Executive Summary: A recommendation to Mary Litton, Chief Operating Officer, Ontario Gateway

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Ontario Gateway Insurance Policy Evaluation

Ontario Gateway, an airline newly formed from the merger of Ontario Airlines and Air Prix, requires a five-year aircraft insurance policy that effectively balances risk coverage with cost efficiency. This analysis, requested by Mary Litton, Ontario Gateway's Chief Operating Officer, explores four insurance policy options from RCNC, CTC, and HIC. Given the company's highly leveraged position and operational risks, selecting the optimal policy is critical to meeting financial obligations, maintaining cash flow, and protecting against unforeseen aircraft loss costs.

Objective

The objective of this analysis is to identify the most cost-effective insurance plan for Ontario Gateway that also limits potential loss exposure to within a $41 million threshold. The firm is currently trying to grow global operations under a highly leveraged capital structure. It needs to maintain high revenue levels in order to continue meeting existing debt obligations. Hence, the firm cannot afford to take chances with respect to unanticipated negative cash flows. The insurance policy we choose must protect us from unanticipated aircraft losses. Specifically, the firm must be insured so it does not incur a liability for more than $41 million in aircraft crash losses and insurance costs combined in the next year (March 1, 1997, to February 28, 1998). As this is the absolute maximum loss the firm can incur, it would be wise to leave ourselves a margin of safety of about 10% which means we should aim to minimize the chance of losses exceeding $37 million.

Insurance Policies Evaluated

In evaluating the three insurance quotes, we need to examine each one in terms of premium costs, coverage conditions, payout structure, and how well they meet Ontario Gateway's unique needs. Here's an outline of what to consider with each insurer, based on typical risk factors and policy features that may apply in this scenario:

1. RCNC (Reinsurance Corporation of Northern California)

- Current Insurer for Boeing 757s: The policy under RCNC is already in place for Ontario Gateway's Boeing fleet, likely covering the aircraft at full replacement cost as required by the U.S. Export-Import Bank.
- Advantages:
    - Known performance: Since Ontario Gateway already uses RCNC, there may be existing relationships and trust.
    - Policy terms likely align with the Export-Import Bank's requirements, which could simplify policy renewal.
- Potential Downsides:
    - Premiums and deductibles may be higher since RCNC specializes in North American coverage, which could make it less competitive internationally.
    - Renewal terms might be adjusted, especially if the merged company has a larger international presence or if RCNC sees increased risks with the A340 fleet.

2. Canadian Trust Company (CTC)

- Proposed Insurer: CTC might offer more competitive pricing tailored to Canadian firms, potentially appealing as a North American alternative to RCNC.
- Advantages:
    - Premiums may be lower, especially if CTC is aiming to increase its market share by offering favorable rates.
    - There may be favorable terms for North American-based coverage, especially given that part of Ontario Gateway's operations are within Canada.
- Potential Downsides:
    - Coverage terms and payout mechanisms could differ, possibly including longer claim processing times.
    - If CTC has less experience insuring aircraft internationally, it may affect the policy's responsiveness to EU-based risks, particularly with the Airbus A340s.

3. Hawthorne Insurance Corporation (HIC)

- Proposed Insurer: Hawthorne Insurance might position itself as a global insurer, possibly offering policies well-suited to international operations.
- Advantages:
    - Likely to offer flexible coverage options that address both North American and European routes, which might be beneficial for Ontario Gateway's multinational structure.

    - Might be able to offer competitive premiums for both the Boeing and Airbus fleets.
- Potential Downsides:
    - If the policy comes with exclusions or limitations on high-risk routes or events, it may not fully cover Ontario Gateway's specific requirements.
    - There may be hidden costs or caps on payouts, particularly for high-value claims or multiple losses within a short period.

The following policies were examined:

1. **RCNC1**: Comprehensive coverage at 0.45% of fleet value with a 10% deductible and a 20% profit rebate over five years.
2. **RCNC2**: A fixed premium of 0.10% of fleet value, plus the lesser of 90% of total losses or 1.0% of fleet value, paid annually.
3. **CTC**: An annual premium of $13 million, covering 90% of losses up to $80 million per year, with no coverage beyond this cap.
4. **HIC**: Coverage for all losses exceeding $24 million, with an annual premium of 0.165% of fleet value and a 3.5% profit rebate over five years.

Methodology

A Monte Carlo simulation was used to model crash losses based on industry crash rates and fleet-specific risk factors. Ontario Gateway's relatively new and homogenous fleet was assumed to have a crash rate 25% safer than the industry average, which informed a sensitivity analysis. The model incorporated both crash-related and incidental costs, running 100,000 simulations to project the expected financial outcomes under each policy.

Results

Baseline Analysis (Industry Crash Rate)

Under standard conditions, CTC emerged as the lowest-cost plan, with an average total five-year cost of $24.88 million. RCNC2 followed closely at $27.52 million, making both plans cost-effective with a favorable balance of premium costs and loss coverage. HIC and RCNC1 were significantly more expensive, with average costs of $119.75 million and $134.47 million, respectively.

Sensitivity Analysis (25% Safer Fleet)

When the crash rate was adjusted to reflect Ontario Gateway's newer fleet, average costs declined across all policies. CTC and RCNC2 remained the most affordable options at $18.66 million and $ 20.64 million, respectively. This reinforces their appeal, especially under safer operating conditions. In comparison, HIC's costs dropped to $89.81 million, and RCNC1's costs fell to $100.85 million, though both remained substantially more expensive.

Recommendation

Based on the baseline and sensitivity analysis, the CTC insurance policy is recommended as the optimal choice for Ontario Gateway company. CTC provides comprehensive coverage within the $37 million safety margin at the lowest cost, fitting both standard and safer crash scenarios. With 90% loss coverage up to $80 million per year, CTC aligns with the company's financial needs, minimizing cash flow disruptions in case of significant losses. Choosing CTC over more expensive alternatives like RCNC1 and HIC demonstrates fiscal prudence, preserving more capital for operational needs and growth.

Conclusion

The CTC policy best meets Ontario Gateway's goals for cost efficiency and risk coverage, supporting financial stability as the company expands globally. It is recommended that the CTC insurance agreement be proceeded with to ensure seamless coverage continuity as the current policy expires. This recommendation provides a strong basis for the Board, ensuring the company secures the most strategic and cost-effective solution.