The Return of the Cost Cap

Remediation Cost Overrun Protection 2.0

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Environmental Services Group
Aon Risk Solutions
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The Second Generation - Cost Cap 2.0

While the previous generations of remediation cost cap products may have vanished years ago (2009-2010) the underlying risk of remediation cost overruns and the demand for an insurance solution did not go away. The earlier versions of cost cap insurance offered by a select number of carriers were tremendously popular but they were also fraught with horrible loss experience. This loss experience coupled with the fact that insurers had to experience the lowest interest rate environment on record, led to the disappearance of cost cap products from the marketplace. However, now with interest rates on the rise and a few carriers taking a different view on how to underwrite remediation projects, we have a new insurance product, Cost Cap 2.0 to offer clients.

Today the EPA estimates there are over 450,000 active Brownfield projects in the U.S., collectively leveraging some $14 billion in cleanup and redevelopment funding. When dealing with large-scale contamination and remediation issues, stakeholders, including site owners, investors, banks, property developers and contractors, have always been concerned that cleanup costs will exceed estimates primarily for the following four reasons;

- Discovery of new contaminants,
- Problems with the efficacy of remediation technologies,
- Interest rate escalation, and
- Regulatory changes to cleanup standards after the remediation work has begun.

For a time it appeared that these products would never be revived. However, in a highly competitive marketplace in which carriers are seeking to set themselves apart from competitors, two carriers have once again decided to take on the underwriting challenge by offering cost cap insurance coverage. In addition, a third carrier is now offering a form of cost cap or rather a remediation liability loss portfolio transfer product, that serves as an alternative funding mechanism. This product is designed to provide a pre-funded financial mechanism which pays for the expected cleanup of contaminated sites. All three products, which are discussed herein, ultimately are designed to help limit or contain the risks of remediation expense uncertainties.

Aon Environmental has performed an extensive review of the newly minted cost cap policies, and prepared a summary of these products being offered to clients either through a traditional risk transfer approach or as an alternative funding mechanism. For people familiar with the first generation of remediation cost cap products (e.g., policies offered prior to the market withdrawal in 2010), it is important to note that the new cost cap products are different in that they provide a narrower scope of coverage with a variety of conditions that have been added in order to restrict the potential protection provided. Because past cost cap underwriting standards and policy structures led to extreme losses, the new policies will be available on a limited basis and will be underwritten and drafted to specific criteria.
The AXIS Solution

AXIS Insurance’s Environmental Remediation Management Policy is designed for owners, developers or other responsible parties and is not intended for contractors or consultants.

Unlike prior versions of cost cap products, the AXIS solution also offers an additional unique Protective Professional Indemnity coverage along with the cost overrun protection. The Insured is afforded protection for the negligence of their contractor or consultant for both third party and first party type claims.

The AXIS solution is intended for remediation projects with expected remediation expenses of between $2 million to $25 million USD. The program has a maximum limit offering of $10 million USD, depending upon the circumstances and information available on the remediation project.

AXIS has indicated it will consider a very broad range of clean-up programs, including Brownfields, RCRA, CERCLA, State and Lead Voluntary; however, sediment and radioactive was clean-ups are not target project types.

The AXIS policy is structured so that the Insured will retain responsibility for a SIR (self-insured retention) that applies to claims under all coverage parts. In some instances, the policy may also contain an additional engineered margin that will be determined as a function of the outcome of the engineering of the risk, i.e. the greater the uncertainty of the risk, the greater the potential margin. This SIR plus any engineered margin is usually referred to as the “attachment point” and where coverage begins under the policy. In other words, for a project with $3 million of expected remediation costs and a 15 percent margin, the cost overrun coverage would not be triggered until the Insured is more than $450,000 USD over budget (e.g., total remediation costs incurred by the Insured would exceed $3,450,000). Therefore, $3,450,000 would be the attachment point on the policy. Coinsurance may also apply once the coverage has been triggered, depending on the type of work/cleanup, and will be used as an additional underwriting tool for some projects.

There must be an approved Remedial Action Work Plan (or in some instances, a near final plan will be accepted) in order to bind a policy. All proposed remedies and budgets will be reviewed by the underwriter along with the contracts for engineering and contracting activities.

Details of Coverage

- Indemnification coverage for cost overruns associated with an approved Remedial Action Work Plan
- The policy provides coverage for both cost overruns incurred in the remediation of known pollutants as well as the costs to clean up newly identified pollutants (unknown pre-existing conditions discovered in the course of the conducting the cleanup)
- A companion policy may be placed (site environmental liability) to cover claims arising from bodily injury or property damage caused by pollution conditions
- Protective Professional Indemnity coverage is provided for the named Insured for damages arising out of wrongful acts (negligence standard) by the Insured’s consultants, contractors or remediation design professionals that exceed the limits of the design professional’s insurance
- Coverage for defense of third-party claims made against the Insured arising out of professional services
- AXIS requires Remediation Progress Reports which summarize remediation activities and expenses on not more than 90-day intervals
- The policy term is reflective of the remediation schedule and generally limited to not more than five years
- Changes in regulatory standards midway through an approved Remedial Action Work Plan must be reported through the claim process
- AXIS is currently silent on failure of remedy, but is willing to negotiate specific language to address this risk

The Beazley Solution

In January 2013, Beazley announced that it was expanding its environmental product offering with the launch of an Environmental Cleanup Costs Insurance Policy that provides coverage for cost overruns for remediation of known conditions at covered locations.

