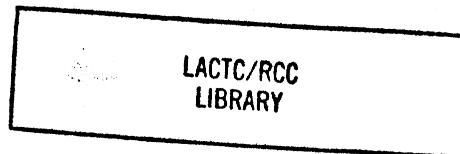
Los Angeles County Transportation Commission

RISK MANAGEMENT STUDY

November 19, 1990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November 19, 1990

Los Angeles County Transportation Commission
403 West Eighth Street, Suite 500
Los Angeles, California 90014-3096

Attention: Mr. Leslie V. Porter
Deputy Executive Director

RISK MANAGEMENT STUDY

This report presents the results of our evaluation of risks and risk management needs of the Los Angeles County Transportation Commission (LACTC). Our activities included:

1. Interviews with management and staff employees of LACTC and with Mr. Robert A. Stevens of Transit Insurance Administrators, LACTC's construction risk management contractor.

2. Inspection of portions of the LA/LB rail line, both completed and under construction.

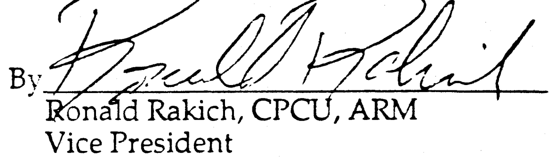
3. Review of financial reports, budgets, correspondence, contracts and other materials provided by LACTC staff.

4. Preparation of this report.

We appreciate the time and cooperation provided by LACTC staff members, especially Richard Dominguez, Annette Colfax and John Adams.

Ronald Rakich and C. C. Griffin performed the work on this project. We appreciate the opportunity to perform this interesting assignment and are prepared to answer any questions you may have concerning this report.

WARREN, McVEIGH & GRIFFIN, INC.



By ______________________
Ronald Rakich, CPCU, ARM
Vice President

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Letter to Annette Colfax dated January 11, 1990
Sample risk management policy

I — Background and Summary

A — Introduction

This document is an update and consolidation of two previous reports. A report on risk management and insurance for Los Angeles County Transportation Commission rail construction, A report dated iscussed overall risk management needs of the Commission.

Attached as appendices to this report, are two letter reports that were prepared in response to LACTC's immediate needs for contract negotiations. One discusses risks arising from ownership of the LB/LA "Blue Line." The second covers insurance requirements for the Blue Line operator. These reports are included as appendices so that the reader will be able to evaluate more easily the broad scope of risk management needs and activities at LACTC and the breadth of our analyses for LACTC.

LACTC is a dynamic agency. Needs, situations and personnel involved with this project have changed rapidly over the course of our engagement. A completely new subsidiary agency, Rail Construction Corporation, has been created since our first draft reports were issued. A number of staff changes have occurred. Critical issues have arisen over the past year as a result of deadlines or operational changes. These issues demanded immediate written response even though the required analysis may have been intended to be part of a later study. As a result, our reports overlap in some areas and many of our earlier recommendations have already been implemented.

B — Background

The Los Angeles County Transportation Commission (LACTC or Commission) constructs rail transportation systems throughout Los Angeles County. Rail lines currently under construction and those planned for the future will eventually link major portions of the greater Los Angeles area.

The Commission also has another role—distributor of federal and state transportation funds to other local agencies. The Commission directs hundreds of millions of federal, state and local tax dollars. It funds local bus lines, dial-a-rides and the Southern California Rapid Transit District. Through its broad scope of activities, the Commission probably affects the daily lives of a majority of the residents of Los Angeles County. Such prominence makes LACTC a target for a variety of claims or lawsuits arising out of both construction and non-construction activities.

These two separate sides of LACTC, construction and non-construction, are best addressed separately from an insurance and risk management perspective because of the wide disparity in risks involved. In this report, our discussion frequently [redacted] as we evaluate various risk management aspects of each operation. [redacted]

[redacted]

A joint venture contractor formed by several insurance brokers provides some risk management services for LACTC rail construction activities. These services include:

- Claims supervision (of the OCIP insurer),
- Safety management including supervision of insurer safety activities,
- Subcontracting for inspections and other services,
- Identification of the need for and purchase of insurance for construction activities, and
- Placement of automobile insurance for LACTC.

Although the Commission distributes millions of dollars, it does not have unlimited capacity to pay for losses.

On the construction side, the loss-paying capacity is great, as the Commission has discretion for expenditures and large sums of money are involved

s. Currently, the Commission pays the first $500,000 of each property or liability loss related to construction and insures the remainder up to $50 million (for liability risks).

On the non-construction side of its operations, LACTC has restrictions on the use of its funds. Most of the money that passes through the Commission is spent by other agencies and is not available to pay for losses. As explained in the main body of this report, we estimate the

C — Recommendations

Our recommendations as stated on February 20, 1990, are included in this revised report. In those situations where we are aware that LACTC has implemented the recommendations, we have noted our understanding of that implementation. We have not attempted to update all financial figures to reflect current budgets or programs, as we believe such activity would duplicate previous work, is not in the scope of our engagement, would result in additional expense to the Commission, and would not change our fundamental conclusions.

In addition to the original recommendations, we have added several others. These should be distinguishable in the text. Our basic recommendations are as follows.

Purchasing these coverages from the current OCIP insurers is one way to insure the risk.

Another way to obtain coverage is to ask the Commission's OCIP insurance broker/contractor to obtain insurance quotes from different insurance companies. A third alternative is to request competitive proposals from different insurance brokers. A final option would be to apply for membership in a governmental self-insurance pool. The Commission should explore all options. To the best of our knowledge, none of these coverages have been purchased as of the date of this revised report. The Commission is uninsured in these areas.

Any Commission activities, construction-related or non-construction could result in considerable losses. LACTC manages several major construction projects, owns an operating rail line, will continue its involvement in funding and oversight of transportation agencies in Los Angeles County and will perform other governmental functions.

In addition, the Commission should develop and adopt a risk management policy to guide the risk manager in making decisions and carrying out the Commission's wishes.

The Commission should give careful consideration to the responsibilities of the risk manager with regard to all aspects of LACTC operations. For example, LACTC has assumed responsibility for rail construction for portions of the system previously managed by Southern California Rapid Transit District. A separate corporation has been formed (Rail Construction Corporation — RCC). LACTC must decide upon the risk

manager's role in construction activities and his relationship to RCC. [redacted]

These benefits alone are sufficient to justify the continued use of the Owner Controlled concept. In addition OCIP *may* provide cost savings to the Commission.

From the information available to us, we cannot determine accurately whether or not the program has saved money thus far as compared to contractor-provided insurance or other alternatives. Part of the reason that we cannot make this determination is the lack of readily available reports and records regarding program costs, losses and other factors. Another reason, however, is that any comparison of hypothetical alternatives on a project of this scope requires sweeping assumptions. A multitude of variables affect each assumption. Inaccuracies or changes in any of the variables could render invalid the resulting conclusions.

In spite of the lack of a definitive cost comparison, we recommend continued use of the OCIP approach for future rail construction because of the benefits OCIP offers. We conclude that the best way to assure the lowest cost is by requesting competitive bids for the entire program.

Risk Management

The current approach to managing construction risks, which uses a contracted, insurance broker-provided risk management unit funded entirely by the Commission, is costly (as explained in the report) and lacks adequate controls. By default, the contractor determines matters such as when insurance is needed and where to get it, what types of information and records to keep, what technical services are needed and who should provide them, and what risk management information should be presented to policy makers. These are issues crucial to the operation and financial well-being of the Commission and should not be delegated outside the organization. Furthermore, having the party responsible for brokering insurance perform these discretionary activities, invites conflicts of interest.

As stated above, we recommend in-house management of construction risks. Although the risk manager may need assistance from contractors, bringing risk management in-house should increase the effectiveness of the function and provide proper attention to some important risk management areas that are now being neglected. We expect also that administrative and contracted costs ultimately will be reduced through this approach.

II — Index of Recommendations

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1.	Obtain quotes for general liability coverage.	17
2.	Investigate the availability of public official liability insurance coverage.	19
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4.	Evaluate the need for boiler and machinery coverage.	22
5.	Evaluate the magnitude of the exposure and request quotations for employee dishonesty and depositor's forgery coverage.	24
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7.	Develop and adopt a risk management policy for LACTC.	28
8.	Assign insurance purchasing responsibilities to the risk manager.	31
9.	Develop standard insurance specifications and indemnity agreements for use in all contracts. Require review of Commission contracts by the risk manager.	32
10.	Assign to the risk manager the responsibility to develop a formal safety and loss control program.	32
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12.	Assign rail construction risk management responsibilities, including management of the OCIP and selection and supervision of contractors to the risk manager.	45

III — Risk Financing

A — Risk Retention Capacity

The term "risk retention capacity" refers to the amount of unplanned loss, measured in dollars, that an organization can tolerate and still meet objectives of its current financial plan. There are no scientifically validated, universally recognized formulas for measuring risk retention capacity. Risk managers use several rules-of-thumb to estimate a range of reasonable retention amounts, although these measurements must be supplemented by judgment and common sense.

