



Energy Market Review:
At Full Stretch?

June 2007

Willis

The energy insurance market has a reputation for volatility. As more capacity joins the market and loss records continue to remain relatively benign, pressure is being brought to bear on insurers to abandon existing underwriting stances and compete more vigorously for premium income and market share. But is this a market that is unaware of the dangers it currently faces? Are the circumstances really similar to the last truly soft market of the late 1990s? Plenty has been written on the subject of "intelligent capital" and the degree of underwriting sophistication that now characterises the energy market. We are constantly being told that if rates decline beyond a certain point, insurers will not hesitate to withdraw. Can we therefore assume that the current market softening will shortly come to an end? Is this a market that is truly at full stretch?



In this issue...

Energy loss record continues to improve

The Willis Energy Loss Database continues to show few, if any, losses of real significance following the hurricane season of 2005. Whilst 2007 has seen two major refinery incidents in the US, the highest loss recorded by our database for upstream exposures so far this year is a mere US\$18 million. Furthermore, figures from Lloyd's suggest that the upstream claims deterioration from hurricanes Katrina and Rita has finally begun to stabilise. However, it is still early days for 2007 and the market now awaits the onset of the Atlantic hurricane season with its usual apprehension.

Commercial market capacity at its highest levels since 9/11

This improvement in the energy loss record has coincided with commercial market capacity levels reaching their highest levels since the dramatic change in the market climate following 9/11. More choices are now open to the buyer as both the new entrants and the existing market begin to compete more aggressively for premium income and market share.

Regionalisation of the downstream sector continues

In our special feature, we show how today's competitive pressures are being reinforced by the growing trend towards the deployment of capacity by global insurers on a regional basis, particularly in the downstream sector. There are signs that regional insurers may now even be competing with their global counterparts in order to build up their energy portfolios.

OIL at a crossroads

Following the recent withdrawal of a further 12 members from Oil Insurance Company (OIL), and in response to rating agency concerns, we anticipate that the mutual may need to consider further changes in its underwriting philosophy such as prospective underwriting, differential rating and coverage restructuring.

Little change in leadership panels, policy wordings or retention levels

The current market softening has largely been restricted to pricing reductions rather than extensions to coverage or reduced retention levels, as the leading underwriting figures in both the upstream and downstream market remain broadly the same. At this stage we see no evidence of any new underwriters offering buyers any radical differences to the products on offer.

Markets are not yet at full stretch as competition intensifies

Despite the absence of any new underwriting initiatives, we believe that rating levels will have to soften a good deal further before insurers begin to exit this market in any significant numbers. Insurer rhetoric may suggest that this market is too sophisticated to allow rates to fall much further; the simple laws of supply and demand, together with increasing investment income returns, suggest otherwise. Whilst the activities of energy underwriters are now monitored more closely than ever before, we do not believe it will be difficult for insurers to demonstrate to their management or their regulators that this portfolio, particularly for non-natural catastrophe risks, can still be underwritten profitably at considerably lower rating levels than those imposed in the aftermath of the 2005 Atlantic windstorm season.

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Foreword

Insurance markets are growing upward and outward. In this issue of Energy Market Review, we will take you on our usual tour of energy markets and give you our views of their condition as the June and July renewal and Gulf hurricane seasons approach. But our main focus is on the continuing and accelerating emergence of market access and capacity outside of London and the corporate headquarters of the leading insurers. So even while the number of insurers has declined since 9/11, the points of access to them, their growing sophistication, and the drive by clients to get the best deal possible customised for their risks are generating more and more competition among markets and choice for clients, especially for downstream business.

This means placements are getting more complex and increasingly global. For brokers, the challenge is to understand and connect the dots for and with our clients, and do so on a global basis. Relationships built over decades and the trust that comes with them among brokers, clients and their market colleagues still count heavily. But most clients, while appreciating the value of this trust, now demand that relationships do not compromise the efficiency of placements. They want solutions that tap into this growing global marketplace.

At the same time, clients are demanding increasing levels of service, and regulators continue their drive to ensure transparency and fairness in all dealings with insurance markets. In this environment, brokers have tremendous opportunities to add value by navigating our clients through this complexity to the best risk management solutions. But we also continue to face important choices that will define our DNA for all to see. One such choice is the emergence of so-called supplemental compensation plans. Our Chairman, Joe Plumeri, has made clear to our clients that we view the current proposals as having the same inherent conflicts that existed under contingent commissions and we will

not accept them. It is one of the many action points we have taken that demonstrate our commitment to put our clients first and at the center of everything we do.

We hope you enjoy this issue and, as always, we invite you to contact anyone on the Willis Energy global team or e-mail willisenergy@willis.com with comments and questions.

Phillip Ellis, Chairman, Willis Energy

Introduction

Welcome to our Energy Market Review for mid-2007. Nothing in the energy market arena remains the same for long, and although there is little to report by way of major losses or dramatic changes in the underwriting environment, we do believe that two major market developments that we highlight in this Review will be of interest to our readers.

The first is that for the first time since the late 1990s, and certainly since the formation of the Lloyd's Franchise Board, the market is facing increasingly soft trading conditions. Despite the gargantuan claims attributable to hurricanes Katrina and Rita, the market as a whole appears to have recovered remarkably well from its ordeal of 2004/05. In virtually all lines of coverage, opportunities for buyers to secure improved terms and conditions provide a welcome alternative to the turbulent climate and rate increases of the last two years.

Most observers would agree that the essential differences between the current market and its late 1990s predecessor are that it is more professional, more sophisticated, more regulated and smaller in terms of actual numbers of insurers. Others would point out that the current softening process originated from much higher overall rating levels than those of the mid 1990s, while in general terms the coverage restrictions and retention levels imposed in the aftermath of 9/11 continue to work to this market's advantage.

