ORDER NO. 04-737

ENTERED DEC 10 2004

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UI 233

In the Matter of	)	
	)	ORDER
PACIFICORP	)	
	)	
Application for Approval to Secure Insurance Coverage from Dornoch Risk International Limited, an Affiliate.	)))	

DISPOSITION: APPLICATION APPROVED WITH CONDITIONS

On June 29, 2004, PacifiCorp filed an affiliated interest application pursuant to ORS 757.490, ORS 757.495 and OAR 860-027-0040. PacifiCorp requests authorization from the Commission to engage in business transactions with Dornoch Risk International Limited (Dornoch) for certain insurance coverage. PacifiCorp sought authorization to secure property damage, liability, and workers compensation insurance from Dornoch. A description of the filing and its procedural history is contained in the Staff Report, attached as Appendix A and incorporated by reference.

On November 3, 2004, PacifiCorp filed a motion to bifurcate issues and consented to an extension of the statutory deadline until March 31, 2005. The motion sought to bifurcate the issue of providing liability insurance. PacifiCorp filed a separate motion on November 3, 2004 to withdraw the portion of its application seeking authorization to secure workers compensation insurance through Dornoch. The Commission granted both motions on November 30, 2004, in Order No. 04-697.

Based on a review of the application and the Commission’s records, the Commission finds that the application satisfies applicable statutes and administrative rules. At its Public Meeting on November 23, 2004, the Commission adopted Staff’s recommendation and this written order memorializes the Commission's formal decision.

OPINION

Jurisdiction

ORS 757.005 defines a "public utility" and the Company is a public utility subject to the Commission's jurisdiction.

Affiliation

An affiliated interest relationship exists under ORS 757.015.

Applicable Law

ORS 757.495 requires public utilities to seek approval of contracts with affiliated interests within 90 days after execution of the contract.

ORS 757.495(3) requires the Commission to approve the contract if the Commission finds that the contract is fair and reasonable and not contrary to the public interest. However, the Commission need not determine the reasonableness of all the financial aspects of the contract for ratemaking purposes. The Commission may reserve that issue for a subsequent proceeding.

CONCLUSIONS

1. The Company is a public utility subject to the jurisdiction of the Commission.

2. An affiliated interest relationship exists.

3. The agreement is fair, reasonable, and not contrary to the public interest.

4. The application should be approved, with certain conditions.

ORDER

IT IS ORDERED that the application of PacifiCorp to enter into an affiliated interest transaction with Dornoch Risk International Limited, is approved, subject to certain conditions, as further stated in Appendix A.

Made, entered, and effective ________________________.

BY THE COMMISSION:

____
Becky L. Beier
Commission Secretary

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-014-0095. A copy of any such request must also be served on each party to the proceeding as provided by OAR 860-013-0070(2). A party may appeal this order to a court pursuant to applicable law.

ITEM NO. CA5

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: November 23, 2004

REGULAR ____ **CONSENT** __X__ **EFFECTIVE DATE** ____N/A____

DATE: November 4, 2004

TO: Lee Sparling through Marc Hellman and Rebecca Trujillo

FROM: Michael Dougherty

SUBJECT: PACIFICORP: (Docket No. UI 233) Application for Approval to Secure Insurance Coverage from Dornoch Risk International, an Affiliate.

STAFF RECOMMENDATION:

The Commission should approve the property and overhead (O/H) line property premiums with Dornoch Risk International Limited (Dornoch), an affiliate. Approval of the property and O/H property premiums are subject to the following conditions:

1. PacifiCorp shall provide the Commission access to all books of account, as well as documents, data, and records of PacifiCorp and Dornoch's affiliated interests that pertain to this transaction.

2. PacifiCorp shall meet with Staff on no less than a twice-yearly basis to review Dornoch property and O/H line property coverage issues, including, but not limited to, premium costs, reserves set aside for claims, claims paid out, and insurance adjustor and legal costs associated with these claims.

3. Premiums paid to Dornoch are to replace current ratepayer contributions for deductible/self insurance and not result in additional costs to ratepayers.

4. The Commission reserves the right to review, for reasonableness, all financial aspects of this transaction in any rate proceeding or alternative form of regulation.

5. PacifiCorp shall notify the Commission in advance of any substantive changes to Dornoch premium costs and coverage. Any such change shall be submitted in an application for a supplemental order (or other appropriate format) in this docket. For this Order, substantive change in price is ten percent in any direction.

Further, Staff recommends the Commission approve PacifiCorp's request to bifurcate its Application and postpone until March 2005, its consideration of PacifiCorp's request to secure liability insurance coverage from Dornoch.

