Property Insurance for Dairy Operations

Keith Peppinck

The Co-operators, 205 East, 8500 Macleod Tr. South, Heritage Square, Calgary AB T2H 0M6
Email: keith_peppinck@cooperators.ca

Take Home Messages

- Deal with an insurance agent or broker whom you trust, and who is familiar with the operations of a dairy farm. The better they understand your needs, the better service they can provide.
- Understand your coverages. The aftermath of a loss is no time to find out what the farm is – and is not – covered for.
- Be vigilant about safety and loss prevention. The best way to control the cost of insurance is to mitigate the possibility of making a claim in the first place.
- Regularly review your insurance policies to verify that you have the types of coverage you need, particularly as things change on your farm.
- Keep your insurance limits updated so that inflation and other changes over time do not leave you underinsured.
- Consider whether your insurance covers every item you want covered, and every peril you wish to insure against. If it does not, look into purchasing endorsements to fill in the gaps.
- Consider various loss scenarios, and how long it might take the operation to recover from them. It may be worthwhile to purchase extended business interruption coverage if replacing equipment or machinery could take an extended period of time.
- Welcome loss prevention inspections and comply with any recommendations.

Property Insurance: the Cost of Transferring Risk

Insurance is all about transferring risk. The client pays the insurance company a set amount, or premium, and in return the company assumes a portion of the client's risk. It allows the client to substitute a known, set cost in place of unknown, potentially devastating losses. This provides a much better opportunity for the client to plan for the future without having to put aside a great deal of money "just in case."

When the client owns and operates a farm the same principles apply, though there is usually a great deal of risk involved. The loss of livestock, buildings, equipment or workers could be a devastating blow for an agricultural business. This fact heightens the importance of insurance in protecting the operation, and highlights how important it is that those running farms thoroughly understand the insurance coverages they purchase – or choose not to purchase.

Buying insurance for your farm involves making a number of decisions about transferring risk. These decisions should be based on the farm operator's financial strength or ability to cover losses, combined with your attitude toward risk. Those who are very risk-averse will have to pay more for insurance than those who are willing to keep more of the risk themselves. The latter will generally pay less for insurance coverage, but will be in a worse condition should they experience a loss than the former.

The cost of insurance – and the amount of risk one assumes on one's own – is mainly a function of four factors:

- what is being insured;
- the types of coverage;
- limitations of those coverages; and
- the applicable deductibles.

There are many decisions to be made regarding each of these factors. These decisions will determine how well property is protected and how much that protection will cost. This is why it is advisable to deal with an insurance agent or broker who is familiar with dairy farm operations, and whom you know well and trust. An insurance professional can lay out the options and make sure clients fully understand the consequences of their choices. Many insurance companies have designed package policies specifically to insure Canadian farmers.

What's covered by Property Insurance?

The property insurance portion of a farm insurance policy can provide coverage for various physical assets on your farm. These include:

- your house;
- barns and other farm buildings;

- objects inside the house and farm buildings;
- equipment in the buildings;
- mobile equipment;
- machinery;
- livestock; and
- produce (milk and other products).

Produce includes farm inputs such as commercial feeds, fertilizers and pesticides, and harvested farm products such as milk. Coverage can be extended to milk in bulk milk tanks due to damage to the building where the tanks are located or due to power interruption to the main electrical power service to the insured farm. If milk, for example, is kept refrigerated it is important to have coverage for the loss or damage that could occur if the refrigeration unit were to fail.

Livestock is divided for insurance purposes into various separate classes. A wide variety of perils can be chosen, depending on the type of livestock and the risks involved. Coverage includes reasonable veterinarian fees to attest to the cause of death. If livestock is bought and sold during the term of an insurance policy, the insurance company should be notified and an agent or broker should explain the notification requirements. This may prevent the denial or partial denial of a claim in the event of a loss.

Farm buildings and contents are generally insured for All Risks and include dairy barns, other barns and outbuildings, and the contents located in the buildings. Contents include milking machines, milk tanks and related equipment. Coverage can be extended for additional cost to include machinery breakdown and collapse of milk tanks. All Risk policies can extend to include losses for collapse caused by snow load and ice load, whereas a Named Perils policy excludes such losses.

