Clean Water Services

AGENDA

CLEAN WATER SERVICES
BOARD OF DIRECTORS

Agenda Category: Action

Agenda Title: **ADOPT RESOLUTION AND ORDER AUTHORIZING THE FORMATION OF A CAPTIVE INSURANCE ENTITY**

Presented by: Bill Gaffi, General Manager (vn)

SUMMARY

Clean Water Services (District) has used a self-insured retention program for many years through the use of the Liability Reserve Fund (Fund 102). This has allowed District to manage the financing of various risks in a cost effective manner through reduced premiums, self-management of claims within the retentions as well as keep loss prevention efforts visible to workgroups. The liability reserve fund also provides funds for losses that are uninsured through the commercial markets, such as physical damage coverage for the pipelines and funding for prior year liabilities such as final adjusted premiums and small medical-only claims in the workers' compensation program.

Over time the uninsured values of District systems have grown and some coverage lines, such as earth movement, have been decreased while the deductibles have increased. In response District staff has researched alternatives including purchasing additional earth movement limits, increasing the Liability Reserves and using a captive insurance entity for retained losses.

Staff research included identifying other public entities that have formed or are considering forming captive insurance entities. The findings showed that while not completely new to public sector entities, the use of a captive is considered to be a leading practice for those entities that have well

(continued)

Attachments: Resolution and Order
Board Recommendation to Form Clean Water Insurance Company
Clean Water Services – Captive Business Plan

REQUESTED ACTION

Adopt resolution and order authorizing the formation of a captive insurance entity.

CWS RO 16-1

Agenda Item No.	**3.a.**
Date:	02/16/16

established risk management and loss prevention programs and need alternative risk financing options other than that offered through the commercial markets. This includes providing coverage for uninsured or under-insured risks, access to the re-insurance markets and as a cost effective structure for self-insured programs.

District staff worked with Marsh Captive Solutions Group to conduct two feasibility studies to evaluate if using a captive entity would be a cost effective alternative for managing District's retained risks. The feasibility studies included a review of District's loss experience, the financial modeling of the potential captive, the organizational structure, as well as a review of the potential domiciles.

The criteria used to identify the recommended domicile included the regulations and experience with public sector owners, the types of coverages allowed and that the regulators are familiar with, the premium tax structure, the availability of the supporting infrastructure to support the captive operation, and the expected costs of operating the entity including travel for conducting captive business. Oregon was reviewed as a potential domicile; however, at this time the regulations do not allow public entity not-for-profit captives and restricts lines of coverage that District wishes to use a captive for. While many domiciles were reviewed, in the final analysis the domicile that ranked the highest was Hawaii with favorable regulations, experience with public sector owners, low cost structure, and operation expenses.

The results of the studies support the formation of a captive by District as outlined in the supporting documents.

BEFORE THE BOARD OF DIRECTORS OF CLEAN WATER SERVICES

In the Matter of Formation of Clean Water Insurance Company.	))))))	RESOLUTION AND ORDER NO. CWS 16-1

The above-entitled matter came before the Board of Directors of Clean Water Services (Board) at its regular meeting of February 16, 2016; and

It appearing to the Board that based on feasibility studies and staff research that the formation of Clean Water Insurance Company (Insurance Entity), as a not-for-profit wholly owned subsidiary of Clean Water Services (District), will result in numerous benefits to District and its rate payers, including but not limited to; (i) formalizing District's self-insurance programs; (ii) providing higher risk and claims management control; and (iii) extending District's risk management approach to provide flexible and proactive risk financing to District's current and ongoing risks.

It appearing to the Board that it has reviewed the attached recommendation and business plan for the Insurance Entity; and

It appearing to the Board that the ability of District to fund mitigation and recovery following a major earthquake can be enhanced by using an Insurance Entity; and

It appearing to the Board that the Insurance Entity would have the potential to provide risk financing not currently available or cost effective for earth movement and the in-ground infrastructure; and

It appearing to the Board that District staff has studied potential domiciles favorable to the cost efficient operation of an Insurance Entity including the regulatory environment, experience with public entity ownership and a well established supporting services infrastructure; and

It appearing to the Board that Oregon is not a viable venue as a domicile because it allows only for profit captives; other states of potential domicile have restrictions that limit the scope of

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potential captive benefits; and only the State of Hawaii not for profit captive rules currently provide District with sufficient flexibility to achieve maximum cost-savings opportunties; and

It appearing to the Board that it is in the best interest of District and its rate payers to form the insurance subsidary under the captive regulations of the recommended domicile; now therefore it is

RESOLVED AND ORDERED that District's General Manager is hereby authorized and directed to take such steps to bring together the designated Board of Directors for the Insurance Entity so that they may organize and incorporate and execute such documents as are necessary to incorporate the Insurance Entity as a wholly owned subsidiary of District in the state of Hawaii.