We were asked to evaluate LACTC's risk retention capacity. We used the following methods to estimate reasonable annual total risk assumption levels for LACTC. All figures are from LACTC's Fiscal Year 1989-90 Budget, or from the Comprehensive Annual Financial Report for the fiscal year ended June 30, 1989. We have not attempted to update these estimations for this revised report. If we did so, we expect that our estimates would indicate greater risk assumption capacity at present, as the Commission has grown considerably in the past year.

We note that because of the nature of funding, the Commission really has two different risk retention capacities—one for construction risks and one for risks arising from general activities. These areas of activity are funded separately and the Commission is restricted from using one type of fund to pay for losses in the other area.

Working Capital Method

Working capital is the amount of current assets left after subtracting current liabilities. This technique considers the financial strength of the organization in terms of readily available surplus cash. The range of acceptable retention is 2% to 25% of working capital depending on how much of the working capital is in inventories (less liquid). Using this method, LACTC's risk retention capacity is shown in Table 1.

Table 1

LACTC RISK RETENTION CAPACITY — WORKING CAPITAL METHOD

	General Fund	Capital Projects Fund
Current Assets	$2,455,000	$97,951,000
Current Liabilities	-452,000	-35,696,000
Total	2,003,000	62,255,000
Suggested retention range:	$ 40,000	$1,250,000
	to	to
	500,000	15,000,000

Because of LACTC's high liquidity as reflected in the balance sheet, the formula suggests that LACTC's retention capacity should be toward the upper end of these ranges, i.e. $500,000 for non-construction and $15,000,000 for construction risks, per year.

Total Asset Method

An organization's assets reflect financial strength and borrowing power. As commonly used, this method suggests a retention range equal to 1% to 5% of total assets. Retention capacity is toward the low end of this range if the organization is highly leveraged. Table 2 shows LACTC's risk retention capacity using this method.

Table 2

LACTC RISK RETENTION CAPACITY — TOTAL ASSET METHOD

	General Fund	Capital Projects Fund
Total Assets	$ 2,455,000	97,796,000
Suggested Retention Range	$ 25,000	$1,000,000
(1% to 5%)	to	to
	125,000	5,000,000

This risk retention capacity measurement is more conservative than the previous method. It suggests annual retentions of no more than $125,000 for non-construction and $5,000,000 for construction risks.

Revenue Budget Method

This measures an organization's ability to produce revenues. The suggested range of retention is 1/2% to 2% of annual revenues.

Table 3

LACTC RISK RETENTION CAPACITY — REVENUE BUDGET METHOD

	General Fund	Capital Projects Fund
Annual Revenues (est.)	$8,249,850	$470,554,120
Suggested Retention Range (1/2% to 2%)	$ 40,000 to 165,000	$ 250,000 to 1,000,000

The revenue budget method is another conservative "quick test" measurement. It suggests annual retentions of no more than $165,000 for non-construction and $1,000,000 for construction risks.

Management Confidence Method

Formulas alone cannot determine an organization's capacity to retain risk. Management tolerance for risk, is crucial in determining risk retention capacity. If management is uncomfortable with a level of risk assumption, suggested by formulas, the formulas will be overruled. Corporate philosophy and long-term plans, as well as insurer pricing, will ultimately determine retention. The fundamental question is: What does management feel it can afford to lose in a year without seriously disrupting other operations? To find the answer to that question as it applies to LACTC, we interviewed several financial management persons at LACTC. They estimated that $5-10 million is reasonable to risk for rail construction risks and up to $2 million for non-rail risks.

Table 4

LACTC RISK RETENTION CAPACITY — MANAGEMENT CONFIDENCE METHOD

	General Fund	Capital Projects Fund
Suggested Retention Range	$1,000,000 to 2,000,000	$ 5,000,000 to 10,000,000

B — Selection of an Appropriate Risk Retention Level

The various methods of measuring risk retention capacity used here suggest a theoretical range of about:

General Fund	$25,000 to $2 million
Capital Projects Fund	$250,000 to $15 million

Based on our analyses, conversations with Commission employees and experience with similar organizations, we recommend a total annual retention range of $250,000 to $500,000 for general fund risks and $5 million to $10 million for rail-related risks.

The per-occurrence amount that can be retained while keeping the annual total retention within the target range depends on the size and frequency of expected losses. Calculation of an exact per-occurrence limit requires statistical analysis beyond the scope of this report. A rough guideline often used by risk managers is to retain up to 10% of the annual retention on each loss. Based on our calculations LACTC could retain $25,000 to $50,000 per occurrence for non-construction risks and $500,000 to $1 million per occurrence for construction risks.

Currently, LACTC insures its construction-related risks through a special construction insurance program called an Owner-Controlled Insurance Program (OCIP). The Commission retains the risk of loss up to $500,000 per occurrence. Based on the analysis completed above, this level of per-occurrence retention seems reasonable, although the Commission probably could retain greater risk if insurance market conditions made that more economical.

Non-construction risks (everything other than rail) are mostly uninsured. The value of furniture and equipment owned by the Commission is $19.7 million, according to the annual financial report we reviewed. The greatest concentration of values is probably no more than $10 million at LACTC's headquarters according to information provided by LACTC's finance department. A total property loss at this location is beyond the Commission's risk retention capacity as defined previously.

Though the probability of liability claims is lower for non-construction than for construction activities, the Commission is retaining too much risk in this area. Potential liability losses are theoretically unlimited. In a later section of this report, we recommend several methods to insure non-construction property and liability risks.

C — Risk Funding Considerations

We were asked to comment on LACTC's need to fund for self- insured losses.

A fully or partially self-insured program may be funded with operating funds or by payments to a special reserve fund. When foreseeable losses are within the organization's capacity to pay them from annual operating funds, the organization often chooses to budget for losses as an annual expense. Normal contingency funds can be used in those years when losses exceed budgeted amounts. This technique is especially applicable when the expected range of loss fluctuation is narrow. Funding for losses in this manner is practical for some larger organizations.

Where losses are infrequent but potentially large, as in public official errors and omissions and general liability losses, organizations with self-insurance programs often make annual contributions to reserve funds. The purpose of these reserve funds is to stabilize annual risk costs. The organization may contribute to the reserve account for many years without experiencing any losses. If a large loss eventually occurs, payment is made from the fund, rather than from operating funds. By establishing the reserve fund, the organization performs the insurer's function of smoothing losses over a period and thus "self-insures."

As noted previously, LACTC controls considerable funds and has the capacity to retain substantial losses on the construction side of operations. With LACTC's ample risk retention capacity and given the extent to which the Commission purchases excess insurance, reserve funding for construction-related losses is a matter of financial management preference and not an economic necessity.

For general administrative activities, the Commission has more limited resources. We conclude that LACTC needs some insurance in this area. That level should be such that, besides the insurance premium, the Commission will pay no more than $250,000 to $500,000 annually from its own funds for losses. Those costs could be funded, if management desires. In the next section of the report, we discuss types of insurance or alternate financing recommended.

IV — Risk Analysis and Recommended Treatment

LACTC has two distinct and separate types of risks: those related to construction of rail lines, and those not related to construction. The Commission treats both sets of risks separately.

LACTC's insures construction risks through an Owner Controlled Insurance Program (OCIP). This comprehensive package covers LACTC and contractors and subcontractors on the project for many exposures under several insurance policies. These policies include general and automobile liability, workers' compensation, property in the course of construction and other property to be used in rail operation. The OCIP insures only risks associated with construction of a particular rail line. Coverage lasts until construction is completed.

Other Commission activities such as approval and distribution of funds or oversight activities as well as administrative activities such as entering contracts, are not insured under the OCIP. In most cases, these risks are not insured at all.

In the following paragraphs, we discuss the types of risks arising from LACTC's two separate activities. Although we are identifying both types of risk, our recommendations for treatment of risk in this chapter apply only to non-construction risks. The complexity of construction risks requires separate treatment. In Chapter VI, we discuss the OCIP program and the treatment of construction-related risks.

