THE DEPARTMENT OF DEFENSE, THE ENVIRONMENT AND YOUR CONTRACT RISKS

A U.S. Department of Defense (DOD) performance-based contract (PBC) has a unique structure, and contractors should contemplate several issues and potential challenges before entering into one.

The objective of the PBC program is to reduce life cycle costs for the DOD while maximizing the number of site closures. The contracts typically prescribe the desired outcome of the work without specifying the methods or technologies to be used to achieve the goals. The performance objectives must be met prior to an established deadline and demonstrate best value to the DOD.

The Willis Environmental Practice has the experience and the expertise to help you navigate the rocky terrain of performance-based contracts for the U.S. Department of Defense.

ISSUES AND CHALLENGES

PBC CONTRACT EXPOSURES

In addition to requiring that a contractor meet the broader goals of site closure for a reduced and guaranteed cost, the DOD PBC contracts typically require that the contractor be responsible for known and unknown contaminants on and emanating from known (covered) sites as well as any regulatory changes. These requirements result in significant exposure for offerors relative to remediation cost overruns, regulatory re-openers and potential third-party property damage and bodily injury exposures associated with pollutants migrating off-site.

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These exposures are somewhat tempered by the fact that contractors are typically not responsible for unknown sites (sites with pollution conditions outside of the sites covered within the scope of the contract). The liabilities associated with each contract vary and should be carefully evaluated, and where possible, insured to limit the contractor's financial exposure.

When choosing to compete in the DOD PBC arena, contractors must be aware that they will be assuming balance sheet risk, whether they self-insure the Contractors Guarantee or purchase commercial environmental insurance. The balance sheet risk remains and can be considerable for larger projects even when using environmental insurance to support the Contractors Guarantee. This risk includes deductibles (per each incident on Pollution Legal Liability (PLL) policies) and funding potential gaps between the Project Price and the Attachment Point of the Cost Cap coverage. The risk also includes the coinsurance provision on Cost Cap policies that mandates the contractor share in the covered losses. Finally, there can be the risk of uninsured or under-insured exposures due to policy coverage limitations and exclusions or the purchase of insufficient limits.

U.S. AIR FORCE (USAF) 2-STEP EVALUATION PROCESS

The USAF recently initiated a 2-Step Evaluation Process for evaluating, among other things, the means by which contractors (or offerors) choose to support their Contractors Guarantee Limit.

This new approach involves:

STEP 1 USAF evaluation of all proposals specifically focusing on how the offeror will financially support their Guarantee

STEP 2 USAF verification of the offeror's financial capabilities, and the assistance in negotiating and purchasing any necessary insurance for the "Apparent Successful Offeror" (ASO).

Offerors can elect to support their Contractors Guarantee by "self insuring" or by using commercial environmental insurance, specifically Cost Cap (remediation project overrun insurance) and/or Pollution Legal Liability (PLL). The USAF will closely evaluate how offerors support this guarantee. They typically require:

- Offerors who are "self insuring" to provide audited financials and/or SEC 10K forms for the three most recent years for which such documents are available

- Offerors who intend to use environmental insurance to support their Guarantee must provide descriptions of the following:
  (1) The offeror's experience with using environmental insurance over the past five years
  (2) Any environmental insurance claims made by the offeror or for projects with which the offeror was involved over the past five years
  (3) Other information the offeror deems relevant to the offeror's experience with environmental insurance

The 2-Step approach is mostly in response to contraction in the Cost Cap market and the desire of the USAF to use their external consultant to work with the ASO to jointly approach the environmental insurance markets and negotiate and procure environmental insurance, if elected, to ensure optimal protection of the USAF's interests.

COST CAP INSURANCE MARKET

The Cost Cap Insurance Market has changed considerably over the past few years. Some of the issues most relevant to insuring PBC projects are:

- **COVERAGE AVAILABILITY.** The poor loss history experienced by the limited number of Cost Cap insurers over the last several years has resulted in a further shrinkage of the market to an even smaller number of carriers who are continually evaluating and further restricting their capacity and coverage terms to attempt to achieve profitability.
- **CONTRACTOR EXPERIENCE.** Insurers prefer to write Cost Cap coverage for "partner" contractors who have a proven track record of success with the insurers on fixed price contracts. Coverage may be difficult to obtain for a contractor who has not performed/insured such work in the past.
- **CONSERVATIVE UNDERWRITING.** Insurers now want to only consider projects that have a regulatory agency-approved remedial action plan. DOD PBC contracts typically include multiple areas of concern, some of which may not have reached the regulatory approved plan stage. Additionally, underwriters are avoiding uncertainty. Where there isn't a high degree of confidence in the existing characterization information, there has been a trend to exclude specific contaminants or sites from coverage. As a result, some specific tasks, sites or contaminants could be excluded from the policy, and the risk would revert to the contractor. Also, underwriters are applying larger contingencies to their clean-up cost estimates, resulting in higher attachment points.

POLLUTION LEGAL LIABILITY (PLL) MARKET

Unlike the Cost Cap product line, the market for PLL is very competitive. Considerable new capacity has entered the market in recent years, resulting in expanded coverage terms and conditions and extremely competitive pricing. The market for PLL includes close to 40 insurers; however, a much smaller number of insurers would have an appetite for covering PBC contracts at DOD sites. Among the insurers who would entertain covering a PBC project, there is ample capacity available ($25M – $50M per individual market), the ability to layer capacity from multiple insurers, great flexibility for negotiating terms and conditions, flexibility with program structuring and 10-year terms readily available for pre-existing conditions. However, the consideration of participating markets may be affected by the need to utilize a Cost Cap in conjunction with a PLL program.

