed costs like payroll taxes, employee benefits,

workers compensation insurance, etc. Since a contractor's existence is based on estimating and tracking costs it is nonsensical to think that there are some costs incurred and paid by the contractor that are just too difficult to calculate accurately when it comes to giving an accounting to the Owner.

## Payments Made Outside the Contract

Many Owners make payments to their contractors outside the GMP contract. Sometimes these payments are for pre-construction services or work performed prior to establishing the GMP, and sometimes for change orders that for some reason the Owner wishes to pay separately. It might be surprising to some that in a high percentage of these cases the contractor accidentally commingles these separate costs into the accounting of the GMP contract costs. On one large contract, the contractor sought to get reimbursed twice for building permits paid by the Owner separately, in the amount of \$125,000. On another project the Owner had paid \$60,000 for the demolition of an existing structure separately only to almost pay for the cost again when the contractor included the same cost in the new building GMP.

## New E-Mail Addresses

Please note the new e-mail addresses for the following CCM personnel:



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## Contract Review

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 results of different contract clauses. Please call for further information.

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