

Workshop T4

Tuesday, November 15
1:30 p.m.–3:00 p.m. and 3:30 p.m.–5:00 p.m.

DECONSTRUCTING THE WRAP-UP PRO FORMA

Presented by



Steven A. Coombs
President
Risk Resources, Inc.



Timothy E. Walsh
Senior Vice President, Regional Director
Aon Construction Services Group

The decision to utilize a wrap-up insurance program on a construction project routinely occurs prior to the letting of contracts on the project. As such, a wrap-up sponsor (owner or general contractor) must rely on a financial pro forma to assess the anticipated financial implications of sponsoring the wrap-up. If the pro forma is inaccurate, it can create unrealistic expectations of the financial performance of the wrap-up and have serious financial implications for the sponsor. This session will analyze all of the key components of the financial pro forma and highlight key assumptions that have the greatest impact on the bottom line. Sponsor expense items that are routinely omitted from a wrap-up financial pro forma will also be identified. Attendees will leave the workshop with an improved understanding of the cost components of a wrap-up and better prepared to evaluate these complex documents.

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Risk. Reinsurance. Human Resources.

Steven A. Coombs
President
Risk Resources, Inc.

Mr. Coombs is one of the presenters for Workshop T4, “Deconstructing the Wrap-Up Pro Forma,” on Tuesday afternoon. He has more than 33 years of industry experience, with the past 26 years in a consulting environment. Prior to that, he was a national accounts underwriter for a large international insurance group. Risk Resources is a risk management and commercial insurance consulting firm based in Elmhurst, Illinois. Risk Resources does not sell insurance and provides consulting services on a fee-for-service basis. Common projects include risk management and insurance audits, insurance requests for proposals/proposal management, wrap-up feasibility reviews, agent/broker/administrator selection, risk financing studies, and litigation support and testimony.

Mr. Coombs has been involved in scores of projects insured by wrap-up and project-specific programs while representing owners, developers, design teams, construction managers, and general contractors. He has extensive knowledge and experience regarding various aspects of construction insurance. He is a coauthor of *The Builders Risk Book*, soon to be published by International Risk Management Institute, Inc. He is also a former president of the Society of Risk Management Consultants.

Mr. Coombs is a graduate of Western Michigan University with a bachelor of business administration. He also holds a master of arts degree from DePaul University with a concentration in risk management and insurance. He has earned the Associate in Risk Management certificate from the Insurance Institute of America and received the Chartered Property Casualty Underwriter designation.


Tim E. Walsh
Senior Vice President, Regional Director
Aon Risk Services

Mr. Walsh is one of the presenters for Workshop T4, “Deconstructing the Wrap-Up Pro Forma,” on Tuesday afternoon. He is a senior vice president and regional director of wrap-up insurance programs for the insurance broker Aon Risk Services. Mr. Walsh has dedicated more than 24 years to structuring and managing sophisticated contractor insurance programs and controlled insurance programs.

His multifaceted experience as both an underwriter for Travelers as well as an insurance broker has helped contractors and owners in risk identification, contract review, structuring complex insurance programs, negotiation of construction agreements, administrative protocols, and the development of safety and drug testing programs.

He is the former national director for Aon's National Wrap-up Group and has been involved in more than 450 commercial and residential projects. His current responsibilities include the management of a \$20 billion portfolio of CCIPs and OCIPs, and he is a senior advisor to Aon's construction and wrap-up insurance clients.

Mr. Walsh is a frequent speaker on construction risk management and wrap-up insurance programs.



The poster for the 31st IRMI Construction Risk Conference features a construction worker in a red hard hat and safety vest looking through a surveying instrument on a construction site. Text on the poster includes: "Take a Closer Look at the Exceptional Networking and Educational Opportunities", "November 13-17, 2011 Hilton San Diego Bayfront", "31st IRMI CONSTRUCTION RISK CONFERENCE", and logos for "Recommended by" and "ACC of America".