A — General Liability Loss Exposures

1 — Premises and Operations

Ownership or use of business premises involves risks of loss from bodily injury or property damage to other parties. Usually, the loss must result from some negligence by the owner or tenant. An example is failure to repair a stair step or handrail resulting in an injury to a visitor using the stairs. The most common type of premises claim results from slip-and-fall injuries.

The uses of a place of business also can cause claims. Examples might include damage from air pollution caused by manufacturing processes, or injuries to

third parties because of carelessness of construction workers in handling construction materials.

LACTC's premises include rented office space and sites where rail construction is taking place. Office locations have few hazards, and therefore usually cause few claims from third parties.

LACTC rents its offices. The tenant usually assumes responsibility for losses resulting from the use of the property, although injured parties may file claims against the property owner, especially if the injury or damage results from a premise defect or neglected repair. However, the tenant could face unlimited liability exposure from an injured third party. Some financing provision should be made to cover the cost of claims or defense expenses. Many tenants purchase general liability insurance policies to cover this type of exposure.

Rail construction sites produce many hazards. Examples include hazards resulting from the work, hazards from the movement of nearby traffic, and unusual hazards that may arise from the location itself, such as the discovery of toxic materials at a construction site.

Thus, LACTC's two major activities, construction and government administration, produce completely different premises and operations risks. Administrative (office) activities generally result in few losses. Those that may occur generally are low severity claims resulting in low dollar costs, although occasional catastrophic losses occur. Construction risks resulting from premises and operations exposures produce a high frequency of claims with high severity potential. For most of these latter claims, LACTC is insured under the OCIP.

2 — Completed Operations

Many organizations are exposed to losses from what insurers call "products and completed operations" exposures. These terms apply to products produced by the entity, such as manufactured goods, or to completed services such as finished construction. An improper technique or use of faulty materials in products or completed operations, may result in injury or property damage. If the manufacturer or service organization was negligent in the production or service, it may be liable for losses that result. As an administrative agency, LACTC lacks discernable products or completed operations exposures.

As a constructor of rail transportation systems, however, LACTC faces significant losses from completed operations. An example would be collapse of an underground tunnel due to faulty materials or faulty design. Although most losses resulting from completed operations would be the responsibility of LACTC's contractors, the possibility exists that LACTC could be called upon to pay a loss if a contractor became insolvent or if LACTC were negligent in

selecting or supervising a contractor. Furthermore, LACTC's presence as a potential "deep pocket" virtually assures that the Commission will be a defendant in any major lawsuit involving faulty design or construction on a rail line.

The OCIP general liability coverage provides insurance against completed operations exposures for three years after completing construction on a rail line. This type of insurance is called "claims made." Only claims occurring the coverage period and reported during the coverage period or any extended reporting period (the three year "tail") are covered. Claims submitted after that time would not be covered.

General liability insurance can be purchased on an "occurrence" basis, meaning that claims occurring during the coverage period are covered, regardless of when reported. Insurance written on this basis would provide coverage indefinitely. However, the coverage must have been in effect when the event giving rise to the claim occurred. In order to have coverage in the future for a present event giving rise to a claim, LACTC would need to purchase and maintain general liability insurance now and in the future.

3 — Contractual

Any business or governmental organization enters a variety of contracts including leases, contracts for services, financing agreements and joint ventures. In most business contracts, there is some element of risk transfer. One party usually assumes part of the risk arising from the activity that might otherwise be the responsibility of the other party.

As a tenant, LACTC contractually assumes some risk for accidents that may result from use of the premises. As a government agency that builds public transportation rail lines, LACTC transfers some risks resulting from construction to contractors and consultants.

In general, a governmental agency transfers more risks through contracts than it accepts. From the few sample LACTC contracts we have reviewed, we conclude that LACTC does not transfer risks as often nor as effectively as some governmental agencies with which we are familiar. There is no formal program to review risk transfer in contracts. We have seen contracts in which LACTC assumed liability where, in our opinion, the risk should have been transferred in the other direction. LACTC has no insurance for non-construction activities to back up this assumed liability. Losses would be paid from LACTC funds.

General liability insurance covers many types of liability assumed under contract. Equally important as insurance is a program to guard against unwarranted assumption of liability and to ensure that other parties to contracts

assume liability as appropriate. In Section V of this report, we discuss procedures for controlling risk transfer in contracts and describe a program that we recommend for LACTC.

4 — Aircraft and Watercraft

Owners and users of aircraft and watercraft may be liable for injuries or property damage arising out of accidents involving these vehicles. Although the Commission owns no aircraft, employees have chartered or borrowed airplanes or helicopters for inspections of rail lines. Liability for accidents involving chartered aircraft would normally fall upon the owner-operator. The Commission could face some exposure, if an accident resulted from flight activity under the direction, control or request of a Commission employee.

According to the information gathered in our field interviews, the Commission does not own, operate or use watercraft. We understand, however, that one executive decision-making meeting was held on board a privately owned watercraft. Incidental liability for accidents involving watercraft used for business purposes could arise in a manner similar to that described above for aircraft. Insurance is available to provide coverage for nonowned aircraft and watercraft.

LACTC should include a requirement for this type of coverage in the insurance specifications recommended in Section 6 of this chapter.

5 — Environmental Impairment

LACTC's activities do not create hazardous by-products or environmental exposures per se. However, during construction of the Los Angeles/Long Beach rail line, Commission contractors have uncovered buried storage tanks and contaminated soils. We were told that two-thirds of the soil at the rail car maintenance facility is contaminated. Future operations such as washing railcars and some maintenance activities may produce hazardous wastes which must be disposed of properly.

Acquisition of contaminated real estate can bring liability for cleanup of the site. The cost of cleanup can be substantial. LACTC will continue to face this exposure as it acquires future right-of-ways and land for other uses.

Environmental impairment liability insurance is difficult (sometimes impossible) for most organizations to obtain. The best risk treatment method for environmental exposures is to prevent the loss to the extent possible through property surveys before purchase of real estate and through proper treatment of any wastes generated. In addition, LACTC, through its insurance broker, could

continuously monitor the market for environmental impairment liability insurance and attempt to obtain coverage when available and acceptably priced.

6 — General Liability Loss Treatment

General liability insurance protects against claims for bodily injury and property damage, advertising injury and personal injury. Coverage includes liability assumed under most types of contracts. Most large public entities in California self-insure for this risk. Smaller entities usually belong to self-insurance pools for coverage. During the liability insurance "crisis" of the last several years, many insurers quit writing general liability coverage for governmental risks.

As stated previously, LACTC purchases no general liability insurance other than the OCIP. Thus claims arising out of non-construction activities are uninsured. Our understanding is that LACTC has had no general liability claims other than those that have occurred under the OCIP. However, the exposure to a variety of claims still exists and the potential maximum dollar amount of these claims is unlimited.

Recommendation

Obtain quotes for general liability coverage.

Considering LACTC's limited risk retention capacity for risks not related to rail construction, we recommend obtaining general liability coverage. This type of coverage is not always easy for public entities to find. Although LACTC is a small agency in terms of employees and administrative budget, insurance underwriters may see the Commission as a substantial risk because of the scope of operations and the number of people its activities will affect.

The current OCIP insurers may be a good source of general liability coverage. As an administrative agency, LACTC may not draw much insurer interest in providing coverage, due to the small premium. As a rail line constructor, LACTC pays large insurance premiums and could attract the interest of many insurers. As long as LACTC continues to construct rail lines, the OCIP insurers remain a potential source of general liability coverage for other commission activities. Considering the scope of the construction activities and the premium paid, the insurers may add non-construction coverage at a nominal cost. The Commission should have the OCIP insurance broker ask the OCIP insurers to add non-construction risks to the OCIP coverage.

LACTC could also ask the OCIP broker/contractor to obtain competitive quotes for non-construction insurance from several insurers. Another alternative would

be to conduct a competitive selection of a broker of record for non-construction risks. We discuss competitive broker selection in Chapter VI.

Many public agencies have elected to cover their liability risks through self-insurance pools. Participation in a self-insurance pool may be impractical for LACTC, in that it is a unique governmental agency, and pooling assumes that similar agencies will share risk. The Commission could explore this alternative through an existing state-wide pool for transit operators or through other pools with broad membership criteria. Commission staff should contact some of these pools to ask about possible membership.

