

Delay in Start-Up

Jardine Lloyd Thompson Limited

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IT'S TIME FOR A CONSISTENT APPROACH

It's not often that you come across a line of insurance which is widely acknowledged to be expensive, confusing, ambiguous, often purchased under duress, and difficult to make a claim and then get that claim paid. But for those involved in construction projects, such a cover is all too familiar: Delay in Start-Up insurance (DSU).



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Fortunately, the mysterious world of DSU insurance was the subject of a recent seminar held by Jardine Lloyd Thompson, entitled "DSU – It's time for a consistent approach", with the aim of demystifying this misunderstood insurance cover.

THE UNDERWRITER'S VIEW

The problem with DSU was laid out by Richard Williams, head of Industry Practice Engineering & Construction, IRI, Global and Large Risks Division, Swiss Re, who explained: "Insureds don't always understand what they are buying; brokers don't always understand what they are broking; underwriters don't always understand what they are underwriting; and loss adjusters don't always know how to adjust it."

He said that DSU is all risks cover for something that hasn't yet been built, providing protection for some anticipated cost in the future. It only covers a small fraction of the risk of delay to a project, but while DSU may not be a panacea for all the problems, it nonetheless does provide protection for some of the more important risks, he said. But he stressed that it is important to recognise its limitations, and to understand what it can do and what it cannot do.

DSU was designed to cover loss of anticipated gross profit actually sustained by the owner or operator, triggered by a loss covered by the builders' risk section, subject to a



time deductible and a maximum indemnity period. In addition, insurers could pay increased costs of working in order to avoid or reduce the delay. That, said Mr Williams, is what it was designed to do.

"However, the boundaries of DSU are being stretched. The first area

“For the right projects, DSU is possible...”

where we have a problem is the sum insured and the certainty we have on that sum assured. For example, it is difficult to apply the standard model of DSU to speculative developments, where there are no guarantees of income. It is also difficult to understand what level of insurance is required when there are severe market fluctuations.”

Other problem areas for underwriters, said Mr Williams, include performance related payments, ramp up, and costs incurred during normal operation such as liquidated damages, take or pay agreements and lump sum payments. “All of these are putting stress on the basic model of DSU, and have made it this animal where no-one really understands what is going on,” he said.

The most important question, said Mr Williams, is ‘Can the insured delay period, and the actual loss sustained, be determined?’ He added that it was important to be

able to differentiate between a delay caused by a physical damage loss, and a delay caused by something else, such as simple lack of progress. “If you cannot, then do not buy the cover,” he advised.

He then gave three reasons as to why it is so expensive: “uncertainty, uncertainty, and uncertainty”. However, he concluded by explaining that there should be a way to provide reasonable cover at a reasonable price, with the emphasis on reasonable. “If you try and get DSU to do things that it wasn't designed for, you won't get your claim paid. For the right projects, DSU is possible. But we have to be selective and choose very carefully those projects that we will offer DSU for.”

LENDER REQUIREMENTS

Provision of DSU protection is more or less a universal requirement on project financed transactions, and the reasons were explained by Martin Benatar, who heads up the JLT Financiers' Insurance Due Diligence Team. “For project finance transactions, protection of the revenue stream in the event of a delay, is one of the most critical things that banks are going to look for,” said Mr Benatar.



The reason for lenders taking this view is to do with the nature of a project financed transaction.

“...DSU insurance needs to be of a certain standard...”

As Mr Benatar pointed out, “The project is highly leveraged, and the only way the banks get back their money is if the project is delivered by a certain deadline, and allows revenue to be generated.”

He went on “The project is extremely vulnerable to financial shocks during the construction period and in the early years of revenue generation, and any delay to achieving operation/ service commencement could be fatal. Therefore, the banks look to DSU insurance as an essential part of risk management strategy to deal with insurable risk, rather than as a complete panacea.”

Not only do lenders insist on DSU, but they also insist that the protection of the revenue stream must be within the control of the project company. From the banks’ point of view, the DSU insurance needs to be of a certain standard, not just in terms of counter-party ratings, but also in terms of information disclosure, said Mr Benatar.

“If the contractor is controlling the insurance relationship, it can be problematic and time-consuming,



because it will be the contractor that is negotiating with insurers, meaning that the project company is trying to negotiate with insurers from two steps removed,” he said. “To have the protection of your revenue stream dictated or controlled by a third party is not the most comforting situation. A contractor has no incentive to ensure that the claim is progressed in the most advantageous fashion for the project company.”

