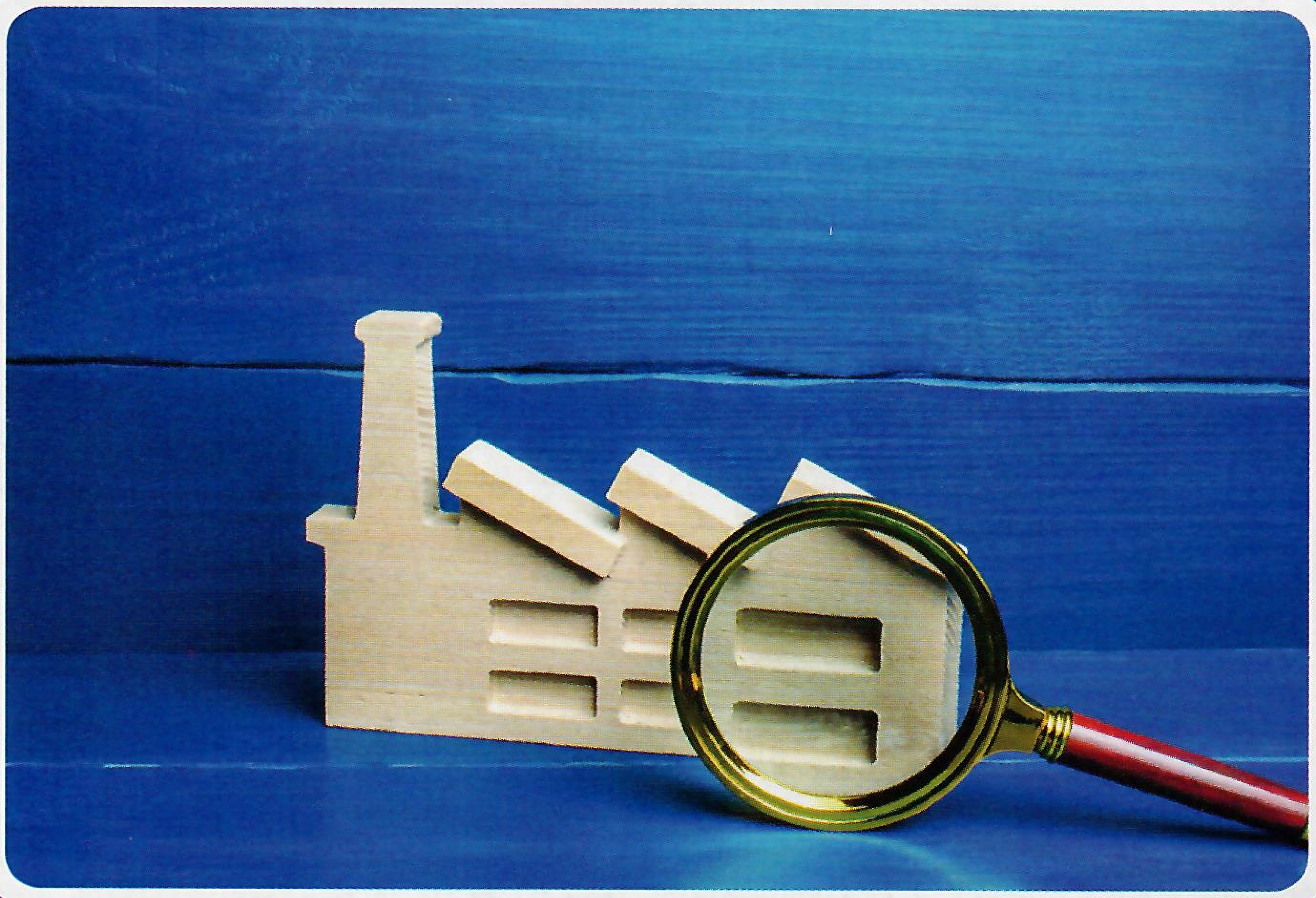
The Value of Property Appraisals:

A Perspective on Public Water Sector Asset Valuation

By Mark T. Hessel



Property insurance coverage for water and wastewater utilities can present many challenges — for insurer and insured, alike. Accurate coverage begins with proper recording and valuation of the underlying exposures; however, property typically found in utility operations can be difficult for underwriters to comprehend and frequently large gaps exist between the level of understanding possessed by the insurer and the insured's comprehension of policy language. Bridging that gap is essential for effectively insuring these assets.