B — Automobile Liability Loss Exposures

LACTC operates a small fleet of automotive vehicles, primarily for use in rail construction operations, such as light pickup trucks for construction supervisors. In general, automobiles have a high accident frequency because vehicles in motion are constantly at risk of striking something. Another factor affecting commission vehicles is the high exposure to other autos in the Los Angeles area. Any motor vehicle accident could cause a catastrophic loss, especially if the accident involved another vehicle with hazardous cargo, or if it involved a loaded commercial passenger-carrying vehicle.

LACTC purchases automobile liability insurance. The bodily injury and property damage limit is $1 million per occurrence. The policy includes actual-cash-value coverage for physical damage to the vehicles. Automobile liability insurance is the only non-construction liability coverage currently purchased by LACTC. Current premium is in the vicinity of $60,000.

Because LACTC leases its vehicles, lease agreements control insurance decisions. If LACTC owned the vehicles, it would want to consider retaining the risk of physical damage to the vehicles and retaining a substantial portion of the liability risk. If LACTC develops its own risk management program, including some element of self-insurance, it may wish to negotiate with the vehicle lessor to allow LACTC to self-insure the physical damage exposure.

C — Public Official Liability Loss Exposures

Public officials face liability for their actions or inactions, errors or omissions, breaches of duty and wrongful acts in performing their duties. Claims may result from eminent domain, land use, personnel actions and a variety of other public official decisions. Generally, these claims allege economic loss not related to bodily injury or property damage and not covered under general liability policies. Although the probability of a claim may be remote, LACTC still faces

substantial defense costs to defend its distribution or allocation of funds. Claims involving liability of public officials are infrequent but costly, due to legal expenses to defend them.

Public official liability insurance protects against claims alleging acts, errors or omissions of the elected or appointed officials of the entity. The types of claims covered by this insurance tend to be infrequent and costly, especially for legal defense. Coverage is often difficult to obtain, especially in so-called "hard" insurance markets where prices rise and availability declines.

Recommendation

> *Investigate the availability of public official liability insurance coverage.*

Public officials and employees may be targets of lawsuits resulting from perceived wrongs by members of the public, by private entities, or by other parties. California statutes require agencies, such as LACTC, to indemnify and defend officials who are sued in their official capacity. Because these claims often involve major financial issues and extensive litigation, defense costs and judgments can be very expensive, often running into the millions of dollars. As the cost of defending this type of claim or paying a judgment may exceed the Commission's retention capacity, LACTC should investigate the availability and price of this coverage.

D — Professional Liability Loss Exposures

Professional or "errors and omissions" liability insurance insures against claims resulting from acts, errors or omissions of professionals. Architects, engineers, consultants, attorneys, physicians and others, whose professional liability is excluded under general liability policies, need professional liability coverage. As professionals, such practitioners are held to a higher standard of care than general liability insurers anticipate covering. This exposure requires special rating and underwriting.

The Commission employs engineers and design professionals who may sign off on plans designs or drawings. The Commission also contracts with design and engineering firms to plan and build rail lines. Thus, LACTC may have some residual professional liability or may be held accountable for selection or supervision of competent professional firms. Third-party claims against the Commission for bodily injury or property damage arising from this exposure normally would be covered under general liability insurance. Claims alleging design error or product failure would be excluded.

LACTC has chosen to purchase "project insurance" to cover the professional liability exposure and the liability exposure of the various design professionals associated with construction of the Los Angeles/Long Beach rail line. This insurance protects against claims arising from errors or omissions in design or engineering of the project. The concept behind project insurance is that the coverage extends for several years, usually three or five, guaranteeing the project owner that coverage will be available even if the design professional cancels insurance or goes out of business after the project is complete. As design errors often do not appear for years and as professional liability is "claims made" (requiring that the claim be presented during the policy period), the extended coverage provided by project insurance is a desirable feature.

Supposedly, design professionals insured under project insurance will report this fact to their professional liability insurers who will then lower premiums for coverage already in place. Design professionals are then supposed to reduce their fees by the amount of insurance premium saved, passing this savings back to the project owner. In practice, however, this process does not always take place. Insurers may not reduce premiums significantly for the design professional. Or the insured may feel that it needs to have its own policy cover losses from the project in the event that an exclusion or another factor precludes coverage under the project insurance policy.

Claims alleging errors or omissions in design are made against the architects or engineers of a project. It is difficult to establish liability on the part of the project owner unless the owner was negligent in the selection or supervision of the design professional. We think project insurance usually benefits the design professionals far more than it benefits the project owner who has little liability for this exposure. In addition, the coverage is expensive. LACTC has paid over $3 million in insurance premiums for $15 million total coverage (aggregate) for project insurance on the LB/LA rail line. As mentioned above, there is no guarantee and no way of determining whether any of the alleged premium savings from the design professionals insurers ever found its way back to the Commission.

We understand from Transit Insurance Administrators that the Commission purchased this coverage without consulting TIA regarding the risk management implications. We recommend that the Commission thoroughly evaluate alternatives to project insurance, such as transferring the risk through indemnity agreements, before purchasing similar coverage for future construction projects.

E — Property Loss Exposures

1 — Real and Personal Property

As an administrative funding agency, LACTC occupies rented office quarters. The Commission owns office equipment, including furniture, copiers, communications equipment, computers and other items. It has also made improvements and betterments to its rented facilities. The value of this property is $19.7 million.

The Commission also owns the rail cars, rail line and structures (stations and maintenance yard) associated with the Los Angeles/Long Beach rail line. This equipment and real property represent values greater than $500 million. Some perils to which this property will be exposed include:

- Vandalism and malicious mischief—a source of high-frequency claims but usually with moderate dollar loss.
- Fire, smoke or explosion—a potentially catastrophic source of loss, especially at the maintenance yard.
- Earthquake—a catastrophic exposure to all owned property, even the rail line itself.
- Flood—a low probability exposure with potential catastrophic consequences, at least in the underground portions of rail lines.
- Civil commotion—a low probability exposure with unknown risk level.

LACTC purchases property insurance only for property in the course of construction on the rail line project. We were told by Tony Stevens of Transit Insurance Administrators that the insurance also covers rail cars and equipment only until revenue operations begin.

Recommendation

Obtain property insurance for rail equipment.

Although LACTC has the financial capacity to absorb annual losses of several million dollars on the rail side of operations, the rolling stock values are far beyond the maximum prudent level of loss retention.

We are aware that LACTC has obtained insurance for property and equipment involved in the operation of the Blue Line. Coverage has actually been purchased through SCRTD as operator of the line. LACTC's risk manager should monitor this insurance program and evaluate purchasing procedures at a future time.

Office equipment and improvements to office space rented by LACTC are still uninsured to the best of our knowledge. LACTC should obtain quotations for this coverage in the same manner as described above for liability insurance.

2 — Boiler and Machinery

Boiler and machinery insurance covers property loss due to explosion of steam boilers or due to arcing or other damage to electrical or mechanical equipment, including certain types of machinery breakdown. As a tenant in office buildings, LACTC is not responsible for purchasing boiler and machinery for rental premises occupied. The owner retains that responsibility. When rail operations begin, however, much of the equipment will be subject to interruption and the cost for emergency repairs could be substantial.

Recommendation

Evaluate the need for boiler and machinery coverage.

Some of the equipment necessary to run the Blue Line is subject to mechanical breakdown and other perils insurable under a machinery policy. SCRTD's insurance broker has included this coverage under the property policy for Blue Line equipment. LACTC should continue to monitor the coverage through its contractual relationship with SCRTD.

3 — Business Income and Extra Expense

Business income risks arise from an organization's exposure to interruption of revenue as well as extra expense resulting from additional costs to remain in business after property damage occurs.

LACTC's revenue sources are local taxes and allocated funds from state and federal sources. As tax dollars are collected by other agencies and come from a variety of tax-paying sources, their interruption as a source of funds is highly unlikely. Likewise, state and federal sources are not subject to interruption because of loss events, although political factors could interrupt some of the funds flow. Nevertheless, income interruption is not a significant loss exposure to LACTC.

Extra expense to continue operations represents an indirect exposure to LACTC. Southern California Rapid Transit District will operate the commuter rail lines being built by LACTC in Los Angeles County. A catastrophic loss affecting rail cars, maintenance facilities or rail lines could require the expenditure of additional, unanticipated funds to restore operations immediately. As funding agency for SCRTD, LACTC would ultimately pay the cost of extra expense incurred to resume operations.

Business income insurance covers loss of revenues and extra expenses to remain in business that occur as a result of damage to property. Retail businesses, for example, must have a location from which to conduct their trade. Because of the nature of LACTC's funding, i.e., federal and state funds and local property tax, the revenue sources are independent of any property loss to LACTC's facilities. Nevertheless, LACTC should consider quotations for insurance to cover extra expense exposures when evaluating property insurance quotes.