DATED this 16th day of February, 2016.

CLEAN WATER SERVICES
By its Board of Directors

	AYE	NAY	ABSENT
DUYCK	✓		
SCHOUTEN	✓		
MALINOWSKI	✓		
ROGERS	✓		
TERRY	✓		

Chairman

Recording Secretary

Board Recommendation to Form Clean Water Insurance Company

Background

Clean Water Services (District) has utilized a self-insured retention program for many years through the use of the Liability Reserve Fund (Fund 102). This has allowed District to manage the financing of various risks in a cost effective through reduced premiums, self-management of claims within the retentions as well as keep loss prevention efforts visible to workgroups. The liability reserve fund also provides funds for losses that are uninsured through the commercial markets, such as physical damage coverage for the pipelines and funding for prior year liabilities such as final adjusted premiums and small medical-only claims in the workers' compensation program.

With changes in coverage sub-limits, increased retentions for earthquake losses and the size of the uninsured risk for the collection system District staff began reviewing alternatives that would cost effectively enhance the self-insurance program. This review included purchasing additional coverage for earth movement and the collection system, increasing the funding into Fund 102 and using a captive insurance entity.

While commercial insurance is available for increased limits for earth movement the premium costs are significant. Commercial insurance coverage for underground pipelines is not readily available and is cost prohibitive. Increasing the funding into Fund 102 to increase the capacity to retain the risk of the earth movement deductible and underground pipe damage would require larger fund transfers to build the balance available to cover the potential losses. This method is not as cost effective as alternatives when considering the returns on the fund balance and the allocations needed to achieve the desired fund balances.

Captive Feasibility Studies

A captive insurance entity is a means of having a formalized self-insurance program that operates as an insurance company to its parent, collecting premiums and paying claims most commonly through reimbursements of claim costs to the parent. The primary use of a captive arrangement is as a funding mechanism for an organization's retained risks. The captive operates within the insurance regulations of the state it is domiciled in including capitalization requirements, actuarial analysis and audits.

District explored the feasibility of using a captive insurance entity by reviewing two studies conducted in 2014 and 2015. The initial feasibility study included examining the risks that could be funded through a captive, analyzing the potential benefits of utilizing a captive versus the liability reserve fund, a review of regulatory issues as well as a cost analysis including start up and initial capitalization costs. After reviewing the initial study District decided to proceed with a more in-depth analysis which included the financial modeling of a potential captive as well as more information regarding the business plan and organizational structure for a captive and a review of the potential domiciles that would best suit the captive.

Financial Modeling

For the financial modeling the study used the current retention of $50,000 per claim for the general and auto liability coverage. For the property coverage an initial program was evaluated using a $5M retention level, up from the current $1M retention as this amount produces a premium savings on the current program. While there is the additional risk exposure for the program, the claims history of District indicates a low probability of an increase in losses within the increased retention limits. The self-insured dental program was analyzed using the current cost and historical claim experience. The premiums used for the financial modeling were $580,700 based on proposed limits and the current set aside (premium) for the self-insured dental program ($245,700)

The financial analysis presented expected retained earnings projection of $1,348,700 at 5 years at 1.5 percent investment returns and adverse retained earnings projection of $842,903. Retained Earnings projections at 10 years were $2,899,865 and $1,879,818 respectively. At 2.5 percent investment return rates the 5 year retained earnings were $1,429,063 (expected) and $921,018 (adverse). Looking at the 10 year projections at 2.5 percent returns the retained earnings are projected at $3,209,072 and $2,182,237. These amounts include the required initial capital as well as loss reserves to satisfy outstanding expected losses and meet regulatory requirements and standard insurance operating principles.

