NOTES FROM KING STREET

Quarterly Newsletter from Energy Insurance Services, Inc., Volume 2, Issue 2

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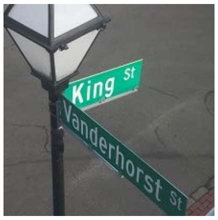

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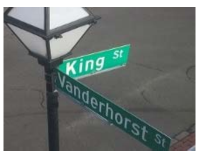
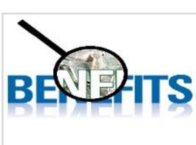


EIS has been named the 2018 Captive of the Year by the Captive Insurance Company Association (CICA). We are pleased to be recognized by CICA and hope to continue the tradition highlighted in the 2018 CICA conference theme of embracing and meeting the challenge of change.

The honor of being named the CICA 2018 Outstanding Captive is a tribute to the participating utility and energy companies that bring dynamic creativity to this facility to solve their unique risk issues. EIS/ECM and EIM thank our Participants for choosing EIS as a trusted partner.

About CICA
CICA was formed in the early 1970's by a handful of U.S. captive owners. Today, as the only domicile-neutral captive insurance association, working with domiciles, captive owners, captive managers, service providers, and regulators, who all come together under the CICA umbrella to advance the captive industry and speak with a common voice. EIS and EIM have been members of this CICA since 2006.

Focus on Benefit Financing



The future of healthcare in the U.S. remains uncertain and, at times, confusing. However, an interesting provision change in a Presidential Executive Order has arisen. The provision relates to the expansion of Association Health Plans (AHPs) allowing employers to now join together across multiple states to pool medical benefits. This will potentially create opportunities for employers with 2 to 5 thousand employees by hopefully adding another option to help control costs while better serving their employees and reinvesting in their own economic growth. A comment period called for by the Employee Benefit Security Division of the Department of Labor closed in early March with over 700 comments submitted. It seems a debate will likely ensue.

One of the strategies to form an AHP is conceivably via a captive facility. EIS is monitoring the debate and how AHPs will develop.

Captive Optima

Reinsurance can be an important element of a captive program. EIS participants utilize reinsurance for a variety of reasons. Traditional reasons, generally cited, include the following:

- Stabilization of profitability
- Provides large limit capacity
- Catastrophe protection
- Supports high growth in premium volume
- Provides help with the underwriting process
- Facilitates withdrawal from a specific risk or line of business

However, the strategy of a captive owner/participant is basically driven by two financial aspects.

- Insurance capacity
- Surplus protection

Insurance capacity helps create limits or additional limits beyond the financial ability or the risk tolerance of the captive owner or participant by line of business. How reinsurance is accessed and applied to execute this strategy varies. EIS participants have deployed reinsurance in several different ways to achieve insurance capacity.

- Facultative reinsurance – Single policy
- Treaty reinsurance – Series of common line of business policies
- Structured multi-line, multi-year contracts

In some instances, facultative reinsurance is used on a 100% pass-through basis. Others use it to enhance captive capacity by quota-sharing or layering with the captive's retained risk. A captive can set up a reinsurance program for a series of policies in a single line of business, such as builder's risk coverage. The reinsurance works like a treaty attaching to each project policy issued by the captive program. Structured reinsurance is typically used across multi-lines to add capacity for an under-capitalized captive program.

Any reinsurance ultimately protects a captive program's surplus. However, the strategy and structure of reinsurance focused on surplus protection has a greater emphasis on the portfolio effect of both underwriting and investment risk. These reinsurance contracts are designed to protect the balance sheet from extreme outliers. The retentions and limits chosen for this strategy typically conform to reinsuring risk in the 85th to 99th percentile range of modeled outcomes.

Whatever the strategy, use or structure, reinsurance can be an effective tool to increase the efficiency of a captive program. We will be drilling down into specific reinsurance strategies and structures in future newsletters.

Operational Considerations – Tax Perspective

Tax Cuts and Jobs Act (TCJA) of December 2017.

