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Report to the Chairman, Subcommittee
on Transportation, Committee on
Appropriations, U.S. Senate

June 1999

TRANSPORTATION INFRASTRUCTURE

Advantages and Disadvantages of Wrap-Up Insurance for Large Construction Projects



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**Resources, Community, and
Economic Development Division**

B-281480

June 1, 1999

The Honorable Richard C. Shelby
Chairman, Subcommittee on Transportation,
Committee on Appropriations
United States Senate

Dear Mr. Chairman:

Traditionally, for large construction projects, project owners (such as state departments of transportation and transit agencies), contractors, and subcontractors have purchased insurance independently to protect themselves from financial losses. In contrast, with wrap-up insurance, the project owner can cover all the parties involved in the project—the owner, the construction manager, the general contractor, and the subcontractors. Over the past decade, wrap-up insurance has been used increasingly on large construction projects because of the potential for cost savings. In 1998, wrap-up insurance covered about 300 construction projects nationwide. However, wrap-up insurance has been used infrequently on highway construction projects because they often are too small. As part of your Committee's continuing oversight of federally funded transportation projects, you asked us to identify the advantages and the disadvantages of wrap-up insurance over traditional insurance and the factors that can affect the broader use of wrap-up insurance. As part of our methodology, we reviewed the justification for, the costs of, and the potential benefits or problems with wrap-up insurance on six federally funded highway and mass transit projects. These projects varied in cost, geographic location, and type of construction and included highway, bridge, tunnel, and rail transit construction. We also interviewed officials in the insurance and construction industry and reviewed reports and analyses of wrap-up insurance in order to gain an understanding of the broad issues in using wrap-up insurance.

Results in Brief

Owners of transportation projects, such as transit agencies and state departments of transportation, experience a number of advantages and disadvantages when they use wrap-up insurance. Major advantages include savings from buying insurance "in bulk," eliminating duplication in coverage, handling claims more efficiently, reducing potential litigation, and enhancing workplace safety. According to insurance industry officials, wrap-up insurance can save project owners up to 50 percent on the cost of traditional insurance, or from 1 to 3 percent of a project's construction

cost, depending on its size. The potential disadvantages of wrap-up insurance include requiring project owners to invest more time and resources in administration. Project owners must hire additional personnel or pay to contract out the management of the wrap-up insurance. In addition, project owners could also have to pay large premiums at the beginning of the project. However, transportation officials said these costs were reasonable.

A number of factors can affect the broader use of wrap-up insurance. Perhaps the most significant barriers are state systems for workers' compensation that, in some states, effectively prevent wrap-up insurance by greatly reducing its potential cost savings. Another limitation is that a project must be sufficiently large, or contain at least a sufficient amount of labor costs, to make wrap-up insurance financially viable. Finally, some contractors dislike wrap-up insurance because it reduces a contractor's profits from insurance rebates.

Background

Contractors and project owners purchase insurance to protect their business assets from potential claims and losses. Under both traditional and wrap-up insurance, the project owner and construction contractors must buy the same kinds of policies. The basic types of insurance for construction projects include workers' compensation, general liability, architects' and engineers' professional liability, builders' risk, excess liability, and pollution liability.¹ For some projects, more specialized insurance policies are needed. For example, construction projects on or near water must have longshoremen's and harborworkers' insurance, while projects on or near a railroad must have railroad protective liability insurance. Wrap-up insurance can provide all of these types of coverage but does not provide for automobile liability or insurance on the contractors' tools and equipment.

In general, a project owner may choose from two basic types of wrap-up insurance. The simplest form of coverage is the payment of a flat premium, also known as a guaranteed cost plan. With this plan, the premiums stay the same during the term of the policy, even if a high amount of claims is paid out. The guaranteed cost plan is the more common form of coverage for small to medium-sized businesses. With the second type of plan, known as a loss-sensitive plan, the premiums depend on the policyholder's claims that are actually paid, called "losses." A loss-sensitive plan generally returns a refund for low losses and charges additional premiums

¹See app. I for a description of these types of policies.

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