

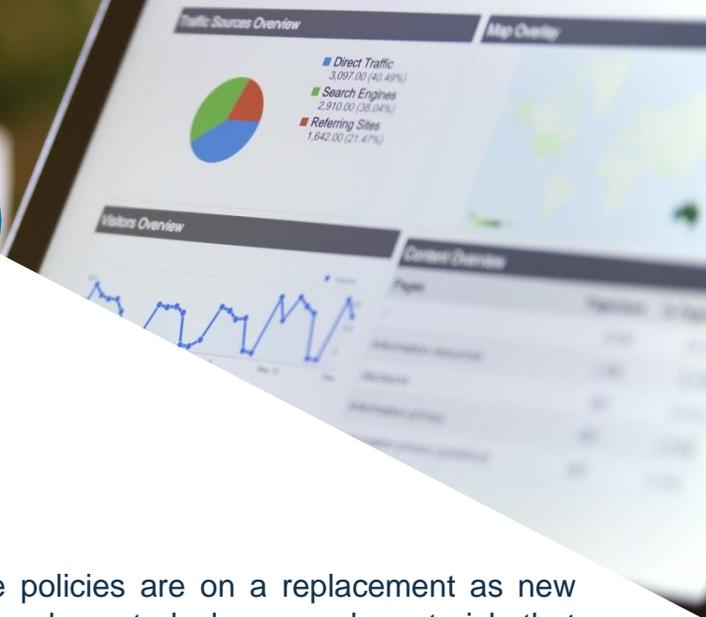
Using alternative replacement costs to arrive at declared values for property damage insurance





Key messages:

- Most property damage insurance policies are written on replacement as new basis
- In certain industries or situations, there may be no need to replace the current facilities on a like-for-like basis due to depleting natural reserves, altering technology or economic obsolescence
- Insuring assets based on net book values under an Actual Cash Value type policy is one alternative, but net book values usually significantly differ from the true cost to replace the function of the assets needed after a loss
- Insurers may consider cover on the basis of the cost of an alternative (reduced) production capacity facility, as derived by current production levels or by what is forecast as needed in the event of a loss
- Insuring on the basis of Alternative Replacement Cost offers owners a cost-effective way to maintain adequate insurance cover and ensure that a replacement facility can meet future needs
- Experienced valuers can assist to independently prepare a sound and reasoned assessment of the alternative replacement costs in a manner that is readily acceptable to both insured and insurers



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 existing assets on a like for like basis with new replacement assets.

In certain industries or situations, there may be no need to replace the current facilities on a like-for-like basis, e.g. due to diminishing natural reserves for an offshore oil platform or changing technology in mining operations. Often these facilities could be replaced with smaller assets that have a reduced function or capacity, or with new technologies that cost considerably less.

In these situations, many owners are seeking alternative strategies to insure their assets.



Insure based on Accounting/Book Value?

One obvious thought by asset owners in these situations is just to declare the value at risk on the basis of the net book value of the assets. However most policies are on a replacement as new basis and this approach runs a number of risks for the insured.

With insurance premiums under constant pressure, there has been a tightening of property claim procedures by insurers after a loss and they are specifically reviewing the sums insured to identify any underinsurance, often with a view to reducing the final settlement amount if found.

Insurers will consider the insured to be a co-insurer, and may pay out only a proportion of any loss, if the values declared when taking out a **replacement as new** policy are below current replacement costs.

By applying depreciation to the original acquisition costs, net book values are likely to be significantly below the current cost to replace the assets new and older facilities could be massively underinsured if net book values are used.



Indemnity/Actual Cash Value

So why not insure these types of assets on an Indemnity/Actual Cash Value basis using Net Book Values?

The first issue with this approach is that asset registers often include a number of items that would be considered as non – insurable for the purposes of property insurance. These can include one-off non-repeatable costs like licences, easements and approvals.

Secondly, where a facility has been built in phases, there may be increased original costs that would not be incurred or as extensive if rebuilding the facility as a whole.

Thirdly, original acquisition costs in asset registers may not include grants and incentives that could have been available at the time of construction (directly or indirectly). Equally they may not fully reflect the true cost of assets acquired secondhand. Therefore original prices (and therefore the resulting net book values) could materially understate the true value of the assets.

Finally, for older assets an Indemnity/Actual Cash Value figure may be less than the funds needed to put operations back to the functionality needed based on current production or requirements.



Alternative Replacement Cost

Insurers may consider cover on the basis of an alternative (reduced) production capacity facility, as derived by current production levels or by what is forecast as needed in the event of a loss

The alternative replacement cost estimate is based on the current replacement cost of alternative facilities to reflect the reduced current production requirement rather than the original ‘as built’ design capacity.



The estimates will be prepared as at the date of the assessment, of alternative reduced production capacity assets, as derived by current production levels or by what is forecast as needed in the event of a loss.

Insuring on the basis of Alternative Replacement Cost offers owners a cost-effective way to maintain adequate insurance cover and ensure that a replacement facility can meet future needs.



Methodology for Calculating Alternative Replacement Cost

So how in practice are alternative costs assessed?

Using an offshore wellhead platform as an example, the alternative facility capacities and material weights are first defined by the owners technical and production personnel with input from John Foord's valuation team.

Through discussion and analysis, a framework is compiled of what the alternative facilities would look like in terms of facilities, specifications and configuration.

Using this data, John Foord would arrive at a cost for the materials and equipment by calculating the cost using an aggregation of the individual components. Costs are typically calculated using a number of techniques including discussion with suppliers and contractors on current costs, analysis of the costs of similar facilities constructed elsewhere recently, analysis of previous John Foord valuations and sophisticated modelling techniques based on economic drivers for price movements in the local market and industry. These techniques also reflect any local requirements/regulations.

For offshore platforms, we would include costs relating to onshore construction, fabrication, procurement, freight charges, insurance, design, engineering, installation, hook-up costs, commissioning and start-up costs.



These costs would be assessed on a similar basis to the currently installed assets in that the client would seek the most economical solution while maintaining similar quality and economic timelines.

Allowances will be made for the professional fees element of the cost estimate – design, basic and detailed engineering, procurement, project management and management support, etc. - on the basis of costs for international and local consultants.

Finally the cost estimate will allow for owner costs which would typically include: owner's engineering costs, third party advisors and consultants appointed by the owner, owner project management team costs and owner administration team costs. However, we would typically exclude costs relating to interest during construction, financing arrangement fees and legal costs from the assessment.



Conclusion

Experienced valuers can assist to independently prepare a sound and reasoned assessment of the alternative replacement costs of assets impacted by depleting natural reserves, altering technology or economic obsolescence in a manner that is readily acceptable to both insured and insurers.

The alternative replacement cost estimate is based on the current replacement cost of alternative facilities to reflect the reduced current production requirement rather than the original 'as built' design capacity.

The process is carried out on-desk and as such can be carried out cost effectively and with minimal disruption to existing operations.

This document is prepared by John Foord as an opinion and should be treated as such. John Foord and its affiliates do not accept any direct or indirect liability arising from reliance on the information stated herein. Please contact John Foord for tailored, professional and detailed valuation advice. John Foord valuations will be undertaken by qualified personnel.



John Foord
ESTABLISHED 1828

johnfoord.com