4 — Crime

As a fund- allocation and distribution agency handling hundreds of millions of public dollars, LACTC has a substantial fidelity exposure to misappropriation or embezzlement of funds. Losses could occur through fraudulent contracts with suppliers or contractors, establishment of nonexistent vendor accounts, illegal payments by potential contractors to obtain preferential treatment and many other methods.

Although LACTC has a variety of control procedures to prevent crime losses, insurance claim history has proven repeatedly that even the most sophisticated crime prevention techniques can be circumvented by a determined, resourceful criminal. Because these losses usually take place over extended periods of time, amounts can be substantial. Often they are undetected for many years. One insurance industry source estimates that the actual annual crime losses in a single state exceed all other known property losses by a factor of five.

In addition to exposure to "white collar crime," LACTC faces substantial risk of loss due to theft at construction sites. These losses are insured under the OCIP. Pilferage is also a common problem in administrative offices, although the dollar exposure is less significant than at construction sites.

Recommendation

Evaluate the magnitude of the exposure and request quotations for employee dishonesty and depositor's forgery coverage.

LACTC does not conduct cash transactions. Revenues are deposited directly. Therefore, the Commission has no need for crime coverage for non-rail activities, other than for employee embezzlement or theft or possible forgery of stolen checks. We recommend that LACTC instruct its insurance broker to obtain quotations for employee fidelity and depositor's forgery coverage for a limit of $10 million or more. Selection of the appropriate limit is a subjective decision, although various formulae developed by the surety industry give some guidance. Our recent experience in evaluating quotations for this type of coverage shows that insurers are often willing to quote competitively in this range. We think lesser limits would be inadequate.

5 — Valuable Papers and Records

Valuable papers and records owned or used by LACTC consist of drawings, plans and designs related to construction or operation of rail lines. Most of these documents are duplicates of records in the custody of LACTC's contractors or of other government agencies. As long as LACTC has a procedure to ensure that backups of important records are available, this method of risk control is preferable to insurance.

6 — Automobile Physical Damage

Owned or leased vehicles are subject to damage or loss due to collision, fire, vandalism, theft and other perils. LACTC leases a fleet of approximately 60 vehicles used for the rail construction program and for LACTC official business. As lessee, the Commission is responsible for property damage to the vehicle. Property damage losses to vehicles tend to be frequent and relatively small in terms of dollar loss. Currently, LACTC insures this risk. As discussed previously, LACTC could negotiate with the lessor for permission to self-insure this exposure.

F — Personnel Loss Exposures

LACTC budgets for approximately 170 staff positions. Employees injured on the job receive statutory workers' compensation benefits. As most of LACTC's employees work in office or supervisory positions, they are less likely than many other workers to be injured. Construction supervisors face greater exposure because of increased hazards of the job site, and because of additional travel, which exposes the worker to potential traffic accidents. Even so, these employees are not subject to the same level of exposure as construction workers.

We were told that LACTC has self-insured its workers' compensation exposure. We have been unable to obtain details about this decision. From the limited

information we have about LACTC's workers' compensation exposure to loss, we question the advisability of self-insuring this risk. Given the size and occupations of LACTC staff, workers' compensation insurance premium probably would be less than the cost of a single accident resulting in permanent disability.

For the policy year ending November 15, 1989, the Commission obtained coverage from the State Compensation Insurance Fund for a total premium of $101,567. A serious automobile accident involving a single LACTC employee resulting in a spinal injury could easily cost over $1 million in compensation and medical expense. Accidents involving more than one employee could be substantially more costly. In general, we recommend against workers' compensation self-insurance for entities with annual premiums less than $400,000-$500,000.

V — Risk Management Administration

A — Risk Management Organization

LACTC has not assigned responsibility for risk management to any current staff member. Instead, the Commission has contracted for services provided by a joint venture of the Commission's insurance broker. The contractor reports to LACTC's rail construction supervisor. The services provided include some, but not all, of the functions of a risk manager. These services apply only to risks and insurance needs related to the construction of the LB/LA rail line.

Recommendation

Create a staff risk manager position.

All organizations practice risk management to some extent, whether or not they appoint a risk manager. Events occur that require decisions that affect the survival of the organization. Some provision has to be made for financing losses. Every manager knows, or should know, that prevention of accidents and injuries is part of the job.

When an organization lacks a policy for managing risks and when no one is responsible for that task, decisions are made on an ad hoc basis. The result is a patchwork program that is usually expensive and inefficient. Major risks may be unprotected. Haphazard insurance purchasing often results in inferior coverage for the money spent, or very expensive coverage.

We recommend that the Commission create a risk management position. We understand that the Commission has decided to implement this recommendation and that a new risk manager will assume his responsibilities on December 3, 1990.

The risk issues represented by the various construction projects, upcoming rail revenue operations, funding activities and other commission functions, justify hiring a full-time risk manager. Since these activities are constantly changing, continuous monitoring and treatment of new risks is necessary.

Although the contract with TIA provides for some services normally performed by a risk manager, TIA, as a consultant, cannot effectively or ethically decide in all cases what needs to be done, or take the initiative for action on behalf of the client. Someone on staff should be responsible to identify major risk decision issues, to analyze them, and to present them to top management and the policy-making body for appropriate action. Outsiders can offer valuable services, but they cannot replace management or make decisions for the organization. LACTC should have a staff risk manager.

The risk manager's functions should include:

- Risk identification, measurement and analysis.
- Employee safety and coordination of other loss prevention functions (fire protection and security).
- Workers' compensation claims administration.
- Supervising adjustment of property losses.
- Evaluation and selection of risk financing alternatives.
- Negotiation and purchase of insurance as appropriate.
- Recordkeeping, including development and maintenance of a comprehensive and effective risk management information system.
- Allocation of risk management costs to the various departments, divisions, and other budgetary units.
- Communication on risk management questions including development of risk management manuals.
- Development of a written risk management policy statement for approval by the Executive Director and Board of Directors.
- Review of indemnity and insurance clauses in leases and other contracts, including monitoring insurance certificates required from contractors, vendors and other parties to Commission contracts.
- Selection and supervision of risk management service contractors.

As risk management involves a significant amount of recordkeeping and correspondence, the risk manager will need a secretary or administrative assistant. Although the person hired needs no special skills, insurance or risk management background would be helpful.

After a risk management department is staffed and functioning, the Commission may decide to add a loss control or claims professional to the staff. Alternatively, the Commission may continue to contract these services.

B — Adoption of a Risk Management Policy

An important part of a program of risk management is a policy statement approved by Commission officials.

Recommendation

Develop and adopt a risk management policy for LACTC.

A well-stated policy will assign responsibility and authority for various risk-related functions and clearly explain management's goals. It should not be a detailed summary of procedures that require frequent changes and restrict management flexibility. Instead, it should be a somewhat permanent document that will do the following:

- Focus the attention of top Commission officials on the fundamental problems relating to risks of accidental loss.
- Give all persons involved with the risk management activities an authoritative guide to action and a clear understanding of their responsibilities.
- Provide a clear statement of loss prevention policy encompassing such areas as employee safety, public safety, fire protection and security.
- Include basic policy regarding insurance purchasing, risk retention, recordkeeping and claim administration.
- Highlight the interdependence of risk management and other activities to improve communication between those responsible for risk management and all departments.

We have included a sample risk management policy in the appendix to this report.

C — Identification and Measurement of Risk

The most fundamental steps in risk management are to:

- Identify the risks that can cause loss, then
- Measure their magnitude and impact on Commission finances.

1 — Identification of Risk

To do a proper job of risk evaluation, the risk manager must be thoroughly familiar with all Commission activities and must communicate regularly with all departments. The risk manager must regularly visit major locations or operations to identify exposures creating risks. He or she must meet with key employees to develop effective ways of getting information about risks.

Techniques for identifying risks include the following:

- Orientation

  The person responsible for identifying risks must gain as thorough a knowledge as possible of the organization and its operations. This individual should have a general knowledge of the goals and functions of the organization. A long-term upper management employee may need no indoctrination. A newly hired risk manager could begin with a review of the annual budget, policy manuals or statements, past Commission minutes and related documents.

- Interviews

  Many persons on the LACTC staff can contribute valuable information regarding the Commission's risks. A newly appointed risk manager should interview department heads and managers, the Executive Director, legal counsel, and key employees who can observe or control major sources of loss.

