Loss Prevention Standards

Business Interruption Insurance - Committed Costs

Introduction

Most manufacturing, retailing and wholesaling businesses are insured by Aviva on an Insured Profit basis. From an insurance perspective Insured Profit is the difference between the Turnover and the Directly Variable Costs incurred by the business (which are specified in the policy). The main directly variable cost is normally the 'purchases of materials for production or resale'.

Generally, following any incident resulting in damage at the premises, any reduction in turnover will then be mirrored by the accompanying proportionate reduction in these purchases. It is for this reason that 'purchases of materials for production or resale' are not normally covered by the insurance, instead they are listed on the policy as an Uninsured Working Expense.

However, there are businesses which do not fully fit this Insured Profit basis model. Some businesses will enter into long term or advance contracts for their purchases to ensure continuity of supply, quality, price, etc. and for it to be worthwhile for the supplier to make necessary investments. Should there be an interruption to the business meaning that these goods cannot be processed, then these contracts will still need to be honoured and these goods still paid for even if they can't be utilised. We refer to these as Committed Costs.

In cases where these goods are not perishable, then those which continue to be supplied can often be stored until such time as they can be utilised.

Note: Abnormal storage, temporary storage, etc. presents its own enhanced risk factors and exposure, e.g. additional stored values; increased fire loads; compromising existing protections; etc. These also need to be carefully managed.

In some instances, these goods can be sold to other parties for their use. However, in the case of the food industry, for example, these goods are often perishable with a very limited lifespan and limited options or availability to sell on. Even where these can be sold, it is often seen that this is at a loss. In extreme cases, it may be necessary to simply scrap these goods, which can also incur additional costs.

Where this is a concern, then the business interruption cover can be adapted to cater for this in one of two ways:

1. The whole cover can be written on a Full Revenue Basis.
   a. This means that all 'Purchases' are covered under the policy for the full duration of the Maximum Indemnity Period chosen.
   b. This is the most reliable way of ensuring that all situations are covered.
   c. The main challenge from this coverage is that the cover generally becomes much more expensive.

2. An additional item in respect of the Committed Costs can be added to the policy.
   a. This item will have a separate sum insured aimed to represent the maximum amount that the Insured expects to lose in respect of Committed Costs as a result of damage.
   b. To arrive at the insured figure, consideration should be given to factors that might reduce the amount at risk, such as the:
      i. Range of supplies - some of which may be contracted and some which may not be.
      ii. Contract - which may only guarantee the purchase of the goods for a short(er) period and not the entire Indemnity Period.
      iii. Potential to store the goods in an arrangement that prevents deterioration, e.g. frozen or another format pending the reopening of the business.
      iv. Possibility of selling some of the goods in their received state with no modification; whether this is at a profit, at cost or at a loss.

Note: Any assumptions made in the decision to insure on a Committed Costs basis would require all details of the calculation and insured sum to be reviewed regularly, considered as part of the Business Impact Analysis and when such things as contracts change; suppliers change, etc.

There is an example calculation below which may assist the understanding of this.

Business Interruption Committed Costs – Fictitious Example

This is a fictional example that has been created merely to help explain this exposure and the provision of Committed Costs.

Oldsocks are a cheese making company and they need a guaranteed source of milk in order to ensure they can make cheese which is sold nationally to major supermarkets.

They have several dairy farmers from whom they commit to buy milk, and this commitment amounts to contracts for 250,000 litres of milk per week at a confirmed price of 0.20p per litre.

Because of this perishable contractual exposure, they decide to arrange a Committed Costs cover which is in addition to their normal Insured Profit cover. As a result, they could calculate their exposure limit (or Sum Insured) in this example based on differing circumstances:

1. The total Committed Costs for the year amounts to 250,000 litres of milk at 0.20p x 52 weeks (12 months) = £2,600,000.

2. Further investigation of the milk contract reveals that there is a break clause in the deal, which they can invoke and cancel the ongoing purchases with 3 months' notice.
   They are confident that they can recover the supplies from these farmers when they return to full production at a later stage.
   By invoking the 3 months' cancellation clause, they can reduce the amount they need to insure their Committed Costs to 3/12 or 25% of the annual amount, i.e. £650,000.

3. The company are also confident that they can sell the contracted milk on to another company, in the powdered milk processing industry, but in this instance, they would only get 0.10p per litre rather than the 0.20p per litre in their contract.
   This could reduce the Committed Costs figure they need to insure further by 50% to £325,000.

As a company they have the option to insure for any one of these scenarios and amounts, or alternatively there may be a different combination they can use to establish their insurable figure.

Further risk management information can be obtained from [Aviva Risk Management Solutions]

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