DISCUSSION:

PacifiCorp filed this application on June 29, 2004, pursuant to ORS 757.490, ORS 757.495 and OAR 860-027-0040. PacifiCorp and Dornoch are both wholly owned subsidiaries of ScottishPower plc and therefore, are affiliated interests as defined in ORS 757.015.

PacifiCorp requests authorization from the Commission to engage in business transactions with Dornoch for certain insurance coverage. Dornoch's primary focus was to provide property damage, liability and workers' compensation insurance coverage of all or significant portions of the deductibles in PacifiCorp's insurance policies, and to provide coverage for O/H lines that the commercial industry carriers no longer cover. The preliminary estimate of costs for the initial year of premiums was set at $13.05 million.

A captive insurer is a limited purpose, wholly owned subsidiary of an organization usually not in the insurance business. The captive's primary function is insuring some or all of the exposures and risks of its parent or parent's affiliates and other subsidiaries. Dornoch will also provide insurance to ScottishPower's UK operations and Pacific Power Marketing (PPM). Dornoch will not provide insurance to any third party.

Staff's initial review of PacifiCorp's filing raised concerns about costs surrounding liability and workers' compensation premiums. Staff prepared a draft memo discussing its review of the filing and distributed it on September 19, 2004, to PacifiCorp, CUB and ICNU. During the initial review, Staff and PacifiCorp representatives met on several occasions to discuss the Dornoch coverage. The most recent meeting was October 28, 2004, which was also attended by counsel on behalf of ICNU. Based on these meetings, PacifiCorp:

a. Submitted letters on September 13, 2004, and September 27, 2004, requesting waiver of the 90-day statutory period pursuant to ORS 757.495(6) in order to gather more information on liability and workers' compensation premium costs.

b. Submitted a letter to Staff dated November 2, 2004, to eliminate Dornoch's provision of workers' compensation insurance, estimated at $4.8 million per year.

c. Submitted a Motion to Bifurcate Issues, dated November 2, 2004, requesting to bifurcate the liability insurance portion of the Dornoch coverage, estimated at $2.5 million per year, until more information on actual costs could be obtained by PacifiCorp from Dornoch. With respect to the portion of the Affiliated Interest Application relating to liability insurance to be bifurcated under PacifiCorp's motion, PacifiCorp expressly consents to extending until March 31, 2005, the statutorily required period for Commission review of affiliated interest applications.

As a result of PacifiCorp's changes to the application, the cost estimates for the initial year of coverage is set at $5.75 million.

Issues

Staff investigated the following issues:

1. The Insurance Market and PacifiCorp Premium Costs
2. Dornoch Premium Costs and Coverage
3. Public Interest Compliance
4. Records Availability, Audit Provisions and Reporting Requirements

The Insurance Market and PacifiCorp Premium Costs

Due to a hardening market in the insurance industry, PacifiCorp's insurance premium costs have risen dramatically over the past few years. A hard market" begins when insurance profits slide to a point of real losses. As a result, insurance underwriters enact price increases to cover past losses. Hard markets are caused by a variety of reasons including lower investment returns, catastrophic losses, new type of claims and higher payments due to litigation. Table 1 highlights PacifiCorp's increasing insurance costs:

Table 1 – PacifiCorp Premium Costs

Cost	**FY 2002**	**FY 2003**	**FY 2004**	**FY 2005**
Property Insurance Premiums	$2,806,042	$11,413,822	$11,049,783	$11,166,156
O/H lines	Included above	No coverage	No coverage	No coverage
Liability Insurance Premium	$2,756,980	$5,626,135	$7,138,045	$7,752,722
Workers' Compensation Premiums	$629,000	$883,000	$826,000	$664,397
Total Premium Costs	**$6,192,022**	**$17,922,957**	**$19,013,828**	**$19,583,275**

In addition to rising premium costs, PacifiCorp has also experienced a dramatic increase in the property insurance deductible amount. In fiscal year 2002, PacifiCorp's property deductible was $2.25 million per event. In fiscal year 2003, deductible per event increased to $7.5 million, where it currently stands. In PacifiCorp's Oregon general rate case, UE 147, PacifiCorp's revenue requirement increased to account for the increased premium costs and greater self-insurance exposure.

Dornoch Premium Prices and Coverage

The following table highlights premium payments to Dornoch associated with each insurance type:

Table 2 – Estimated Dornoch Premiums

Cover	PacifiCorp Deductible	Dornoch Exposure	2004 Premium
Property	$1.5 million per event	$6 million per event	$2.75 million
O/H lines	$5 million aggregate	$10 million annual aggregate	$3.00 million
Total			**$5.75 million**

Costs will change annually since individual business premiums will be based on a number of factors including the value of assets to be insured, number of employees, risk factors and the business loss experience. Additionally, returns on capital investments by Dornoch may be used to lower future premiums.

