Owner Controlled Insurance Programs - Part 1

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Owner-controlled insurance programs (OCIPs) are a type of wrap-up, an increasingly popular insurance procurement option that allows coverages for multiple insureds to be bundled (or wrapped up) into one consolidated program.

OCIPs are typically used on very large construction projects involving many contractors and subcontractors. They provide an owner with certain cost savings; as well, they offer some advantages for the contractors and subcontractors working on the project.

Construction financial managers should familiarize themselves with these programs in order to ensure that their companies are adequately protected when they choose to bid on and/or participate in an OCIP.

An OCIP is a wrap-up under which a project owner provides various insurance coverages to contractors and subcontractors. OCIPs comprise about 90% of the wrap-up programs currently being performed in the U.S. Another type of wrap-up is a contractor-controlled insurance program (CCIP), under which the general contractor is the sponsor

The two programs are basically the same. The main difference is sponsorship (owner vs. contractor) and the main question concerns control: Who is responsible for what? The issue of control can pose potential problems if the wrap-up is not structured with partnering and collaboration in mind. Having the proper scope definition, delineation of responsibilities, and program structure, as well as communication and cooperation, are critical to the success of any wrap-up. That said, let’s now turn to the specifics of the OCIP.

Why OCIPs Now?

OCIPs have been around for more than 40 years; however, within the last decade, we’ve seen a proliferation of this type of insurance program on construction projects throughout the U.S. and abroad.

The use of OCIPs continues to grow as a result of several factors:

The increase in the number of large capital improvement projects undertaken to repair the nation’s deteriorating infrastructure.

The booming economy, fueled by the growth and expansion of high-tech businesses.

The implementation of less stringent insurance regulations.

A highly competitive construction insurance market.

Defining OCIPs

As stated at the outset, an OCIP is a wrap-up under which a project owner provides various insurance coverages to contractors and subcontractors. OCIPs can potentially reduce an owner’s project costs by approximately 1-2%, compared to traditional, fragmented insurance programs.

Who & What Is Included

An OCIP can be site-specific or it can be for multiple jobsites. Most OCIPs are multi-year programs with a fixed duration. For large construction projects, the most common duration is two to five years. And, the

OCIP normally applies to all contractors and subcontractors performing work at the project jobsite. This jobsite is defined to include the construction site, all on-site fabrication shops, and associated material storage and laydown yards.

The insurance coverages most commonly included in an OCIP are workers' compensation (workers' comp), employers liability, commercial general liability (CGL), and excess/umbrella liability. In addition (but not always), an OCIP can include builder's risk, professional liability for design professionals, and environmental liability insurance coverages.

In the last few years, design liability and environmental liability insurance have been bundled by some insurance carriers to provide professional and pollution coverage. In addition, some insurers have introduced subcontractor default liability policies into the OCIP mix as an alternative to surety bonds.

Who & What Is Excluded

If the majority of a contractor's work is performed away from the project site, the contractor may be excluded from the OCIP. The reason is simple: Limited jobsite exposure in the contractor's contract means limited exposure to jobsite injuries/claims. An OCIP should also exclude contractors with a contract amount below a certain threshold. (Depending on the total construction costs, $25,000-$50,000 in contract value is a good rule of thumb.)

Commercial auto liability coverage is usually excluded due to the difficulty of controlling/verifying losses. If included, such coverage could negatively impact OCIP savings.

Traditional vs. OCIP Approaches

In order to gain a better understanding of the OCIP, let's first examine how an owner would traditionally mitigate risk on a construction project.

Traditionally, an owner and a contractor execute a construction contract, which includes an indemnification clause with exculpatory language expressly stating that the contractor shall hold the owner harmless for any loss arising out of the execution of the contract. This type of indemnification clause usually protects the owner from any vicarious liability and mitigates the owner's contributory negligence exposure.

In addition to this contractual provision, the project owner would require that the contractor purchase and maintain adequate insurance coverage with specified minimum limits of liability. At the very least, owners normally require contractors to provide workers' comp, employers liability, and CGL coverages. The owner will usually require that the contractor name the owner as an additional insured on the contractor's liability policies; this ensures that the contractor will defend the owner in the event of any third party action-over claims.

Under traditional insurance programs, one alternative to being named as an additional insured is for the owner to require the contractor to purchase an owners' and contractors' protective liability policy. This project-specific policy is purchased and maintained by the contractor; however, the cost for this policy is reimbursed by the owner when required by the owner.