T.4. Deconstructing the Wrap-Up Pro Forma

Presented by:

Steve Coombs
President
Risk Resources

Tim Walsh
EVP, Managing National Director
Aon Construction Services Group

Goals for Today

- Understand pro forma components and their financial impact to the project on fixed-price and cost-plus contracts
- Share information on pro forma “best practices”

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The Wrap-Up Pro Forma

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Pro Forma Primer

What Is a Pro Forma?

- A financial projection prepared in advance of a planned event or transaction (i.e., CIP)
- A model of anticipated results of the event with emphasis on cash flows and savings
- aka feasibility study

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Why Is a Pro Forma Important?

- It is used as a tool to forecast all identified inflow/outflow line items
- It provides guidance on the financial feasibility of a CIP

fea·si·ble (fe'z?-b?l) adj.

Capable of being accomplished or brought about; possible: a feasible project; capable of being utilized with or dealt with successfully; suitable; logical; likely.

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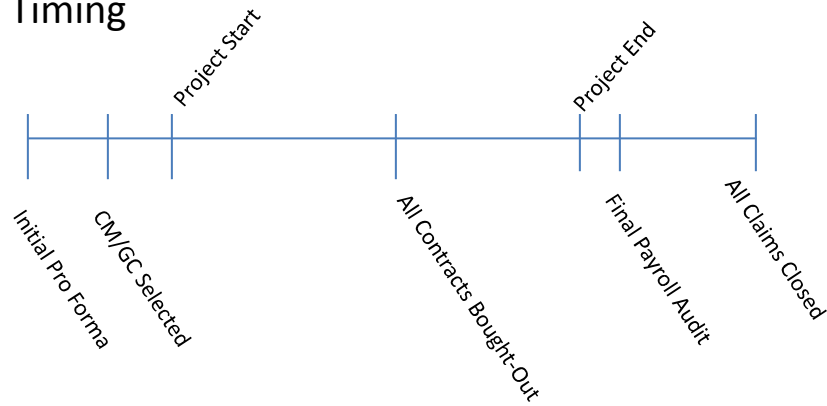
What Pro Forma Terms Should I Be Aware of?

- Project cost
- Hard cost
- Workers compensation payroll
- Contractor insurance credits
- Fixed costs
- Variable costs
- Loss aggregate
- Collateral

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Challenges of Pro Forma Process

- Timing



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Challenges of Pro Forma Process

- Quality of Information
 - Information may not be accurate
 - Same facts—different interpretations
 - Different facts to different preparers
 - Information can change
- Unknown CM/GC insurance credit
- Expertise of preparer—quality of baseline data

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What Are the Implications of an Inaccurate Pro Forma?

- Impacts Go/No-Go Decision To Sponsor CIP
- Anticipated Results Will Be Over-/Under Inflated:
 - Contractor credits (\$\$ inflow)
 - Expenses (\$\$ outflow)
 - Savings/Loss (net result)
 - Collateral requirements
- Increased Tension between Sponsor, Contractors, Broker, and Insurer
- Impact on Project Contingencies and Budget

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Real Life Examples—Disparity in CV/Payroll Assumptions

	<u>Broker A</u>	<u>Broker B</u>	<u>Broker C</u>
Hard Costs	\$248.9MM	\$261.0MM	\$248.2MM
WC Payroll	\$ 63.7MM	\$ 54.8MM	\$45.4MM
WC Payroll (as % of hard costs)	25.6%	21.0%	18.3%

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Real Life Examples—Disparity in Estimated Insurance Credits

	<u>Broker A</u>	<u>Broker B</u>	<u>Broker C</u>
WC Payroll	\$ 88.7MM	\$ 88.7MM	\$ 88.7MM
Ins. Credits	\$ 15.2MM	\$ 10.7MM	\$ 9.7MM
Ins. Credits (per \$100 of payroll)	\$ 17.14	\$ 12.06	\$ 10.94

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Real Life Examples—Disparity in Estimated CIP Premiums/Costs

