

Q. *State your name and business address.*

A. Jim Smego, ARM
Department of Natural Resources
Financial Management Division
P.O. Box 47041
Olympia, WA 98504-7041

Q. *Where are you employed and what is your job title?*

A. I am employed with the Financial Management Division. My job title is Risk Manager.

Q. *What is your educational background?*

A. B.S. Resource Conservation, University of Montana, 1976
M.S. Forest Economics, Colorado State University, 1979
Associate in Risk Management, Insurance Institute of America, 1996
Intermediate Risk Management Certificate, Public Risk Management Association, 1997
General Insurance Program, Insurance Institute of America, 1998

Q. *Summarize your professional experience.*

A. Employed by DNR since 1979.
Sept. 1979 to Dec. 1988 Economist
Dec. 1988 to Dec. 1994 Financial Manager
Dec. 1994 to Present Risk Manager

As risk manager I conduct risk analysis, review loss control efforts, and analyze and recommend options to manage/mitigate loss exposures for department operations, programs, and activities. I am responsible for developing and implementing loss control and risk financing plans, which includes insurance and indemnity/hold harmless contract requirements. Specifically, I participated in the Right-of-Way program review conducted through the Resource Planning and Asset Management (RPAM) Division and developed the insurance and indemnification/hold harmless contract requirements currently in use for upland easements. I also assisted Aquatic Resources Division in the development of identical contract language for their easements and leases.

Q. What is the subject matter of your testimony?

A. The focus of my testimony is on the risk management aspects of the Olympic Pipeline Co. (OPL) proposal for a cross state pipeline and the potential impacts on state managed lands (upland and aquatic). The potential impacts I will address are the liability and related financial consequences of an incident (loss) occurring on or along the pipeline during construction and/or operation while traversing state managed lands. These concerns are addressed in the department's easement contracts (upland and aquatic) in the form of insurance and indemnification/hold harmless clauses. My area of expertise are these contractual risk transfer provisions and ensuring adequate protection for state assets and resources, including financial interests.

Q. Have you read Olympic Pipeline's Application No 96-1, specifically Section 1.3

Assurances, which includes subsection 1.3.1, Statement of Financial Responsibility, and subsection 1.3.2, Insurance?

A. Yes

Q. *How is risk management integrated into decisions to grant or deny requests for easement interests or access through state managed lands (upland and aquatic)?*

R. The risk management aspects of granting or denying easement or access requests across department managed lands (upland and aquatic) are incorporated into each contract agreement entered by the department and another party through the insurance and indemnification/hold harmless clauses. These are both mandatory clauses for each contract situation, though the amount of insurance coverage requested by the department, and some of the coverages, can vary depending on the nature of activities being carried out on the land and the relative risk/loss exposure associated with those activities.

Q. *What risk management issues are raised by the Olympic Pipeline's Cross Cascade Pipeline proposal?*

A. There are two primary risk management issues raised by this proposal. The first is third party or premises liability, and the second is pollution liability. Both of these types of loss exposures could occur at any time during construction of the pipeline or during operation of the pipeline following construction.

Q. *In general, what type of indemnification/hold harmless agreement does DNR require for*

an easement/right-of-way document across state managed lands (upland or aquatic)?

A. Contractual (easement) agreements between the department and another party for use of or access through state managed lands (upland or aquatic) require an intermediate form of hold harmless and indemnity agreement or clause. An intermediate form of indemnity or hold harmless clause protects the department against actual claim and legal costs incurred due to actual and alleged negligence on the part of the contractor or department. There are three reasons why this would be an appropriate contract condition (requirement) in granting OPL access across department managed lands (upland and aquatic). First, the department (state) should be indemnified for uses of the lands they manage for negligent acts/damages caused by OPL or their employees, agents, contractors and subcontractors. Second, the department (state) has no control over these lands once permitted uses occur, or control of the actions of OPL and its employees, agents, contractors and subcontractors. Third, the department (state) is perceived as “deep pockets” and will be named in any legal action should an incident or other loss event occur during construction or operation of the pipeline.

Q. *Does the insurance certificate in the application (App. No. 96-1) provide sufficient information to evaluate coverages, exclusions and available limits of liability?*

A. No. Certificates of insurance provide only a basic representation of the insurance policies, coverages, and limits of liability in effect at the time a certificate is requested. Given the size and scope of the cross Cascade pipeline project as outlined in App. No. 96-1, the coverages and limits of liability listed on the certificate do not provide sufficient information to validate if the coverages are adequate to protect the state’s interests and assets (financial and otherwise). The only other way to ensure adequate safeguards are

available for liability protection and coverage would be to read the individual insurance policies listed on the certificate.