Farm machinery and implements can be insured for fire, lightning and explosion or for All Risks. Coverage is available for scheduled equipment, where everything to be insured must be listed in a schedule, or on a blanket basis, which applies to all mobile machinery and implements and tools used for maintenance and repairs owned, rented or leased. Most policies can be extended to insure loss of use to cover the cost to rent substitute machinery in the event the machinery suffers a loss due to an insured peril. Coverage can also be extended to scheduled equipment for limited waiver of depreciation. The equipment must suffer a total loss, the loss or damage must occur within 60 months (5 years) of the date on which the machinery was purchased and applies only to the original purchaser. Coverage can be extended, at an additional premium, to cover internal damage to harvesting machinery caused by materials or objects not intended to be ingested into the machinery.

Some farmers do custom farming for others. Typical farm policies in Canada insure custom farming if the annual gross receipts are less than $2,000. In cases where the gross receipts are greater than $2,000, or if this type of work is performed outside of Canada, the agent or broker should be contacted to ensure there is proper coverage for equipment used during custom combining.

If machinery or equipment will be bought or sold during the term of an insurance policy, the notification requirements must be adhered to. It is also important to make sure that coverage is in place for any non-owned (borrowed, rented, etc.) equipment; the standard Co-operators policy extends coverage to borrowed or replacement equipment.

Coverage for motor vehicles that are required to be registered is provided under auto insurance policies, not farm insurance. Boats, recreational vehicles and aircraft are also excluded, and are likely to require special coverage.

▪ Types of Policies: Named Peril and Broad Form

There are two basic types of insurance policy that offer different levels of protection: Named Perils and All Risk (also called Broad Form). They have different ways of defining what "perils" are covered by the policy.

All Risk policies are the most common type of policy purchased. Under these policies, all direct damage to insured property is covered unless the particular peril that caused the damage is listed as "excluded" in the policy or its attachments. As might be expected, this type of policy is generally more comprehensive and more expensive than Named Peril policies.

Named Perils policies are not as broad as All Risk policies. These insurance contracts contain a list of perils against which the property is protected; anything that is not listed in the policy is not an "insured peril." If, for example, an insured building collapses due to a build up of ice or snow and that peril is not specifically listed in the policy, the damage will not be covered. Anything that is listed is covered. If there are particular perils the client wishes to be insured against that are not listed, it may be possible to add that coverage by purchasing an endorsement.

All Risk policies provide broader coverage and are therefore more costly than Named Perils. All Risk policies may not be available for older properties. Named Perils coverage may be selected to reduce premiums. Named Perils coverages provide protection against loss or damage caused by such things as:

- fire;
- lightning;
- explosion;
- smoke;
- falling objects;
- impact by aircraft or land vehicle;
- vandalism or malicious acts; and
- windstorm, hail and tornado.

Named Perils policies can be extended to include:

- earthquake;
- building collapse;
- flood; and
- theft.

Livestock is generally insured against all the Named Perils previously mentioned; in addition, most policies provide coverage for livestock damage or loss caused by:

- accidental shooting;
- lightning;
- theft;
- electrocution;
- attack by wild animals;
- fumes;
- entrapment, piling, smothering;
- falling trees; and
- drowning.

Produce can be insured for Named Perils previously mentioned. Perils may also include:

- collision, derailment or overturn of vehicles on which the insured produce is being shipped; and
- spoilage to milk contained in bulk milk tanks.

Coverages will vary from one policy and one company to the next, and it may be possible to purchase endorsements to protect against additional perils such as ingestion of hardware.

Any compensation for livestock losses provided by the government will be deducted from any insurance settlement.

Purchasing Extra Protection: Endorsements

Regardless of which type of policy is purchased, there may be a desire to add coverage related to an otherwise uninsured peril or piece of property, or to enhance the level of certain coverages. This can be done by purchasing an endorsement. Using the example above, if building collapse due to ice and snow is not covered under the standard policy, the insurance company may offer to sell an endorsement covering that particular risk. The company will want to verify that the building in question is well built and maintained to appropriate standards before agreeing to provide the coverage.

An additional coverage that dairy farmers should consider is an endorsement to protect against milk contamination, which is a common claim from dairy operations. When a cow is medicated and therefore taken off the milk line, they sometimes manage to get back in line without the farmer noticing, thereby contaminating the milk. Similarly, when the tank is shut off for cleaning and someone forgets to turn it back on, the milk can be spoiled. This endorsement provides coverage when milk is condemned by Dairyworld due to contamination by animal medication, cleaning solution and failure to activate the bulk cooling tank. Coverage may be limited to the lesser of the value of the milk at the time of the loss or $20,000; as well as a $500 or 50% of the loss deductible, whichever is greater.

