

ADVANCE LOSS OF PROFITS (ALOP)

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No Statistics

INTRODUCTION

Business income protection by means of a Loss of Profits Insurance or a Business Interruption Insurance is a common and well-known solution in all countries with developed insurance markets. However, it is not that common, better to say it is very rare to insure the consequences of a project being delayed due to a material damage occurring during construction or erection.

The topic was dealt with very carefully and comprehensively eleven years ago in the paper IMIA 6-32 (82) E called "Advance Loss of Profits Insurance (ALOP), (Loss of Profits due to Delay following CAR/EAR loss)".

The theory and practice of this type of insurance has been presented in various books about Loss of Profits Insurance as well, for example G.J.R. Hickmott: "Principles and Practice of Interruption Insurance", (1982) and Dennis Riley: "Consequential Loss and Business Interruption Insurance and Claims", fifth edition published in 1981.

The general theory and insurance solutions for Loss of Profits Insurance was last presented in Swiss Re's publication "Business Income Protection" (1991). This booklet covers Loss of

Profits Insurance in a very clear, comprehensive and educative way. It should be borne in mind that ALOP is intended to provide protection only for a specific type of loss of profits covering non-operating risks.

In view of what has been previously written about this subject, it is very difficult to bring new ideas, solutions or information to this audience. Instead of going into too much details, I will briefly describe ALOP in general terms and concentrate more on the problems raised during my discussions with various specialists whilst collating the material for this presentation. In addition, the aim is to ascertain, why the experience and volume for ALOP is so limited.

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The final question is, should ALOP business be encouraged and if so, how is this best to be achieved?

BUSINESS VOLUME AND EXPERIENCE

The volume of ALOP business transacted - when considering the number of policies issued and the amount of premium written - is very limited. In addition; the results have not been very satisfactory. This is the information received following a questionnaire sent to, and discussions held with representatives in various insurance companies in selective countries.

Insurance companies do not usually maintain separate records for ALOP business. According to their replies, ALOP is regarded as a part of EAR/CAR insurance because of its low volume and therefore it was impossible to get any comprehensive statistics. However, some companies were able to supply overall figures for their ALOP business, which helped to get some idea of the market volume, the degree of market penetration and results, but it is not possible to publish any reliable statistical information.

ADVANCE LOSS OF PROFITS INSURANCE (ALOP)

Before the construction of a modern factory there lies months of research, planning, budgeting, negotiations, obtaining estimates, placing orders and signing contracts for buildings, plant and machinery, the advance engagement of key staff and many other matters before the actual work of construction starts. However, everything will be geared towards a completion date, at which time the factory should start operating and begin earning a return on the capital invested in it as well as the loss of interest on that capital or interest to be paid on loans obtained and the overhead expenses which have accumulated during the period of construction.

Any interruption which delays the start-up date means a considerable loss through the deferral of production and sales. The loss could be substantially increased if a competitor engaged in preparations to put a similar product onto the market gets into production first and captures part or all of an insured's anticipated share of the market. Many things can happen which can cause delays and which are not covered by penalty clauses in contracts.

Hence the advisability of insuring against all possible insurable contingencies which might delay the completion of a new factory unit or a major extension to an existing one. This is called "Advance Loss of Profits Insurance" (ALOP), which in principle follows the characteristics of an annual loss of profits/business interruption policy, but is issued with an effective date in advance of the actual commencement date of the business.

In various insurance markets ALOP may also be known as:

Advance(d) Profits Insurance
 Advance(d) Business Interruption Insurance
 EAR/CAR - Loss of Profits
 Delayed Earnings Insurance
 CAR - Loss of Rent/Interest
 Perte d'Exploitation anticipée (P.E.A)
 Pertes financières (pertes de layers, agios bancaires, charges fixes etc.)
 Montage BU (Montage Betriebsunterbrechungs Versicherung)
 Bauleistungs BU
 Delayed Opening of Business
 Delay in Start-up Coverage (DISC)
 Soft Costs

It should be noted that the form ALOP is not used in the U.S. market and that soft costs are usually intended to cover specific expenses.