- Inspections

  The risk manager must make initial and periodic inspections of Commission-owned property and observe service operations firsthand. Only through familiarity with the locations and activities can the risk manager comprehend those elements of the Commission's operations that could cause losses.

- Loss Reports

  Although loss reports cannot be relied on exclusively to be predictive of potential losses, they can show the kind of losses that are occurring and can help assess the degree of risk of certain activities or operations. Once the risk management program is set up, review of losses is crucial to setting goals and measuring results.

- Internal Documents

  Ongoing review of internal documents is critical to keeping aware of what is happening in the organization. The risk manager should periodically review:

  — Minutes of Council Meetings

  — Requests for funds

  — Contracts and leases

  — Union agreements or employee policy changes

- Checklists

  A variety of checklists is available from professional risk management associations, insurance brokers and consultants. These are useful to avoid overlooking an area of potential exposure.

2 — Measurement of Risk

Property risks can be measured by determining values of buildings, equipment and contents. The risk manager should be concerned with the cost of replacing damaged property with serviceable replacement property, not with establishing accounting values. Any measurement of property loss should include the hidden costs of extra expense to return operations to normal and continue operating after the loss. Disruptions to Commission activity may sometimes be more important than direct physical damage.

Evaluating the maximum loss potential from liability is difficult because that potential is the largest judgment that could be rendered against the Commission. No one knows what that judgment could be, although many informed parties, including the Commission's legal counsel, could make an educated guess. The risk manager should keep up with legal developments and awards in those types of cases that involve municipal legal liability exposures. He or she should

consider the history of liability claims and suits in the local area and nationally, since precedent affects both the probability of an award and the amount.

D — Insurance Purchasing

Under the current contracted risk management arrangement, the contractor (TIA) identifies risks related to construction and other Commission activities that TIA learns of. TIA then recommends appropriate insurance coverage to the Commission official responsible for the area where the risk applies. If the official approves purchase of the coverage, TIA prepares the insurance application and submits it to Sedgwick James (one of TIA's joint venture parents) Dallas office. Sedgwick James then contacts its insurance markets and places coverage.

Recommendation

Assign insurance purchasing responsibilities to the risk manager.

If the Commission hires a risk manager, that person should evaluate the need for insurance and should decide how coverage should be obtained.

E — Risk Transfer in Contracts

The Commission regularly enters contracts that can affect the risk management program. These include construction contracts, lease agreements, purchase orders, supply contracts and even joint-venture or participation agreements with other entities. Such contracts almost invariably contain conditions on risk and insurance. Examples are:

- Requirements that one or the other party carry certain types of insurance and, sometimes, performance bonds.
- Indemnity or "hold-harmless" clauses by which one party agrees to assume responsibility for the liability of another.

Many contracts also contain somewhat obscure clauses creating liability. For example, lease agreements often include a requirement that the lessee return the premises at lease termination in the same condition received, subject to certain exceptions such as normal wear and tear. If not properly qualified, such return-of-premises clauses will impose upon the lessee responsibility for all conceivable types of damage to the premises, including often uninsured risks such as flood or collapse.

The risk manager needs to be aware of risks to which the Commission is exposed, including those assumed under contract, to manage them.

Recommendation

Develop standard insurance specifications and indemnity agreements for use in all contracts. Require review of Commission contracts by the risk manager.

We recommend that the Commission use standardized insurance and indemnity wording for each contract entered by the Commission (purchase orders, construction contracts, etc.). The risk manager should develop this wording with assistance from other appropriate parties, such as the attorneys or risk management consultants.

The risk manager should review all proposed contracts that do not contain standard wording as early as possible in the negotiations.

F — Safety and Loss Control

Recommendation

Assign to the risk manager the responsibility to develop a formal safety and loss control program.

At present, the Commission lacks a formal safety or loss control program, although consultants and insurers provide loss control services on LB/LA line construction. The Commission should have a plan to oversee services of the insurers and contractors and to provide consistency as future construction projects commence.

The key elements of any effective safety program are:

- The support of the chief executive, department managers and other members of the management team. If employees (or contractor employees) suspect that top management has only a superficial interest in the safety program, their cooperation will not be enthusiastic.

- Goal setting of practical, reasonable, workable and enforceable objectives.

- Assignment of responsibilities for the various segments of the program to specific persons.

- Measurement and review of performance by upper management. Managers and supervisors within departments should be held accountable for performance according to written standards.

- Timely accident reporting and an information system developed for analysis and the preparation of summary reports.

- Orientation of new employees or transferred employees, including on-the-job training in safe job procedures.

Because loss prevention and control is the most effective way to achieve the fundamental goal of risk management (protecting the organization against financial dislocation from accidental losses), the risk manager should be responsible.

G — Claim Administration

The risk manager's primary role in liability and workers' compensation loss adjusting is the management responsibility of seeing that the function is done well. In property loss adjusting, the risk manager's role is ensuring that the organization receives an adequate settlement for the loss.

Continual involvement and supervision is the key to controlling costs—especially for workers' compensation claims where the ultimate cost of the claim relates directly to the employer's handling of the claimant. The risk manager should assure that a program of claimant contact and medical case management is in place. He should frequently review open claims with the claims adjustors. He should assure that return-to-work and work-modification programs are available to assist the employee's recovery and return to employment.

H — Information Management

Maintenance of complete, accurate and current risk-related records is vital. These include insurance policies and premiums, losses (both insured and uninsured), certificates of insurance, insurable values, risk cost charges to operating units and various other data.

Liability, workers' compensation and employee fidelity policies should be retained indefinitely. They typically cover "occurrences" during the policy

period even if claims for injury or damage are brought months or years afterward. Future claims may create the need to refer to expired policies for coverage information.

Current and historical premium information should be maintained by the risk manager, including the date and amount of premium payments, insurance agency commissions, insurer dividends and additional or return premiums. Records on expenditures for consultants and other outside service providers, such as appraisers, also should be maintained. This information will allow the risk manager to:

- Determine the net cost of insurance protection (earned premium less any dividend).
- Evaluate the appropriateness of payments to agents and other service providers.
- Recognize potential savings from adjustments to premium payment terms.

The risk manager also should keep current loss records by coverage year for each major area of risk. Accurate, timely and descriptive loss information is needed to:

- Identify unsafe conditions and practices that may cause additional losses.
- Measure the impact of safety efforts over time.
- Form the basis of future loss predictions that in turn are used to make decisions about loss funding methods and to price insurance bids or self-insurance alternatives. If underwriters consider the information unreliable or incomplete, insurers will price more conservatively.

The Commission should keep its own property loss data that should include the following information:

- Amount of loss.
- Date of loss.
- Location.
- Cause.
- Amount of recovery from insurance or third party, if any.
- Type loss (i.e., crime, fire, etc.).

In addition, the Commission should keep insurer-provided loss information for all insured types of coverage.

Maintaining accurate information on insurable property locations and values is critical in determining the Commission's loss exposure. The risk manager should be responsible for maintaining a current, complete schedule of Commission real and personal property by location. This schedule should be reviewed at least annually and updated as necessary.

Reports

The risk manager should make formal reports to the Executive Director and Commissioners at least annually. The report should focus on three key aspects of the risk management program:

- Insurance coverage summary. A summary of coverages, limits, deductibles and insurers.
- Self-Insurance or pooled risk summary. A summary of self-insured or pooled programs, funding mechanisms, reported losses and reserves.
- Identification of and reasons for uninsured risks.
- Cost of risk. The sum of uninsured losses, self-insured losses, insurance premiums, loss prevention expense and cost to administer all functions.

Coverage adequacy should be discussed. Protection against catastrophes should be outlined briefly, with the rationale for limits of protection chosen. Any major uninsured exposures should be pointed out with the reasons for noninsurance.

Setting up a recordkeeping procedure as outlined above will allow the Commission to estimate its total cost of risk with complete information.

VI — Risk Management and Insurance for Rail Construction

A — Insurance Coverage

Large-scale construction projects, such as the rail construction undertaken by the LACTC, involve numerous contractors, subcontractors, consultants and other parties, all subject to a variety of risks arising out of the work. Because of the numerous entities and activities involved, establishing adequate insurance protection for all participants poses certain technical and logistical problems. An approach often advocated to deal with these complexities is called the Owner Controlled Insurance Program (OCIP).

OCIP usually involves procurement by the project owner of certain insurance policies which protect both the project owner and various contractors and subcontractors involved in the construction. Usually, these coverages include general liability, workers' compensation, umbrella liability and builders risk. The owner arranges for safety and loss control services, if any, beyond those provided by the insurer.