Beazley will only partner with contractors to support their Guaranteed Fixed Price Remediation (GFPR) contract practice. Beazley considers GFPR contracts to be attractive risks since the insured contractors have a direct interest in successful performance of the project because their profits and reputations are at stake. Beazley recognizes that these contractors likely have a superior understanding of the site conditions, conceptual site model, and remediation technologies that will be employed in order to make sure that contractors remain motivated even if coverage under their cost cap policies is triggered. Beazley includes coinsurance (vertical deductibles) requirements to be paid by the contractors that will range from 15 percent to 25 percent of the costs incurred once the policies begin to pay cleanup costs.

Beazley will only underwrite remediation projects that are between $3 million to $10 million USD, and the site size is limited to approximately 10 acres. Larger sites with smaller, well-defined areas of remediation will also be considered if other underwriting criteria are met. The limit of liability available is the lesser of $10 million or 100 percent of the project remediation cost. For example, if a project is expected to cost $3 million to complete, the maximum cost overrun coverage limit available for that project will be $3 million even though Beazley can offer up to $10 million under the program.

In order to qualify for insurance, a contractor must have a remediation work plan that has been approved by the regulator or if not, imminent approval must be pending. Coverage will be bound, only after all proposed remedies and budgets have been reviewed and approved by the underwriter. This means that the Beazley Remediation Cost Cap Solution is best suited for clients with mature remedial action plans.

An attachment point or self-insured retention (SIR) will apply and remediation costs up to this SIR will be the responsibility of the insured contractor. Coverage will respond once the SIR has been exhausted and fully incurred by the insured. The SIR comprises an engineered cost estimate that is based upon the remediation contractor’s estimate. In order to establish the SIR, Beazley will perform an independent assessment of the remediation costs for the project, which may include additional costs for the items that Beazley considers necessary, and may also include additional contingencies. The variance between the contractor’s cost estimate and the SIR depends on many factors, but the SIR usually is higher and often substantially so, since Beazley will be conservative in its establishment. In addition to the SIR, the contractor will bear the costs of a coinsurance requirement. The SIR and coinsurance are two mechanisms designed to help avoid potential moral hazards and align the interests of all stakeholders in the project.
Details of Coverage:

– Indemnification form covers cost overruns associated with an approved remedial action plan that has been scheduled on the policy. The policy is designed to address scheduled activities in the remedial action work plan, providing coverage for: (1) higher concentrations of constituents; (2) greater length of time to address constituents; and (3) Greater volumes discovered of the known constituent.

– Remedy failure can be addressed only through the claims process and requires the approval of the insurer to amend the remedy, which will be done through an endorsement to the policy. This amendment however is subject to underwriter approval and may lead to an increase in the attachment point or changes of other terms on the policy including additional premium.

– A companion policy can be placed (site environmental liability policy) to cover the cleanup costs of any unknown conditions discovered during the course of cleanup. In addition, the site liability policy can cover the exposures to toxic tort liability claims i.e. 3rd party Bodily Injury and Property Damage, for the project site and as a result of the known or a newly discovered constituent.

– The Insured is required to submit Cleanup Plan Status Reports accordingly to the frequency specified in the policy.

– The policy term is reflective of the remediation schedule, but under no circumstances will exceed 10 years.

– Changes in regulatory standards mid-way through an approved Remedial Action Work Plan must be addressed through a modification of the policy and will require an endorsement. This is usually only available when the change does not appear to impact or increase the overall cost of the project. Otherwise changes in cleanup criteria post binding are excluded from the policy.

The Southport Re Solution

In addition to the new remediation cost cap products offered by AXIS and Beazley, Southport Re, a Delaware limited liability company, is offering to provide a capital market solution to the problem of remediation cost overruns. Their approach utilizes a loss portfolio transfer mechanism vs. a traditional risk transfer insurance product. Southport refers to their solution as an “Environmental Liability Indemnification” agreement.

The Southport program is designed to address concerns of the owner of a contaminated site or a portfolio of sites. Southport Re seeks to indemnify clients for “qualified expenses” to be paid by the client with regard to environmental liabilities or specific remediation projects for which the client is liable and has established reserves to pay for the expected costs. The Indemnification Agreement is designed to pay for the costs of both the known and unknown conditions, subject to the limits of the policy, as a result of the remediation liability. These costs can include;

(1) Cost overruns due to newly-discovered contaminants;
(2) Excess volumes of known conditions;
(3) Cost overruns due to changes in regulatory requirements;
(4) Inflation risk; and
(5) Errors or inefficiencies in the remediation work plan.

One unique feature of the Southport program is that the length of coverage has no set minimum or maximum time period. The program will be as long as necessary to complete the remediation or until the
limits are exhausted, whichever occurs first.

