

# Warranty Challenge Brings Alternative Solution

*Can the captive solution be a successful risk financing strategy alternative for turbine owners?*

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**I**t cannot be disputed that the wind energy industry is growing. The number of turbines, their size and the amount of energy produced all add to the increased amount of risk involved in wind power.

Turbine owners have five areas of risk management insurance coverage:

- general liability;
- property;
- business income;
- equipment breakdown; and
- manufacturer's warranty.

Although equipment breakdown insurance can continue for as long as the owner would like, a manufacturer's warranty typically lasts for only five years. As a rule, the equipment breakdown coverage does not cover faulty, inadequate or defective design, specifications, workmanship, repair, and hidden or latent defects. The ending of this warranty leaves owners in a uniquely vulnerable position, but at this point, what are the options?

These short-lived manufacturers' warranties have sent many turbine owners in search of a cost-efficient way to insure their turbines. Currently, if the turbine begins experiencing design malfunctions after the expiration of the warranty, owners are left to absorb the expense themselves.

Although most owners would like to continue coverage for manufac-

turing malfunctions, renewing their warranty is not an option. These problems can lower the productivity of the turbine or halt energy production altogether – with a risk so large, protection is a must.

A solution to this warranty problem is moving turbine owners in the direction of captive insurance. Similar to wind energy, captive insurance is nontraditional, but can offer owners the security they need at a cost they can afford.

Part of the problem with traditional U.S.-domiciled insurance companies is that it is difficult to get warranty coverage after the manufacturer's warranty is exhausted. In recent years, turbine engineering has accelerated from small kilowatt-producing units to towering multi-megawatt giants.

This is a great opportunity for the owners and investors because bigger units equate to larger revenue streams. But warranty insurance is one major drawback to the improved units. These new turbines lack the actuarial data and track records that insurance companies need to feel comfortable generating a rate or premium structure.

## **What is a captive?**

The captive strategy brings turbine owners together to form their own insurance company. The captive

participants own the right to their underwriting and investment income. The funds that would cover excess warranty payments, under a captive structure, would be available to cover manufacturer's defects. Formally, premium dollars paid to traditional insurance brought little return – even in a good year with minimal losses. A captive helps members turn their premiums into a profit center by offering control.

The captive solution could involve having stable, successful risk financing solutions that offer a unique insurance alternative to turbine owners.

Wind energy captive groups could range from a single parent captive – where there is only one member in the captive – to multiple member captives where there could be as many as 20 members per captive. The amount of risk involved determines which group the captive participants join and the number of participants in each group.

## **Captive benefits**

One of the most appealing benefits of a captive is the ability to reclaim underwriting profit. Joining a captive is the best alternative option to traditional insurance because it's an opportunity for turbine owners to earn money by reinvesting in their turbines. Since members own the stock, they have the ability to earn back 60% to 70% of

their premium. As a captive owner, when there are lower losses, the money vested is kept.

Typically, traditional insurance works on a 60/40 ratio, which means 60% of insurance costs are allocated for potential losses while the remaining 40% is spent on fixed costs, such as the insurance company's overhead and operations costs. After losses, the remaining 60% becomes revenue to the insurance company. With a captive, the unused funds are invested and ultimately the owners gain the underwriting profit and investment income.

It is recognized that in the traditional insurance market, once the warranty expires most owners have few options. Since the life expectancy of a new-age turbine is unknown, it is dangerous to leave the warranty's umbrella of safety.

The technology is completely different in new turbines, and there is not a long enough history to predict their longevity. This increased uncertainty is another reason to consider becoming a captive company before the manufacturer's warranty is expired.

For a long time traditional insurance has been very black and white – there has been very little room for choice or differentiation. The captive concept was built upon new ideas. Jeff Matney, vice president with the captive consulting company Innovative Captive Strategies Inc., accentuates the freedom of choice that a captive offers its members.

“What a captive boils down to is control. Captive owners have control over every aspect of their insurance, from who becomes a member to how much and what types of risk the group wants to as-

sume,” says Matney. “Groups that are financially sound going into the captive, and are able to maintain a safe and stable company, are better able to profit from their insurance.”

Another benefit of a captive is the ability for owners to network with one another. In the past, captive members have found that the relationships they've formed with other members have been helpful when making business decisions.

“Most of the time, if you're making any kind of change to your business, someone in your captive has been there before,” says Matney. “Owners find their partners to be great resources when looking for advice or suggestions on how to make their company more successful in the industry.”

Committing to captive insurance is a way to protect your company's assets and advance your wind energy business toward its goals. A candidate must show good loss history for the past five years, as well as demonstrate financial stability. Captive companies must encourage collective accountability and be committed to long-term partnerships. Beyond that, a desire for control and stability, as well as an entrepreneurial personality, are characteristics usually present in business owners who have been successful with captive insurance.

### **Captive success**

Seven years ago, Lisa Heimer's business, Woodharbor Doors and Cabinetry, joined Capstone, an Innovative Captive Strategies Inc. captive.

“Our initial reason for joining was the ability to manage our risk,” says Heimer. “It wasn't just about the premium dollar, but it was the opportunity to, in the long run, see a financial reward coming back to the company.”

Woodharbor Doors and Cabinetry is a custom manufacturer – this makes employee safety a challenge and risk management pivotal to the success of the company. “We are constantly looking for ways to improve,” says Heimer. “And it's nice to be rewarded for that. In years prior to being a captive member, if we'd had a good year, we didn't get any money back and it just dictated our carrier renewal. Captives explore each individual risk driven by our company's experience.”

“Another benefit to being a captive member is the added control of claims management and having those added characteristics you can't get from the standard market,” she adds.

Although a cabinetry company and a wind-energy business differ in risk management concerns, the concept of captive success within the two industries is the same. Where there are employee safety claims in cabinetry, there are warranty losses in wind energy. Captives have the ability to successfully span different risk management needs because of the consistency of their structure.

The captive concept has become a new option for this modern energy source. Wind energy is changing the way we look at power, just as captives are changing the way we look at risk management insurance. **SNP**

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