OCIP works best on large projects such as those exceeding $100 million, where there are a number of contractors, where the project is labor intensive, where construction takes place in a limited geographical area, and where the owner is committed to safety and loss control, including top quality claims management.

1 — Cost

Theoretically, the OCIP concept should provide for cost savings to the owner due to purchasing economies of scale, cash flow advantages from controlling premium payments, potential for dividend returns and potential for savings due to coordinated loss control. In practice, however a number of factors can reduce or eliminate these potential savings. Some of these factors may include:

- Insufficient contractor motivation to control losses. Many contractors do not realize that workers' compensation losses on an OCIP project will affect the contractor's experience modifier. The contractor may therefore be more highly motivated to complete the project ahead of schedule or under budget than to pay attention to safety.

- Inclusion of contractor insurance charges. Depending on the competitive environment, contractors may not actually remove the cost of insurance from their bid pricing. Or, the contractor may feel it necessary to charge for "difference in conditions" coverage to fill any gaps in the owner's insurance program as it applies to the contractor.

- Inclusion of non project-related claims. If a contractor has employees assigned to the project who also work on other projects for the contractor, it is possible that workers' compensation claims not related to the project may show up on the owner's loss runs.

- Increased administrative costs. The owner of an OCIP project, in order to obtain the cost-saving benefits of the concept, must provide superior loss control services either through staff or contractors. Keeping track of various workers' compensation insurance policies and other paperwork adds administrative expense to the project.

To a certain extent, all of the above factors can be controlled. If properly administered, the OCIP concept should generate cost savings, some of which may be realized by the project owner.

Insurance costs attributable to construction of the Long Beach/Los Angeles line through June 30, 1989, are shown in Exhibit 1.

Exhibit 1

INSURANCE PREMIUMS PAID
LB/LA RAIL CONSTRUCTION
FROM PROGRAM START TO 6/30/90

General Liability	1,957,419
Excess Liability	3,817,856
Railroad Protective Liability	759,808
Automobile Liability	60,801
Workers' Compensation	8,535,000
Builders Risk	2,023,772
Errors and Omissions Liability	3,179,625
Total Premium	20,334,281

Source: Notes from Dick Bennett, LACTC Accounting.

Total workers' compensation costs have been reduced by a premium refund of nearly $2.5 million resulting from favorable experience. Although this appears to be a savings, it actually represents a refund of LACTC money not needed to pay claims. The insurer has collected full premium in advance and obtained the use of the funds for an extended period of time. We are aware of programs that allow the insured to retain use of the funds, thereby obtaining investment income

or other time value of money. Such an approach should save money provided that loss levels remain relatively low.

Because of the variables cited above and other factors, we do not believe that any precision is possible in estimating savings that may be attributable to use of an OCIP. We have seen TIA-prepared materials that attempt to demonstrate savings under the OCIP by comparing insurance costs as a percentage of contract price on LACTC projects both before and after inception of the OCIP. We do not believe the percentages are comparable as the scope and nature of the projects compared are dissimilar.

We have also reviewed a report prepared for the Southern California Rapid Transit District purporting to demonstrate cost savings through an OCIP. The report was prepared prior to construction on the Metro Red Line and demonstrated hypothetical savings from an OCIP approach. None of the alleged theoretical savings were substantiated.

Even conjectural estimates of cost savings attributable to one insurance method over another are not possible in this report due to the lack of information available to us to evaluate costs. This matter also is discussed under "Risk Management Administration on Construction Projects."

In spite of the lack of certainty regarding potential savings, it is our opinion that other factors, namely coverage superiority and community relations advantages, are sufficient reasons to continue with the OCIP concept even if costs were the same as or slightly higher than those under contractor-purchased insurance programs. However as recommended elsewhere in this report, controlled competitive bidding for the OCIP offers the best opportunity to assure the lowest possible premiums.

2 — Coverage

Because of the single policy feature for liability insurance, limits and breadth of coverage under an OCIP are known and uniform, rather than a patchwork quilt of different insurance that might be purchased by the various contractors.

Under the contractor-purchased insurance alternative, limits of coverage are difficult to control. Even though the Commission could stipulate coverage limits to general contractors and require the general contractors to ensure similar terms for subcontractors, there will inevitably be some contractors who are unable to obtain the limits necessary to fully protect the Commission's interests. Furthermore, a variety of contractors attempting to purchase high limits of coverage for the same project may use up the insurance market's capacity for that particular type of coverage, or may require limits that would exceed underwriter's willingness to concentrate exposure in a particular geographical area.

Type and breadth of coverage is even more difficult to control than limits under contractor-purchased insurance. The Commission could stipulate terms and conditions for insurance in its contracts, but drafting broad enough specifications to cover all the risks inherent in a rail construction project would be very difficult. In negotiating coverage under the OCIP, general specifications can be drawn and then each detail of coverage can be individually negotiated with the underwriters. Such precision would be impossible in a contractor-purchased insurance situation. The contractors usually have already placed their insurance coverages prior to bidding on a project. Meeting the conditions required by the Commission might require extensive renegotiations with the contractor's insurer—a costly, time-consuming and uncertain exercise. Without a copy of every contractor-purchased insurance policy affecting the Commission, LACTC would not know if an underwriter may have inserted an exclusion that would eliminate critically needed coverage.

Under an OCIP of the size and scope of the Commission's projects, it may be possible to purchase higher limits than would be available to any of the individual contractors as the size of the premium may attract larger insurance markets than those that might be available to individual contractors. Coverage can be detailed through carefully written specifications, and each point of the policy can be negotiated.

Another problem with contractor-purchased coverage occurs when portions of the construction project are completed. As the property is turned over to the Commission, LACTC would need to procure coverage for the property and add the liability exposure base to its liability coverage. Although this task may not be an especially complicated process, the possibility is increased for uninsured exposures due to administrative oversight.

3 — Community Relations

Under a contractor-purchased insurance program, third-party claims must be submitted to the appropriate contractor's insurer. The Commission would have little influence over the claims settlement outcome. As more than one insurer may be involved because of the many contractors on site, delays could occur as the insurers settle the issue of liability among themselves.

We have been told in interviews with LACTC staff that good community relations along the rail alignment is a top priority, and that the Commission will go out of its way to satisfy a property owner affected by construction. The OCIP program has given the Commission the control necessary to respond quickly to citizen claims. Alternative contractor-purchased insurance would not provide this same level of control.

LACTC, like many governmental agencies, has established goals for participation of disadvantaged and women-owned business enterprises in contracts for Commission projects. Many such businesses, because of small size or lack of a risk history, cannot obtain the kind of insurance coverages and limits that good risk management practice dictates that the Commission should require. As a result, some of these companies would not be able to bid on Commission projects, even as subcontractors in some cases.

Under the OCIP concept, contractors and subcontractors are covered, with certain potential limitations or restrictions, according to the limits and scope of Commission-negotiated coverage. By arranging insurance through the Commission's resources, the DBE/WBE contractor has a chance to compete for Commission business on a more equal basis.

4 — Insurance for the Norwalk/El Segundo Line

We recommend continued use of the OCIP concept for the next phase of rail construction, but competitively selected to assure lowest cost and best coverage.

Recommendation

Request competitive proposals for an OCIP program for future construction of rail lines.

Although we advocate the continued use of the OCIP program because of issues other than cost, it is possible for the Commission to ensure that its OCIP program for the Norwalk/El Segundo (Green Line) project is as competitively priced as possible by obtaining coverage through a controlled bidding process. The selection process would involve requesting qualifications from interested insurance brokers, screening responding brokers to the three or four most qualified based on their written presentations, interviewing the most qualified and selecting a finalist based on objective criteria. The finalist would then be allowed to compete against the incumbent broker. To avoid market confusion, each broker would be assigned specific insurance markets which it could approach.

An alternative to the above approach would be to allow an open competition in which the incumbent broker would be required to compete on an even basis with the other interested brokers. The most qualified brokers, regardless of incumbency, could then be selected to bring insurance proposals.

We understand that a few contracts for construction on the Green Line are about to proceed, but that major construction is still several months away. If no major portions of the project have begun, there still may be time to arrange for competitive bidding on the Green Line. Warren, McVeigh & Griffin can prepare

specifications and assist the Commission in the broker selection process if desired.