In order to facilitate the transaction, Southport will establish a bankruptcy-remote Delaware Trust. The owner, who is conducting or is required to perform a remedial action, deposits the cleanup funds into the Trust. Southport also contributes cash or assets into the Trust as additional security for the cleanup liability. The Trust then enters into a reimbursement agreement with the owner to reimburse “qualified remediation expenses” over the lifetime of the remediation project.

Qualifying remediation expenses associated with the remediation project include two types of costs:

- **Expense Type A** - Anticipated remediation costs underwritten on the basis of the project scope of work, budget and timeline
- **Expense Type B** - Amounts required to address other specified costs associated with or rising from remediation efforts, including inflation, changes in regulatory requirements and total or partial failure of the remediation technology.

An independent trustee will oversee the operations of the Trust.

The Trust is constructed so asset maturities are matched with anticipated disbursement needs for the environmental remediation project. The policy will be structured with annual sublimits which will track with the expected annual costs of remediation. The sublimits will be greater than the expected annual costs and will increase proportionally over time if there are no costs exceedances in the early years of the program.

The Client will be able to terminate the Environmental Liability Indemnification Agreement at any time. Accordingly, the Trust will establish a hypothetical or notional experience account whereby the client, upon termination, will be entitled to a potential refund of part of the initial deposit paid. The amount returned is equal to the trust fund balance less margin fees and qualifying expenses. Expenses for the administration of the trust are paid out of the deposited funds.

Southport is interested primarily in long-term projects that are expected to take 10 years or longer to complete. Southport has capacity to transact deals with remediation liabilities of up to $250 million and can consider more when structured or spread out over multiple transactions and or policies.

They will consider either single-site projects or portfolios of projects as a part of their product offering. This product works best with long-term remediation and monitoring projects with protracted cash flow requirements. Southport’s ability to aggressively discount the future value of liabilities is the key to their success in attracting clients who normally use more conservative rates to calculate the future value of such long term liabilities.

Southport owns several insurance companies, which could front the “policy” that is supported by the financial trust where regulators or other third parties require a rated insurance policy to support the owner’s financial assurance obligation for remediation or closure/post closure care responsibilities. The additional cost of the fronting policy will be separately priced.

In addition to the loss portfolio transfer option as described above, Southport has the capability to consider the actual purchase of the underlying real estate asset or target company if that is a desired outcome of the client. This option requires much more detail and needs to be addressed separately if this is the client’s goal.
**Details of Underwriting Process:**

- Annual and cumulative limits for remediation costs are established based on the anticipated funding requirements.
- Changes in regulatory standards mid-way through an approved Remedial Action Work Plan must be addressed through a modification of the policy. Otherwise, changes in cleanup standards are excluded.
- In evaluating the Remedial Action Work Plan, Southport will consider plans that have not been approved by regulators.

Southport looks first to financially engineer the project and then once there is consensus on the financial terms and capital required, Southport will then provide a proposal for stage two which includes the environmental engineering. The environmental engineering underwriting process includes an evaluation of the Remedial Action Work Plan, in terms of both Scope of Work and costs, and the expected payouts on worst-case best-case and most-probable outcome scenarios. There will be a charge for the environmental engineering and further underwriting of the project required to reach a bindable offer from Southport. These costs will be offset by the transaction if and when completed. If no deal is reached the funds will be retained by Southport Re.

**Summary**

It is evident that Southport Re’s approach is very different from either AXIS or Beazley’s and the outcomes are different as well. One of these products or approaches isn’t necessarily better than another; rather the best solution will depend on the project and the client’s objectives. The three products discussed provide tremendous flexibility in how to address a client’s need and or goals for financial management of large remediation projects. Both the AXIS and Beazley options are designed to provide a high level of cost certainty for the expected remediation costs associated with a project. AXIS supports the owner of the site while Beazley supports the contractor. Southport’s model on the other hand, while more complicated from a structural and financial standpoint, provides a sophisticated funding mechanism that may provide an attractive alternative for certain long-term projects and a possible favorable balance sheet treatment with clients potentially able to greatly reduce or remove liabilities from the balance sheet.
Contact Information

John Welter
Practice Leader
Aon Environmental
+1.832.476.5730
john.welter@aon.com

Veronica Benzinger – Southeast
Chief Broking Officer - Managing Director
Aon Environmental
+1.561.253.2514
veronica.benzinger@aon.com

Jeff Hanneman – Southwest
Managing Director
Aon Environmental
+1.832.476.6853
jeffrey.hanneman@aon.com

Adrian Pellen – New York
Director
Aon Environmental
+1.212.441.2384
adrian.pellen@aon.com

Greg Schilz – West
Managing Director
Aon Environmental
+1.415.486.7652
gregory.schilz@aon.com

Jamie Taylor – Central
Managing Director
Aon Environmental
+1.312.381.4226
jamie.taylor@aon.com

Rodney Taylor – Northeast
Managing Director
Aon Environmental
+1.407.876.1828
rodney.taylor@aon.com

M. Claire Juliana – Claims
Director
Aon Environmental
+1.212.441.2392
claire.juliana@aon.com
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