

Step by Step Advice In Understanding & Implementing A Service Labor Rate

*Establishing a "PROFITABLE" Service Street Labor Rate
is Critical to Service Department Excellence!*

Whether you are on time and material, or flat rate pricing, your company must know what its base labor rate needs to be in order to recover the costs in the service department.

Many companies are **not departmentalized** in their gross margins let alone the overhead.

No matter, even in a company that has little structure to the profit and loss statement, the service street labor rate needs to be calculated properly to insure the costs of doing business in service are profitable.

HVAC Facts:

1. Most HVAC companies are losing money in service and do NOT Know it!
2. Average profit in 2005 for HVAC is approximately 1.2%.
3. Most HVAC companies are fearful of raising their service rates in fear they may lose customers.

Why?

The simple reasons are most companies simply do not understand how to charge properly for what it truly costs to send a qualified, trained service technician to a home or business. They don't know their true costs of doing business.

- What we pay a serviceman for 1 hour of wage is not our costs.
- Add the benefit burden, and this still does not equal our costs?
- Add overhead and that still is not an accurate gauge of our costs?

One must look at the entire service operation to determine the costs. It cannot be ignored.

Also, we as contractors typically allow the "Market" or what we refer to as the market to influence our belief systems for setting prices. While this isn't always bad, it is ONLY good if you know your costs first and foremost!

Your belief systems of what is fair, or market allowable, get in the way with a stark reality; while we think we are making a profit in service we are in fact losing millions of dollars in service as an industry because we do NOT understand our true costs and we use the market as an excuse to NOT raise prices or improve operations.

We have met the enemy and it is US!

What do we do?

1. Know your costs of doing business in service, as well as other departments.
2. Set your street rate properly and remain vigilant on # 1, and # 2 because they can and do change.
3. You probably need to raise your street rate.
4. Improve your operational efficiencies so you can stop raising your rates.
5. Then use the “Market” to position your rates after 1-5 are in control.

Here is the major issue. It is about costs – truly understanding your costs and then pricing from there.

Understanding Your Costs:

Whatever we charge, we have to understand two fundamentals:

1. **Our service efficiency** - Billed Hours/Paid Hours gives us this figure.
4 hours billed/ 8 hours paid = 50% efficiency.
So I need to work 2 hours to get 1 billed.
2. **The Costs of our Wage for Labor** – 1 hour paid is not the same as what it costs to actually get 1 hour of billable time. Assume an example wage of \$25.00 an hour for a top technician.
3. **Effective Wage Rate** = $\$25.00/.50$ or $50\% = \$50.00$ per hour to bill one hour street rate
Since I have to work 2 to bill one my rate needs to accommodate this inefficiency.
Whatever rate I have to bill, I know that that rate I charge for my labor has to make \$50.00 be in a ratio of where I want my labor to show-up.
4. **KPI's and Industry Ratios for Profit** - That ratio in history – for profitable companies – is 22% - meaning \$50.00 needs become 22% of the rate I charge for my labor. So the street labor rate has to be divided by .22 or 22% to get the divisor figure that will make \$50.00 become 22% of the sale for labor only. $\$50./.22 = \227.27 and that makes \$50 = 22% of \$227.27

You will see on the next page why this is imperative that you charge so your labor equals 22% of the street retail labor rate. In virtually any example the labor margin gets pulled down by the parts margin.

The gross profit dollars of parts are generally much greater than the labor gross profit dollars. So you **HAVE** to charge properly for both, and labor is crucial because it is the variable that changes each time.

5. **Parts Costs, Taxes, and our Markup Factors** – We have to get our parts priced properly as well to create a total repair.

6. **Total Repair** - So we bundle up the parts retail price, and the labor retail price, and that gives us a full repair that hopefully covers the costs of the service department.

One of things least understood is labor being the variable that changes each hour, every day. Labor can change dramatically. When in all the other costs remain consistent. Meaning if you mark up a part 3 times, then the cost of the part is all you need to get it priced retail properly to insure a profit on the part.

Labor is not that way. An extra hour or two on a repair for any of a dozen reasons can ruin a perfectly good labor price. Do it enough times and your rate is no longer perfectly good.

What happens on a repair is not the same as the next. So, we have to check our efficiency rates no less than monthly and I highly suggest weekly tracking and review.

Review each repair below.

