Expectation Gap

- 9 November 2016
- Presented by:
  - Ewan Cresswell, Integra
  - Justin Crick, RGL Forensics

RGL Forensics

integra
TECHNICAL SERVICES

Agenda

* Time deductible and sales based wording
* Take or pay contracts
* Opting not to reinstate - what does the wording say?

1

Time deductible and sales based wording

Scenario 1 – ABC Refinery

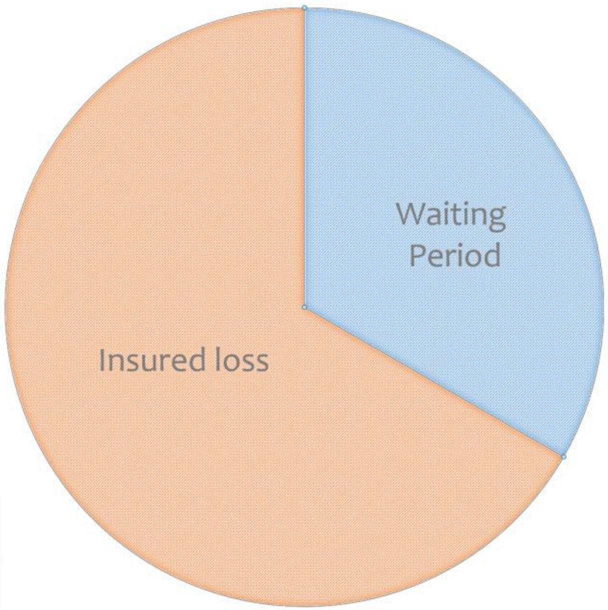
* Fire at a refinery
* 100% lost production for 90 days
* 30 day waiting period from date of occurrence
* Insured has option of loss of gross profit wording, i.e. sales based
* Daily loss of gross profit is USD 1,000,000

RGL Forensics

integra TECHNICAL SERVICES

Insurers' expectations

* 90 days interruption = USD 90 million
* Insured will pick up the loss in the WP
* Insurers pick up the remainder
* i.e. share the burden



Description	Unit	Claim
Loss of gross profit	USD	90,000,000
Waiting Period days	Days	30
Insurers' expectation	**USD**	**60,000,000**

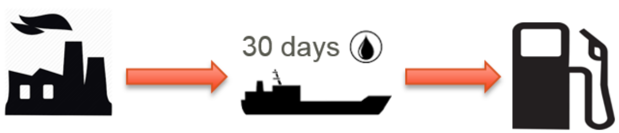
RGL Forensics

integra TECHNICAL SERVICES

Insured's expectations

* Loss of sales not immediately suffered as:

