THE RISK MANAGEMENT LETTER

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More On OCIPs, Part I: Deducting Insurance Costs From Contractor Bids

In our continuing coverage of OCIP issues, Linda Carnevale analyzes the bid-deduct process and gives a breakdown of the various options available to the OCIP administrator to eliminate contractor insurance costs and mark-ups.

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BY LINDA CARNEVALE

Owner-Controlled Insurance Programs (OCIPs) have become a very popular method for insuring multiple entities under large construction projects.[1] An OCIP is an insurance program in which the owner[2] arranges a master program of insurance to protect its interests and the interests of most or all other parties involved in the construction project. There are many purported benefits to the OCIP approach, including:

- Concentration of purchasing power
- Opportunity for large-deductible savings
- Opportunity for dividends or premium returns
- Guaranteed insurance for the project term
- Reduced need to monitor contractor insurance compliance
- Improved loss control
- Coordinated loss control without subrogation
- Improved community relations
- Comprehensive insurance
- Dedicated limits of insurance
- Opportunity for guaranteed cost savings

Although the purported benefits of the OCIP approach are many, the potential for substantial savings is probably the biggest contributing factor to the recent success of OCIPs. To maximize cost savings over traditional insurance, it is necessary for the construction contractors and subcontractors to remove from their bid their normal cost of insurance associated with the proposed project. Doing so not only eliminates duplicating insurance covered under the OCIP, but also eliminates the 5–10% loading contractors normally add to insurance costs as mark-ups.

The Bid-Deduct Process

The process of removing the contractors' insurance costs and mark-ups from the OCIP construction project is sometimes known as the "bid-deduct" process. This process usually requires a careful review by the OCIP administrator to verify that the cost of insurance deducted by the contractor has actually been deducted from the bid, and that such deductions are reasonable.

Analysis Before The Award

From a cost point of view, there may be significant advantages to reviewing the insurance deduction before the award of the contract. If the contractor has not deducted all appropriate insurance costs as requested, the project owner may reduce the amount of the contract by the amount of insurance costs not already deducted.

Options In The "Bid-Deduct" Process

The following matrix illustrates some of the options in the "bid-deduct" process. Columns I, II, and III represent three examples which show a variety of methods used to verify that insurance costs have been removed from contractors' bids. In each example, the analysis can be done before the award of the contract or after it has been awarded. The elements of each example are arbitrary, and in fact, an owner can take elements from each example to tailor a plan that best meets his or her goals and objectives.

+ = Pro – = Con	I Contractor Takes Insurance Costs Out Of Bid	II Contractor Provides Bids With And Without Insurance Costs	III Contractor Leaves Insurance Costs In Bid And Owner Deducts Them From Progress Payments
Whether Analysis is Before or After the Award	+ Disclosure of insurance costs is needed to assure that they have been deducted. – There is no guarantee that the contractor is deducting all (or any) insurance costs unless we get copies of the policies and perhaps other documentation.	+ Can compare the bids to determine the insurance components being deducted. + May force contractors to give more thought to what the insurance costs are. – Same as Column I – Contractors may play games with the figures if adverse to an OCIP. – Labor intensive for contractors. – Could reduce the number of bidders. – Higher administrative costs because there are two bids to review for each bidder.	+ Owner has greater assurance that insurance costs are deducted. + Insurance costs are removed from change orders too. – Must obtain copies of policies and perhaps other documentation. – Higher administrative costs. – Contractual language must allow deduction. – More complicated. – Inevitable contractor complaints when insurance costs are deducted from progress payments and at contract close out. – Cooperation from prime contractor(s) is critical. – The WC carrier expense factor may increase to recognize additional service requirements.
If Analysis is Before the Award	+ May be able to get bid reduced if all applicable insurance costs were not deducted. – Labor intensive and time consuming award process. – Bid documents must define this process and what supporting documents may be required. – Could delay the award or cause contested awards. – Could reduce the number of bidders	+/– Same as Column I	+ May reduce contractor complaints when insurance costs are deducted. – Contractors estimate some subcontractor costs or end up using different subcontractors. – Same as Column I. – Highest administrative cost of all options.
If Analysis is After the Award	+ Least labor intensive administrative process and therefore least administrative cost to Owner. – Bid tracking of insurance deductions becomes more of a recordkeeping process than a means to force additional cost savings.	+/– Same as Column I unless Owner selects the bid with insurance costs and deducts them from progress payments. In that case refer to comments in Column III.	– Difficult to assess cost of risk within deductibles without contractor cooperation. – Owner's accounting department must be considered. – Cooperation from prime contractor(s) is critical. – If contractor umbrella/excess liability is subject to a flat premium, there will be resistance to deducting any costs.