Mr Benatar concluded, “Why banks require DSU insurance is all about the criticality of getting insurance payments as soon as possible following a delay. Anything that causes a delay in getting those insurance payments or that can confuse a claim negotiation, is going to be harmful to the project company’s interests and therefore to the bank’s. That is why they require project company control.”



GETTING A DSU CLAIM PAID

The vexed issue of making a claim and getting it paid, was discussed by Ewan Cresswell, managing director of Integra Technical Services. He explained that there are a number of difficult areas when it comes to dealing with DSU claims. He said the majority of problems in DSU claims arise because there are often disputes as to the indemnifiable time which is attributable to an insured delay. There is also the problem of the insured proving the loss, especially in connection with a brand new plant making a brand new product into a brand new market where measurement of the loss of gross profit is sometimes very subjective.

“There can only be a single DSU claim

...I would want DSU to ignore liquidated damages...”



Works-related problems include accurate, real time reporting of contract progress, and concurrent non-insurance delays with insured delays, and subsequent uninsured delays following insurance-related delays, and how to differentiate between them.

A common mistake that people make is assuming that each time there is a physical damage loss which may result in a delay, that is a DSU claim. But Mr Cresswell explained that there can only be a single DSU claim and that is often made up of a number of individual delay events. It is the sum of all of those interruptions that has to be considered before applying the cover.

He gave a number of pointers to help in getting claims paid. The first is that “There must be a free flow of

information from the outset, and there should be an exchange of findings on progress being made,” he said.

Ewan pointed out that there are two different approaches to monitoring and claims handling, namely post or pre-loss involvement. With a post-loss approach, the monitoring and adjustment team is involved only after a damage loss and a subsequent delay in start up exposure. If the decision is made to take a post loss approach, then if there is no loss, no monitoring or adjustment is required and the underwriter maximises his return. He said. “The downside is that if there is a claim towards the end of the project then it becomes extremely expensive and time-consuming to retrospectively



analyse all of the contract progress.” This, he said, can be avoided if you begin the process with the commencement of the project, not knowing whether you have an exposure, although the main impediment to pre-loss involvement is cost.

He suggested a potential solution to this issue could be to ask whether insurers and financiers have the same interest in monitoring and claim handling. If so, he pointed out that in most cases, the lending consortium will have their own engineering team monitoring the progress of the contract. “Are we not just duplicating those costs?,” he asked. “A single independent source of data could serve both interests, and the result would be significant cost savings to both parties and a common basis for any review of the claim. And that would provide a significantly better opportunity for an amicable outcome to a claims situation.”

CAUTIONARY TALES

Tony Rastall, Partner, JLT Construction, provided a number of cautionary tales in relation to DSU insurance. The first involved liquidated damages (LDs), and the question of who pays first. “This is a very grey area, and a lot of wordings don’t address this,” he explained. “The concern I have with LDs is that when a project is two years late, the first thing the contractor typically does not do is put his hand up and say sorry, it’s my fault. He will have fifty reasons as to why it wasn’t his fault, and some of them may be valid.”

According to Mr Rastall, “if you have to exhaust the LD route before you can claim for DSU, if you are an off balance sheet vehicle, I would suggest that you are probably going to go under before you have recovered the LDs to service the debt. If I were a lender, I would want the DSU to ignore the LDs initially.

Clearly, there are rights of subrogation against the LDs. But I would want the insurers to pay the DSU loss, and then subrogate against the LDs.”

Another cautionary tale from Mr Rastall concerned the issue of contract waivers where the contractor group is the same as the owner group, as in a lot of PFI’s. “Clearly, the contractor group does not want to get subrogated against. However, some sophisticated contractors will hide in their contractual language the fact that they must be waived against by all project policies,” said Mr Rastall. “That is a very big material fact for DSU insurers and if you don’t disclose that and you have a DSU claim, and the insurer tries to subrogate and the contractor shows the waiver, there will be a major problem.” He advised: “Always be clear whether a contractor can be subrogated against or not.”



