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Executive Summary

Just as the economic outlook appears to be stabilizing or, just a little more optimistic for the bedraggled construction marketplace, the property and casualty industry has begun to show real signs of change.

Many of our clients are experiencing some sort of market conservatism. Market constriction and price increases are not felt universally but are changing from a regional perspective. New York-based risks are feeling the most pain as the impact of Labor Law 240 and a protracted soft pricing market have sent insurers elsewhere to deploy their capital. Those markets with a commitment to the space are pushing rate, retentions and are shrinking appetite for capacity on significant projects.

Similarly, risks in the Western states are subject to increased general liability pricing from the impact of construction defect claims and most contractors, regardless of jurisdiction, will likely be subject to increased workers compensation costs.

The insurance market in general and specifically for construction risk, appears to be becoming more conservative relative to both pricing and coverage terms. The question to ask is: will it have a lasting impact? Insurers are still flush with cash and the return on investment is improving. Surplus is still at a record level and capital continues to enter the sector. With this, sparing any real catastrophe or significant change in the financial marketplace, there will still be competitive deals available for the best risks.

Capital is slowly being redeployed to construction projects of all types. It is important for individual contractors to work closely with their account teams to address specific expectations for project solutions and renewal expectations.

If you have any comments or questions about this report, or wish to discuss the findings further, please contact your Aon account executive.

Best regards,

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Construction Market Update

General Introduction

Current-dollar GDP, the market value of the nation's output of goods and services, increased 3.1 percent, or USD 117.6 billion, in the second quarter to a level of USD 15,595.9 billion. In the first quarter, current-dollar GDP increased 4.2 percent, or USD 157.3 billion.

The industry has been given some positive news with Congress finally passing a transportation bill that will include USD 1.75 billion in authorized funding for the Transportation Infrastructure Finance and Innovation Act (TIFIA). This advance will also boost the opportunity for both public and private organizations to secure additional funding for surface transportation projects.

While consumer spending is still at somewhat of a standstill, it appears that prices in the housing sector have begun to stabilize. New home sales dropped by 8.4 percent month to month but the number of unsold residential properties remained the same.1

Meanwhile, the U.S. Census Bureau report for May states new construction spending rose by .9 percent in May. Year-to-date construction spending increased by 9.4 percent over the same period of 2011. We hope to see nominal growth in the sector for the remainder of 2012 although pre-presidential election jitters might result in less than 10 percent increase in spending. Contractors have been holding out until 2013 to believe in any robust recovery.2

Unemployment Rates

Source: BLS employment

1 U.S. Bureau of Economic Statistics May 2012
2 Census Bureau, U.S. Department of Commerce
Construction growth is still very much based upon the type of work performed, e.g., geographic concentration or focus on public vs. private concerns. Spending has increased in manufacturing, energy, telecommunications, petro-chemical plants and industrial sectors. Contractors and design firms are enjoying revenue gains but margins remain tight. From a public perspective, infrastructure including waste water treatment, transportation projects and hazardous waste projects are experiencing growth. Global or multinational contractors are having the most success in this market. Others have bolstered revenue through acquisition. Notable acquisitions include the recent agreement between CB&I and The Shaw Group. Contractors continue to look for additional opportunities for growth whether it is strategic acquisitions or branching out into new territories.

Insurance Industry

The rate of loss over the past couple of years and the impact of a slow economic recovery are prompting underwriters to increase rates in most sectors. Many risks will experience single- to double-digit rate increases on at least casualty lines of business. Second half 2011 catastrophes left year-end combined ratios at 108.2. The first quarter of 2012 looks good so far with a posted combined ratio of 99.0. The health of the industry has been driven by the lack of catastrophic events for the first quarter and another year of reserve releases. At some point, the impact of these releases will diminish.

Commercial lines pricing has been on the rise for the last two quarters and the trend is expected to continue for the remainder of 2012 and most likely, into the first quarter of 2013. According to the Insurance Information Institute, insurance carriers are experiencing modest premium growth from a slightly recovering economy. A more robust economic picture will increase the demand for insurance and could keep the conservative trend in motion. However, it is unlikely that the industry will declare a “hard market” as was the case in 2001/2003. Policyholder surplus is still at an all-time high and capital continues to gravitate towards the industry. We do see sporadic difficulty based upon certain classes such as workers compensation, which represents a very large percentage of insurance spend for construction risks.
Aon’s experience relative to rate increases in the construction lines of business is outpacing that of other industry segments which is illustrated in the following tables.