Domicile Review

While Oregon has become a domicile for captives, the current regulations restrict captives to for profit captives only and have other rules and restrictions that would prevent District from being able to form a viable captive domiciled in Oregon. Other potential domiciles were reviewed using criteria including allowing and experience with public sector captive owners, cost factors including premium tax, operating fees and travel to the Domicile for board and operational meetings and allowing and experience with benefit related coverages. While Utah and Arizona were ranked high during the initial study they did not rank as high when considering the combination of public sector parent and offering benefit related coverages. In the final analysis Hawaii was the highest ranking domicile with favorable regulations, experience with public sector owners, low cost structure and operational expenses including travel to conduct business.

Because District is a public entity and we do not pay state and federal income taxes and have a conservative investment profile the pure financial benefits of forming a captive are lower than that of a private sector company. (i.e. direct savings from premiums paid and fund transfers). While the pure financial benefits would be lower than a private sector owner, there are other factors that were considered. These factors include providing a formalized approach for the self-insured program to include trend and actuarial analysis, loss prevention and claims management controls as well as providing a means for insuring risks currently not provided or not cost effective in the commercial markets.

Using a captive would also provide the opportunity for increased investment returns as a captive would be able to invest its capital in a wider variety of financial markets that may yield greater returns than

District's current participation in the investment pool. Another potential benefit is that over time the captive could be used to fund reserves for disaster recovery through providing insured funds for catastrophic events such as earthquake damage that either have higher retention levels, the commercial market does not provide coverage (pipelines) or has policy sub-limits where additional coverage is warranted. As an insurance entity the captive would also have access to the re-insurance market allowing excess coverage to be purchased at more affordable rates.

As an example, our current property policy through FM Global has a $100M sublimit for earthquake coverage as well as a 2 percent per location deductible. Once there is enough capital the captive could provide a policy to cover the 2 percent deductible, as an additional coverage not currently funded within Fund 102, as well as providing additional coverage above the $100M limit. A captive could then access the reinsurance market to provide a financial backstop at a more affordable price than the increased limits that District can purchase through the traditional markets.

Staff Recommendation

District staff recommends that District form a captive insurance entity as a wholly owned subsidiary of District to insure retained risks. The captive would be incorporated as a not-for-profit LLC, but not as a charitable organization. Based on experience with public entity captives as well as experience with benefit coverages, low premium tax structures and the infrastructure (service providers) to support captive entities it is recommended that the captive be initially domiciled in Hawaii. If at a later date another domicile, including Oregon, becomes more advantageous the captive could be relocated.

The start-up costs are estimated to run around $30,000 and include the formation and actuarial work, legal fees, licenses and fees and miscellaneous fees that would include a pre-incorporation meeting with the regulators and some of the service providers. The annual operating costs are estimated at $68,200 a year. This number includes the captive management fee, actuarial work, audit fee, legal fees, licenses and fees, domicile premium taxes, regulatory exam and miscellaneous expenses.

Clean Water Services –Captive Business Plan

Parent Overview

Clean Water Services (District) is a water resources management utility in the Tualatin River Watershed. Their services are crucial to the region's public health, environmental protection, and economic vitality. District operates four wastewater treatment plants and 40 pump stations. They also work with their 12 member cities to build and maintain the public sanitary sewer and surface water management system. In 1970, District was formed as the Unified Sewerage Agency of Washington County by a 2-to-1 vote of the people to address serious health and pollution problems in the Tualatin River and its tributaries. District met that challenge by unifying 26 inefficient wastewater treatment plants into one coordinated system.

In 2001, District changed its name from the Unified Sewerage Agency to reflect its broader role in managing water resources. Today District works to improve water quality in our local streams, manage flooding, protect fish habitat, manage flow in the Tualatin River, and operate four award-winning wastewater treatment facilities. Their nationally recognized work in water resource management is an investment in clean and thriving waterways.

Business Plan/Insurance Program

District's intent is to establish a pure captive insurance company, Clean Water Insurance Company, under the laws of Hawaii which will be a wholly owned subsidiary of District. The captive will prospectively insure the following risk of the parent on a direct basis.