TERMS AND CONDITIONS

The Insured

It is very important to note that the Insured is the principal, the future operator of an industrial plant or building and this is the reason why the insurance is sometimes called "Principal's Advance Loss of Profits Insurance". This is contrary to the solutions for the material damage insurance through CAR/EAR policies, where all participants in the project can be insured.

Period of Insurance

The Period of Insurance is usually determined by the length of the contract period, this being defined as the contractual dates between which erection of the insured property takes place on the contract site. In some markets it is possible to extend the insurance period to also include the transportation of materials to the site and also planning

prior to the actual commencement of the construction or erection itself. This extension is possible only if the materials concerned can be specifically identified at the manufacturer's works. This also applies for the extensions regarding transportation and suppliers' premises.

Deductible

The deductible can be stated in time, monetary units or a combination of both. Since every project is different, it is difficult to give precise instructions for the deductible. The appropriate deductible is dependent on the construction period, complexity of the risk, location, possible extension to cover and the technology used.

The deductible is operative from the commencement of the indemnity period. Minimum deductible varies according to the market. However, it is recommended to apply at least one week for each 6 month's contract period or in the case of a monetary deductible the equivalent amount of cost/loss arising during this period.

neu | The deductible should be applied per occurrence. ^{*} In specific cases the deductible can also be defined and calculated in another way. If the deductible is of an aggregate type, it should be sufficiently long enough to prevent several minor losses exhausting the excess period, or there should be an agreed minimum monetary limit which needs to be exceeded before the losses are taken into the aggregate time excess.

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Indemnity Period

The indemnity period should be sufficiently long enough to enable the Insured to commence production during that period and to achieve the situation he would - without the loss occurring - have been able to achieve. This is the same principle as in standard loss of profits

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insurance. The indemnity period is usually provided for in accordance with the construction/erection time and the requirements of the Insured.

However, too long an indemnity period should be avoided, especially if the sum insured is based on an estimated gross profit figure, because in these circumstances it is very difficult to obtain accurate figures for operations, which are to start some years in the future. Normally the EML for an advance loss of profits claim, regarding time is less than the original construction period, because there is always some reserve and overlapping in the time schedule of the project and also, because of the fact that the organization for completing the project already exists and is available.

According to the project the indemnity period varies normally from 3 months to 2 years.

Site of Insurance

The site of insurance covers the contract site on which the construction or erection is taking place. In some markets it is possible to include a suppliers' extension or inland transit as well. If marine transit is to be covered the risks involved can be insured under Marine Consequential Loss Insurance. As already mentioned, the extensions should be granted only if the materials concerned can be identified at the manufacturer's works or in transit. It is also dependent on how wide the cover will be: It is of course easier to keep the business under control when the perils covered are limited and the possible accumulation risk is as small as possible.

Perils Covered

The ALOP insurance is written in conjunction with the material damage cover and the scope of cover should be the same or more restricted than in the EAR/CAR cover for that particular project. This means that

usually ALOP policies are written on all risk basis with or without machinery breakdown.

It should also be noted that ALOP is written for the project with its own specific terms and conditions even when there might be various other covers for various parts of the project in existence.

For several reasons it is very important to investigate the risk and to know the local conditions . First: The insurance industry must be able to provide the client with the correct kind of coverage that he needs for his project. Second: Depending on the location of the site and its surrounding environment, it might be very important to limit the liability to "sudden and unforeseen" losses and to advise the client, on how to avoid particular risks or on how to protect himself against those risks occurring. Third: ALOP is not meant to cover risks or interests which according to the project contract belong to the suppliers. Fourth: Major projects usually need reinsurance capacity as well, and to be able to place the risk properly it is important to determine the amount of capacity needed.