- Rates in the Construction Services (CS) sector increased across the major product lines in Q1 and Q2.
- Exposures in the CS sector fell across workers compensation, property and financial lines and increased across casualty/liability lines in Q1 and Q2.
- Price per million in the CS sector increased across the major product lines in Q1 and Q2.

**U.S. Construction Services Annual % Change in Rates on Renewal**

Source: GRIP

**U.S. All Products Annual % Change in Rates on Renewal**

Source: GRIP
The major insurers of construction risk have exhibited poor loss experience in most lines of business. In particular, workers compensation has been a poor performer in all states. General liability has also performed poorly specifically in states where over action activity is a concern and regions that have been heavily hit with construction defect claims. In these instances, loss activity has also compromised umbrella/excess experience as the value of these claims has greatly escalated over the last several years. We will examine each major segment separately.

**Builders Risk**

This sector of the market continues to be stable. Rates have leveled off but there are still exceptions where risks can be priced very competitively. One area that continues to be a challenge is projects that are materially exposed to catastrophic loss (named windstorm, earthquake and flood). Key factors such as the type of construction, project schedules in relationship to the hurricane season and mitigation measures (design and/or means and methods) all contribute to the availability and cost of capacity. The accumulation of exposure varies by carrier and modeling of cat exposure is a required process for key markets with substantial capacity to be deployed.

New capacity continues to come into the marketplace and virtually all markets report that their reinsurance treaties were favorably renewed. In most cases the cost of reinsurance was flat and many markets were able to increase net and treaty capacity overall. Policy terms and conditions continue to be very competitive and most insurers will provide extensions of coverage and increased sublimits that are very favorable to the insured. Should the market avoid a major cat event, it is expected that conditions will remain very competitive with ample capacity to respond to the majority of risks being marketed.

**Primary and Excess Casualty**

Casualty rates continue to rise, specifically in the construction marketplace. The charts on the previous page mask the geographic-specific issues that are creeping into this space. New York has exhibited the most rate strengthening relative to general liability and umbrella/excess pricing in the last quarter. It is not unusual to see at least single digit increases for construction risk. The terms and conditions available vary greatly based upon class of business and geography.

New York Labor Law over action claims have plagued construction risks for many years. The escalation of medical costs has increased exponentially in the last few years, impacting workers compensation pricing. The awards from a third party perspective have become difficult for insurers to bear as well. Claimants demands from a general liability perspective resulting from falls have risen into the millions of dollars and have caused some insurers to leave the state altogether for construction risk. Those who will provide cover in the state, particularly in the five boroughs, are looking for significant retentions and significant premiums. We continue to seek appropriate terms for New York-based construction projects. We should see an increase in project-based solutions such as contractor controlled programs to assure the appropriate risk transfer. Subcontractors will have more difficulty in securing coverage as insurers remove capacity from the area. We are experiencing a number of insurers that will offer coverage, but they have begun providing exclusions for "Employee Injury-Over Action" on the policy. This trend should continue through the end of 2012.

Contractors and developers with residential exposures from the Western states will continue to find it difficult to obtain the broad coverage at competitive pricing that was available during the housing boom. Construction defect cases have caused much consternation with insurers who provided risk transfer solutions to this sector. Claimants tend to be homeowners or condominium associations who allege construction defects in windows, exterior elevations, decks, roofs, fire resistivity and plumbing. Many insurers have reverted to the courts to determine whether or not the policy covers these claims resulting in difficult legislation state to state. In some instances the primary carrier might afford coverage but the excess carrier refuses to take the defense. Also, many insurers have reverted to providing coverage to general contractors with a residential
exclusion. In the past, there may have been an exception for rental properties. It is not uncommon to see the addition of “rental property” to the residential exclusion. It has become extremely important for contractors to review policies carefully to look for amendments to terms.