The Irish Financial Services Regulatory Authority regulates Dornoch. The Irish Regulator restricts investing of regulated entities to specified types of conservative investments thereby providing a very high likelihood of reliable returns on investments.

For ratemaking treatment of premium costs, PacifiCorp proposes that the Dornoch premiums replace $5.75 million of current ratepayer contributions covering PacifiCorp's high deductibles for property damage.

Public Interest Compliance

In the application, PacifiCorp list the following benefits of doing business with Dornoch.

1. No profit component in premiums.
2. Provides coverage unavailable from industry sources.
3. All capital ($36 - $63 million) for the business is coming from ScottishPower. The income generated by Dornoch on this capital is earmarked to cover operating costs and provide a surplus. (Distributable reserves would be distributed in the form of dividends to ScottishPower.)
4. Premium costs with no profit component will closely track loss experience.
5. Reduced experienced loss volatility.
6. Low operating costs.
7. Potential savings in "Fronting Fees"[1] of $50,000 and possible reductions in self-insurance collateralization costs.
8. Potential for coverage of other activities such as health and disability benefit coverage.

PacifiCorp contends that the presence of a captive insurance company will provide PacifiCorp with an economic, efficient, and realistic alternative to commercial market insurers. Since Dornoch is a regulated insurance organization that will serve as a source

[1] "Fronting" is when PacifiCorp uses an insurance carrier to write the cover for certain risks that PacifiCorp self-insures. The fronting carrier does not retain any of the actual claim exposure.

of deductible buy-down policies, PacifiCorp believes that it will be able to more effectively manage its deductible limits to reduce third party premiums.

Staff closely examined the proposed cost of using Dornoch and compared these costs to five-year self-insurance losses for property coverage and three-year self-insurance losses for O/H line property coverage. In order to do this comparison, Staff used the hypothetical model of what PacifiCorp's insurance costs would have been if the Company was able to conduct business during these years under Dornoch's current terms and conditions.

Property (Not including O/H Line Losses)
Currently, PacifiCorp's property deductible is $7.5 million per event through third-party insurers. Under the proposed coverage with Dornoch, PacifiCorp will still cover (self-insure) $1.5 million of the property deductible and Dornoch will cover the remaining deductible amount of $1.5 million to $7.5 million per event. In other words, $6.0 million per event will be covered by Dornoch for damages over $1.5 million and under $7.5 million. Property premium payments to Dornoch are set at $2.75 million for the first year of coverage.

Staff reviewed five years of PacifiCorp's self-insured property damage. Under the proposed coverage with Dornoch, if the captive insurance were in place, Dornoch's payments to PacifiCorp would have averaged $1.58 million per year. Although no claims would have been covered by Dornoch in fiscal years 2003 and 2004, the high deductible exposes PacifiCorp to considerable risk of major losses.

The following table highlights the costs and savings for the past five years, if the captive insurance arrangement was in place.

Table 3 – Costs/Savings by Using Dornoch for Property Insurance Coverage

Fiscal Year	**Dornoch Premium Costs**	**Dornoch Insurance payments to PacifiCorp**	**Gain / (Loss) to PacifiCorp**
FY 2004	$2,750,000	$0	($2,750,000)
FY 2003	$2,750,000	$0	($2,750,000)
FY 2002	$2,750,000	$601,799	($2,148,201)
FY 2001	$2,750,000	$7,306,890	$4,556,890
FY 2000	$2,750,000	$0	($2,750,000)
Total	**$13,750,000**	**$7,908,689**	**($5,841,311)**

As a result of PacifiCorp's current high property damage deductible, the potential for major losses, and PacifiCorp's proposed replacement of ratepayer contributions with premium costs (no additional costs to ratepayers); Staff recommends that the Commission approve PacifiCorp's request to transact business with Dornoch concerning property insurance at the proposed terms and conditions.

Staff also recommends that PacifiCorp meet with Staff, on no less than a twice-yearly basis, to review Dornoch property coverage issues, including, but not limited to, premium costs, reserves set aside for claims, claims paid out, and insurance adjustor and legal costs associated with these claims.

Overhead Line Property Insurance
For the last three fiscal years, PacifiCorp has been unable to obtain O/H line property insurance. This is prevalent among the industry as major storm losses in the U. S. and Europe has resulted in the withdrawal of reinsurers from the Transmission and Distribution "windstorm" risk market in 2001.[2] Staff was able to substantiate this difficulty in obtaining O/H coverage through contact with other energy insurance providers and with other electric utilities.