It is also important to investigate the risks involved when providing cover for suppliers' extension or transportation and also for keeping the risks and their accumulation under control. It may also be prudent to limit the extensions to losses caused by fire and or allied perils only.

Exclusions for natural hazards, like earthquake, volcanic eruption or tsunami for political risks or for nuclear radiation etc. are naturally the same for ALOP as for the material damage section.

It should also be noted that ALOP is meant to cover delays caused by material damage under EAR/CAR policy. Therefore there should be a clear distinction between guarantee, performance guarantee and delays caused by other perils or reasons, like loss of or damage to surrounding property or construction machinery, plant or equipment or shortage,

destruction or damage to any materials necessary or restrictions imposed by public authority or any alterations, additions or improvements made.

Sum Insured

Sum insured is the interest the Insured is willing to protect and it is also the base for premium calculation and for possible indemnification. Some markets and some companies prefer to use the anticipated annual gross profit (gross earnings) figure for the sum insured. Other companies prefer fixed costs or specified extra expenses for the sum insured.

Anticipated annual gross profit has its advantages. The Insured is protected in accordance with the same standards as for existing operations and various revenues and costs need not be calculated so precisely as would be the case, if they were to be insured separately. However, the problem is to find correct figures for the period, which is due to start some years in the future. Sometimes the problem has been solved by using the premium adjustment clause to correct the figures afterwards. By insuring the gross profit, insurers are accepting also entrepreneurial risks, but even more important is that when the premium adjustment clause is used, the Insured might get some of his premium back, even when in the case of loss, the insurers would have paid in full. This is of course very advantageous from the Insured's point of view, but it would be easier for both parties and more fair to the insurance companies that when the gross profit figure is used as the sum insured, both the Insured and the insurers could agree on a reasonable level for gross profit and wages/salaries and use that as the sum insured without any subsequent adjustments.

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A list taken from the Bulletin of U.S. Inland Marine Underwriters Association (appendix 1) gives a good idea of the various extra costs or expenses which can be covered and chosen as the sum insured. In Europe it is more common to select fixed costs less all or part of the annual depreciation for sum insured. In this case the financial position of the insured is already protected and only the possible net profit remains within the insured's own liability.

In the case of a loss, it is also easier to calculate the amount of indemnification if the sum insured is clearly defined and calculated according to well-known factors.

Policy Wordings

The ALOP is written in conjunction with the material damage section of the EAR/CAR policy covering the contract and therefore the terms and conditions for ALOP must be comparable to them.

In Germany the ALOP business is based on the additional clauses, numbers 50-60 of the General Machinery Loss of Profits Insurance Policy Wording (Klauseln 50-60 zu den AMBUB, Allgemeine Maschinen- Betriebsunterbrechungs-Versicherungsbedingungen). In other European countries companies do have their own policy wordings for EAR and CAR to which ALOP is also based.

In Japan the companies use General Conditions for Advanced Loss of Profits Insurance (EAR). In the USA companies also have their own policy wordings such as "Project All Risks Insurance", which also covers the requirements of ALOP.

The special requirements for ALOP insurance have often been adopted or agreed for reinsurance reasons from Munich Re's "Principal's Advance Loss of Profits Insurance following EAR/CAR", or Swiss Re's

"Advance Loss of Profits Insurance" wordings.

For major projects the terms and conditions are always agreed separately between the insurers, reinsurers and the insured/broker.

RATING PRINCIPLES

Various rating principles have been presented very comprehensively in the previous IMIA paper dealing with ALOP. However, it seems to be that the basic rate is obtained by applying an adjustment factor to the material damage rate, based on the technical particulars of the project, the period of indemnity and the deductible used, and thereby arriving at the final rate to be used. It should also be noted that due to the low volume of ALOP business, companies do not have adequate statistics for rating purposes, therefore the obtained rates must be corrected based on the experience they have had on similar or equivalent sized projects.