	<u>Broker A</u>	<u>Broker B</u>	<u>Broker C</u>
WC Payroll	\$88.9MM	\$88.9MM	\$88.9MM
CIP Costs	\$ 7.3MM	\$ 6.9MM	\$4.6MM
CIP Costs (per \$100 of payroll)	\$8.21	\$7.76	\$5.17

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Real Life Examples—Disparity in Estimated Broker Administration Fees

	<u>Broker A</u>	<u>Broker B</u>	<u>Broker C</u>
WC Payroll	\$64.2MM	\$64.2MM	\$64.2MM
Broker Fee	\$ 1.70MM	\$ 1.2MM	\$.77MM
Broker Fee (per \$100 of payroll)	\$2.66	\$1.87	\$1.20

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Real Life Examples—Disparity in Estimated CIP Losses

	<u>Broker A</u>	<u>Broker B</u>	<u>Broker C</u>
WC Payroll	\$98.5MM	\$98.5MM	\$98.5MM
CIP Losses	\$ 5.38MM	\$ 3.76MM	\$ 2.91MM
CIP Losses (per \$100 of payroll)	5.46%	3.82%	2.95%

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The Wrap-Up Pro Forma Components

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Pro Forma Components

- Project Assumptions
- Contractor Insurance Credits
- CIP Premiums, Surcharges & Assessments
- Claims & Claims Handling Charges
- Other Costs

The screenshot shows a detailed spreadsheet with multiple columns and rows. The title 'Sample Project' is at the top. The spreadsheet is organized into sections with green headers. Key sections include 'Project Assumptions', 'Contractor Insurance Credits', 'CIP Premiums, Surcharges & Assessments', and 'Claims & Claims Handling Charges'. The data is presented in a structured format with numerical values and text descriptions.

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Project Assumptions

- Project Cost vs. “Hard” Construction Cost
- “Workers Compensation” Payroll
- Construction Type
- Project Duration—Start/End Date

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Project Cost

“Project Cost” Includes Many Items Which Do Not Generate WC Payroll:

- Finance Costs
- Land Acquisition
- Relocation Cost
- Design & Design Contingency
- Management (Owner & CM/GC non-site management labor)
- Inspections
- Permits
- CM/GC Fee
- CM/GC Surety Bonds, CDI, Insurance
- Off-Site Prefabricated Items
- Major Equipment
- General Excise Tax (e.g., HI GET)

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Workers Compensation Payroll Definition

“Labor”

vs.

“Workers Compensation Remuneration”

Important Because:

- Contractors Pay WC Premiums on this Basis
- Contractors May Pay CGL Premiums on this Basis
- CIP Premiums Calculated by WC Payroll

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Workers Compensation Payroll

Beware of WC Payroll Limitations* (per employee):

Nevada: \$36,000 Annual (All Projects)

New York: \$1,159.44/Week

Ohio: \$1,175/Week

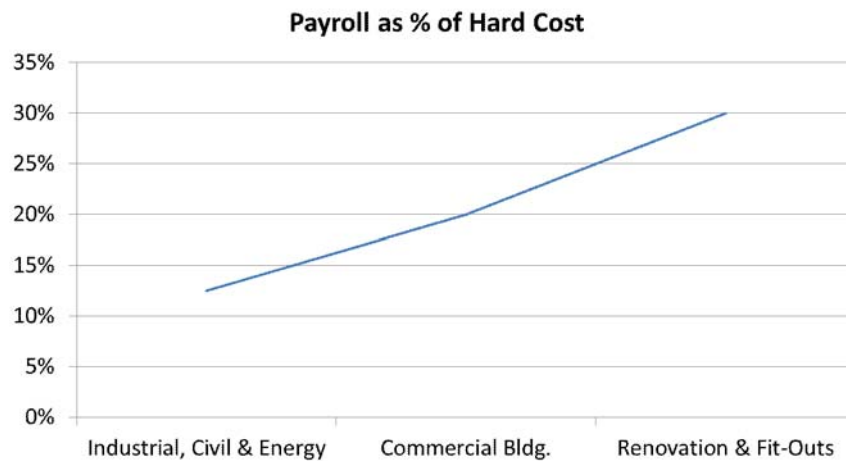
Beware of Multiple WC Codes Based on Wage Rate:

California

* For Eligible Class Codes. Also see definition of payroll.