Q. *What types of insurance coverage, exclusions, and limits of liability does DNR generally require when it grants interests in state land (upland and aquatic)?*

R. The department requires the following insurance policies and coverages for easements and related agreements with other parties. First, commercial general liability (CGL) insurance with a minimum \$1 million per occurrence and \$2 million annual aggregate coverage limits. These limits will increase as the amount of risk/loss exposure increases.

Second, the department requires Business Auto Policy insurance with a minimum \$1 million each accident for bodily injury and property damage related to the use of vehicles on the property. Third, the department requires contractors to comply with all applicable worker's compensation statutes and in addition requires employer's liability (stop gap) insurance with minimum \$1 million coverage limits. This is intended to cover the gaps between worker's compensation (Title 51 RCW) and CGL insurance. These three liability insurance policies are standard requirements in all easement and lease contracts. In some situations the department may require additional insurance policies. Examples include, (a) Builder's Risk insurance if major building construction activity is to occur on site (this would not be applicable to pipeline construction activity), (b) Property insurance if the department leased a building or other structure on site, (c) Pollution Legal Liability insurance or similar policy to provide protection from pollution related losses, and (d) Longshore and Harbor Worker's insurance which is federally mandated for employers to compensate employees engaged in maritime employment on

navigable waters or on adjoining facilities used in loading, unloading or building of vessels.

Q. *What additional information should OPL supply to provide adequate financial protection to the state as evidenced by DNR's liability insurance requirements for granting an easement/right-of-way across state managed lands (upland or aquatic)?*

A. First, OPL appears to have more coverage for first party property exposures than for third party liability exposures, including coverage for pollution events. This provides protection for OPL's equipment and assets, while the third party liability and pollution liability exposures of most concern to DNR may not be provided adequate coverage in the event of a major loss event. In order to more fully assess this risk exposure, a summary of OPL's risk analysis which shows that the liability coverage is sufficient to cover the maximum probable liability loss of any incident and aggregate losses on an annualized basis, is needed for review.

Second, OPL must disclose whether any annual aggregate limits are on the excess liability policy and whether these are impaired. This is important because if the annual aggregate limits are impaired and there are outstanding claims, then there would effectively be less coverage available for any new claims.

Third, whether the liability policies provide coverage for contractual liability. When contractual liability coverage is provided, CGL and other insurance will pay for many losses transferred in a hold harmless or indemnity agreement.

Fourth, whether employer's liability coverage is included in the umbrella policies.

This covers the gaps between worker's compensation (Title 51 RCW) and Commercial

General Liability insurance.

Five, a review of liability policies and/or endorsements which describe pollution coverages for “sudden and accidental seepage and pollution on a named perils/time element ‘blended’ basis” is needed. The information provided should include whether coverage will apply in event pollution is sudden and accidental and/or if injury or damage is caused by continuous and repeated exposure to pollutants. This information is needed to assess whether the individual liability policies provide or exclude coverage for a given pollution event during construction and operation of the pipeline.

Six, specifically what are the “named perils” as mentioned in the insurance certificate? This information is needed to assess whether certain perils are excluded for coverage during construction and operation of the pipeline.

Seven, OPL must provide a complete copy of the umbrella liability insurance policies to evaluate and review. Based on the information provided on the certificate, these policies appear to be “manuscript” forms and the extent of coverages and exclusions cannot be determined without reviewing the policy forms.

Eight, the financial viability of the companies listed on the insurance certificate needs to be evaluated so that it can be determined if sufficient reserves and assets are in place to cover a major loss event.

Nine, the department requires being named specifically as an additional insured on the certificate of insurance. This requires the insurer, (a) provide for defense if the department is named in a lawsuit, (b) to pay for defense costs along with providing liability insurance, (c) to not dismiss the obligations to DNR or a third party claimant due

to bankruptcy of the named insured (OPL), and (d) cannot subrogate against DNR, even if the department were legally liable for the loss.

Ten, the certificate of insurance states that the policies are on a claims made basis, and shows the excess liability, umbrella form has \$24 million per occurrence and a \$24 million aggregate. The statement of financial responsibility (1.3.1) states that OPL has excess liability coverage of \$49 million per occurrence. Further information is needed to evaluate these liability coverages. These statements are in apparent conflict and reviewing the individual policies will clarify these coverages and liability limits.

Eleven, whether business auto/vehicle liability coverage is part of the \$1 million self-insured retention, and whether OPL's umbrella policies cover auto exposures? There is no evidence of coverage for vehicle liability exposures on either the certificate of insurance or on the statement of financial responsibility (subsection 1.3.1). This loss exposure needs to be addressed.

I certify and declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct to the best of my knowledge and belief.

SIGNED AT _____, Washington on this ____ day of February 1999.

Jim Smego