But obtaining the documents necessary to assure the accuracy of the insurance deduction and agreeing on a reasonable figure can be a laborious and time-consuming process. Most contractors fundamentally dislike OCIPs and may not be entirely cooperative. Such distaste for OCIPs stems from the fact that contractors are often adept at negotiating their own insurance program, include mark-ups under such programs, and may receive a dividend under their workers' compensation policy. In essence, many contractors enjoy their insurance as a profit center.

In addition, cost estimators for the contractor usually apply insurance loadings based on payroll and may not be able to establish how much would be based on the coverages to be provided by the OCIP. Such calculations normally must be done by the person responsible for insurance at the contractor's office or by the contractor's insurance broker.

The bid-deduct process can become grueling for everyone involved when it is done before the award. Some contractors may become dissatisfied with the process, which could lead to contested awards and reduce the number of bidders.

Analysis After The Award

The primary benefit of reviewing bid deductions after the contract is awarded is that only the insurance deduction of the successful contractor needs to be reviewed. Although there is less administrative work and cost to the owner, it may be difficult or impossible to adjust the award amount should it be determined that the bid deduct is insufficient. To avoid such a problem, the contractual agreement between the owner and contractor should address this issue and provide the owner with a legal basis for reduction of the amount of the award, should bid-deduct amounts require adjustment.

If the bid-deduct review is done after the award, the OCIP administrator will review the insurance costs for only one contractor, greatly reducing administrative effort and cost. However, unless the OCIP administrator has the contractual right and remedies to reduce the owner's cost, this method becomes primarily a recordkeeping process. This may be considered adequate, for example, in a low-bid situation where the competition between bidders is seen as sufficient to assure that appropriate costs have been removed.

Bids With And Without Insurance Costs

Requiring the contractor to provide bids with and without insurance costs may compel the contractor to give more thought to what the insurance costs are. However, this process is complicated and means more work for the contractor, which could reduce the number of bidders. Some contractors intentionally may not deduct the full insurance costs in order to encourage the traditional approach rather than an OCIP. Administrative work also increases for the project owner because there are two bids to review for each contractor.

Leave Insurance Costs In the Bid And Deduct From Progress Payments

Project owners can have much greater assurance that insurance costs have been deducted, and reduce the administrative burden of verification, by requiring contractors to leave insurance costs in the bid and then deducting such costs from progress payments.

This approach involves obtaining copies of the contractors insurance policies and other documents, including evidence of the cost of risk within deductibles or self-insured retentions for the purpose of determining an appropriate allocation of the bid-deduct amount. Further communication with the contractor may be necessary if insurance policies do not provide adequate detail or significant pricing information for an allocation to be made. Even when insurance costs are left out of the bid, they may be *loaded into* contractor billings and change orders as part of a lump sum. These and many other factors make the process one of negotiation, rather than an exact science.

Successful execution of this process requires properly worded contractual agreements, including the owner's expectations *and* remedies, specified in all prime contracts with pass-through of these provisions to all subcontract agreements. Excellent communication and prompt attention from the owner's representatives, including its accounting, department is also needed. Cooperation from the prime contractors is important, as the insurance costs are deducted from the progress payments, and the prime contractors must pass on such deductions to its subcontractors. Once a contractor has completed the project, the insurer must audit the payroll *immediately* and produce a final audit before the retained amount is returned to the contractor. The insurer would normally expect to schedule final audits for all contractors shortly following policy expiration. Instead, the insurer must audit payroll on a monthly basis. If the voluntary payroll collected by the OCIP administrator appears credible, the insurer may be able to eliminate the expense of physical audits on policies that generate small premiums.

While highly effective in making certain bid-deduct amounts, this method carries a relatively high administrative burden.

Conclusion

While the project owner can never be sure that all insurance costs have been removed from a bid or change order, there are a variety of methods that provide differing levels of assurance. As with the other components of a large insurance program, the method of handling the deduction of insurance costs under an OCIP should be individually designed to meet the needs and achieve the objectives of the owner. ☙

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Notes

1 Generally those with in excess of $100 million in construction hard costs.
2 Contractor-controlled insurance programs are called CCIPs.