So the besetting question for buyers is this: just how far will rating levels drop before key players in this sophisticated market withdraw their capacity and the next upswing of the market cycle begins? Should one accept a commonly-held insurer view that the market is already "at full stretch" with a significant withdrawal of capacity imminent should prices fall still further? In this Review, our objective has been to give the reader as clear a picture as possible of how much "stretch" there is in each of our market sectors as the next Atlantic windstorm season approaches. We have

done this by indicating, at the end of each sector update, one of four alternative "stretch factors" which can be defined as follows:

No Discernable Stretch:

The market has only just begun to soften in certain areas; however current rating levels are sufficiently robust to ensure that profits will be maintained, although probably not at the same rates of return.

Slightly Stretched:

The softening process has been evident for a little while but further reductions can be expected in the future.

Significantly Stretched:

The market has softened to the point whereby further rate reductions may lead to some capacity withdrawals.

Fully Stretched:

Any further premium reductions will result in a significant withdrawal of capacity and a turnaround in market conditions.

These forecasts are naturally subject to the crucial proviso that there are no catastrophic losses during 2007 which in themselves may be sufficient to bring about a change in market conditions.

The second major market development is the gradual fragmentation of the downstream insurance market caused by global insurers' deployment of underwriting authority in key areas of the world such as the Middle East, Latin America and Asia Pacific regions. We have devoted our feature article to this development, which examines the main issues arising from the deployment of regional capital, including the advantages and disadvantages of underwriting on a regional basis, and whether or not buyers now need to adapt their marketing strategies and relationships with key insurers.

As ever, we hope you enjoy reading this Review and if you have any observations at all we would be delighted if you would let us know by e-mailing us at willisenergy@willis.com

The rise of the regional market – the beginning of the end for global energy underwriting?

“We do not have any fixed guidelines as to where business is placed. It is up to the client where they want to access AIG.”

David S. Hawksby,
President, Energy Division,
American International Underwriters

One of the most significant developments in the energy market in recent years has been the deployment of underwriting capacity on a regionalised rather than a centralised basis, particularly in the downstream sector. As overall trading conditions continue to soften, these changes in global market dynamics are having a profound impact on buyers’ relationships with insurers, often causing a reassessment of marketing strategies for their insurance programmes.

We have therefore dedicated our main feature to a thorough examination of the delegation of underwriting authority and the trend towards regional underwriting in various parts of the world – particularly in the downstream sector.

We spoke to two well-known energy underwriters, David Hawksby of AIG, who leads their global downstream energy underwriting team, and Brad Berg of ACE’s Bahrain office, who will shortly be running ACE’s new energy underwriting hub in the Middle East. Both underwriters were kind enough to provide us with their own thoughts as to the various merits or otherwise of both the global and regional underwriting perspectives, and were keen to emphasise the merits of each side of the debate. We have reproduced some of the key observations that they made to us in the following pages on this feature.

“We won’t undercut existing placements, but we’ll see some shift of Middle East business into the regional office from other markets.”

Brad J. Berg, Chief Underwriting Officer
(O&P, Tech Lines) ACE Overseas General
(Middle East and North Africa)

Introduction – in the beginning, there was a subscription market...

From its formation in the mid-20th century, the energy insurance market, both upstream and downstream, has generally been described as a subscription market. The main features of such a market can be summarised as follows:

- Values are high, requiring the participation of a panel of separate insurers in order for sufficient coverage to be purchased.
- Risks are generally specific to the industry sector and of a sophisticated nature, so their evaluation requires specific expertise.
- Participating insurers can be identified either as leading insurers, where there is sufficient underwriting expertise to enable the insurer to provide the terms and conditions relating to the placement, or as following insurers, that do not possess such expertise but are nevertheless willing to underwrite in the sector on the basis of following the terms and conditions set by the leaders.

However, in recent years the expansion of the major composite insurers, such as AIG, Ace, Allianz, Axis, Liberty, SCOR, XL and Zurich into specific territories with a view to increasing the spread and value of their energy portfolio has now enabled them to absorb a significant proportion of their energy business without reference to the existing global subscription market; in other words, they have full underwriting authority to accept risks using their own skill and judgement.

So how has this been achieved and, perhaps more importantly, what effect is it now having on the buyer of energy insurance?