Notice the gross profit dollars may be high on parts, but since we have a lower margin percentage on those parts, we drag the overall margin percentage down in service for the total repair. Thus, a 73% labor margin, does not account for profit, as the repair total is closer to 55-65% after both labor and parts are added together.

Only then do we cover expenses.

Example \$ 100.00 street rate, \$59.00 Diagnostic

1 hour labor
Part Cost \$50.
Markup 2.0

1 hour labor
Part cost \$100
Markup 2.5

1 hrs. labor (1 Hr \$59 diagnostic)
Part cost \$ 150
Markup 2.0

2 Hrs
Total

	Example 1			Example 2			Example 3		
	Labor Only	Parts Only	Total	Labor Only	Parts Only	Total	Labor Only	Parts Only	Total
Sales	100	100	200	100	250	350	159	300	459
Cost of Sales									
Labor	22	0	23	22	0	22	44	0	44
Materials	0	50	50	0	100	100	0	150	150
Equipment	0	0	0	0	0	0	0	0	0
Benefits	4	0	4	4	0	4	8	0	8
Subcontracts	0	0	0	0	0	0	0	0	0
Commissions	0	0	0	0	0	0	0	0	0
Warranty Reserve	1	0	1	1	0	1	2	0	2
Buydowns/Promotions	0	0	0	0	0	0	0	0	0
Permits	0	0	0	0	0	0	0	0	0
Total Cost of Sales	27	50	77	27	100	127	52	150	202
Gross Profit \$\$	73	50	123	73	150	223	107	150	257
Gross Margin %	73%	50%	61.5%	73%	60%	63.71%	67.29%	50%	56%

This profit and loss representation of a set of service calls, shows costs down to the gross profit dollar line, and you will notice the labor retail and the parts retail are broken down for you, so you can see the impact of the parts dollars being greater and the margin being lower, creating a drag on the margin percentage.

Overhead of course is still below the Gross Profit line. If we assume a 50% overhead rate in a service company, the first repair generates 11.5% profit. The second a 13.71% profit and the third a 6% profit. The key factor here is that we DO pay our overhead bills with dollars, so a 6% profit may not be bad if the dollars are great enough to recover our overhead costs (Be careful that is a slippery slope.) Ideally what we want is our street rate to produce close to a 70% gross margin, and markup our parts, so our prices are set based on costs. This allows us to then turn our attention to operational efficiency enhancements!

Here is the summarized version of the three repairs above.

Summary of the Above Repairs

	Labor Only	Parts Only	Total
Sales	359	650	1009
Cost of Sales			
Labor	88	0	88
Materials	0	300	300
Equipment	0	0	0
Benefits	16	0	16
Subcontracts	0	0	0
Commissions	0	0	0
Warranty Reserve	4	0	4
Buydowns/Promotions	0	0	0
Permits	0	0	0
Total Cost of Sales	108	300	408
Gross Profit \$\$	251	350	601
Gross Margin %	69.91%	53.84%	59.56%

What can be learned from these examples - the net effects are these:

1. The initial diagnostic fee to get to the home, being set to get the repair are great for strategy, to book calls, but it drags down the overall labor margin. So the street rate has to be high enough to compensate for this.

In effect the diagnostic lowers your productivity. You spend that hour doing the job at a lower price than you will bill the same hour repairing the job.

Flat rate pricing does allow you to charge a higher street rate because it is not published to the homeowner, just be sure to understand the rate that needs charged to have a lower diagnostic fee.
2. The parts dollars are greater than the labor dollars in most cases, and therefore create a situation whereby the labor rate must be set properly to achieve the desired margin for the company.
3. This also implies that the parts costs are accurately set, kept up-to-date and are marked-up, according to the company wishes. Markup factors vary widely but should be set and controlled by the management not the technician.

Example Parts Markup Tables:

Parts Mark-Up Factors	
\$ 00.00 - \$ 4.99	5.00
\$ 05.00 - \$9.99	4.00
\$10.00 - \$49.99	3.30
\$50.00 - \$99.99	3.00
\$100.00 and Over	2.70

Assume a part cost of \$2.90

A Tax Rate of 6.75%

The parts markup and calculation of parts retail price would go like this:

- 1. 2.90 gets marked up times 5 so, $2.9 \times 5 = \$14.50$**
- 2. The tax of 6.75% is calculated on the part cost of 2.90 and equals \$.20 cents**
- 3. Add the retail price of \$14.50 + the Tax of \$.20 to equal parts retail of \$14.70**

So a part that costs \$ 2.90 will be charged at \$14.70

Once again, small dollars are being generated to cover big overhead costs in the service business.

