John Foord
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Reasons why recent contract price costs may not be appropriate in determining replacement costs for property damage insurance

Key messages:

- Insurance policies are usually written on a Replacement as New basis which may not match with recent contract prices, e.g. if assets were second hand or relocated
- Contract prices may include significant non-insurable assets or costs that are excluded from property damage insurance policies
- Contract prices may not reflect the true financial investment in the facilities
- Locations, markets and suppliers change, so modifying prices even over short periods
- Contract prices may be based on tenders or procurement agreements that were agreed several years ago, or may include discounts, which would not be applicable post loss
- Regulations, accounting standards and construction methods are continually evolving, and these may not be reflected in contract prices
- For large contracts, often the client's own costs and expenses may not be reflected but would need to be recovered in the event of a loss

1. Insurance policies are usually written on "Replacement as New" basis, do these match with contract prices?

Most property damage insurance policies are on a Replacement as New basis. This means that the insured must declare a value at risk that reflects the current cost to replace the assets on a like for like with new replacement assets.

Particularly for reconfiguration or expansion of facilities there can be elements of the contract sums that relate to temporary works, second hand assets or assets relocated from elsewhere. This could mean that actual costs on a Replacement as New basis would be significantly higher or lower than the contract prices. These issues can be overlooked when just considering actual project prices.

Likewise contract prices can often omit third party assets where the liability for insurance may rest with the operator of a location.

2. Do contract prices include all non-insurable assets?

In many large construction projects there will be elements that are non-insurable from the point of view of property damage insurance.

Excluding obvious elements such as land acquisition costs, projects can include one-off costs such as feasibility studies, environmental impact assessment studies, licence fees, easement rights, temporary structures, etc. which would not need to be replaced or reflected in the reconstruction of the facilities after a loss.

Contract prices may also reflect the owner’s financing, banking and insurance costs. These would not usually be incurred following a loss, since the insurance company would fund the reconstruction, so ought to be excluded from the declared sums insured.

In a similar vein, contract prices can include a number of items that are insured under different policies including road registered vehicles and assets transferred after completion to third parties etc.

3. Do original prices accurately reflect the investment?

Many governments have been highly supportive of fixed asset investment, often creating the right environment for investments in terms of incentives, reduction in administrative barriers and provision of associated infrastructure.

Many of these incentives and support mechanisms for businesses are temporary and may have been withdrawn or scaled back since the project was commissioned.

Accordingly, it may be harder to secure the same level of cost rebates, development grants and other incentives that were available in the past.

Besides direct incentives, companies may occasionally have been provided with disguised benefits during initial construction or set up, including subsidized local infrastructure, contractor worker subsidies, interest free loans, and administration and project management support.

In new industrial zones, governments may have subsidized costs by providing construction of fencing/land boundaries or financing connections to utilities. Most of these payments would not be available in the event of a post loss reconstruction.

Contract prices may fail to reflect these grants/incentives and therefore would materially understate the true replacement cost at today's prices.

4. Has the infrastructure around the subject location changed, thus increasing or decreasing current replacement costs?

For older projects, or where the development period has been over a number of years, increased expectations or regulations on building standards, noise and emissions limits could significantly drive up the cost to replace an existing facility post loss or even restrict the ability of the facility to be reinstated at all at the same location. It is important to consider how this has been reflected in the declaration to the insurers.

On the other hand, urbanisation has often been matched with infrastructure investment including improved utilities, road and rail links. For some locations this can now mean easier or cheaper logistics and access to both materials and labour so reducing construction, delivery or installation costs.

5. Have global or regional markets shifted, thus affecting access to products or services?

One of the changes to occur with the globalization of manufacturing is that many international suppliers and producers have moved operations across continents to take advantage of access to different markets and lower manufacturing costs.

In practice, this now means that products and equipment that were only available from certain markets when the facility was constructed may today be readily available from cheaper producers and suppliers.

Combined with changes in import duties and transportation costs, firms may be able to replace machinery and equipment at prices significantly below those incurred originally.

Equally, where tariffs or duties have increased, costs could be significantly more today.

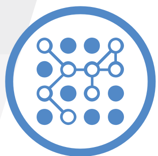
6. Is the impact of economic and labour changes affecting contract prices?

As economies have matured so have labour laws and protection of workers' rights. Employment laws and minimum wage legislation have dramatically changed the cost of labour in many jurisdictions.

The increased prosperity in traditionally rural locations has also meant that in some areas there are now labour shortages which can slow down construction periods so driving up overall costs.

Many markets have also shifted their economic focus from manufacturing and investment driven growth to consumption-driven growth and this is having an effect on the manufacturing sector and labour markets.

Key elements of this new strategy are a shift towards services, real wage growth and improved welfare (i.e. healthcare). This shift does not just mean higher wages but is likely to influence the way manufacturers and suppliers focus their sales, in turn influencing availability of materials and equipment as well as costs.



7. Other issues that can distort contract prices

One reason why the use of contract prices and asset registers to establish replacement costs can be challenging is that the treatment of costs as capital expenditure or expenses may be defined in local general accepted accounting practice (GAAP).

These rules continually evolve over time and occasionally costs are expensed rather than recognized in the asset registers. This can mean using contract prices could materially undervalue the true replacement cost of a capital project.

For larger construction projects the end client may have their own design, engineering and project management teams to manage the delivery of the final scheme. Asset registers and Engineering, Procurement Construction (EPC) costs often fail to include these items that would be considered as part of the replacement cost of the facilities for the purposes of property insurance.

In most contracts, clients will capitalize their finance costs. As mentioned previously, in a post loss situation, since the insurers will be providing the funding for the reconstruction, this cost would not be incurred.

In a similar manner, the treatment of VAT and sales taxes can differ depending on the regulatory environment and some reconstruction costs post loss may be at different rates to those incurred during original construction.

Conclusion

On the face of it, the contract price for a recent finished scheme would appear to be the perfect way for assessing current replacement costs but as shown above there are numerous factors that mean these costs may not reflect the replacement costs as understood by insurers.

Carrying out a regular detailed insurance valuation remains the primary and most defendable way to ensure that replacement costs reported to insurers are accurate and realistic.

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