To obtain the correct rate, it is important to understand, how EAR/CAR risks differ from those of ALOP and how even a minor material damage occurring in a critical stage of the project could cause a delay and a consequent loss totally disproportionate to the amount of the material damage itself. It is also important to apply terms and conditions that clearly state what will be covered in the event of a loss and to use deductibles of sufficient amount to eliminate the influence of minor claims to enable money to be saved for real losses, which is the basic aim of the insurance.

In view of the low volume the ALOP business portfolio cannot be very balanced. Even when ALOP is normally written in conjunction with the material damage section of an EAR/CAR policy, the aim should be that all the lines of business will be profitable.

SERVICES RELATED TO THE ALOP

Since every project differs from the another, technical and insurance know-how is required for both the EAR/CAR and ALOP insurances. Before acceptance, the risk must be inspected carefully in order to provide the correct insurance solution and ensure the correct rating is applied.

Maintaining a balanced portfolio for ALOP business means that large or potential hazardous risks must be inspected and monitored regularly. It may also be prudent to check and monitor the transportation of heavy and important equipments to the contract site including their installation, i.e. lifting of heavy equipment and other hazardous phases of the project. If the risk level increases or if a loss occurs, the company can by utilizing previous experience gained with similar cases do much to reduce the risk or minimize the loss.

Engineering services is an important part of the coverage with benefits for both the insured as well as the insurer. By reviewing plans and specifications we can make recommendations and comments to increase the safety level. It is possible to provide advice regarding plant protection, look for process bottlenecks, make recommendations concerning essential spares and equipment, and for example assist in the preparation of emergency contingency plans. By making periodic inspections the insurance company can ensure that everything is under control. After following the completion of a well organized project, during which every possible safety aspect has been taken into consideration, the client is able to present a better risk to be covered under a normal fire, machinery breakdown and loss of profits policy.

CLAIMS HANDLING AND LOSS SETTLEMENT

Advanced loss of profits insurance differs from normal loss of profits in that respect, that the material damage which eventually causes a delay in commercial start-up or in the commencement date of a business, can happen at a much earlier stage and a considerable period may elapse before the delay and possible claim is realized. This means that all material damages which occur during the construction/erection period should be reported immediately and their possible effect on the starting date must be evaluated. This also means that those claims likely to exceed the deductible must be dealt with immediately after the loss has occurred in order to expedite repairs, organize temporary alternative premises or production equipment etc. to ensure that the delays are kept to a minimum.

ALOP covers the consequences of a delay in the commencement of the insured's business and the indemnity period begins with the anticipated date upon which the project should have been completed. However, loss minimizing costs and costs expended on speeding-up the return to production may already arise during the insurance period prior to the commencement of the indemnity period.

Loss adjustment will be carried out in accordance with the policy wording and this is very much dependent on what the insured's interest is, i.e. how the sum insured is defined and calculated.

The cover based on anticipated gross profit will indemnify the actual loss of gross profit due to the reduction in turnover and increased costs of working and the amount payable shall be

- in respect of loss of gross profit: the sum obtained by applying the rate of gross profit to the amount by which the actual turnover during the Indemnity Period falls short of the turnover which would have been

achieved had the delay not occurred.

- in respect of increased cost of working: the additional expenditure necessarily and reasonable incurred for the sole purpose of avoiding or diminishing the reduction in turnover which, without such expenditure, would have taken place during the Indemnity Period, but not exceeding the sum by which such loss amount otherwise payable under this Endorsement is thereby reduced
- less any sum saved during the Indemnity Period as may cease or be reduced in consequence of the accident (including any liquidated damages and penalties the Insured is entitled to receive).

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Depending on the market and the company, there are also other methods of calculating as accurately as possible the actual loss incurred, but the above is most commonly used.

If the cover is based on fixed costs or extra expenses the calculation of indemnity is modified accordingly.