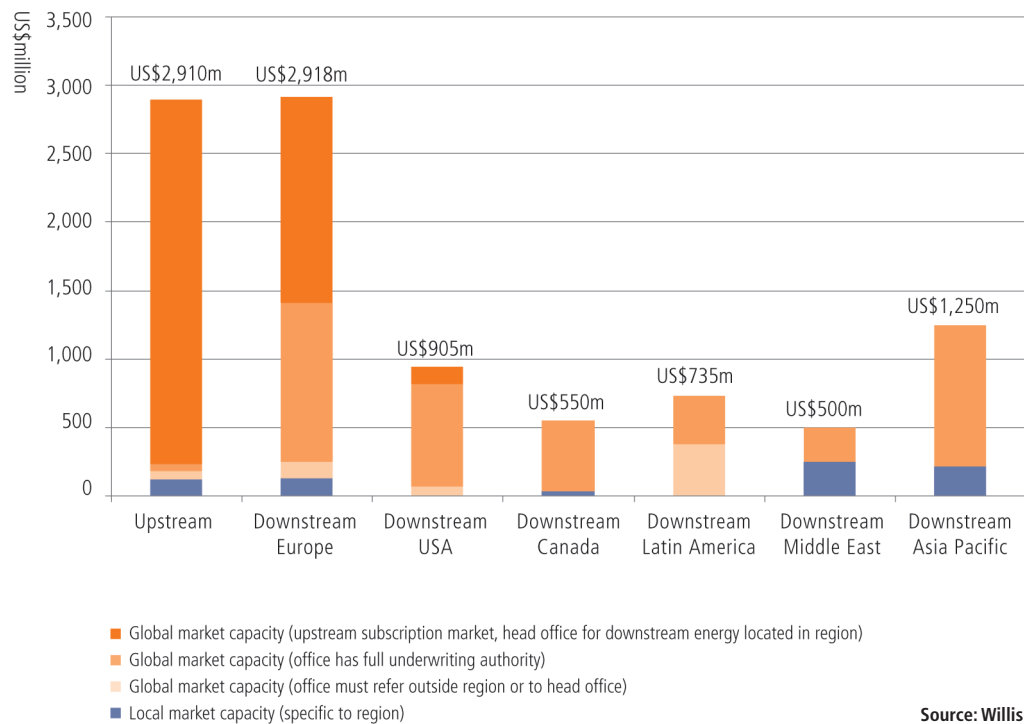
"Clients appreciate the service levels of the existing ACE companies in the region and perceive them to be superior to our competitors. Furthermore, brokers appreciate our sophisticated approach to the reinsurance placement of major risks in the international market."

Brad J. Berg

Perhaps the best way of answering this is to demonstrate the dynamics of regional development and then outline how this is manifesting itself in different regions around the world, before analysing whether or not the global

dynamics have fundamentally altered. We have done this in some detail on pages 11 to 20 of this Review following this feature (please note that underwriting capacity for all our charts excludes natural catastrophe risks).

The situation today



"There is no doubt we will see larger percentage growth, albeit from a lower base, from our regional offices than the London hub."

David S. Hawksby

From our summary chart of the data contained on pages 15 to 20, which shows the amount and nature of energy market capacity deployed regionally in 2007, we can draw several conclusions:

- The upstream market remains a subscription market, and is heavily reliant on leadership from London and Continental Europe. However, this may be about to change as more underwriting expertise is deployed in key regions such as South East Asia and the Middle East, where upstream activity is expected to increase sharply.
- With policy limits in excess of US\$ 2 billion for downstream risks now being purchased by some major buyers, there is insufficient regional capacity to cover the largest risks, even in the Asia Pacific region (US\$ 1.25 billion)
- However, there is now sufficient regional capacity in virtually every region to cover the policy limits required for most downstream energy programmes.

“Insurance can be viewed as a people business, and where there’s history the London operation will certainly retain a lot of major accounts domiciled around the world. However I must stress that our regional offices are just as important. Expanding economies in different parts of the world reinforces our need for local offices, and as they grow, business relationships will mature and we may see some shift of business out of London.”

David S. Hawksby

“I would say confidence in the risk is maybe more important than the overall relationship, in that if you know the account intimately you have the ability to better underwrite the risk and commit resources to it.”

Brad J. Berg

- Most regional insurers specialising in downstream energy now have full underwriting authority to write business on behalf of their head office.
- Buyers should therefore think carefully about how they wish to develop their relationships with key insurers, both at a regional and at a global level.

The rise of regional capacity – two schools of thought

As of May 2007, there are two schools of thought within the energy insurance market as to what implications the developments in regional underwriting will really mean in terms of overall market dynamics. Put simply, these can be distilled as follows:

- 1) **There is very little truly regional underwriting for downstream energy risks.** Virtually all the capacity deployed in the regions is provided by global insurers, who are tightly controlled by their head offices. What is apparently separate regional capacity is in fact simply global capacity delegated to experts working in the region.
- 2) **Regional underwriters are rapidly becoming autonomous** in terms of their underwriting authority and are consequently driven by regional rather than global considerations. Because of this, most buyers no longer need to rely on the global market and should focus on growing their relationships in their own region.

What are the arguments for and against these two schools of thought? From our own point of view, we feel that the debate surrounding each of these views can be summarised as follows:

The global school

- London is the historic centre of excellence for onshore energy risks. Therefore the expertise, direction, philosophy will come from London or other global market centres such as New York or Zurich.
- Downstream energy placements are often complicated, especially in a hard market. In addition, more and more placements will need global capacity as values increase.
- Key downstream energy clients already have extensive London market relationships, and these partnerships provide consistency and continuity. Should the leading underwriter on a given programme be regionally located, the buyers’ access to the global market may not be as smooth as if the programme were lead off by a globally recognised underwriter.
- Most large insurers make sure that it is their head office product managers who really call the tune on underwriting guidelines. These specialists establish the underwriting philosophy and essential criteria, such as risk analysis, pricing and deductible levels. Furthermore, the product managers also understand the various dynamics of different regions and business environments.
- Head energy offices tend to still have their claims and engineering expertise located centrally.
- To date, there has been no real transfer of global business to the regions so far. One commonly held view is that regional underwriters are deployed simply to attract business that would not otherwise have found its way to the global market.

“We want to grow our business, not to switch it from office to office just for the sake of it. So we will maintain existing business in London while our regional offices develop their own opportunities.”

David S. Hawksby

“We are not just a capacity facilitator. We have full underwriting capacity and capability, we are leading construction projects located in the Middle East and we feel that the market will soon understand and conform to lead terms coming out of our region.”