Change is the only constant in life (Heraclitus.) This rings especially true when thinking about taxes. EIS participants saw some of the effects of the new tax law at the end of last year (on deferred tax calculations) and additional changes have been reported in 2018 activity. Effective in January 2018 the top rate was reduced to 21% (from 35%) which allowed EIS members to keep a larger share of earnings and increases to surplus.

A short detour is required prior to a further discussion of the change in tax rates. EIS calculates federal taxes due by each MBP (protected cell) as if it were a stand-alone taxpayer. All of the MBPs except one pay taxes using property and casualty (P&C) taxation principles. If a policy issued by an MBP is deemed to be insurance for federal tax purposes, then the MBP may deduct loss reserves as an expense. This results in a significant tax timing benefit for an EIS Participant that would not be available to the Participant if the same reserves were held at the Participant.

Tax rules do not allow for a full deduction for P&C reserves. The reported GAAP reserves must be discounted (decreased) according to IRS rules that vary by line of business and loss year to compensate for imputed investment earnings available on deducted reserves. It should also be noted that each EIS policy must be assessed to determine if it qualifies for this insurance tax treatment. If the insurance activity does not qualify as insurance for tax purposes, the transactions are recognized as deposits for tax purposes and there is no deduction for reserves. This potential benefit relates to the timing of tax payments not to the actual amounts of the deductions. Loss reserves held by a non-P&C tax filer are deducted by the entity when losses are actually paid.

Now we can return to the discussion of the new tax law. The decrease in the tax rate has the effect of reducing the value of the ability to deduct reserves as a P&C tax filer. This does not eliminate this benefit but it does reduce the value of it.

The new law brings with it other technical changes to the way that P&C and life insurers are taxed but the effects of those changes are not as significant as the tax rate reduction. The IRS is currently working to revamp the discount calculation process as mandated by the new law.

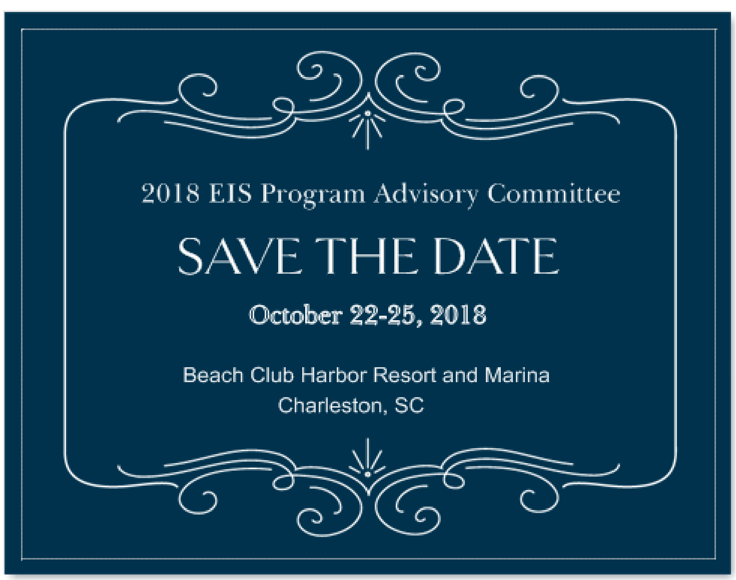
Tax professionals expect that this change will also reduce the value of the reserve deduction to some degree.

Johnson Lambert has worked with EIS for many years as EIS's tax advisers and are available as a training and educational resource about insurance taxation. In addition, this discussion will continue as part of the EIS members' South Carolina meeting in October.

EIS Financials & Operations

Energy Insurance Services, Inc.
Key Financial Data - As of March 31, 2018

	1st Quarter		2018		2017
(In thousands)	2018	2017	Forecast	Budget	Actual
Revenue	$598	$582	$2,412	$2,329	$2,391
Expenses	$436	$459	$1,809	$1,835	$1,768
Surplus	$3,062	$2,628	$3,409	$3,324	$2,934



Helpful Links:

General Captive Information | **South Carolina Captive Information**

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Energy Insurance Services, Inc.
409 King Street, Suite 201
Charleston, SC 29403
www.eimltd.com/EIS

Contact Us:

Randy Martin rmartin@eimltd.com
Taniyka Ragland tragland@eimltd.com