He concluded with some more advice for project companies. “DSU is a very complicated and very expensive cover, so understand your needs intimately, and only deal with people, both from the broking and underwriting side, who understand your needs, because the time to realise that you have a bad wording is not when the claim occurs,” said Mr Rastall, adding “View the broking and getting the wording done, as pre-adjusting the loss.”



CONCLUSION

The seminar went a long way to clarify some of the issues around DSU insurance. And the good news is that it can provide useful and much needed protection. The message is that everyone needs to be involved, there needs to be greater trust and transparency, and above all, a realistic understanding of what the cover can provide. As Swiss Re’s Mr Williams concluded: “Very high levels of mutual respect and understanding are required during and after the underwriting stage to reduce the level of uncertainty, when the project is being undertaken. We want to be kept involved. All of this will help to reduce the uncertainty and result in the cover that people need, at the price that they recognise as being value for money and a much higher level of transparency.”

SPEAKER PROFILES

Richard Williams
Head of Industry Practice
Engineering and Construction Unit,
Industrial Risk Insurer, Global and
Large Risks Division, Swiss Re
International SE, UK Branch

Richard is a Chartered Civil Engineer and has worked for Swiss Re 17 years. For the previous 15 years he was employed in the construction industry working in contracting in the UK and West Africa. He currently leads a team of underwriters in London writing International Construction business. Typically this is high risk, complex, 'capacity' business. He has, over the course of his career with Swiss Re, been involved in underwriting all aspects of Engineering and Construction Insurance and Reinsurance – the latter on both a treaty and facultative basis.

Ewan M Cresswell
Managing Director, Integra
Technical Services

Ewan began his professional life as a graduate chartered quantity surveyor in 1976. In 1979 he moved into loss adjusting which led to him serving as Managing Director of International Adjusters Partnership/ Cunningham IAP, Thomas Howell Group; Technical & Specialist

Services Company and IRISC Technical Services. In 1998 he set up Integra Technical Services Ltd which now operates in the area of complex claims and risks related to construction, engineering and oil, gas & petrochemicals insurance. Ewan has been a pioneer of developing the claim handling of DISU Insurance, working closely with broking and underwriting interests to improve the product.

Jeff Powell
Chairman, JLT Construction

After ten years handling international Property and Casualty business, Jeff switched to Construction business and he has specialised in this area ever since. Prior to joining JLT in 1996 he was the Managing Director of the Minet Construction Division. During his career he has handled major annual Contractor programmes and single project business in Europe, USA, Africa and the Middle East.

Martin Benatar
Partner, JLT Due Diligence

Martin's 21-year insurance career began as an underwriter for a major composite insurer where he built up experience of the Construction and Property markets. He has provided dedicated consultancy

advice to financiers since 1997 and successfully developed the lender advisory business for a leading broker before joining JLT in 2006. He has served on a number of market bodies and regularly speaks at conferences and seminars for lawyers, ECAs and project finance teams. He presented an annual insurance lecture on the project finance course at the London Business School between 2000 and 2006. He is ACII qualified and a Chartered Insurance Practitioner.

Tony Rastall
Partner, JLT Construction

With 30 years specialising in Construction and Engineering insurance, Tony has acted as either lender's adviser or project broker to numerous projects with values up to US\$4bn. He has lectured widely on international insurance and related matters and was invited to address the World Bank in Washington DC on major project risk issues. Tony also sat on the London Market Engineering Insurance Group Non Vitiating committee, and has completed a Gas Turbine design course with the American Society of Mechanical Engineers. He joined JLT in 1988. Tony is ACII qualified.

CONSTRUCTION EVENTS

Jardine Lloyd Thompson Limited (JLT) is the London market's leading Construction insurance broker, placing more than £275m premium into the market. Our team of over 120 construction insurance professionals managing global construction risks have a reputation for excellence, built on knowledge and performance. This makes us the partner of choice for some of the world's major construction projects, UK and European contractors and PFI/PPP projects where our notable industry experience helps to differentiate our service:

- power
- oil and gas
- tunnelling
- railways
- infrastructure
- buildings
- facility management.

We take pride in our broad transactional skills, to bring you the right cover at the best price but it is the way we deliver this service – managing each key area of risk and applying superior industry knowledge – that makes JLT an indispensable part of your team.

Through 2008 we will be running a number of events debating key topics and issues that affect the construction sector and that would interest project principals, contractors and financiers.

If you would like information about our services or these events then please contact:

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