By comparison, under an OCIP, insurance coverage (usually the workers' comp and CGL) is provided by the owner to the contractor, subcontractors, and sub-subcontractors. The indemnification provision still exists, but the standard contractor insurance requirements are removed.

Advantages & Disadvantages for Owners

OCIPs hold advantages and disadvantages for both the owner and the contractors performing the work. Advantages to owners include:

The ability to obtain broader insurance coverage with higher dedicated limits for contractors, which ultimately provides better protection for an owner.

Potentially lower construction costs resulting from volume discounts on insurance purchases and reduced losses from more effective, comprehensive, safety and loss control programs.

Improved quality of risk management services (e.g., claim handling, loss control).

Substantial reduction in the amount of time required for obtaining certificates of insurance from contractors.

Insurance requirements no longer an obstacle for contractors bidding work.

However, an OCIP is not the perfect risk management tool by any means. Here are several owner disadvantages:

The additional administrative burden can require a substantial level of effort if not managed competently by the owner's OCIP administrator.

If the insurance market hardens, there is a potential financial risk inherent in loss-sensitive programs, resulting in premium cost increases and/or coverage reductions.

An additional accounting effort may be required for extracting insurance costs from contractor and subcontractor bids and change orders.

An additional monitoring effort is required by the OCIP administrator to ensure that claims from a contractor's employees injured on other projects are not charged to the OCIP.

Owner responsibility is increased for the implementation of safety and loss control programs.

The Time Factor

In many cases, the additional administrative burden associated with the OCIP may be outsourced to an insurance agent or broker, risk management consultant, or a third-party administrator. However, there is still an administrative impact on an owner's operations because a number of departmental resources (e.g., legal, human resources, accounting, finance, purchasing, facilities and construction, safety and risk management) are affected throughout OCIP implementation and administration.
With the exception of risk management, the time burden placed on these other departmental resources is minimal, usually requiring only a few hours during the design and implementation phases. Post-implementation, an owner's day-to-day involvement should only be periodic, and will probably be limited to premium payment, claims reviews, and administrator coordination.

Other Owner Considerations

Owners should be cognizant of the financial risk inherent with a loss-sensitive OCIP, and understand how this differs from guaranteed-cost insurance.

With a traditional insurance program, the owner transfers all risk of loss to the contractor and subcontractors, and pays a fixed premium to the insurer for guaranteed-cost insurance. When an owner changes from a fixed-price, guaranteed-cost program to a loss sensitive OCIP, an owner is trading off some financial certainty for the potential to lower the cost of risk.

The total cost of risk is limited by the application of per-occurrence and aggregate retentions, and by implementing an aggressive safety and loss-control program to mitigate losses. However, owners cannot completely protect themselves from risk unless they purchase a guaranteed-cost insurance program, which usually comes with higher fixed costs, particularly in a hardening insurance market.

Pros for Contractors

Just as there are advantages for owners, an OCIP offers a number of pluses to participating contractors, including:

The ability to obtain broader coverage with higher liability limits.

More effective safety, loss control, and risk management programs.

Coordinated claims handling/adjusting procedures and claims management services.

Elimination of coverage disputes and subrogation between contractor and insurers.

OCIP claims not counted as part of the contractor's own aggregate limit.

But, OCIPs present a downside for contractors, just as they do for owners. Here are several disadvantages for contractors:

Since bids must be provided with and without insurance, a more complicated bidding process is required in order to delineate bid credits.

In a close bidding situation, a contractor with a good safety record may lose out when competing against a less safety-conscious contractor. (This could occur if the workers' comp experience modifier is not taken into consideration as part of the bid process.)

Documentation and reporting requirements impose an additional administrative burden.

Since OCIP costs must be segregated from other project costs, additional bookkeeping is required to maintain duplicate payroll records.

OCIP coverage may not be as broad as, or may have lower limits than, the coverage provided by the contractor's own insurance policies. In this case, the contractor will have to negotiate with its own insurer to obtain excess limits or difference-in-conditions (DIC) liability coverage.

An OCIP usually includes completed operations coverage for losses in a specified period of time (e.g., a two to five year "tail" after project completion). However, a contractor's exposure continues for a longer period of time. Therefore, whenever possible, a contractor should endorse its own general liability policy to include any exposures beyond the OCIP period.

Due to the decrease in payroll volume, the contractor's own insurance company may reduce its premium credits; also, dividends for workers' comp may go to the owner, not the contractor.