  - Stock in transit – initial sales would flow from production made pre-incident



  - Sell stock to meet sales in the short term

  - Lost production may be feedstock not final products

RGL Forensics

integra
TECHNICAL SERVICES

Insured's expectations

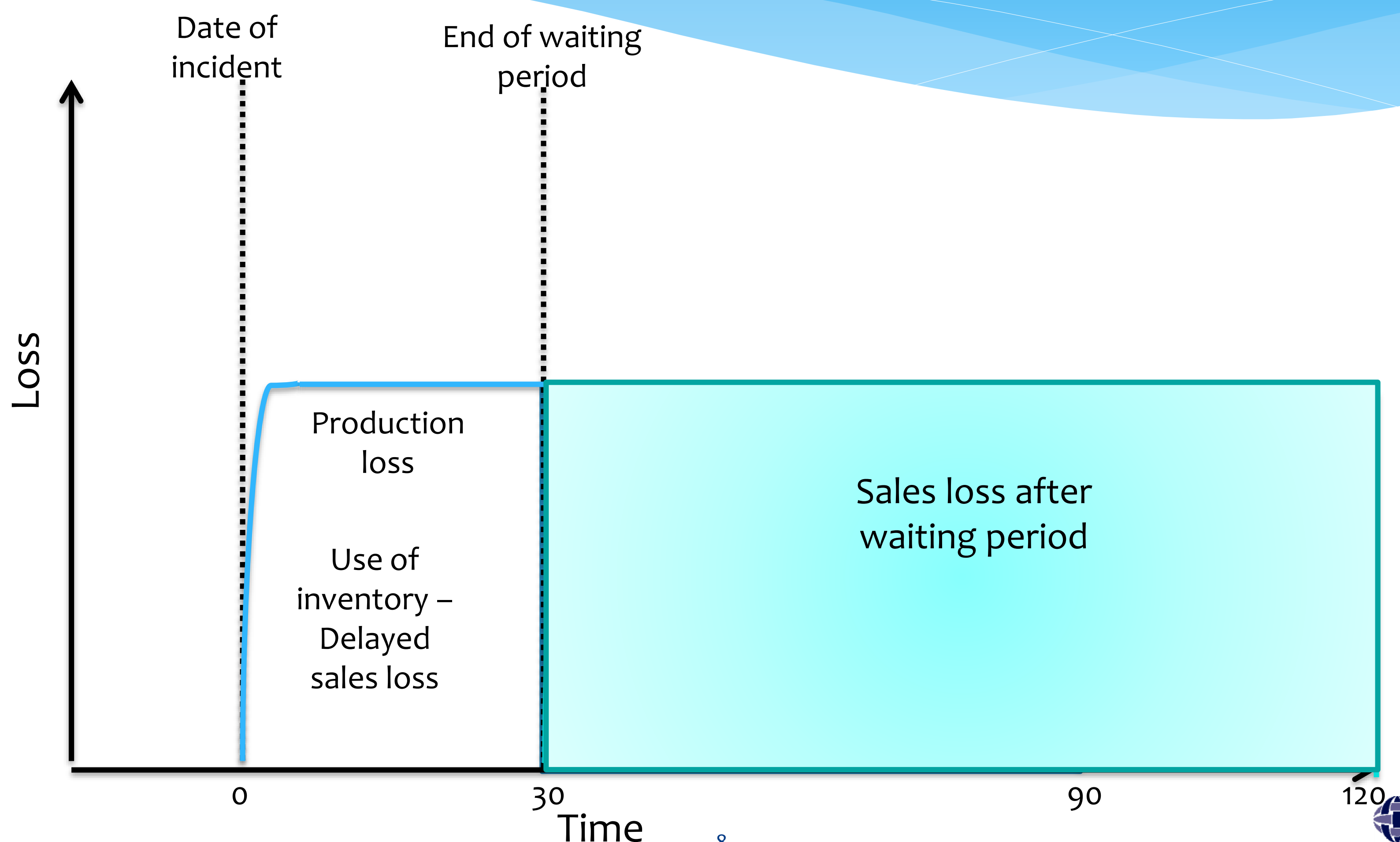
* Actual sales in the first 30 days = Expected sales
  (i.e. no loss during the waiting period)

* Sales loss commences after the WP expires.

* Once production resumes it takes 30 days to fill the 'sales pipeline' and therefore 30 days before sales recommence and recover to 'normal' levels.

Description	Unit	First 30 days	Post WP
Expected gross profit	USD	30,000,000	90,000,000
Less: Actual gross profit	USD	(30,000,000)	0
Insured's expectation	**USD**	**0**	**90,000,000**

Difference between Insurer and Insured's expectation



RGL Forensics

integra TECHNICAL SERVICES

Does Average Daily Value assist?

* In theory, Average Daily Value ("ADV") spreads the exposure between the Insured and Insurer
* What is the denominator - production or sales loss days?
* What happens when:
  * Tail to the loss due to ramp up, or a minor by-product loss prolongs the interruption period
  * Temporary repair, prolonged period of minimal/no loss followed by permanent repair

Scenario 1 – ABC Refinery – additional information

Description	Unit	Claim
Expected gross profit	USD	120,000,000
Actual gross profit	USD	(30,000,000)
Loss of gross profit	**USD**	**90,000,000**
7 day outage for permanent repair	USD	7,000,000
Total loss	**USD**	**97,000,000**

* 100% lost production for 90 days (but ongoing sales impact)
* Only temporary repair
* 7 day outage for permanent repair in six months

Comparison of ADV and Waiting Period

* ADV results in deductible having some value
* Based on the full period, Insurers still take greater proportion of loss
* More proportional if ADV based on loss days only, but is this appropriate?
* How would it changes if there was, say, a 10% loss whilst awaiting the permanent repair?
* ADV approach may not fully bridge the 'expectation gap'

Description	Unit	Value
Loss of production	Days	90
Awaiting permanent repair	Days	183
Permanent repair	Days	7
Period until permanent repair	**Days**	**280**
Total loss	USD	97,000,000
Value of 30 days:		
- Waiting period (first 30 days)	**USD**	**0**
- ADV full period (30/280 days)	**USD**	**10,392,857**
- ADV on production loss (30/97 days)	**USD**	**30,000,000**
- ADV on sales loss (30/127 days)	**USD**	**22,913,386**
- ADV on Sum Insured ($365 million)	**USD**	**30,000,000**

Other options

* Monetary deductible:
  * Easy to understand
  * No variation with loss value

* Set a 'higher of' monetary amount or first 30/45/60 days:
  * Deductible will always have a value
  * Potential difficulty in arriving at the minimum level for a large group with different sized operations

* Waiting Period commences when financial loss starts:
  * Definition of a financial loss / when does the financial loss start?
  * What if a minimal financial loss / increased cost of working incurred from Day 1?

