

Functional Replacement Cost: Do municipalities have a choice on how to insure their buildings?

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Everyone in a Saskatchewan town knows which building is the arena. It is usually the largest building in the community. It is almost always a curved quonset or 'arch rib' type building. If you're lucky, it even has artificial ice.

That is the picture for many of the communities in Saskatchewan. It's very nostalgic, but it poses a unique risk-management situation for a municipal council: If you had to replace that building after an insurance loss, what would be the best type of replacement? Do you replace the natural ice with artificial ice? Do you retain the same 'arch rib' style of construction? Would you increase the size of the arena to suit a growing municipality? Should you downsize because of a shift in demographics? Is there historic significance to this building that you would want to retain? These structures may contain obsolete building materials, and are very costly to rebuild or reproduce. All of these are very important questions

and your answers can change how your municipality purchases its insurance.

Under a typical commercial property insurance policy, many municipalities in Saskatchewan have the option of purchasing Replacement Cost coverage. **Replacement Cost is usually defined as replacing the damaged property with materials of like kind and quality without any deduction for depreciation** (versus Actual Cash Value which *does* deduct for depreciation).

So if you have a 5,000 square foot wood arch rib style arena, following a loss, insurance would replace it with a new 5,000 square foot building using the same wood arch rib style of construction. Your municipality would need to establish accurate limits of insurance to match to this type of construction and pay the premiums associated with that limit. If it costs \$3 million to replace this old style arena, your insurance limits would need to be \$3 million.

While this arch rib style of design is a Saskatchewan icon, it is no longer

an economical design. A more modern design would be to build the arena using steel construction or a pre-fabricated building design using artificial ice. The cost for this arena might only be \$1.5 million — theoretically cutting the property insurance premium in half. Many municipalities insured with SUMAssure are making the switch and saving their ratepayers dollars in the process.

People commonly ask SUMAssure why a municipality should have to pay the premium on a \$3 million facility when the building can realistically be built for \$1.5 million? You can, through Functional Replacement Cost. Functional Replacement Cost is similar to Replacement Cost in that it will replace the building — but **with Functional Replacement Cost, you can go for a less expensive, more modern type of construction rather than the 'like, kind and quality' required for a Replacement Cost settlement.** A municipality would be

able to insure to \$1.5 million and only pay the premium on that amount. Assuming you have insured to the full Functional Replacement Cost value, there would be no penalties for under-insurance.

Determining the values for either Replacement Cost or Functional Replacement Cost uses the same valuation methods. Currently, the majority of municipal property appraisals are being completed by Saskatoon-based Suncorp Valuations. (*Editor's Note: Suncorp is a SUMAdvantage partner, and SUMA members receive a discount on their services.*) Suncorp has options for municipalities under both the Functional Replacement Cost and the Replacement Cost settlement options.

While the terminology varies slightly from the insurance world to the appraisal world, the terms are considered more or less synonymous. For example, the insurance world's version of Replacement Cost is known to appraisers as 'CRN' or 'Cost Replacement New.' Translate the insurance definition for Functional Replacement Cost and you come up with 'LU' or 'Like Utility.'

Tom Gardiner, President and CEO of Suncorp Valuations, defines 'Like Utility' as "the estimated monetary cost as of the valuation date, of constructing new building or structure that would have a similar utility to the subject property under appraisal, but constructed with modern materials and according to current standards, design and layout." You just need to ask the appraiser to add the valuation.

This type of coverage would not apply only to arenas. It's also common for a municipality to repurpose a building in the community to suit their needs. Perhaps you converted an old school house to your town office. This building is three stories high and 100 per cent brick construction with lath and plaster wall construction on the interior. Is it economical to rebuild a three-story brick schoolhouse for the town office? Probably not -- it would be a much more cost-effective and practical to rebuild a wood frame, one-story town office. The Functional Replacement Cost settlement option allows municipalities to do just that.

Functional Replacement Cost does have its potential drawbacks though, and they need to be fully considered by councils. The above scenarios consider only total loss of the facility. What if exactly half of the structure burns down

and the other half remains perfectly intact? Obviously an old arch rib structure on one end of the facility joined to a modern, straight-walled steel structure would not only be impractical but also an embarrassing eyesore! Fortunately, modern Functional Replacement Cost policy wordings factor in just such a scenario and provide a more practical marriage between Replacement Cost and Functional Replacement Cost. In the case of a partial loss, restoration of the

damaged portion would be in the same architectural style, but with less costly material (such as replacing plaster and lath with drywall or faux laminated beams).

So the question that every council should be asking is: What would we want to do if we lost this building? Once you answer that, talk to your insurance broker or risk manager. They can discuss all of the insurance settlement options available with municipal councils and administrative staff. ■



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