Brad J. Berg

The regional school

- Placing a programme in the regional market is easier, cheaper and more efficient.
- Regional underwriters are closer to the buyer's exposures and overall risk profile. They therefore have a more detailed understanding of the risks involved and are therefore generally in a better position to offer more competitive terms than the global market. Confidence in the buyer's risk is therefore more easily established.
- Regional capacity is now often sufficient to absorb all but the largest risks. Some companies are actively transferring business from London to the regions.
- Regional underwriters are gradually assuming more responsibility and autonomy as levels of expertise increase. It can also only be a matter of time before levels of claims and engineering expertise increase in line with that of the underwriters as regional expansion continues.
- Regional underwriting is already a reality in most non-specialty lines of business. In many key areas around the world, the infrastructure to accommodate more energy underwriting expertise is already in place.
- The recent deployment of a “hub and spoke” philosophy by global insurers – i.e. the establishment of regional energy “hub” offices with direct relationships with all the insurer's offices located in the region – allows insurers to construct regional portfolios that are sufficiently robust to enable professional energy underwriting to be conducted at a regional level.

Our own view – regional power is growing, but ignore global underwriters at your peril...

Our own findings show that regional underwriters are increasingly taking control of the majority of downstream energy risks located in their region, especially in the Middle East and Asia Pacific regions.

All the signs are that they increasingly intend to absorb business traditionally written by the overall heads of energy global underwriting. Indeed, in some major insurers we understand that regional underwriters are now happy to compete against their head offices in order to ensure that firm orders are directed towards their own regional business units rather than to London or elsewhere.

So if their capacity needs can now be met locally, do energy buyers need to maintain relationships with the global market? As usual, the reality is that not everything in the energy insurance market is exactly as it appears, and we would advise most buyers to continue to take the global market into account in developing their marketing strategies. With project values increasing at an alarming pace, and oil prices still at historically high levels, our chart shows that there is still insufficient capacity at local level to meet the requirements of a large segment of the energy industry.

Furthermore, we believe that a series of losses, such as the North American refinery losses of 2001, could provoke a re-centralisation of major insurers' global underwriting strategies.

We should also point out that not every energy underwriter located away from the global market is completely free to underwrite energy business as he or she deems fit. So perhaps in most instances the global underwriter still holds the balance of power.

The rise of the regional market – the beginning of the end for global energy underwriting? continued

“Insurance is a people business. We often meet with our clients, we are only an hour away from many of the major oil and petrochemical facilities over in Saudi Arabia, we have gotten to know those risk managers and we can be on their doorstep every day.”

Brad J. Berg

Be that as it may, buyers are left facing the challenge of negotiating what is rapidly becoming a minefield of competing regional and global industry priorities in the energy sector. Get these specific intricacies wrong, and the chances of optimising today’s attractive market climate are all but eliminated. A fine balance needs to be struck with each insurer, in order to maintain contact with the global underwriter whilst developing new relationships with the upcoming regional experts.

As 2007 unfolds, we believe that it will be the buyer who achieves the optimum mix between the various global and regional markets that stands to gain most from the rise of regional underwriting.

“London is and probably will remain the dominant Energy underwriting office for AIG. However, growth in our regional offices, like Singapore, has been tremendous over the last five years.”

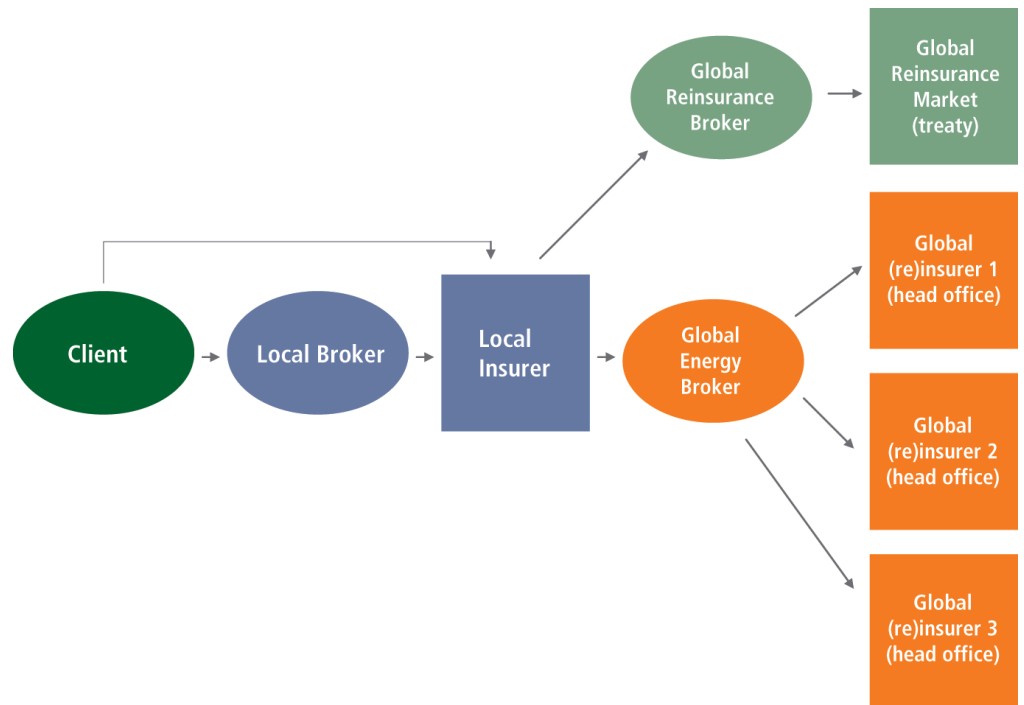
David S. Hawksby



The Four Stages of Regional Market Development

Regional markets around the world are in a range of evolutionary stages.