Normal provisions for underinsurance, limit of liability, indemnity period and deductible will naturally be applied. The deductible may according to the actual policy wording also be calculated on a proportional basis i.e. multiplying the average daily loss by the number of days agreed upon as the deductible.

BUSINESS PROSPECTS

One of the reasons for the low volume of ALOP business is that, it is not actively marketed. The clients do not have enough information and it is not normal practice for them to ask for ALOP cover. In addition insurers are not eager to promote or offer this type of protection,

because of poor results and bad loss experience from previous cases. In fact, ALOP is only offered and granted as a part of a comprehensive insurance program, when the client, lenders or financiers of the project insist on it to secure their financial position. This means that ALOP policies are mainly written for large "greenfield operations" in hazardous environment. It is self-evident that the business cannot be balanced or the results especially good with this type of portfolio.

According to the insurers, there is a demand for more ALOP protection. The companies should organize the underwriting of ALOP risks at the same time they are dealing with EAR/CAR risks. We should also bear in mind that ALOP insurance is also suitable for, in fact I would say essential, to cover the risks involved with modifications or improvements to existing and fully operating factories or processes. Undoubtedly the market potential would then be much higher and the portfolio much more balanced, when considering the distribution of risks in accordance with business operation, size and the risk level. In fact it can be predicted with a fair amount of confidence, that the market will grow more rapidly in this area than for the completion of new projects.

CONCLUSIONS

Advance Loss of Profits Insurance is a very special type of insurance, which requires a lot of know-how, experience and work to underwrite and serve the client in order to ensure the results of the business. However, at least major re-insurers and leading insurance companies seem to have enough know-how to increase and develop the ALOP business.

After all, Advance Loss of Profits insurance is only a particular type of Business income protection covering operating risks and as such should be handled as a normal risk procedure by the protective insurance companies.

The volume of the business is today very limited and the portfolio is not balanced. However, the only way to achieve more stable results is to increase the volume by starting to offer ALOP covers more often in conjunction with EAR/CAR coverage and also for other projects than difficult "greenfield operations". According to the companies, there is a demand for this type of cover." Time is money", meaning that if you want to be able to serve your clients on time, your own premises and production equipment must be ready on time as well. This applies equally for the principals of various projects as well as for the insurers.

SOFT COSTS

Soft costs is a phrase utilized by developers as part of the total cost of a construction project not directly related to "bricks and mortar" (which are considered "hard" costs). These expenses are incurred when there is a delay in the completion of the project and an interruption in expected revenue that would normally be earned upon completion of the project. Soft costs, like business interruption coverages, are generally provided as an endorsement or extension to a Builders' Risk policy. These coverages apply only in the event of a covered loss in the property damage section of the Builders' Risk policy. Due diligence, as with any other business interruption coverage, is an integral part of the policy wording for soft costs.

There are a number of costs and expenses that fall into the category of soft costs, some of which include:

- 1) Interest expense on money borrowed to finance construction or reconstruction.
- 2) Real estate or property taxes.
- 3) Additional expenses for extension or renewal of the financing for the project.
- 4) Debt service payments that must be paid whether or not the project has been completed.

- 5) Bond interest payments that must be paid whether or not the project is completed.
- 6) Advertising and promotional expenses.
- 7) Construction loan fees paid to others to help rearrange financing.
- 8) Fees for letters of credit and re-marketing of bonds.
- 9) Founders Fees Refunds Deposits that are made by prospective occupants that may have to be returned if the completion is late.
- 10) Commissions, legal and accounting costs and fees and administrative expenses incurred in renegotiating existing leases or pre-leasing the project resulting from a delay in completion.
- 11) Storage costs, architectural fees, building inspection fees.
- 12) Loss of rental income can be combined with soft costs in an overall business interruption extension to a builders' risk policy.
- 13) Expediting expenses.

Source: Bulletin/Inland Marine Underwriters Association