2

‘Take or Pay’ contracts

‘Take or pay’ contracts

- Long-term minimum off-take commitment
- Ensures continuity of supply for buyers & continuity of revenue for sellers

- But, if agreed or minimum quantity not taken, could result in cost to the buyer

- Contractual clause may restrict the buyer’s ability to consume at alternative locations or sell on
- Basis of cost depends on the contract wording, but ultimately part of the cost becomes ‘fixed’

- How does the Policy wording respond to these costs?

Scenario 2 – XYZ refinery

- Long term crude oil 'take or pay' contract – 100,000 Barrels per day + / - 10%
- Minimum take – 90,000 barrels per day
- Consider 2 scenarios
  - Cost of distressed sale, i.e. selling costs and lost sales value equal to 20%;
  - Full value of shortfall against minimum take

Description	Unit	Cost of distressed sale	Full value of shortfall
Minimum take	BBL	90,000	90,000
Contract price	USD/BBL	40	40
Value of daily take	USD/BBL	3,600,000	3,600,000
'Take or Pay' cost	%	20%	100%
Daily fixed cost	**USD**	**720,000**	**3,600,000**

Insured's expectation

* Incident occurs
* Contract reviewed and declare Force Majeure on 'Take or Pay' contract
* Force Majeure not accepted and Insured will incur cost and suffer a financial loss
* Turn to insurance policy as cost is due to an Insured Event

Result = Claim made for daily contractual cost

Insurer's review

- Purchases are an uninsured working expense per the Policy
- Can an ICW be claimed for an uninsured working expense?

- Is it:
  - *"…additional expenditure…"*

- Is it:
  - *"…necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover… …but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided"?*
  - Does it reduce the turnover loss?
  - Is it economic?

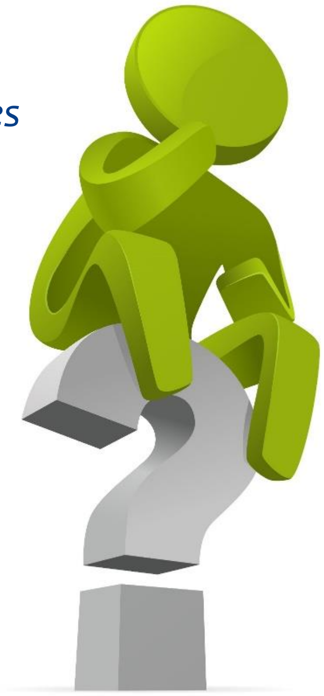
Insurer’s review

* Does it fit better as an Additional Increased Cost of Working?
* Is it:
  * *“…additional expenditure…”*
* Is it:
  * *“…necessarily and reasonably incurred for the sole purpose of avoiding diminishing a reduction in Turnover…”*
  * *“…or resuming or maintaining normal business operations”*?
  * Does it reduce the turnover loss? Does it maintain normal business operations?
  * Extension not subject to economic limit

Insurer's review

* Does it fit better as an Extra Expense?
  * *"…reasonable and necessary extra costs incurred by the Insured to temporarily continue as nearly normal as practicable the conduct of the Insured's business; and extra costs of temporarily using property or facilities of the Insured or others…"*

* However, excluded are:
  * *"…costs that normally would have been incurred in conducting the business during the same period had no direct physical loss or damage occurred."*



Result = potential expectation gap as no clear place in the policy for this cost

RGL Forensics

integra TECHNICAL SERVICES

Possible options

* Include as part of definition of standing charges:
  * Could the 'take or pay' element be included in definition of a standing charges
  * Has a premium been paid for this?
* Gross revenue cover:
* Specific sub-limited cover:
  * Provide some protection for the Insured
  * Isolates the issue to avoid different interpretation
  * Relatively easy to calculate exposure

3

Opting not to reinstate ~ What does the wording say?

Why not reinstate?

* Obsolete plant
* Loss of Market
* Economic changes ~ State owned v Privatisation
* Condition of balance of plant
* Reliability of feedstock supply

Physical Damage

* Policy usually clear on options
* Most likely basis of cover is Actual Cash Value (ACV)
* In most cases, relatively simple to determine
* Start from New build cost
* Apply some measure of depreciation based on operational age of the plant
* Alternatively, is the "Book value" the correct basis of indemnity?