Auto liability coverage is usually excluded from an OCIP. This can make it more difficult to separate general liability and auto liability claims if these coverages are with different insurers.

Some OCIP administrators do not report workers' comp loss data to rating bureaus in a timely manner, thereby affecting the contractor's experience calculation.

Other Contractor Considerations

As previously mentioned, contractors have additional administrative burdens associated with an OCIP, as do the subcontractors enrolled in the program. First, the contractor must expand its bid package to define the OCIP for subcontractors and identify the subcontractors' insurance deductions. The project pre-bid and pre-mobilization meetings must be expanded to educate all subcontractors about the implementation and administration of the OCIP. The contractor must also work with the owner's insurance representative, and/or designated OCIP administrator, to validate insurance deductions and enroll all subcontractors who will be working on the project.

The Time Factor

Contractors should expect the incorporation of the OCIP documentation to add more time to the preparation of each bid package. (This would include the OCIP manual and associated pre-bid and bid clarification meetings with subcontractors bidding work on the project.) However, under a traditional insurance program, the contractor would probably have expended an equal amount of time tracking its subcontractors' certificates of insurance. Under an OCIP, this burdensome task is not required.

In addition, the contractor's and subcontractors' insurances must be modified to dovetail with the OCIP coverages. Subcontractors must complete wrap-up enrollment forms and monthly payroll reports, and must report claims to an OCIP administrator and insurer in lieu of their own insurers. Additional time should be budgeted for participating in OCIP orientation meetings, completing enrollment forms, and pre-paring periodic payroll reports.

Potential Savings to the Owner

It's extremely difficult to determine the total savings an owner can realize from an OCIP because the potential savings can vary significantly based on a number of factors.

Savings are derived when contractors and subcontractors remove insurance costs from their bids because these bid reductions lower the contract price. The owner's cost for providing workers' comp, CGL, and excess liability coverage on behalf of contractors and subcontractors will likely be substantially less than the deduction received from the contractors and subcontractors. The potential savings is the difference between the bid reductions and the owner's cost of contractor and subcontractor-provided insurance coverages.

Contractor and subcontractor bid deductions can vary between 2-5% of construction costs. However, the amount contractors and subcontractors spend on OCIP-provided coverages will vary by geographic area, contractor size, and type of project.

Some Numbers to Crunch

A study conducted by the Risk and Insurance Management Society provided statistical data from 30 contractors on the cost of risk (COR) based on annual revenue. This is a small sample from a much larger total population of contractors, but it will serve our purposes here.

The largest contractors in this study indicated a COR of approximately $25 per $1,000 of revenue. If you subtract the cost of the insurance coverages an OCIP would not normally include and then subtract a contractor's average risk-management administration costs, the OCIP-provided insurance cost would be less than $20 per $1,000 or 2% of revenue.

Assuming a total bid reduction of 2%, total owner savings would be 2% of construction costs less what the owner expends to purchase the OCIP-provided insurance coverages or an estimated savings in the range of 0.5-1% of construction costs.

Cost Comparisons

Most construction estimators use one of several techniques when preparing their bids. When bidding fixed-price work, they may use either a unit rate (cost per square foot for an office building or cost per floor, room, etc., for a hotel) or they may use labor and material estimates provided by the owner or owner's design professional. When bidding cost-plus work, estimators may use the prevailing wage rates for the geographical area and then gross-up this rate to include G&A expenses. Regardless of what method is used, each contractor's bid will contain insurance costs.

The costs on fixed-price bids are usually embedded in the wage rate, which can be directly factored into the estimate or indirectly included in the unit rate. The contractor's bid includes wage rates that are comprised of its employees' base wages and overheads, and are usually expressed as a percentage of the base wage. Some of the overheads that are factored into the gross billing rate include profit, G&A, benefits, taxes, and insurance.

Contractors typically include state workers' comp rates (adjusted by their own experience modification rates) and company-specific general liability rates in their insurance overhead calculations. The insurance overhead assumes first-dollar (i.e., no retrospective rating plan or deductible fixed-cost) coverage. This is usually in the range of 8-14% of payroll, depending on the specific geographic location under consideration.

Many large contractors will include a standard premium figure in their billing rates because their actual insurance cost is undetermined at the time they are bidding on a proposed project. If these contractors were willing to gamble on the unknown, they could ultimately pay less by purchasing first-dollar, guaranteed-cost coverage.