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Impact of Construction Type on Workers Compensation Payroll



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Project Duration

- Estimated Start and End Dates CIP Coverage Is in Place
 - Impact Broker/Administrator Fees
 - Potential Reinsurance Impact

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Project Assumptions

Sample Project Hospital Initial OCIP Pro-Forma			
Project Budget	\$	285,000,000	
Hard Cost	\$	250,000,000	
Hard Cost Less: Fee/Ins.	\$	215,000,000	
Estimated WC Payroll	\$	43,000,000	20.0%
Duration		36 months	

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Contractor Insurance Credits

“Cost of CM/GC and All Subcontractors To Provide Coverages Being Provided under CIP at the Project Site”

- Workers Compensation
- General Liability
- Excess Liability

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Contractor Insurance Credits—Workers Compensation Considerations

- Typical Methodology: Discount Manual Premiums
- Rates vs. Loss Costs vs. Each Carrier Files Rates
- Discount High Rate Class Codes (e.g., 5040)
- Class Code Distribution Can Impact Estimate Significantly
- Prevailing Wage vs. Open Shop

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Contractor Insurance Credits—Workers Compensation Considerations

- Typically Exclude WC Payroll for:
 - Excluded Subcontractors (e.g., Elevator, IBEW Local 3)
 - Abatement
 - Demolition
 - Subs Performing Work under Small Contracts
 - Utility Work Performed by Utility Company
 - Subs Excluded by CIP Sponsor
- Understand if Rates Are Trending Up or Down

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Contractor Insurance Credits—Workers Compensation Considerations

Adjust Manual Premium for:

- EMR
- Scheduled Credits
- Premium Discounts
- Deductible Credits
- Safety/Drug Testing Discounts
- Contractor/Association Discounts
- Surcharges
- Employers Liability
- TRIA
- Waivers of Subrogation

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Contractor Insurance Credits—WC

WORKERS COMPENSATION RATES						
Class Description	WC Code #	Payroll %	Payroll	Standard Rate*	Manual Premium	
Doors Frames Hardware	3724	6.75%	\$ 2,902,500	\$ 5.76	\$	167,163
Masonry	5022	1.50%	\$ 645,000	\$ 7.34	\$	47,316
Structural Steel (Used 50% of Manual Rate)	5040	5.00%	\$ 2,150,000	\$ 15.18	\$	326,369
Floor Installation	5102	1.40%	\$ 602,000	\$ 8.05	\$	48,476
Glazing	5445	4.25%	\$ 1,827,500	\$ 7.52	\$	137,397
Elevators	5160	1.40%	\$ 602,000	\$ 4.40		Excluded Sub
Plumbing	5183	9.75%	\$ 4,192,500	\$ 5.28	\$	221,245
Fire Protection	5188	1.15%	\$ 494,500	\$ 6.65	\$	32,861
HVAC	5183	15.00%	\$ 6,450,000	\$ 5.28	\$	340,376
Electrical	5190	10.50%	\$ 4,515,000	\$ 4.43	\$	200,024
Concrete	5213	4.00%	\$ 1,720,000	\$ 10.92	\$	187,809
Ceramic Tile	5348	1.20%	\$ 516,000	\$ 4.48	\$	23,129
Carpentry	5403	16.00%	\$ 6,880,000	\$ 7.37	\$	507,399
Drywall	5445	7.00%	\$ 3,010,000	\$ 7.52	\$	226,301
Roofing	5551	1.10%	\$ 473,000	\$ 20.99	\$	99,289
Painting	5474	1.00%	\$ 430,000	\$ 6.14	\$	26,390
Sheet Metal	5535	7.00%	\$ 3,010,000	\$ 6.19	\$	186,296
Excavation	6217	3.00%	\$ 1,290,000	\$ 6.67	\$	86,061
Crane & Hoisting	9534	3.00%	\$ 1,290,000	\$ 7.53	\$	97,098
Total Manual Premium		100.00%	\$ 43,000,000	\$ 6.89	\$	2,940,998
WC Discounts / Modifiers		0.75		5.16	\$	2,220,749