Stage 1 – local capacity only located in region

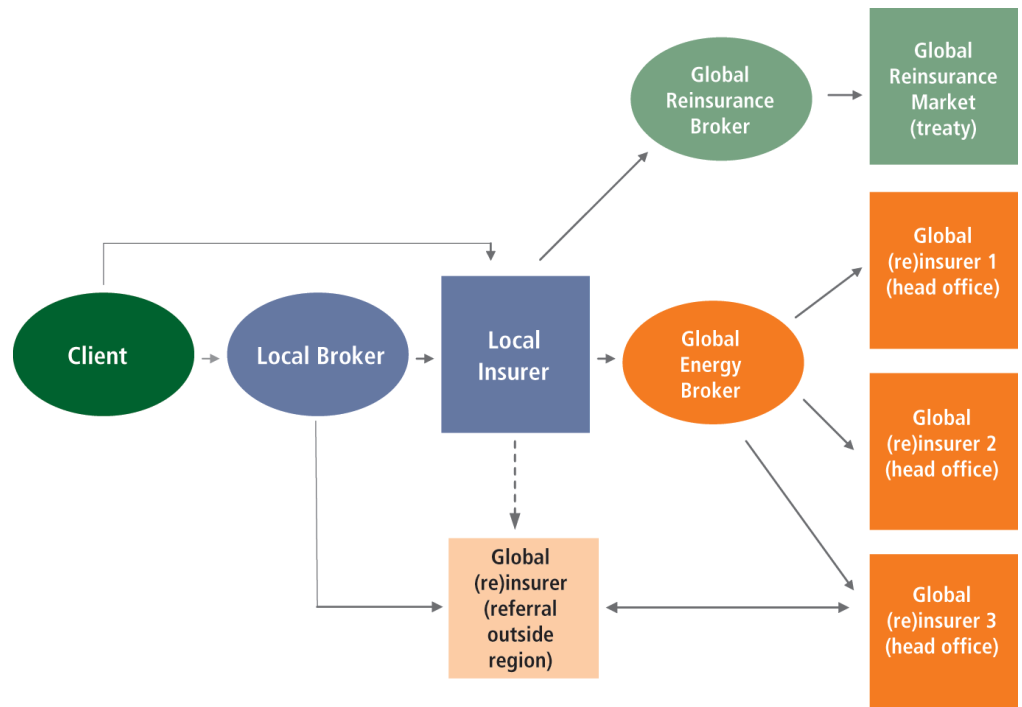


At Stage 1, the buyer is dependent on the global market in the absence of any local energy capacity. Whether the buyer accesses this capacity directly through a local insurer or through a local broker, the key player in this dynamic is the global energy

insurance broker, who has responsibility for accessing all underwriting security, with the exception of local insurers' retentions, which tend to be marginal compared to the remainder of the capacity required.

The rise of the regional market – the beginning of the end for global energy underwriting? continued

Stage 2 – additional global capacity located in region

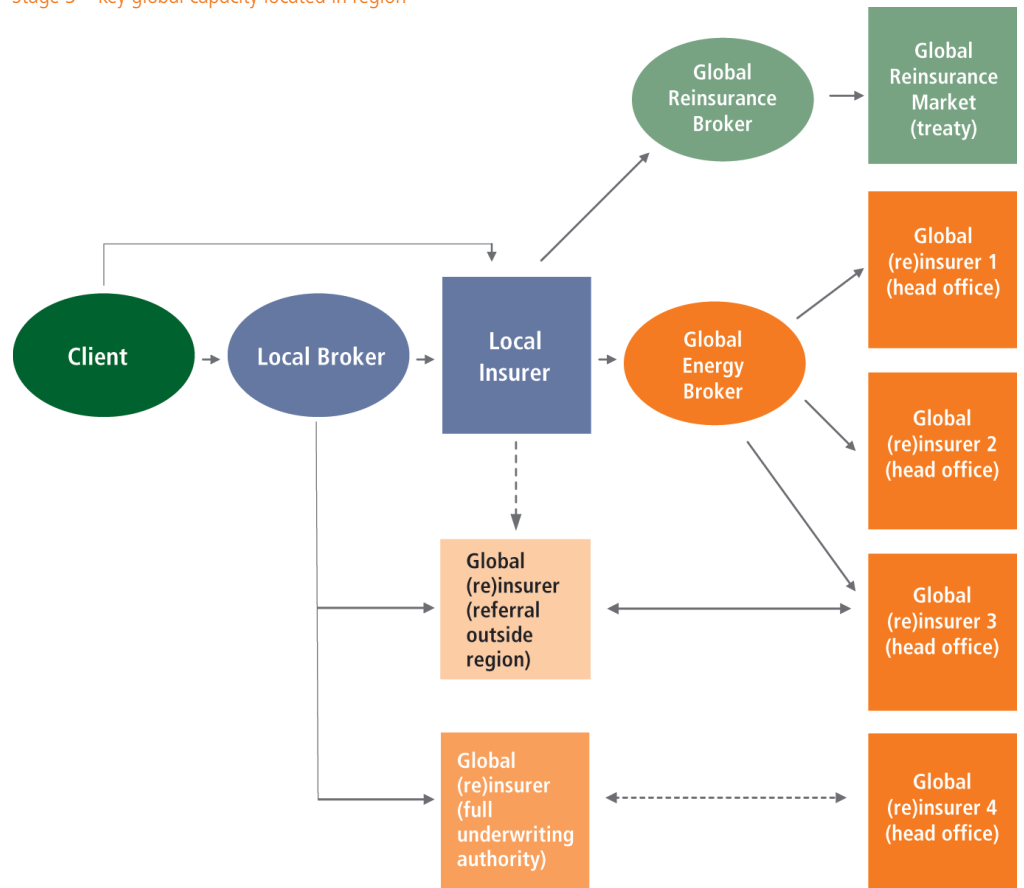


At Stage 2, global insurers can deploy their capacity locally without having a specialist energy underwriter located in the region. The office of the global insurer is used as a capacity facilitator and to obtain a local licence so that the global insurer is able not only to access business that would not otherwise have been seen but is also provided with an opportunity to underwrite preferred business (either on a direct basis or as a reinsurance of the local market) on a more

competitive basis than might otherwise have been the case. However, the local office has no underwriting authority and effectively acts as a “gateway” for the head office.