Coverage	Policy Period	Policy Structure	Captive Policy Limits
Property	7/1/2016 – 6/30/17	Direct	$5 million per occurrence and in the aggregate
General Liability	1/1/2016 – 12/31/2016	Direct	$50,000 per occurrence and in the aggregate
Auto Liability	1/1/2016 – 12/31/2016	Direct	$50,000 per occurrence and in the aggregate
Dental	1/1/2016 – 12/31/2016	Direct	Fully insured, $1,500 per participant benefit

Premium and Capitalization

The Property premium is based on benchmarking of commercial markets, General Liability and Auto Liability assumes one loss limit, and Dental is based on an analysis completed by Mercer. (An actuarial analysis will be performed for all lines of coverage upon implementation)

Coverage	Captive Premium	Capitalization
Property	$235,000	$250,000
General Liability	$50,000	
Auto Liability	$50,000	

Dental	$245,700	
Total	$580,700	$250,000

The above premiums are sufficient to cover the captive's estimated year one start-up costs of $30,000, annual operating expenses of approximately $68,200 and domicile premium tax of $1,452 (based upon 0.25 percent on all written direct premium) as supported in the financial projections provided.

Initial capitalization will be a minimum of $250,000 in the form of cash or letter of credit inclusive of the statutory minimum of $250,000 for pure captives in Hawaii.

Loss Prevention and Safety

District has an active loss prevention program that includes a full time Loss Prevention Technician, the Risk and Benefits Manager as well as loss prevention responsibilities incorporated into supervisors and managers job descriptions. Working with the commercial insurers, District maintains a highly protected designation on all its facilities and incorporates mitigation of risks in older facilities as remodeling or upgrades are constructed. Loss prevention programs relating to liability risks include employee, supervisor and manager training on employment risks such as discrimination and harassment, pre-employment screenings, driver training as well as policies and procedures established to guide employees at all levels on their duties and responsibilities.

The captive will provide additional visibility and focus on the return on investment of the loss prevention efforts. By supporting opportunities to reduce the risk of loss at District level the captive will improve its own performance and thus provide additional stability and value to the rate payers of District.

Investment Strategy

In the future, the captive may engage a professional investment manager to manage its funds. The captive's investment strategy will seek to ensure the preservation of capital while earning a return through capital appreciation and current income. The captive will generally seek to match the term of is investments to the term of the risk it underwrites and to maintain sufficient liquidity to meet anticipated claim payments. The captive's funds will be invested in a diversified portfolio potentially comprised of the following types of investments as approved by the captive's board and investment policy:

- Cash, cash equivalents and money market instruments
- U.S. Treasury securities
- Corporate bonds
- Corporate common and preferred equity
- Loan backs to the captive's parent and/or its subsidiaries or affiliates
- Real estate or other alternative assets of the parent

Dividends may be approved by the captive's Board of Directors, based on loss exposure and the financial viability of the captive. Any dividends will be approved by the Hawaii regulators prior to payment to Shareholders.

Directors and Officers

Directors – Original captive board approved by the District Board of Directors with five board members coming from the following:

- District Board Member
- District Executive, Deputy General Manager
- District Legal Counsel
- District Director of Business Operations
- District Board Member or Appointee

Board Officers - The captive board would elect board officers (Recommended)

- Chairman of the Board (elected by Captive Board)
- Board Secretary (District Legal Counsel)
- Board Treasurer (Director of Business Operations)

Corporate Officers – The board would establish corporate officers (Recommended)

- President and Chief Operations Officer (District Risk and Benefits Manager)
- Vice President and Chief Financial Officer (District Financial Manager)
- General Counsel (Domicile based legal counsel)
- Assistant Secretary (Domicile based captive manager)

Service Providers

- Captive Management Services – Marsh Management Services (recommended)
- Actuary – Dawne Davenport, VP Marsh Captive Solutions (recommended)
- Legal Counsel – Char Hamilton Campbell & Yoshida, Paul Shimomoto (recommended)
- Auditor – Accuity LLP (recommended)
- Banking – Bank of Hawaii (recommended)
- Financial Advice/Investment Consulting – Bank of Hawaii or independent advisor

Corporate By-Laws

The Captive Board would establish the corporate by-laws during the initial incorporation process. Items to be addressed in the By-laws would include finalization of corporate structure, board member terms and replacement procedures, board meeting schedule (must meet at least annually), establishment/authorization of the investment policy and other corporate operating parameters.