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Contractor Insurance Credits—General & Excess Liability Considerations

Typical Methodology: Benchmark Local Market Conditions

- Separate:
 - CM/GC Credit
 - Subcontractor Credits

- Can Be Based on Payroll or Receipts

- Discount Subcontractor Credit for CM/GC Self-Performed Work

Insurance Credits

Insurance Credits	Rate				
WC Insurance Credit (Rate / \$100 Payroll)	5.16	\$	2,220,749		
Subcontractor GL & XS Insurance Credit (Rate / \$100 Payroll)	2.75	\$	1,005,125	(Assume CM/GC Self Performs 15% of Total Payroll)	
CM/GC GL & XS Insurance Credit (\$7.50 / \$1,000 CV)	7.50	\$	1,875,000		
Total Insurance Credits		\$	5,100,874		
Rate as % of Hard Cost				2.04%	

CIP Premiums, Surcharges & Assessments

- **Primary Premiums**
 - Premium Calculated on Estimated WC Exposure
 - May be Auditable on WC Payroll or Construction Value
 - Does Not Include Retained Losses
 - Note Estimated Minimum Premiums
 - Include Surplus Lines Tax, If Applicable
- **TRIA, Assessments & Surcharges**
 - Understand State Assessments & Surcharges
 - Can Be Significant Dollars & Can Vary by Insurer (e.g., MN Special Compensation Fund Assessment)

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CIP Premiums, Surcharges & Assessments

- **Excess Premiums**
 - Pricing Driven by Primary GL rate
 - Specify Limit
 - Note Estimated Minimum Premiums
 - Include Surplus Lines Tax, If Applicable
- **CIP Administration Fee**
 - Driven by:
 - Volume (Size, # Contractors)
 - Duration
 - Anticipated Scope of Services

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CIP Premiums, Surcharges & Assessments

Loss Ratios	Rate	@ No Losses	
CIP Premiums / Assessments / Administration Fee's			
WC Ded. Prem. (Rate / \$100 Payroll)	1.65	\$ 709,500	(1)
\$2/4/4M GL Ded. Prem. (Rate / \$100 Payroll)	0.75	\$ 322,500	(1)
TRIA / Surcharges / Assessments	3.50%	24,833	
Excess Liability Premium (\$100 Million)		\$ 471,656	(2)
CIP Administration Fee		\$ 700,000	
Total CIP Fixed Expenses		\$ 2,228,489	
(1) Subject to 80% Minimum			
(2) Flat Premium			

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Claims & Claims Handling Expense

- Insurance Industry Averages
- Type of Work and Nuances of Project
- Historical Loss Experience of CIP Sponsor
- Historical Loss Experience of CM/GC
- Benefit Levels & Litigation Environment
- Other Intangibles

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Claims & Claims Handling Expense

Loss Ratios	Rate	@No Losses	@40%Max Losses	@60%Max Losses	@80%Max Losses	@Max Losses
Claims & Claims Handling Expense						
Deductible Claims (\$250,000 WC / \$250,000 CL)	6.50	\$ -	\$ 1,118,000	\$ 1,677,000	\$ 2,236,000	\$ 2,795,000 ⁽³⁾
Loss Handling Costs (%x Est. Claims)	5.00%	\$ -	\$ 55,900	\$ 83,850	\$ 111,800	\$ 139,750
Total Claims/ Claims Handling Expenses		\$ -	\$ 1,173,900	\$ 1,760,850	\$ 2,347,800	\$ 2,934,750
<small>(3) Adjustable at Rate; Subject to 100% Minimum</small>						