Utility concerns have several options for procuring property coverage. Understanding the differences between traditional insurers and risk pooling organizations is an important first step. Actual policy language in either scenario can be complex — especially for utilities where significant portions of exposures can reside below grade level.

Since their introduction into the insurance markets in the early 1980s, risk sharing pools have provided a viable alternative to the traditional insurance company. Current census data suggests there are some 89,000 unique units of local government throughout the United States today (many either directly or indirectly operating utilities). The Association of Governmental Risk Pools (AGRIP) has recently estimated that over 84 percent of these actively participate in risk pools for a variety of insurance needs, including property coverage. Many of these tend to be smaller or mid-sized entities lacking depth or experience in managing their risks, possessing limited or no full-time risk management staff.

On the flip side of this are corporate insurance carriers. Several are uniquely specialized and experienced in providing coverages to a wide range of public sector clients. Frequently, their insureds are larger with more sophisticated (and often full-time) risk management capabilities. Many of the largest utility districts in the United States are protected by traditional insurers, or they opt for self-insurance alternatives. Regardless of where the insurance originates, property coverage for water and wastewater exposures creates an interesting and complex landscape.

What's So Tough About This?

Sticking with the theme of complexity, we'll dive a little deeper into specific challenges you may face.

Valuation Challenges

If you're even remotely familiar with property valuation techniques and tools, you'll agree there are several options now available to appraisal professionals, brokers/agents, insurers, etc. CoreLogic's suite of online and print resources is just one example. Their Marshall Valuation Service has been an industry-standard for decades in both commercial and residential markets. With over 150 individual occupancies to select from, the possibilities seem endless – city halls; courthouses; office occupancies; etc. What you won't find, however, is a model for a water treatment plant or a clarifier tank. Fact is, there are no credible subscription-based resources available in today's property valuation world for water utilities and related structures. Development of reliable, proprietary data has become essential for professionals seeking to accurately estimate these risks.

Underwriting Challenges

Ask an experienced underwriter how comfortable they feel when an insured adds a $20 million plant expansion to the Statement of Values… how much of that project replaced what was previously there? How much of that total is truly insurable? What portion should be allocated to Building, Contents/BPP, or other property designations? How much should be excluded from coverage (if any)? Are there various construction classifications involved for proper rating? Insurance-to-value ("ITV") is an issue all insurers face, and in the utility markets the challenges compound.

Property underwriters routinely struggle to grasp exactly what it is they are being asked to insure. Without proper documentation the process breaks down.

Policy Exclusions

Typical commercial policy language provides for certain portions of an exposure to be excluded from coverage. These issues quickly become muddied in a utility environment. Individual structures often contain high-value, process-related equipment and frequently a significant percentage of an overall plant resides below ground. Interpreting the difference between covered and excluded property requires attention to detail and related experience. Consider an elevated water storage tank. A relatively high percentage of construction costs will rest in below ground foundations, footings, piles, etc. — sometimes in the range of 15-20 percent. When seismic considerations are present, perhaps more. Should those be included / excluded in a proper valuation? Another exposure worth mentioning is in-plant piping and electrical duct bank (typically defined as the piping see& electrical conduits between structures and not within them). Some consider these excluded property, however, the values can easily exceed 10 percent of the plant total insured value ("TIV"). Reconciling these issues pre-appraisal (and pre-loss!) is imperative to avoid under- or over-insurance concerns.