This additional capacity should not therefore technically be termed regional, but its creation is often a necessary prerequisite to the deployment of energy-specific resources to the region.

Stage 3 – key global capacity located in region



Stage 3 is when the local office of the global insurer has full underwriting authority. Now the dynamics of the regional market begin to change significantly. In the above scenario, the regional office of the global insurer can make a decision to deploy the company's capacity without direct referral to the head office. The deployment of an energy expert within the regional office is also often accompanied by claims and engineering expertise.

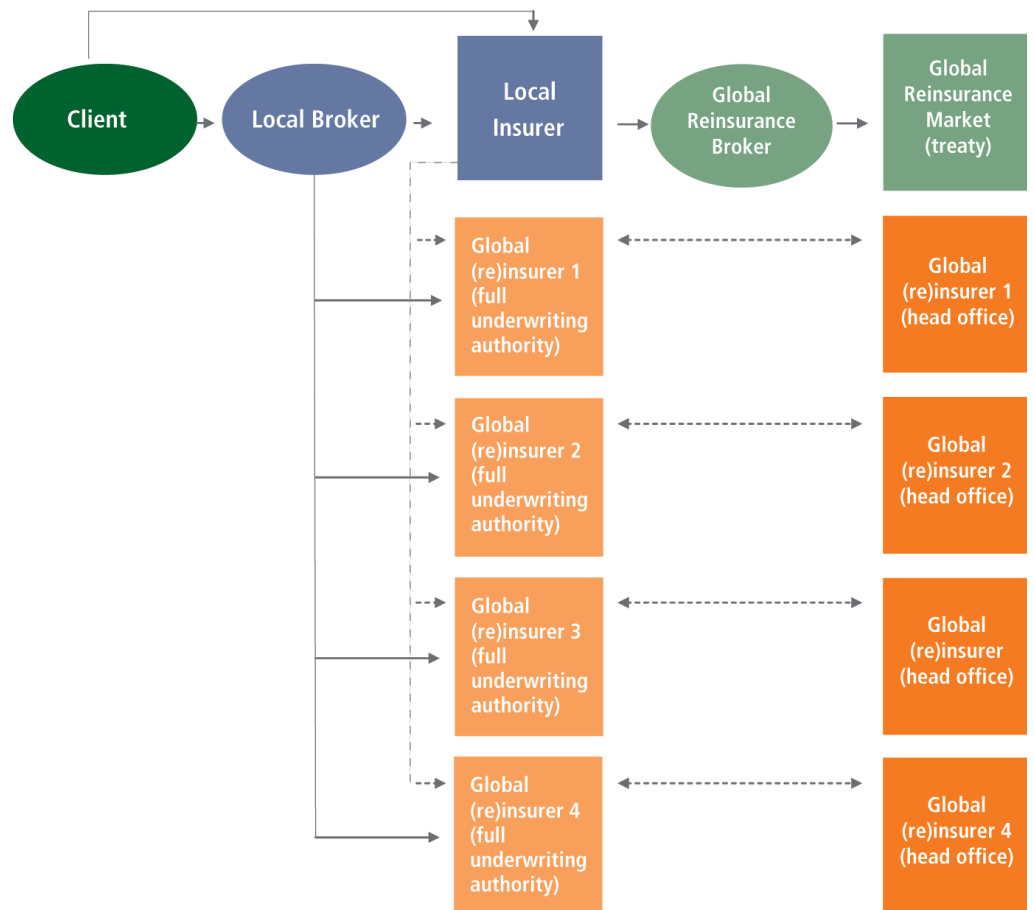
This fundamentally alters the roles of both the global and the local broker, as it is now the local broker's responsibility to negotiate with a significant portion of the available insurance capacity, whereas in both

previous scenarios this role exclusively belonged to the global broker. The broker must therefore ensure that the marketing efforts in both the regional and global markets are co-ordinated effectively, which in effect means that the broker's energy-specific resources must also be deployed in both locations.

It should of course be pointed out that there is still considerable communication between the head office and its regional offices, and in most instances the head office continues to play a substantial and vital role in the development and implementation of underwriting philosophy.

The rise of the regional market – the beginning of the end for global energy underwriting? continued

Stage 4 – all required capacity located in region



At Stage 4, all the required capacity to complete a placement is available within the region, so that the local broker has no need to access the global insurance market. The individual insurers in the region all consider the risk from a position of “leadership” – there is no following market and each local underwriter is an expert in the energy field.

With the dynamics having fully shifted from the global to the regional market, the key considerations for such a market may well prove to be regional as well as industry-related. It is also possible that the insurer’s head office will perhaps play less of a role in

formulating underwriting strategies. In any event, such a market is indeed a far cry from the energy insurance market’s historical subscription market structure.

Should this scenario eventually materialise across the world, energy insurance buyers with exposures in different locations may find that the terms and conditions obtainable in one region may differ quite significantly from those obtainable in another.