Workers compensation continues to show signs of distress. The health of this line of business has also come under some of the same constraints mentioned earlier that are directly impacted by the length of the current economic situation. Employment growth continues to be stagnant with a difficult labor market forecast for the next two years at a minimum. This relates to slow exposure-based premium growth. One of the key drivers of combined ratio for this line of business is the change in medical severity. Cost of medical care increases pressure on medical costs per claim. A recent Moody’s Analytics study indicates that medical price inflation will continue to rise into the foreseeable future. Contractors have experienced double digit rate increases in the comp line which should continue into 2013.

Another warning to contractors will be the actualization of the 2011 NCCI announcement of changes to the method of calculating experience modifiers. With 2011 average claim costs of USD 8,800, the decision was made to modify the “split point” (the division point between primary and excess losses under the experience rating plan) for loss calculation.

NCCI has filed plans to increase the split point from USD 5,000 to roughly USD 15,000 over a three-year transition period. This change will allow greater dollars to move into the primary portion of the experience rating formula. Primary losses are weighted more heavily in the calculation, the spread of modification factors will increase with each increase in dollars attributed to the primary layer.

The impact to individual contractors will be viewed as follows:

Lower modifiers will be seen with contractors that currently hold an EMR of less than 1.00. Contractors with EMR of greater than 1.00 should expect to see an increase. An EMR of close to 1.00 should result in only a slight change. However, the impact could result in a unity or slight credit mod migrating to a debit mod. Contractual restrictions relative to unity or credit mod requirements may be impacted by this change. It is possible to receive a “test mod” calculation to understand the impact of this change.
Environmental Market Update

At present, the market for mono-line environmental products (site pollution and contractor’s pollution) remains relatively soft. Recent renewals representing low risk sectors and positive performance are experiencing rate reductions of as much as 15 percent.

For well-performing accounts, underwriters are attempting renewals at flat rates but, with the number of competitors in the space, even holding rate is tough. Pricing on combined lines policies offering general liability and environmental liability coverage remain stable however some leading markets are seeking rate increases up to 15 percent. Environmental rate firming may be a product of the general conservatism creeping into the casualty market. Those insurers that have increased market share over the past several years are experiencing a general claw back of the generous terms and conditions enjoyed by contractors.

In particular, contractors with any exposure in New York will also find exclusions for third party over action on their general liability policies even if underwritten from the environmental division. One insurer in particular will require exclusion or as much as a USD 1,000,000 self-insured retention related to action over claims regardless of whether the client is performing operations in the New York.

Placements for underground storage tank business has also become more challenging in the past year as markets previously interested in this business are in the process of non-renewing the vast majority of their tank policies, many of which had been in force for a number of years. Carriers that are willing to write underground storage tank business are being very selective about how they provide coverage, especially on tanks over 25 years old, and prices are increasing steadily, especially on more mature tank portfolios.

Professional Liability

Capacity for engineers and design professional liability insurance remains consistent with recent historic levels. Among the major insurers of professional practice policies, for any individual qualified insured firm, most offer capacity of USD 25 million to USD 50 million. Excess limits are readily available from both North American and market sources in London and Bermuda.

Given the current professional liability market conditions, the expectation for more restrictive terms seems imminent. The number of insurers for project specific placements is fairly tight, but there are some new entrants willing to add capacity if others reduce their appetite.

In early 2012, we have seen some market firming with rate increases of as much as 10 percent to 15 percent. Of the 10 leading insurance companies providing this cover, 70 percent have a stated plan to raise rates in 2012.

The drive for increased premiums stems from perceived rate inadequacy and reduced premiums over the last few competitive market years as well as deteriorating claims experience. A recent survey indicated insurers anticipate rate changes based upon the following:

- Recent claims experience
- Type of work being performed or services rendered
- Project type
- Historic loss experience
Surety

The surety market remains profitable and capacity is available for good credits. The Surety and Fidelity Association of America (SFAA) recently reported mid-year results. The overall industry loss ratio is 24 percent which is profitable but up from 13 percent at year-end 2011. The top line of the business remains relatively flat with the underlying construction economics showing modest improvement from recent years. Surety business remains largely concentrated with the lead 10 carriers managing 65 percent of all available premiums. Single bond capacity may exceed USD 1.5 billion for strong JV teams. Rates remain stable to slightly competitive as underwriters are keen to hang onto their best customers. New entrants to the surety market are finding that winning new business is a challenge as the incumbents are willing to be competitive in order to retain business. Underwriters are reporting a meaningful increase in claim notices. As a result, surety for companies experiencing difficult results is becoming increasingly problematic. We expect the market to remain stable for the next several months and do not anticipate a dramatic shift to a more conservative surety market.