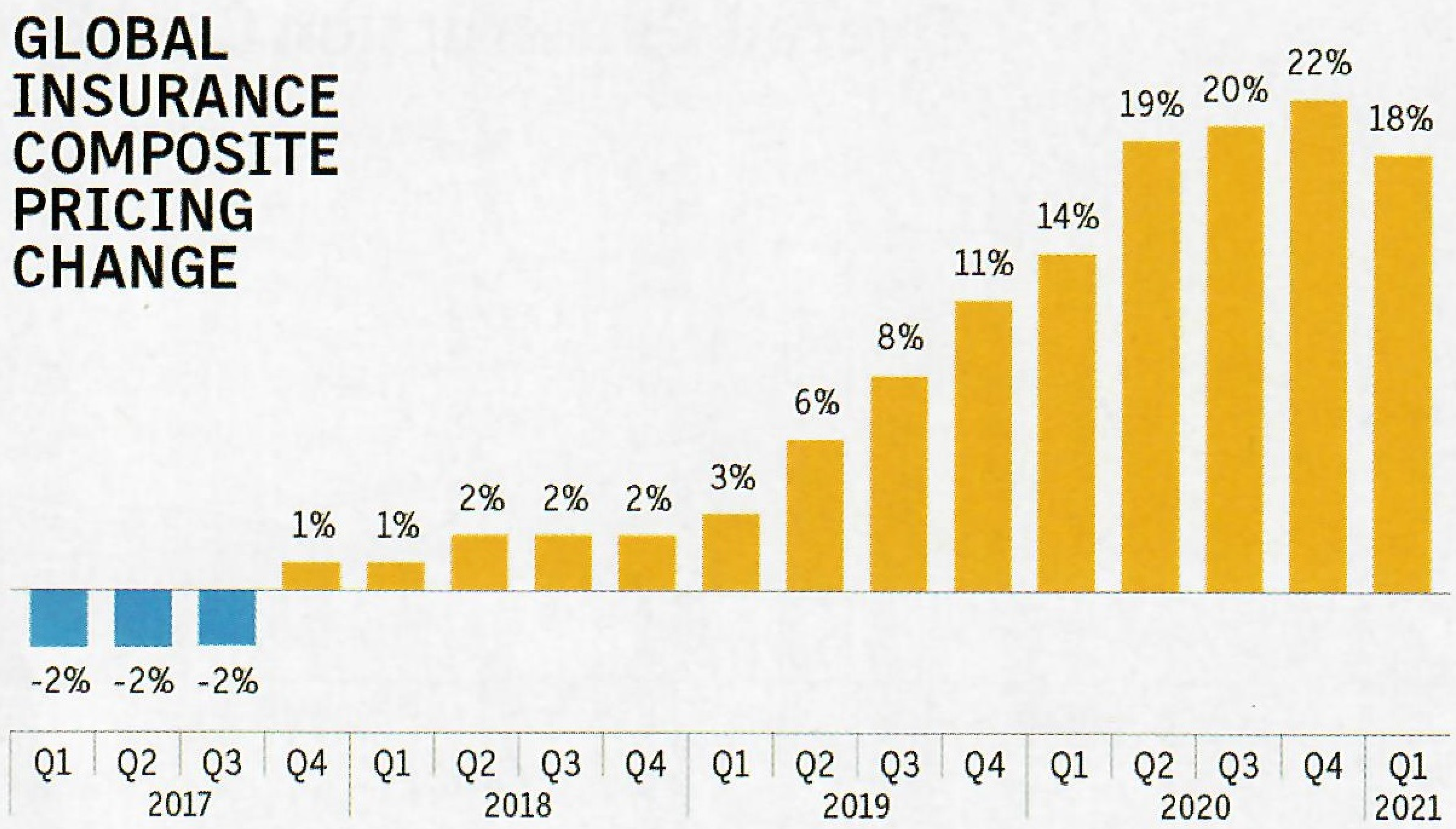


Figure 1 – Global insurance composite pricing change. Source: Marsh.

Property Insurance in 2021 (and Beyond!)