B — Risk Management Administration on Construction Projects

Risk management for construction of the LB/LA Blue Line has been administered by an outside contractor. According to its contract with LACTC, Transit Insurance Administrators (TIA), the contractor, is a joint venture of three insurance brokerages: Sedgwick James; Akasaka, Ortiz and Ciocatto Insurance Assoc.; and Rideau & Associates Insurance Agency. A fourth joint venture partner has since left the project.

Sedgwick James' Dallas office arranges placement of insurance coverages for rail construction, with assistance from TIA. "Iris C. Rideau Insurance Agency" (as identified in materials prepared by TIA) is responsible, under a subcontract, for the minority bonding program that places surety bonds for minority contractors on construction formerly managed by the Southern California Rapid Transit District. Woolsey and Associates provides preconstruction engineering surveys under another subcontract.

The administration contract includes services normally performed by an insurance broker, as well as those normally performed by a risk manager. Any of these services could be contracted to unrelated entities by LACTC directly, rather than controlled by a single contractor. Risk managers generally prefer to "unbundle" services in this manner to avoid potential conflicts of interest.

The scope of our assignment did not include a review of contractor performance. However, we were asked to determine the effectiveness of OCIP on the Blue Line as a basis for a recommendation on the use of OCIP for future construction. Thus, some evaluation of contractor cost and service was necessary in order to comment on the effectiveness of the program for future use.

Cost

The contract between TIA and LACTC states: "All insurance premiums shall be exclusive of any commission to TIA or any of its members individually." We have not attempted to verify whether or not any commissions are paid by the insurers to any of the parties or related entities in the insurance or reinsurance transaction. To the extent that any commissions are paid, LACTC's cost is increased by no less than the amount paid to TIA as a service fee in lieu of commission. This issue is discussed further in the section entitled "Risk Management Administration on Construction Projects."

Due to the creation of the Rail Construction Corporation and its assumption of responsibility for construction previously managed by SCRTD, TIA has merged with District Insurance Administrators (DIA), a parallel joint venture that performed duties for SCRTD similar to TIA's duties for LACTC. The new venture is called Metro Transit Insurance Administrators (MTIA) and will consolidate the staffs and functions of the two prior agencies.

Exhibit 2 is a summary of the proposed annual budget, dated May 23, 1990, submitted by MTIA for providing risk management services to the Commission.

Exhibit 2

PROPOSED ANNUAL BUDGET
METRO TRANSIT INSURANCE ADMINISTRATORS

Item	Amount	Total
Direct Labor Total		481,213
Managing Director	73,875	
Deputy Managing Director	63,194	
Claims Manager	55,083	
Claims Supervisor	36,575	
Claims Specialist*	7,128	
Manager, Loss Control/Light Rail	55,634	
Manager, Loss Control/Subway	64,070	
Loss Control Specialist*	28,552	
Admin Assistant/Office Manager	25,114	
OCIP Program Coordinator	31,470	
Clerk Typist — Administration	20,754	
Clerk Typist — Claims & Safety	19,764	
Employee Benefits 32.77%		157,693
Total Subcontractors		927,496
Pre/Post Construction Survey (Woolsey)	375,000	
Transit Bond Guarantee Program (Rideau)	552,496	
Direct Costs Total		256,500
Office Rental	40,000	
Furnishings & Fixtures	15,000	
Office Equipment	35,000	
Maint. & Misc.	3,000	
Office Supplies	40,000	
Communications	30,000	
Auto Expense	51,000	
Travel Expense	10,000	
Relocation Expense	6,000	
Dues & Subscriptions	2,500	
Insurance	4,000	
Fixed Project Cost		350,000
Total		**$2,172,902**

*Funding for part of year. New position.

Source: Contract Pricing Proposal from TIA/DIA, May 23, 1990

In our opinion, the Commission could reduce the cost of operating this unit by staffing a department to perform the same functions. At the very least, the profit element could be removed. Although this table does not show a profit calculation, previous proposals for TIA's contract included a 9.95% profit factor. However those proposals only allowed 21% of payroll for employee benefits. This proposal has increased that benefits overhead factor by 11.77% to 32.77%. Thus, overall costs are still similar to previous budgets that include profit.

Some of the overhead might be reduced by using existing Commission resources such as office space and equipment. Subcontractor costs could be more tightly controlled if let by LACTC on a competitive basis. One of the major complaints from LACTC staff familiar with the contract risk management operation concerned the cost of pre-construction surveys, which are performed by an East Coast subcontractor, thereby involving substantial travel costs. We were told that costs were charged on a square-foot basis. The costs are passed through to the Commission. The Director of Rail Construction (now head of RCC) told us he believed that an add-on charge made by the contractor also applies, creating a disincentive to moderate costs. We were unable to confirm this opinion with the records provided to us.

"Fixed project cost" in the budget compensates the contractor for insurance brokerage services, in lieu of commissions. The contract with TIA states (Amendment No. 2) that a fixed project cost of $1,132,662, plus allowable expenses will be paid to TIA over the life of the Blue Line contract from May 6, 1985 to June 30, 1991. We are aware of the existence of subsequent amendments that have increased the fixed project cost amount, but have not seen the amendments. We have been unable to obtain a breakdown, by year, of these costs in order to determine if they are reasonable.

As stated previously, the contract with TIA provided that commissions are not to be paid to "TIA or any of its members individually." We are not sure what that contract wording means. For example, if commissions are not payable to TIA or its members "individually," one could interpret the language to imply that they may be payable collectively. Commissions to related entities, such as Sedgwick James London affiliates or reinsurance subsidiaries do not appear to be prohibited by the contract.

We asked Transit Insurance Administrators for a total of fees and administrative expenses to date and were told that they didn't have that information. According to Dick Bennett from the LACTC accounting department, the Commission has paid to Transit Insurance Administrators a total of $2,922,946.88 in insurance administration fees and expenses since the beginning of construction on the LB/LA rail project through June 30, 1989. He also said that a new amendment, No. 5 has just been approved, resulting in about $1 million in additional costs. These costs were not separated into categories. We noted that the contract provides for additional labor costs, such as appearing at hearings, to

be billed at time and expense. We do not know if any such costs have been passed along to the Commission.

Without an audit, of the program, we can not determine if the current OCIP program costs are as low as they should be. If commissions are paid to affiliates or other parties related to TIA or its joint venture partners, then the cost of this program is probably inflated compared to what would be available in a competitive market. The only way to tell if costs are too high is to arrange for competitive bidding as recommended earlier in this report, or arrange for an audit of the program contractor's administrative records and financial transactions, or both. An audit should be performed by a competent, independent financial auditor with the assistance of someone familiar with insurance and insurance financial transactions. An audit of the contractor was not in the scope of this engagement.

Service

At the outset of this project, and later in two letters, we provided the Commission with a list of materials that we would need to complete our analysis. Included in that list were the following:

- Complete copies of all current property automobile and workers' compensation policies, including copies of all endorsements, insurer inspection reports and pertinent correspondence.
- Loss and premium information, by year, for each type of insurance.
- A record of payments made to LACTC's insurance broker for coverage for the rail project.
- A record of payments made to TIA and any payments to its loss control subcontractors.

Normally, we would expect that clients would have on hand reports that would provide all of the above information. These reports are customarily developed by the person responsible for risk management for the entity. If these reports exist at LACTC, none of the LACTC staff to whom we spoke are aware of them. We did not receive the information listed above as we asked for it. Instead, we received mostly hand-written summaries, prepared in response to our specific questions. The type of information we asked for should be readily available so that all that would be necessary is to make copies and send them to us. If these reports are not available, we conclude that top management is not getting the kind of information it needs to make decisions on risk-management-related matters.

The present relationship between TIA and LACTC staff is like an insured's relationship with an insurance broker. Delegation of risk management decision making to an insurance broker creates a potential conflict of interest. Even though the contract with TIA calls for a budget item identified as "fixed project costs," which is supposed to be in lieu of commission, the contractor can ask for additional compensation for placing coverage outside the basic OCIP. Furthermore, the contractor has been allowed to determine the need for and hire subcontractors, passing through the cost to the Commission.

Recommendation

Assign rail construction risk management responsibilities, including management of the OCIP and selection and supervision of contractors to the risk manager.

Someone on staff at a reasonably high level should be responsible to see that major risk issues are analyzed and presented to top management and the policy-making body for appropriate action. This same person should determine the need for insurance or contracted risk management services, and should negotiate that insurance or contract for those services. The Commission should assign responsibility for oversight of the rail construction risk management to its newly hired risk manager. That responsibility should include selection and supervision of all contractors supplying risk management or insurance services to the OCIP.