A larger part like a compressor cannot be marked up 5 times, so the dollars are much larger but end up shrinking our gross margin since the markup is smaller (2.7 in above example).

So we tend to get the mix as contractors. Who can predict. That is why the parts markups are set ahead of time. Parts costs must be kept up to date. And the street labor rate needs to counteract the lack of billing efficiency that all companies run into, even great ones!

Follow These Steps To Establishing A Profitable Retail Street Service Labor Rate

1. The easy way is to divide your average service direct labor cost (Adding up all your service labor hours paid, and dividing by service payroll to get an average cost per service labor hour) let's just say \$35.00 per hour.

This will account for your inefficiency.

By dividing all hours billed off tickets in service by paid hours for those tickets, you are including all the issues operationally that challenge us all. Dispatching errors, travel time, supply house time training etc. so the number you come up with will be much higher than your wage rate.

A better method is to have a departmentalized Profit and Loss Statement with these breakdowns:

- Residential Service Labor
 - Residential Service Parts
 - Residential Service Accessories/Sales
 - Residential Maintenance
2. Take the \$35.00 and divide by the ratio of 22% (the labor standard for service in our industry), which is equal to \$159. And that assumes a diagnostic fee was in those figures below of 1142 hours billed.

\$20.00 hour technician wage rate

1142 hours billed/2000 hours paid = 57% efficiency ratio

$\$20/.57 = \35.00 per hour effective wage rate

If we plan the future to bill at 75% efficiency

1500 hours out of 2000 work hours

700 hours at \$159.

750 Hours at \$ 59.

Watch:

\$119,250 in Billable Revenues

\$ 44,250 in Diagnostic Revenues

Total of \$ 163,000 in revenues at 75% efficiency – not bad!

Even at 50% billable efficiency

500 hours x 159. = \$ 79,500

500 hours at \$59 = \$ 29,500

Total of \$109,000 in revenue

Benchmark minimum for a residential service truck is \$125,000, target is \$150,000

3. Know your parts costs and establish your parts markup tables.
4. Know your tax rate – each state and local municipality is different.
5. Make sure your taxes get added to the retail parts costs.
6. Street Labor Rate positioning: A contractor must determine how they are going to position this labor rate.

Are you charging a diagnostic fee to travel to the home and diagnose the trouble?

This is a common pricing component in a flat rate system.

Are they going to charge by the ¼ hour, or the ½ hour, the diagnostic and the ½ hour, or are they going to get on flat rate which charges by the task and the amount of labor time it takes for the task?

There are myriad ways to charge for service, but in the end it is all about whether you have your base labor rate set correctly to cover your costs, based on efficiency and these factors affect efficiency:

- Dispatch procedures
- Truck Replenishment
- Technician competency/or new green technicians
- Technician Billing Disciplines
- Discounts for diagnostics (some companies give this away if repair is completed)
- Travel times
- Supply House visits
- Pay Plans and Reward Systems
- Service Management tracking or lack of tracking
- Training and Meeting Time

7. Each month, check your average labor cost per hour.

Overtime, and a labor force that is dragging out calls due to poor training or skills, or simply a new technician or two can change the way the labor per hour cost is occurring in the company. We are not suggesting you change your rates monthly, but if you hired two new technicians because you needed one, and another quality technician of yours retired or left, the direct labor cost per hour could have climbed to 40.00 per hour to bill one hour, leaving the company service labor margin in decline at a base labor rate price of 159.00, as the new rate should be close to \$200. If the rate has changed drastically, you may need to adjust your street rate price. By the way, the average base retail labor rate in the industry is right at \$110 per hour with a \$59 diagnostic (flat rate only).

8. Track your performance. Use a service tracking system. No exceptions! What gets measured gets done! It's cliché but it has lasted because it's truthful.

Why is this Critical to my Success?

- Having a service labor rate that is properly established will allow your service segment to be profitable even if you are not the most efficient company in your market.
- Checking the service labor rate monthly is important.
- Be sure the labor rate is taking into account the changes in the service department efficiency.
- Update your parts costs monthly.
- New technicians can change this average cost per hour rate for the company, which of course affects the overall retail price needing to be charged.
- **Proper pricing helps you make more profit!**