To say we're in a "hard" market would be a major understatement. Multiple sources report we've just passed through our 14th consecutive quarter of significant rate increases (see figure 1). Today's insurers are reeling from record-setting catastrophic ("CAT") losses and extreme weather patterns show no sign of diminishing anytime soon. For most, the days of comfortable "blanket" coverage are gone and the carriers, pools and reinsurers are pressing for very detailed property data. Without it, you stand to pay an extra premium for your insurance.

If you live near the Atlantic Coast, it won't surprise you that 2020 was a record hurricane year with 30 named storms; 12 of them making U.S. landfall. The previous record (28) had stood for more than 100 years. Couple that with recent wildfires on the West Coast and violent convective storms across the Heartland, and no one is immune from the resulting spikes in rates and insurance costs. The following map shows a slice of estimated 2020 property loss data from a recent RMS report:

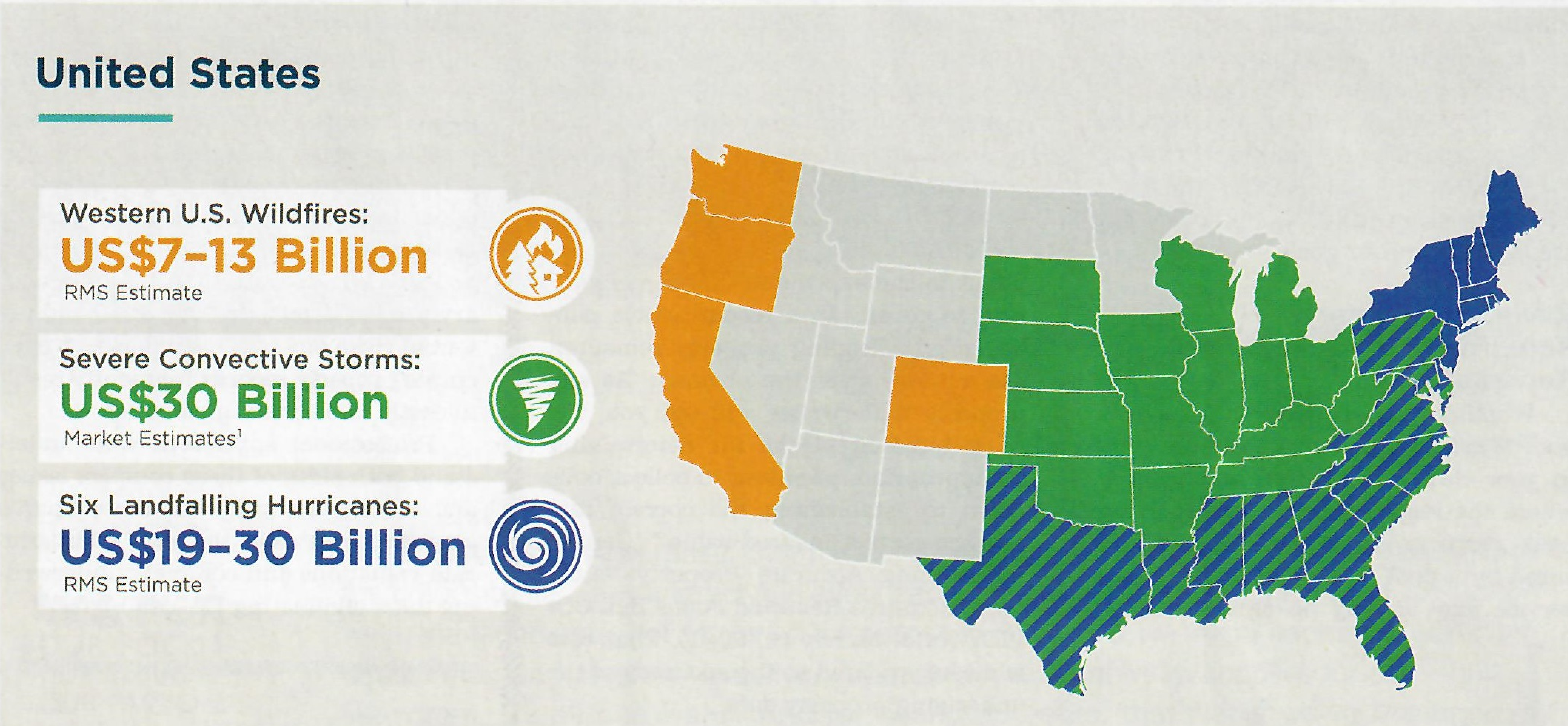
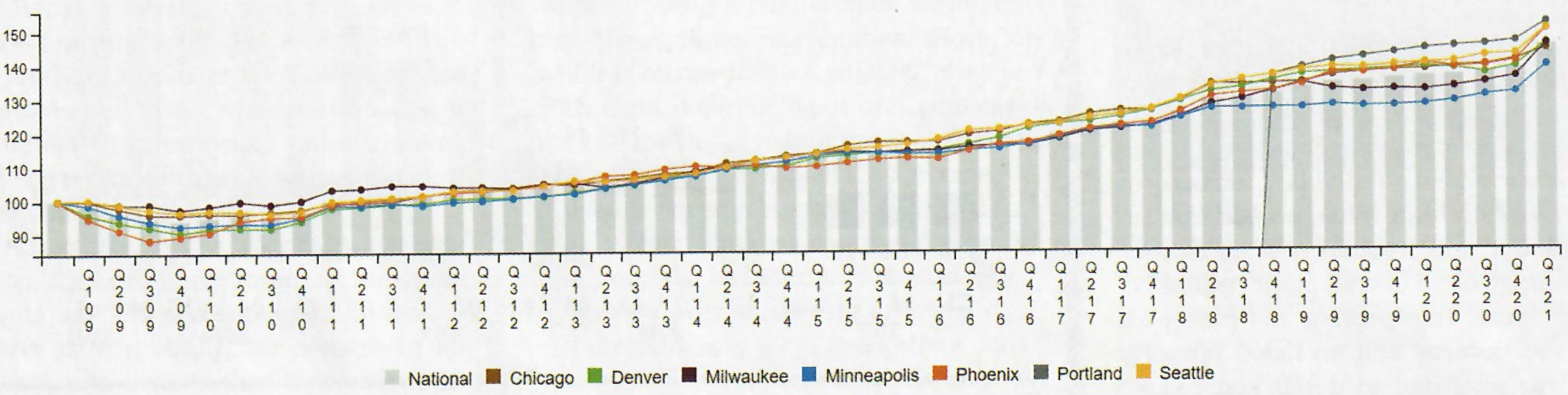