Insured's expectations

* Cash value of asset

* However, can be difficult to quantify:
  * What if a like for like asset cannot be found?
  * How do you find a market value?
  * How much should a new asset be depreciated?
  * What is the useful economic life of the asset?

Insurer's expectations

* Net book value

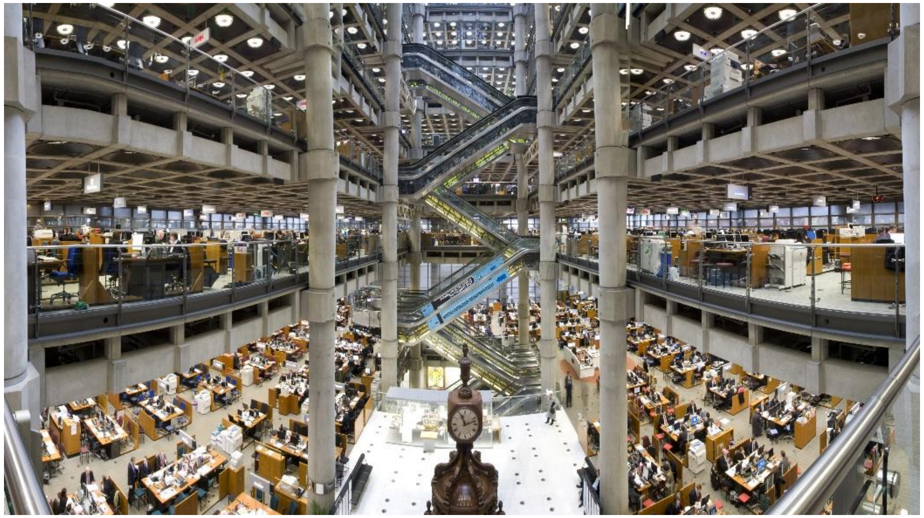
* However, may not be representative of true value:
  * How has the asset been depreciated?
  * What if asset has no or very limited net book value?

RGL Forensics

integra TECHNICAL SERVICES

Business Interruption

* How does the Policy provide for this eventuality?
* Is it correct to try to apply the prescriptive wording
* If the Insured's business decision is to cease trading, is there a loss to measure?

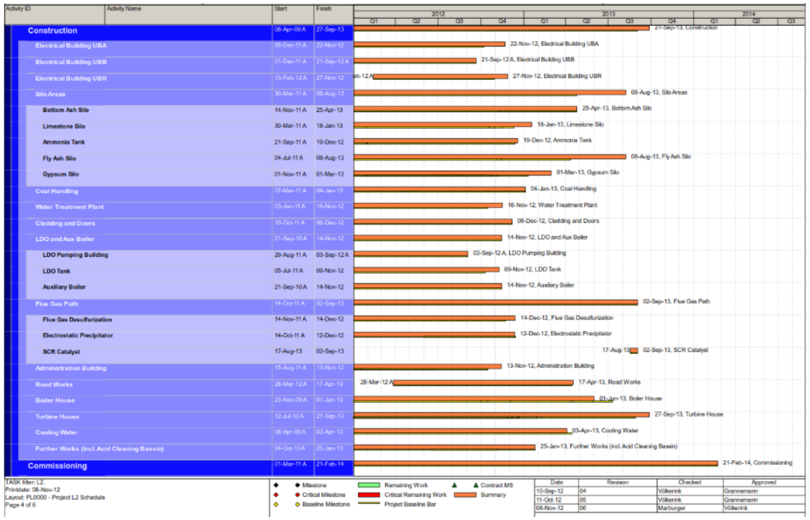


RGL Forensics

integra TECHNICAL SERVICES

Timeline

- What is the Period of Indemnity?
- When does it start?
- Involvement of Statutory Authorities, should this be reflected?
- Is it correct to establish a theoretical re-construction period, based on the extent of known damage?



RGL Forensics

integra TECHNICAL SERVICES

Money

* What comprises the Indemnity?

* Should the Policy formula be observed?

* Is historical experience the best measure or should the "Actual experience" be measured during the theoretical period of indemnity, based on a virtual business model?

* What happens in a sales based Wording?

RGL Forensics

integra TECHNICAL SERVICES

Fixed costs

* What savings should be reflected in Fixed costs due to the voluntary discontinuity of the business?

* “Insurers shall only indemnify the insured for that part of the indemnity equal to the unavoidable insured costs effectively incurred”

* Co-Insurance / Average, does this reduce the threshold?

RGL Forensics

integra TECHNICAL SERVICES

Summary

- What the parties expect from the wording can be very different
- This may give rise to a poor claims experience
- Pre risk scenario planning can help narrow the gaps or even amend the wording