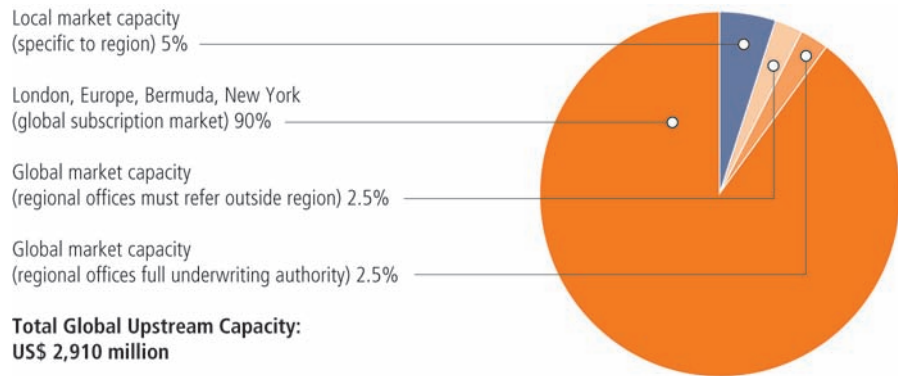
So how has regional underwriting developed in the various parts of the world? Is there really sufficient capacity available to enable buyers to ignore the global market?



Today's Regional Markets

Let's take a look at some energy markets and estimate the extent of the regional underwriting capacity available.

Towards a regionalised energy insurance market? – Upstream

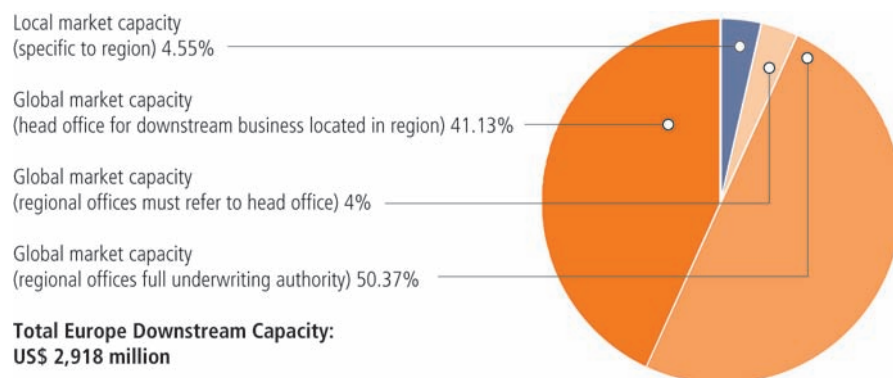


After careful analysis we have decided to treat the upstream market as a whole because, as our chart suggests, this remains by and large a global subscription market. Indeed, we estimate that approximately 90% of the worldwide capacity for upstream risks resides with global energy insurers located in London, Europe, Bermuda and New York.

With its unique risks, policy wordings, rating structures and interdependencies, it is perhaps unsurprising that the upstream sector has not yet developed any meaningful regional underwriting capabilities. However, the genesis of an upstream market in Singapore may signal that change is in the air.

In Singapore, London-trained upstream specialists such as Chris Wildee of Chaucer, Bobby Herring of Catlin, Rowan Davies of Liberty, Matt Allen of Watkins and Alex Lumby of Ascot have established the basis for a market for upstream risks from the Asia Pacific region. Other than Singapore, there is a limited market for upstream risks in the Middle East but very little, if any, regional capacity in other parts of the world.

Towards a regionalised energy insurance market? – Downstream Europe



The downstream energy market in Europe is split into four main regions, each of which has the capability and capacity to provide lead terms.

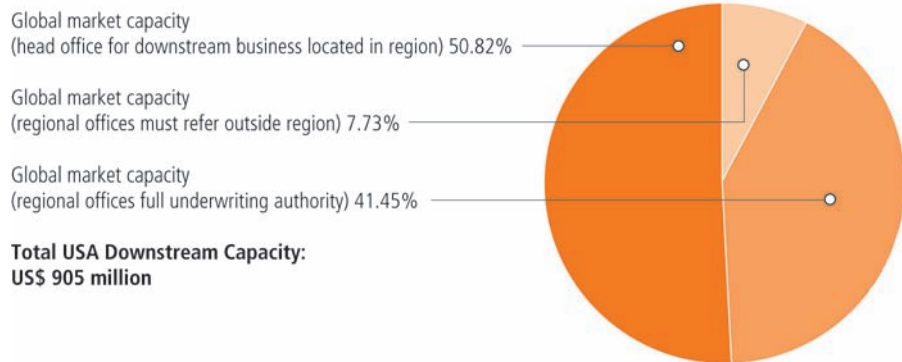
- London:** The London energy market remains the leading provider of capacity to the downstream sector. With excess of US\$ 2 billion of capacity available in the city, it is home to the downstream energy broking community, with a significant number of brokers demonstrating specific expertise in this sector.
- Germany:** Several major facultative carriers from Germany can provide global capacity for downstream energy risks.
- France:** The key international insurers writing from Paris are SCOR and Paris Re (formerly Axa), both of whom are able to provide lead terms for international business.
- Switzerland:** Switzerland is growing significantly as a market place for downstream energy. The traditional heavyweights of Swiss Re and Zurich Re have been joined by new players such as Infrassure and Glacier Re.

Having representation for downstream energy business within their European retail network has been a clearly

stated major European carrier objective. Generally the offices do not technically set terms or conditions alone but rather in consultation with their counterparts in the energy hubs located in London, Munich, Zurich and Paris. The recent expansion of the European Union has been followed by a similar expansion of these carriers into the region and there is now a general desire from them to write this business on a direct basis where possible, or alternatively through their local offices. However, major state reinsurers in countries such as Poland still have a significant role to play and provide vital capacity for domestic placements, although to date there is little sign of regional expansion from these companies.