Contractor Default Insurance

The contractor default insurance (CDI) landscape is ever changing. As owners and developers explore all options beyond the traditional risk transfer tools, CDI continues to be a discussed as a performance security option. In the current strained economic construction market, labor demands and the ability of a general contractor to employ responsive subcontractors to complete projects is becoming a concern.

There are now three well-versed insurers offering this product to construction risks. This should keep the topic in play and allow a greater number of contractors to have access to CDI in a more competitive market. There have been several changes to terms over the years as this product has evolved. Contractors with interest should be instructed to carefully review terms as well as pricing to understand the nuances of each approach.

Trends

Regulatory Issues

With the introduction of the Dodd-Frank Act, U.S. insureds are operating in an environment of heightened legal liability. It is expected that the Dodd-Frank Act will have the greatest impact on the professional liability market over the next 12 to 18 months. This act extends the reach of regulatory oversight to private and public companies and moves far beyond the Sarbanes-Oxley Act of 2002. The promulgation of the Dodd-Frank Act will likely result in increased corporate investigations, greater need for loss control services and may result in an increase of “whistleblower” cases. The cumulative effect may result in increased compliance costs, new avenues of liability and potential litigation for both public and private companies.

Public Private Partnerships

The trend towards public private partnerships for infrastructure continues to gain momentum in the U.S. The recently signed surface transportation law increases the amount of funding available under TIFIA. This section of the law will make nearly USD 2 billion available over the next two years. The availability of these loans will help get many more projects off the ground by enhancing the likelihood of acceptance.

Also, more U.S. contractors are considering or have already set up mechanisms to take an equity stake in projects. Unlike their counterparts in other parts of the world, U.S. contractors have not been keen to offer up equity to support project funding. U.S. contractors bring a realistic point of view to their non-U.S. counterparts when it comes to dealing with
the various public entities, unions and the insurance risks facing contractors in over 50 jurisdictions. While some U.S. contractors have experience in taking equity positions in projects, others are just getting started. This trend is expected to grow as contractors become more comfortable with the concept. According to InfraAmericas the following projects can expect at least a portion of the equity coming from the construction team:

- Denver FasTracks Eagle P3
- I-495 Capital Beltway
- Ohio River Bridges East End
- Presidio Parkway
- Goethals Bridge P3
- I-95 HOV/HOT Lanes
- Knik Arm Bridge

The U.S. must find ways to invest in infrastructure. Not only is this good for job growth, it is vital to a strong economy. Roads, bridges, water, energy, schools, jails and hospitals will all benefit from this type of project delivery.

**Legislation**

**Anti-Indemnity Statutes**

In June of 2011, Texas Governor Rick Perry signed into law a bill (HB 2093) which includes a clause to revise Texas’s anti-indemnity statute for any construction contract executed after January 1, 2012.

Any contract requiring one party to indemnify another for a claim caused by the negligence or fault of the indemnitee (or under the control of the indemnitee) will be void. However, an exception preserves the right to seek indemnification for an employee of the indemnitor or one acting on its behalf. The ability to transfer liability for third-party-over actions thus remains intact. The limitation additional insured coverage that exceeds the allowable scope of indemnity.

The law does contain an exception for controlled insurance programs.

General contractors and trade contractors alike view these changes negatively. If more business goes into wraps solely to combat anti-indemnity, this is certain to impact cost and availability of insurance. In many cases insurers are hesitant to offer excess wrap cover on subcontractor’s policies. The ability to transfer risk to the appropriate party is fundamental to construction contracts. Costs will likely increase until this settles out. Rates go up on smaller exposures; general contractors or owners will have to fund loss within deductibles. All of this varies on the type of construction as well. The ability to rely upon insurance to support contractual obligations continues to be an issue for contractors.