For this coverage, PacifiCorp will pay an annual $3.0 million premium and the deductible will be set at $5.0 million aggregate. Dornoch will cover an additional $10 million aggregate beyond the $5.0 million deductible. In other words, PacifiCorp will pay $8.0 million per year between premium and deductibles before Dornoch contributes any claim payments to PacifiCorp. Any losses from $5 million up to $15 million per year would be covered by Dornoch.

This arrangement in terms of deductible and coverage is similar to what PacifiCorp maintained for O/H lines before third party coverage became unavailable. Staff reviewed three years of PacifiCorp's self-insured O/H property damage (since coverage has only been unavailable for three years). Dornoch's average payments to PacifiCorp in the last three years would have been $5.93 million. The following table highlights the savings for the past three years, if the captive insurance arrangement was in place.

Table 4 – Costs/Savings by Using Dornoch for O/H Property Insurance Coverage

Fiscal Year	**Dornoch Premium Costs**	**Dornoch Insurance payments to PacifiCorp**	**Gain / (Loss) to PacifiCorp**
FY 2004	$3,000,000	$10,000,000	$7,000,000
FY 2003	$3,000,000	$4,649,857	$1,649,857
FY 2002	$3,000,000	$3,134,784	$134,784
Total	**$9,000,000**	**$17,784,641**	**$8,784,641**

As a result of the unavailability of coverage, potential for high aggregate costs to O/H lines, and financial benefit to ratepayers, Staff recommends that PacifiCorp receive approval to transact business with Dornoch concerning O/H line property insurance at the proposed terms and conditions.

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[2] Marsh Ltd., Electricity Networks – Coverage Availability letter to ScottishPower dated February 25, 2004.

Staff also recommends that PacifiCorp meet with Staff, on no less than a twice-yearly basis, to review Dornoch O/H line property coverage issues, including, but not limited to, premium costs, reserves set aside for claims, claims paid out, and insurance adjustor and legal costs associated with these claims.

Liability Insurance

As noted above, PacifiCorp submitted a Motion to Bifurcate Issues, dated November 2, 2004, requesting to bifurcate its request for approval of the liability insurance portion of the Dornoch coverage, estimated at $2.5 million per year, until more information on actual costs can be obtained from Dornoch. PacifiCorp anticipates filing supplemental information regarding this request in the February/March 2005 timeframe.

Staff recommends that the Commission approve this request to bifurcate. However, PacifiCorp has only consented to extending the statutory period for Commission review of Affiliated Interest Applications with Dornoch to March 31, 2005. Accordingly, Staff recommends that the Commission condition its approval of PacifiCorp's request to bifurcate on PacifiCorp's agreement to submit to Staff and interested parties additional information regarding the proposed liability insurance no later than March 1, 2005.

Workers' Compensation

Although included in the original application, PacifiCorp submitted a letter to Staff dated November 2, 2004, to eliminate workers' compensation insurance, estimated at $4.8 million per year, from the scope of Dornoch coverage. Per PacifiCorp, as Dornoch matures, PacifiCorp may revisit the possibility of Dornoch providing workers' compensation coverage.

Records Availability, Audit Provisions and Reporting Requirements

The proposed ordering conditions Nos. 1, 2, and 4 provide the necessary records access to PacifiCorp's relevant books and records.

Based on review of the application, Staff concludes the following:

1. The application involves an affiliated interest transaction;
2. The property and O/H line property insurance transactions with Dornoch are fair and reasonable and not contrary to the public interest, with the inclusion of the proposed ordering conditions; and
3. The Commission will have the necessary records access to PacifiCorp's books and records.

Alternative

Because recent published information is indicating that in many areas of insurance the cyclical hard market is beginning to soften, resulting in lower premium costs and lower deductible amounts, the Commission may consider not approving the transactions and maintaining the current method of ratepayer contributions for deductible/self insurance.

Staff does not support this alternative.

PROPOSED COMMISSION MOTION:

The property and O/H property transactions portion of PacifiCorp's UI 233 application to enter into an affiliated transaction with Dornoch Risk International Ltd be approved, subject to the five recommended conditions.

PacifiCorp's request to bifurcate its request for approval of the affiliated interest contract be approved to allow PacifiCorp additional time to obtain further information to address concerns regarding liability insurance coverage by Dornoch; subject to the condition that PacifiCorp will file additional information regarding the liability coverage no later than March 1, 2005.

PM Memo UI 233