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Other Costs

Potential Additional Costs—Sponsor May View Some or All of These as Additional Costs:

- Sponsor Administration—Time/Expense
 - Risk Management Oversight
 - Legal
 - Claims
 - Safety
 - CIP Administration

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Other Costs

- Safety Staffing
- Safety Incentives
- Medical Trailer
- Premium Finance
- Cost of Collateral (Letter of Credit)—Until Claims Closed Out
- CCIP—Excess/Corporate Charges

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Other Savings

Potential Additional Savings—Sponsor May View Some or All of These as Additional Savings:

- Net Present Value (NPV) of Premiums & Losses
- Additional Operating Revenue (Hospitals)
- Sponsor Cost Avoidance

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Sponsor Cost Avoidance

“The Value of Protecting a Sponsor’s Corporate Insurance Program (SIRs and Future Premiums) through the Use of a CIP.”

- Value Is Determined by Sponsor or Quote for Project-Specific GL/XS Policy To Protect the Interests of the Owner

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Other Costs/Savings

Loss Ratios	Rate	@No Losses	@40%Max Losses	@60%Max Losses	@80%Max Losses	@Max Losses
Other Expense/ (Savings)						
Internal Administration	\$	200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Owner Cost Avoidance	\$	(300,000)	\$ (300,000)	\$ (300,000)	\$ (300,000)	\$ (300,000)
Letter of Credit (Step-Up/Down - Est. 7 Years)	\$	80,000	\$ 85,000	\$ 90,000	\$ 95,000	\$ 100,000
Safety Incentives	\$	75,000	\$ 75,000	\$ 75,000	\$ 75,000	\$ 75,000
Total Other Expenses/ (Savings)	\$	55,000	\$ 60,000	\$ 65,000	\$ 70,000	\$ 75,000

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Total CIP Cost

Loss Ratios	Rate	@ No Losses	@ 40% Max Losses	@ 60% Max Losses	@ 80% Max Losses	@ Max Losses
CIP Premiums / Assessments / Administration Fee's						
WC Ded. Prem. (Rate / \$100 Payroll)	1.65	\$ 709,500	\$ 709,500	\$ 709,500	\$ 709,500	\$ 709,500 ⁽¹⁾
\$2/4/4M GL Ded. Prem. (Rate / \$100 Payroll)	0.75	\$ 322,500	\$ 322,500	\$ 322,500	\$ 322,500	\$ 322,500 ⁽¹⁾
TRIA / Surcharges / Assessments	3.50%	\$ 24,833	\$ 24,833	\$ 24,833	\$ 24,833	\$ 24,833
Excess Liability Premium (\$100 Million)		\$ 471,656	\$ 471,656	\$ 471,656	\$ 471,656	\$ 471,656 ⁽²⁾
CIP Administration Fee		\$ 700,000	\$ 700,000	\$ 700,000	\$ 700,000	\$ 700,000
Total CIP Fixed Expenses		\$ 2,228,489	\$ 2,228,489	\$ 2,228,489	\$ 2,228,489	\$ 2,228,489
Claims & Claims Handling Expense						
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Other Expense / (Savings)						
Internal Administration		\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Owner Cost Avoidance		\$ (300,000)	\$ (300,000)	\$ (300,000)	\$ (300,000)	\$ (300,000)
Letter of Credit (Step-Up/Down - Est. 7 Years)		\$ 80,000	\$ 85,000	\$ 90,000	\$ 95,000	\$ 100,000
Safety Incentives		\$ 75,000	\$ 75,000	\$ 75,000	\$ 75,000	\$ 75,000
Total Other Expenses / (Savings)		\$ 55,000	\$ 60,000	\$ 65,000	\$ 70,000	\$ 75,000
Total CIP Costs		\$ 2,283,489	\$ 3,462,389	\$ 4,054,339	\$ 4,646,289	\$ 5,238,239
<small>(1) Subject to 80% Minimum</small>						
<small>(2) Flat Premium</small>						
<small>(3) Adjustable at Rate; Subject to 100% Minimum</small>						