OCIP Costs/Benefits

On an OCIP, the bid packages issued to contractors and subcontractors will contain an "Instructions to Bidders" section specifically stating that bids are to be submitted with and without insurance. However, the cost of insurance is to be included with their bids, as either an alternate/add or an alternate/deduct.

By combining the cost for all of the contractors' and subcontractors' owner-furnished insurance coverages into an OCIP, an owner creates substantial leverage in the insurance market. That's why owners are able to purchase insurance at a lower rate than individual contractors. An owner can realize cost savings of as much as 10-15% due to the volume purchasing of the OCIP coverages.

Owners can also significantly reduce project insurance costs through risk retention. This is achieved by assuming a higher deductible (e.g., $100K-$250K) per loss. Additional savings can be realized if project loss experience is better than the actuarial loss experience factors contained in the insurer's guaranteed-cost rates. It should be noted that loss experience on a significant number of OCIPs has historically averaged less than 40% of standard insurance rates.

A Hypothetical Example

Let's look at a hypothetical example of how an OCIP works in practice. An owner is considering building a $500 million luxury hotel and entertainment complex. The estimated payroll for this proposed project is equal to 25% of the hard construction cost, and the average contractor and subcontractor insurance rate is $10.75 per $100 of payroll (a composite rate, which includes workers' comp and general liability). Using a traditional insurance approach, the insurance cost on this project would be approximately $13.5 million.

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[($500M x .25)/100] x $10.75 = $13,437,500
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Based on empirical data collected over the past several years on various types of projects, we can expect to reduce this insurance cost by approximately 5% through the use of an OCIP – spending $12.8 million over a 24-month period, instead of the $13.5 million in the above example. The cost of owner-provided insurance contains two components: fixed expenses and retained losses. Fixed expenses include overhead expenses, claim reporting, commissions (if fixed), and premium taxes and assessments. Retained losses are the contractor's and subcontractors' losses that are paid by the owner under the owner's established deductible threshold. If the loss experience on this project is average, the total OCIP insurance cost would be approximately $8.75 million, and the owner's savings would be $4.05 million.

Insurance Coverage Considerations

Workers’ Compensation & Employers Liability

Workers’ comp and employers liability insurance are statutory, and the limits of liability coverage are regulated by each state’s Department of Insurance. Workers’ comp coverage is a major component of most OCIPs. This is due to the large premiums that are required, the level of claims handling, and the degree of control needed over the safety, loss control, and risk management aspects of the project. The majority of an OCIP’s administrative burden is associated with workers’ comp because, in most states, individual workers’ comp policies must be issued to all participating contractors and subcontractors. On large projects, this can be substantial.

Commercial General Liability

The Insurance Services Office (ISO) CGL Coverage Form, CG 0001, 1986 or later, is the form predominantly used on most projects; it provides bodily injury and property damage liability coverage. Regardless of the specific form used, general liability coverage for an OCIP should include (but not be limited to) several key provisions to safeguard the owner’s interest: contractual liability; broad-form property damage; OCP liability (usually written on a separate project-specific policy); explosion, collapse, and underground coverages; personal injury liability; and employees-as-insureds. In addition, there are a number of endorsements that can be used with the CGL form to broaden coverage or reduce coverage.

It is highly recommended that contractors remove any wrap-up exclusion endorsement from their own individual CGL policy. Contractors should also attach a DIC endorsement to their CGL policy. This is required so that their CGL policy will apply as excess insurance coverage over the OCIP-provided CGL policy. (Note: The limits of these master policies may be less than the contractor would normally provide for its own non-OCIP projects.) This also provides the contractor with coverage at least as broad as that provided under its own policy. Other considerations relative to the contractor’s CGL policy include:

Liability limits. Under an OCIP, aggregate and per-occurrence limits apply to all contractors and subcontractors for the term of the project. Aggregate limits are usually two to three times the per-occurrence limit for any given year on the project. OCIP per-occurrence limits allow the full limit of the policy for each named insured. The coverage provided under the OCIP is extended separately to each entity, which can result in pyramiding limits. Limits can usually start at $25 million and may be $100 million or more, depending on the project’s exposures and owner’s requirements.

Guaranteed-cost vs. loss-sensitive programs. Most OCIPs are written using large deductibles, large retentions, or retrospective rating plans. Under these programs, the total OCIP cost depends on the actual losses incurred. One disadvantage to this is the continuation of premium adjustments years after the project is actually completed. OCIPs can also be written at fixed rates for the project term, but these plans are more expensive due to the risk associated with the uncertainty of large losses.