SURETY BONDS

Some of the PBC contracts require payment and performance bonds for the traditional construction portions of the task order. This can be a challenge, as some sureties are reluctant to provide bonding for the construction portion of a project, which includes a significant environmental component.

THE WILLIS APPROACH

ENVIRONMENTAL SURETY SOLUTIONS. Willis has an Environmental Surety Working Group comprised of 14 Environmental and Construction Surety professionals across the country with expertise in placing environmental surety bonds. These specialists are available to assist our local surety teams in complex environmental project surety placements.

PRESENTATION OF CONTRACTOR'S CAPABILITIES AND EXPERIENCE TO INSURERS AND THE AIR FORCE. When pursuing Cost Cap coverage for a PBC project, both the USAF and the environmental insurers will be evaluating the contractor's experience with fixed price contracts, environmental insurance and DOD PBC projects. Willis has considerable experience in this area including working with contractors to best position their experience to address the concerns of the Air Force and the insurance markets.

We arrange introductory meetings with Cost Cap and PLL insurance markets and advise the contractor how to best represent their capabilities and experience (including claim management) relative to fixed price remediation and government contracts. In addition, we can train project managers, estimators, contract administrators, attorneys and other personnel involved in quoting these projects with Cost Cap and PLL insurance and provide them with the knowledge of available coverages necessary to develop an accurate risk profile for projects.

ONGOING MANAGEMENT OF INSURANCE PROGRAMS. In addition to the insurance coverage and proposal training for personnel involved in quoting PBC contracts, we can provide instruction for personnel involved in the ongoing management of insured PBC projects. We can assist you in identifying provisions of the insurance contract that require attention throughout the course of the project, including a basic review of the coverage and policy requirements for progress reporting, claim notifications, scope of work modifications and needed amendments to coverage as work progresses.

WILLIS QUALIFICATIONS

The complexities of the PBC contracts, the new two-step evaluation process and the challenges of the Cost Cap market require an experienced broker with established underwriter relationships. The environmental insurance market is a very specialized, niche market place and credibility, experience and history with the carriers is crucial.

Willis knows what concerns insurers and the Air Force have; we know the issues that both need to have addressed, and we have the experience and skill to present our clients in a manner to achieve the desired results.

Willis has broad experience with government clean-up projects, including the Base Realignment and Closure (BRAC) program, DOD PBC and similar projects. We understand the specific risk factors and technical challenges associated with military clean-up projects, including UXO, MEC, emerging or unique contaminants, such as perchlorate and chemical weapons material (CWM) and their breakdown products and other hazardous, toxic and radiological wastes (HTRW). Willis helped pioneer the development of many of the insurance solutions to these unique exposures. For example, we placed one of the first Cost Cap programs to include coverage for MEC clean-up cost overruns.

A representative list of BRAC & DOD projects includes:

- **FORT MCCLELLAN, ANNISTON, ALABAMA.** One of the most visible current BRAC projects is Ft. McClellan, Alabama. Willis placed both a site-wide Pollution Legal Liability policy (including coverage for concussive effects of MEC) for approximately 10,000 acres of FOST and FOSET base property transferred to the local re-use authority, as well as a clean-up Cost Cap policy for one phase of MEC, Chemical Weapons Materials (CWM) remediation. The clean-up Cost Cap program was the first such program written for MEC remediation on a pure risk transfer basis. The base was closed in the 1995 BRAC round and the facility has become one of the highest profile federal clean-up and redevelopment projects in North America. A $50 million remediation agreement represents the largest privatized clean-up of a BRAC site to date and the first time the Army has transferred and privatized an unexploded ordnance removal action.

- **NAVAL AIR WARFARE CENTER (NAWC), WARMINSTER, PENNSYLVANIA.** Nine land parcels were transferred to the Federal Land Reuse Authority (FLRA) of Bucks County under Economic Development and Public Benefit Conveyances in 2001. The transfer occurred as part of the Department of Defense's closure of the base. Environmental contamination was identified at NAWC in late 1979, a CERCLA preliminary assessment/site inspection was completed in 1985, and the site was placed on the National Priorities List in 1989. CERCLA Remedial Investigation and Feasibility Studies (RI/FS) were performed at eight sites throughout the 1990s and were completed in 2000. A groundwater pumping and treatment system is in place and will remain active for the foreseeable future. The FLRA retained Willis to obtain a 10-year term environmental liability policy that responds excess to the existing policy. This policy also drops down to provide primary coverage through at least 2017 when the current policy expires in 2012. The new "sunset policy" was bound at the completion of the redevelopment.

- **FORMER CHANUTE AFB, RANTOUL, ILLINOIS: PERFORMANCE-BASED TASK ORDER.** This base was closed in 1993 and the Air Force has been working to clean the site to allow for its redevelopment. The goal of this performance-based, firm fixed price task order was to reduce Air Force life cycle costs for the remediation by maximizing the number of sites achieving site closure and/or regulatory closure. Other goals were to develop and implement an optimized exit strategy toward site or regulatory closure for the remaining sites and include interim property transfer for the 47 sites at the former Chanute AFB. Environmental insurance was required by the task order to cover the risks associated with work to be performed at the 47 sites, which had a history of waste fuels, solvents and oil disposal in open dumps across the facility. Willis placed a combined environmental policy form that provides cost overrun and site pollution liability coverage with limits in excess of $32 million for the eight-year, multi-million dollar remediation contract. Willis worked closely with the contractor and the Air Force to structure a policy that contains several unique enhancements designed to protect the Air Force's interests as well as those of the contractor.

The Willis Environmental Practice background and experience in this area provides a broad and in-depth arsenal of solutions to align with your DOD PBC risk management strategies.

CONTACT

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