**Conclusion**

There are a few bright spots on the horizon for the construction industry though growth continues to be slow. The decline in the housing market has been so devastating that it will be a difficult recovery. The commercial market is a little better, however a strong surge in spending in this area is still somewhat off into the future.

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3 InfraAmericas June 1, 2012
Spending is evident in areas such as healthcare, energy, Infrastructure, mining and natural gas. Natural gas exploration investment (or not) depends very much on the price of oil which has been decreasing of late. This is all very good news for heavy contractors that have maintained backlog throughout the sluggish economic cycle.

We shouldn’t experience much change from Congress until after the 2012 presidential election but, some money is trickling out with the transportation bill and funds made available to states for specific transit projects. Efforts to pursue public private partnerships is becoming more attractive in state and city government sectors as they can rely less on the federal government and/or rising tax revenues to manage even the most basic services for water, roads, courthouses, and the like. Those contractors that have been studying this method of delivery and investing in the skill set to give themselves a competitive advantage will be sought after to collaborate with financial markets and public entities alike to support a win/win solution for the public.

From an insurance perspective, the right client can get the right deal but we do see market correction on the horizon. Even though the insurance industry appears healthy after the first half 2012 results, we have not seen the impact of drought, fires and the series of earthquakes that have hit in the second half. It is very likely that rates will continue to go up and capacity to shrink through at least the first half of 2013.

Contractors must work with their advisors to obtain the appropriate coverage and general contractors must be very careful to review coverage terms provided by their subcontractors against contractual obligations. Insurers are both increasing rates and offering restrictive terms that may put a subcontractor in breach of contract before stepping onto the jobsite. We still see many insurers tying coverage to written contracts relative to additional insured status; limits provided, aggregate treatment, etc. We are definitely in a changing insurance market, however short lived it might be.
Aon at a Glance

Aon plc (NYSE:AON) is the leading global provider of risk management, insurance and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 61,000 colleagues worldwide, Aon units to empower results for clients in over 120 countries via innovative and effective risk and people solutions and through industry-leading global resources and technical expertise. Aon has been named repeatedly as the world’s best broker, best insurance intermediary, reinsurance intermediary, captives manager and best employee benefits consulting firm by multiple industry sources. Visit aon.com for more information on Aon and aon.com/manchesterunited to learn about Aon’s global partnership and shirt sponsorship with Manchester United.

Aon Analytics provides clients with forward-looking business intelligence, comprehensive benchmarking and total cost-of-risk analysis as well as global market insights using proprietary technology like the Aon Global Risk Insight Platform to enable more informed and fact-based decision making around risk management, risk retention and risk transfer goals and objectives.

Aon Global Risk Insight Platform® (Aon GRIPSM) is the world’s leading global repository of global risk and insurance placement information. By providing fact-based insights into Aon’s USD 78 billion global premium flow, Aon GRIP helps identify the best placement option regardless of size, industry coverage line or geography.

The Web-accessible data produced by Aon GRIP helps Aon brokers evaluate which markets to approach with a placement and which carriers may provide the best value for clients. It also gives Aon brokers a leg up when it comes to negotiations, making sure every conversation is based on the most complete, most current set of facts.

Based in Dublin, Ireland, the Aon Centre for Innovation and Analytics provides Aon colleagues and their clients around the globe fact-based market insights. As the owner of the Aon GRIP, one of the world’s largest repositories of risk and insurance placement information, the Centre analyzes Aon’s USD 78 billion global premium flow to identify innovative new products and to provide Aon brokers insights as to which markets and which carriers provide the best value for clients.

Construction Services Group

Aon’s Construction Services Group (CSG) is a dedicated practice group of 600 professionals who work in the construction marketplace every day. Aon places more business than any broker in the world for the construction industry. To support the entire construction project lifecycle, our clients have access to industry-leading experts in performance security, P3 and APD, project placements, contractor default insurance, professional liability, builders risk, safety, construction captives and other construction risk management disciplines. Our integrated approach is readily aligned to projects of all scales and various levels of complexity.
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