There are many other types of additional coverages, which vary from one company to the next. Below is a list of additional coverages that companies may offer. In some cases they are offered as endorsements at an additional cost; in other cases they may be included at no extra cost:

- enhanced property coverage;
- replacement cost for farm tools;

- sewer backup;
- loss of use of farm machinery (i.e., to rent substitute machinery);
- power interruption;
- business interruption (protection against loss of income);
- fire department charges;
- livestock mortality;
- earthquake damage; and
- loss of/damage to embryos and semen.

Basis of Settlement: Replacement Cost vs. Actual Cash Value

There are two ways that claims can be calculated following an insured loss: on the basis of Replacement Cost, and Actual Cash Value.

Replacement Cost basis is the preferred type of coverage. The settlement will be calculated based on the cost of replacing it with new property of “like kind and quality”, with no deduction for depreciation. The other option insures property on an Actual Cash Value basis, where the loss is settled by depreciating the replacement cost based on age and condition.

As an example, consider a four year old tractor that would sell used for $50,000 but would cost $100,000 to buy brand new. If it were destroyed in an insured loss, the settlement under a Replacement Cost policy would come out to approximately $100,000. In comparison, under an Actual Cash Value policy, the settlement would be around $50,000. In both cases, there may be applicable limits, and a deductible would usually apply. Generally speaking, Replacement Cost policies are more expensive than Actual Cash Value policies, because the settlements are higher.

Guaranteed Replacement Cost (Applies only to Dwellings)

Many insurance companies offer protection for dwellings against sudden inflationary factors through guaranteed replacement cost coverage. If, for example, a devastating tornado tears through the prairies, similar to what occurred in Manitoba in the summer of 2007, the elevated demand for labour and material in the aftermath of the storm may dramatically increase the cost of rebuilding a home. Suppose the dwelling was insured for $100,000, which was the estimated cost to replace it at the time the insurance policy was renewed. Under guaranteed replacement cost, as long as the dwelling was insured to 100% of the replacement cost, as it was in this example, the settlement will not be restricted to the limit in the policy which in this case is $100,000. If the additional costs brought about by the tornado result in the rebuild costing $150,000, the full amount would be covered. Without the guaranteed replacement cost coverage, the dwelling's owner may be out the additional $50,000.

At The Co-operators, guaranteed replacement cost coverage is available for dwellings but not other buildings such as barns, which reinforces the importance of keeping coverage limits up-to-date.

▪ Adequate and Current Insurance Limits are Crucial

It is important to carefully consider what adequate and acceptable limits are in any insurance policy. A common mistake is to believe that the value of property – what it would actually sell for – is what it should be insured for. Property should be insured for the cost of actually replacing it, and dwellings should be appraised every few years.

Construction costs in western Canada have increased dramatically in recent years because the demand for labour and material is outpacing its supply. A home that might have cost $150,000 to build five years ago may cost $300,000 or more today. If the owner of the property bought insurance with a limit of $150,000 five years ago and has not increased the limit since, the property may be underinsured. If the home were to burn to the ground, the cost of building the exact same home in the same location may be $300,000 whereas the policy would cover only up to $150,000.

Most property insurance policies provide inflation protection. Each year the insurance company determines the local inflation rate on property and when a policy is renewed the property limit is adjusted accordingly. However, if renovations are made or additions built, the agent or broker must be informed. Insurance agents and brokers should use a building valuation tool to estimate the potential cost to replace property, but it is the client who is ultimately responsible for choosing the limit. A professional appraisal can be very useful in helping to determine an appropriate limit, which fully covers the replacement if necessary but does not unnecessarily inflate the premiums (known as being "overinsured.")

For insurance purposes, stabling, heating and ventilation equipment generally considered part of the farm building and their value should be included in the calculation of the building value. Stable cleaners, milking equipment and coolers are not normally considered to be part of the building and should be separately insured.

After a loss of livestock, market value is normally used to determine the value of the dead animals. Policies normally establish upper limits, for example $4,000 for an individual animal. Animals whose value is greater than the norm should be identified and listed separately when insurance is purchased.