Figure 2 – Major event loss estimates around the globe. Source: Risk Management Solutions, Inc. (RMS) 2020 Catastrophe Review Executive Summary.

Overall Construction Cost Index Q1 2021

(JANUARY 2009 = 100)



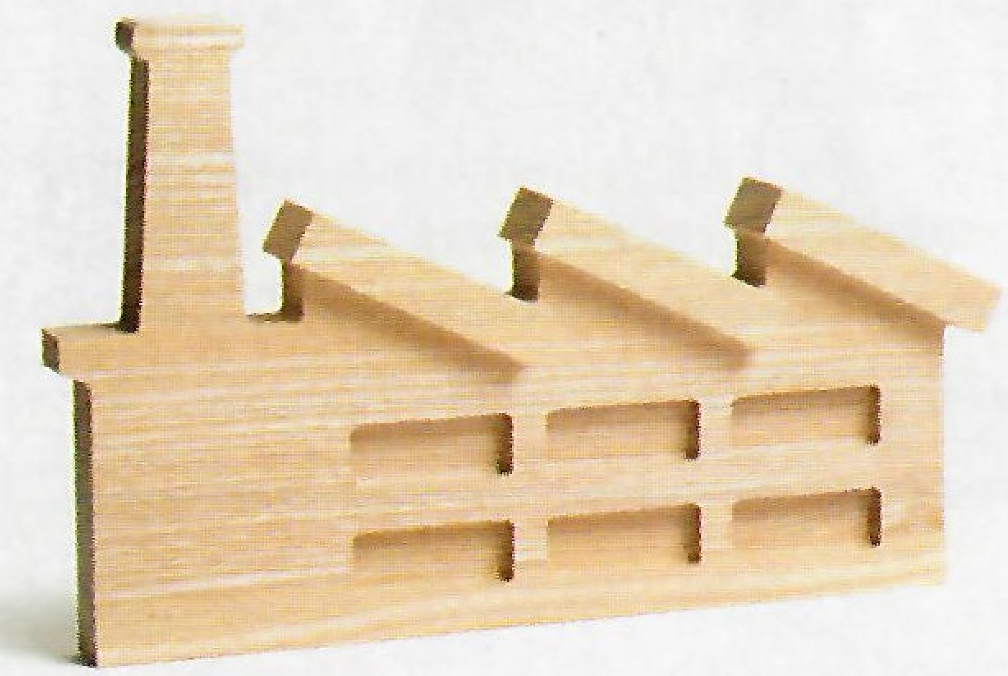
Overall construction cost index Q1 2021. Source: Mortenson Construction.