Pro Forma Savings (Loss)

$$\text{Savings or (Loss) = Contractor Insurance Credits—CIP Costs}$$

Pro Forma Savings (Loss)

Insurance Credits		Rate					
WC Insurance Credit (Rate / \$100 Payroll)	5.16	\$	2,220,749				
Subcontractor GL & XS Insurance Credit (Rate / \$100 Payroll)	2.75	\$	1,005,125	(Assume CM/GC Self Performs 15% of Total Payroll)			
CM/GC GL & XS Insurance Credit (\$7.50 / \$1,000 CV)	7.50	\$	1,875,000				
Total Insurance Credits		\$	5,100,874				
Rate as % of Hard Cost			2.04%				
Loss Ratios		Rate	@ No Losses	@ 40% Max Losses	@ 60% Max Losses	@ 80% Max Losses	@ Max Losses
CIP Premiums / Assessments / Administration Fee's							
WC Ded. Prem. (Rate / \$100 Payroll)	1.65	\$	709,500	\$ 709,500	\$ 709,500	\$ 709,500	\$ 709,500 (1)
\$2/4/4M GL Ded. Prem. (Rate / \$100 Payroll)	0.75	\$	322,500	\$ 322,500	\$ 322,500	\$ 322,500	\$ 322,500 (1)
TRIA / Surcharges / Assessments	3.50%	\$	24,833	\$ 24,833	\$ 24,833	\$ 24,833	\$ 24,833
Excess Liability Premium (\$100 Million)		\$	471,656	\$ 471,656	\$ 471,656	\$ 471,656	\$ 471,656 (2)
CIP Administration Fee		\$	700,000	\$ 700,000	\$ 700,000	\$ 700,000	\$ 700,000
Total CIP Fixed Expenses		\$	2,228,489	\$ 2,228,489	\$ 2,228,489	\$ 2,228,489	\$ 2,228,489
Claims & Claims Handling Expense							
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Other Expense / (Savings)							
Internal Administration		\$	200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
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Safety Incentives		\$	75,000	\$ 75,000	\$ 75,000	\$ 75,000	\$ 75,000
Total Other Expenses / (Savings)		\$	55,000	\$ 60,000	\$ 65,000	\$ 70,000	\$ 75,000
Total CIP Costs		\$	2,283,489	\$ 3,462,389	\$ 4,054,339	\$ 4,646,289	\$ 5,238,239
CIP Savings (Loss)		\$	2,817,385	\$ 1,638,485	\$ 1,046,535	\$ 454,585	\$ (137,365)
Savings As % CV			1.1%	0.7%	0.4%	0.2%	-0.1%
(1) Subject to 80% Minimum							
(2) Flat Premium							
(3) Adjustable at Rate; Subject to 100% Minimum							

Wrap-Up Pro Forma Best Practices

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Wrap-Up Pro Forma Best Practices

- ✓ Goal: Reflect All Costs Accurately
- ✓ Understand the Project Demographics, Budget, Schedule, and Unique Features
- ✓ Establish “Project Assumptions”
- ✓ Ensure All Parties Are Using the Same Data
- ✓ Identify “Other Expenses”

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Wrap-Up Pro Forma Best Practices

- ✓ Reconcile Differences between Broker Pro Formas
- ✓ Fully Understand CIP Parameters, Including Min/Max Costs & Collateral Requirements
- ✓ Benchmark Initial “Project Assumptions” to Broker Experiences—Benchmark Data Produces the Most Credible Data Source
- ✓ If CIP Is Utilized, Use Feasibility To Benchmark Against Future Results

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Questions?



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Notes

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