▪ Coinsurance

Failure to keep property values current may result in a charge if the policy contains a coinsurance clause. This clause states property must be insured to a certain percentage of the true cost of replacing the property, usually between 80 and 100%. If it is not insured to that amount, the client will have to bear part of the cost. For example, if the cost of replacing a herd is $100,000, an 80% coinsurance clause would require that the insurance limit on the herd be at least $80,000. If that herd were insured for only $60,000, which is 75% of the required minimum of $80,000, settlement of a claim would be 75% of the value of the animals lost. This applies to both total and partial losses of insured property.

Part of the dairy farmer's risk management strategy is to decide upon levels at which to insure property. To insure items at less than 100% of their replacement cost is to assume a degree of the risk in exchange for the resulting savings in premiums. It is extremely important to be fully aware of these decisions and their repercussions at the time insurance coverage is purchased or renewed. It is advisable to periodically review policies to make sure the client is aware of and comfortable with the limits and the associated risk assumed.

▪ Business Interruption Coverage

An important consideration for any farm operation, or any business for that matter, is what will happen if the business is not able to operate for some period of time. Business interruption insurance is an optional coverage designed to help the business through such times. In some cases, business interruption insurance is not optional – it is a requirement of some lending institutions, which is an indication of the value of this coverage.

There are special considerations in the case of dairy operations. Under the right conditions, it may be possible for a dairy farmer to lease out their milk quota. If an arrangement is made to lease out the quota for the same amount that would have been earned in income under normal circumstances, there will have been no loss and therefore there would be no claim payable by the insurance company. A claim would be payable only if the operation were out-of-pocket as a result of an insurable loss.

If leasing out quota is not an option, business interruption should be seriously considered. Under current market conditions where milk tends to be in short supply and most producers are producing at maximum capacity, the ability to lease out quota may not be a reliable contingency plan, and the value of business interruption coverage is heightened.

Businesses must consider how long they could potentially be out of business under certain circumstances, how much income they could lose, and how they would recover from various events. Agricultural businesses often order specialized equipment from overseas. These operators should consider that if they were to lose such machinery, it could take an extended period of time to replace it, particularly if such products are on back-order and need to be transported overseas. The standard indemnity period is 12 months. In many cases that is likely to be an adequate period, but in more complex situations serious consideration should be given to having the indemnity period extended, perhaps to 18 or 24 months.

Similarly, under the current state of the construction industry in western Canada, in which projects are typically taking longer than usual to complete, an extended business interruption indemnity period should be considered.

■ Deductibles

Most types of loss insured under farm policies are subject to a deductible – that is, the portion the insured person has to pay before insurance benefits are provided. Buying insurance is a means of transferring risk to the insurance company for a set premium. A deductible is a way for the client to retain a portion of that risk, in exchange for a lesser premium. If a farmer’s fully-insured tractor is destroyed and must be replaced at a cost of $100,000 and the applicable deductible is $500, the farmer will have to pay the first $500 and the remainder ($99,500) will be covered by insurance.

Many farm operators are taking on higher deductibles while increasing the limits of their property insurance, which is a prudent approach that allows for a greater degree of protection against devastating events, while keeping premiums affordable. It is increasingly common for farm buildings to have deductibles of $2,000 or higher.

▪ Managing Insurance Costs

Being familiar with what coverages are in place and what the limits are set at can help control the price of insurance by ensuring the client is not paying for coverage that either is not needed or not wanted. As values, or more accurately, replacement costs of insured property rise, so do insurance premiums; they also rise in accordance with increased costs associated with claims, such as construction costs.

The single most effective way to control insurance costs is to avoid making a claim in the first place. Beyond the more obvious benefits of proper risk management and loss prevention practices, avoiding claims helps avoid significant premium increases.

Past insurance claims are a major factor that insurance companies consider when setting rates for a client. History is one of the best predictors of the future. Statistical analyses indicate that operations that suffer losses and make insurance claims are more likely to make future claims than those that have never had a claim; and this is generally reflected in insurance rates.

In some cases, changes to enhance the safety of an operation can lead directly to lower premiums for the farm. A good insurance advisor or risk manager can visit a dairy operation and make suggestions on ways to minimize the risks. Farm operators who proactively manage their risk and regularly review their insurance coverage should benefit from a safer farm environment and more affordable and effective insurance coverage for their business.

▪ References

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