Be Proactive

We have laid out just a few of issues and challenges, so now what? Wait for the next renewal period with your fingers crossed? With the experience of more than $100 billion in annual valuations for public entity clients, our team will tell you most utilities have great data to get them started – accurate, as-built plans; asset management databases; well organized facilities management teams; vested personnel; documented capital improvement programs, and more. All these ingredients assist in preparing an accurate property schedule for valuation and submission for that annual insurance renewal. Bridging the gap between insurer and insured and preparing an accurate property schedule with all the required property characteristics are commonly the missing links. The following steps outline recommended best practices for accomplishing your goals.

Review All Property Requirements with Insurance Representatives

Whether you are insured by a risk pool or in traditional markets, start within your own organization and identify where the responsibilities for reporting your property schedules exists. If insured by a pool, some level of appraisal service may already be provided, however, that does not mean the quality of your data is as accurate as it can be. If an onsite appraisal has not been performed recently, identify all potential stakeholders (internal and external) in the process and get them involved in initial discussions. Frequently, gaps exist in the data – specific property information that can assist underwriters should be identified and outlined so it can be captured in an accurate, consistent manner. Standard "COPE" (Construction, Occupancy, Protection and Exposure) fields should all be complete and up to date. In today's environment, insurers, underwriters and reinsures are requesting additional secondary characteristics for insured property. For larger property portfolios / programs, underwriting data is pushed upstream into CAT loss models, resulting in conclusions which directly impact the cost of insurance.



When property data is incomplete and/or inaccurate, insurers are less confident in the exposures they're committing to cover. In a recent article published by a leading property reinsurer, the authors state the obvious: "As any property underwriter will tell you, the basic building blocks for determining an appropriate premium to collect boils down to establishing the correct rate and the correct insured value." (GenRe, Maintaining Accurate Property Valuations Requires Renewed Focus in a COVID World. March 10, 2021). That rate is directly related to the accuracy of the underlying property data.

Commit to Reasonable Cycles for Onsite Appraisal

Most governmental entities throughout the United States have their property schedules reviewed and (re)appraised in roughly 3- to 7-year cycles. Many factors contribute to where you may fall in that range, but if it has been more than 7 or 8 years since your last insurance appraisal, you may be rolling the dice with your property coverage. Don't think so? Using Mortenson's Construction Cost Index from Q1, 2021 (above) we can see overall construction costs have risen at least 40-50 percent in the last 10 years or so (depending on market). It should also be noted that current COVID-19 considerations have only exacerbated this trend.

Final Thoughts

We have all heard the old adage, "garbage in, garbage out," right? No truer words have ever been spoken as relates to today's property underwriting processes. Water and wastewater treatment exposures present truly unique challenges for underwriters. Add to that an increased appetite for accurate COPE and secondary property underwriting data, and potential risks emerge. Incomplete or inaccurate property records frequently result in costly underwriting penalties.

Professional appraisers who understand both sides of these complex issues and are experienced with these unique exposures can close the gaps with accurate valuations and complete underwriting data, eliminating ITV concerns.

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