Completed-operations coverage. Completed-operations coverage should extend for at least three years after final project completion or acceptance. This does not mean the completion of the contractor’s or subcontractors’ specific portion of the project, but the completion of the total project as delineated in the contract.

Contractors may negotiate “tail coverage” (which can be endorsed on their own CGL policy) with their own insurance carrier to extend permanent completed-operations coverage beyond the expiration of the OCIP-provided project insurance. Contractors are advised to negotiate this coverage before work begins so as not to lose their ability to obtain this coverage once the work actually starts.

Excess/Umbrella Liability

An excess/umbrella liability policy may be purchased in the excess and surplus insurance markets or as an umbrella policy form. This type of policy provides a buffer layer over the underlying CGL policy.

Many umbrella policies contain a contractor's limitation endorsement, which may include a blanket exclusion for wrap-up projects. For the reasons previously noted, these policies need to be modified.

Builder's Risk

The builder's risk insurance policy should cover project exposures associated with earthquakes and floods, damage to existing/adjoining property, boilers and machinery, project delays, the transit and storage of materials off-site, and explosion and collapse. Contractors are required to retain some portion of each property loss. The deductible should be at least $2,500 in order to provide an incentive for contractors to mitigate losses.

Professional Liability

Owners may purchase a professional liability insurance policy to provide coverage for all of the design professionals (e.g., architects, engineers, etc.) on the OCIP project. Ideally, the design professionals would subtract the cost of their own individual professional liability (or practice) insurance from their fees on the OCIP. This may not always be possible, however, because the insurer providing the practice policy may not provide a premium reduction to the owner.

Regardless of obtaining a premium cost savings, an owner may want to obtain a professional liability policy on the OCIP project to provide coverage for design professionals who may not have this coverage or whose coverage does not satisfy the owner's requirements. Also, an owner can purchase broader and more uniform coverage for the OCIP than each design professional could purchase individually in a stand-alone policy.

Environmental Liability

An OCIP can include pollution liability coverage. Policies can be written on an occurrence or claims-made form, can include completed operations coverage, and can be written for the total duration of the project.

Most policies provide coverage for environmental hazards arising from three sources: known pollutants existing on the jobsite which are accidentally released during construction (pollutants collected by a remediation contractor); unknown pollutants existing on the jobsite that are uncovered by excavation operations (buried fuel oil tanks or barrels of toxic waste); and pollutants brought to the jobsite by a contractor or subcontractor (fuel, hydraulic fluids, paint, etc.).

Owners should seriously consider obtaining coverage for these types of exposures and should require environmental consultants to obtain environmental liability coverage.

Surety Bonds & OCIPs

Surety bonds (typically payment and performance bonds) are procured by the contractor at the request of the owner as a requirement of the contract. The surety guarantees the contractor's performance to the project owner and does whatever is necessary to get the project completed, should the contractor default.

So, surety bonds should not be included as part of an OCIP. Contractor-surety relationships are based on mutual trust, confidentiality, and the contractor's performance and financial solvency. However, the contractor is solely responsible for its own income statement and balance sheet. The owner should not attempt to gain any additional control over the contractor's bonding arrangement, over and above requiring such bonding.

Something New Has Been Added

Subcontractor default insurance provides an alternative to surety bonds. This type of coverage directly indemnifies owners for the costs resulting from contractor or subcontractor performance default.

Coverage applies to reimbursement of both direct and indirect costs incurred to complete unfulfilled contractor obligations, including costs related to job acceleration, extended overhead expenses, and liquidated damages. This approach allows an owner to retain control of the project if there is a default without jeopardizing any of the contractor-surety relationship issues, as mentioned above. There may also be a potential cost savings compared to the traditional surety-bond approach.

These types of policies usually include a deductible, a co-payment percentage, and an aggregate limit. The insurer underwrites the coverage by evaluating the owner's method of prequalifying, managing, and controlling the performance of the contractors and subcontractors (i.e., by reviewing the owner's project management and contract administration procedures). Pricing is determined by project size, geographical location, and the number of contracts.

Conclusion

Now you have a better understanding of an OCIP's features, benefits, and drawbacks. Next time, we'll review the assessment and implementation processes: how to determine if this program is right for the project and how to go about putting an OCIP in place.

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