The presence of the London market inevitably masks the development of regional underwriting in formulating capacity statistics for the European region. Western European buyers clearly have little need for a specifically regional market, but there are at least signs of specific regional capabilities in Eastern Europe and the Former Soviet Union. Whether these insurers will be able to form their own distinct identity separated from the global market in the years ahead is uncertain. What is clear is that for the moment, European downstream energy buyers overwhelmingly rely on the global market capacity conveniently located in their region, although some buyers may express a preference for utilising capacity from their own country.

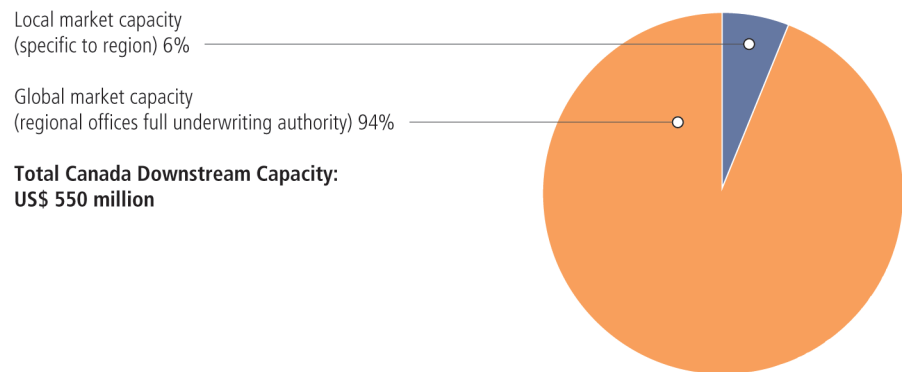
Towards a regionalised energy insurance market? – Downstream USA (mainly Houston)



In the last edition of the Energy Market Review, we commented on the evolution of Houston as a major centre for downstream energy risks. In particular, we stated that Houston is now a market not only for smaller risks that require lower limits but also as a lead market with enough clout to set the terms for and underwrite more sizeable placements – either in their entirety or at least be able to lead layers of sizeable placements. This has certainly continued to

be the case during 2007 and capacity for downstream risks in Houston has increased further now that the AIG has increased its capacity to US\$200 million. However, our chart shows that there is no regional market for US risks as such; all the available capacity is from global insurers, whether from companies whose head office is domiciled within the region or from Bermudan or European carriers keen to expand their US portfolio.

Towards a regionalised energy insurance market? – Downstream Canada

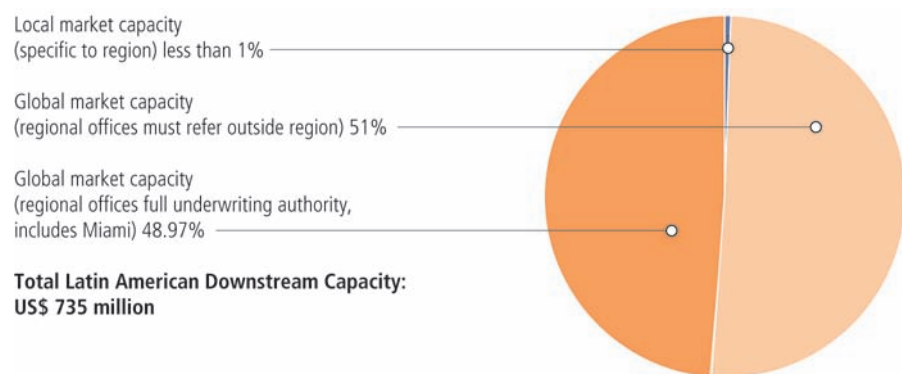


In Canada, the situation is similar. Whilst there is a small amount of genuinely local capacity, the vast

majority of capacity available within the country is provided by the major global insurers.

The rise of the regional market – the beginning of the end for global energy underwriting? continued

Towards a regionalised energy insurance market? – Downstream Latin America (includes Miami)

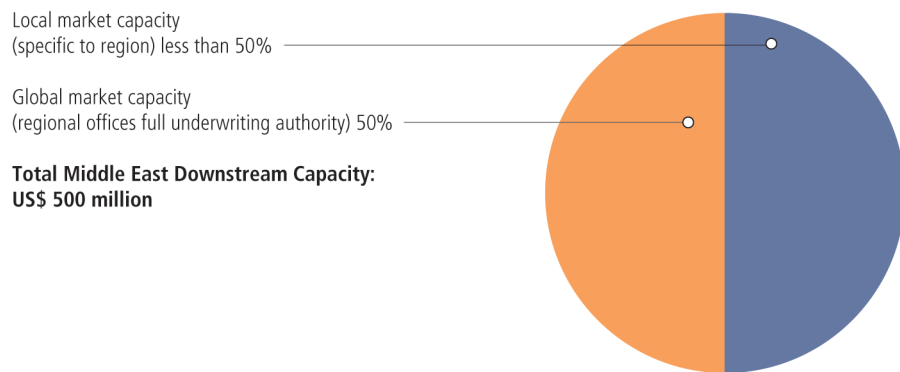


In Latin America, there is virtually no regional underwriting capacity for downstream energy risks. All regional market capacity is provided by the major global insurers, most of whom have offices throughout the region. However, in recent years Miami has emerged as the major “hub” for Latin American energy business and so there is now roughly an equal split between capacity with full underwriting authority (whose underwriters are mainly based in Miami) and those offices actually located in the region that

generally must refer to their head office in order to participate in downstream risks. The most significant insurers are AIG, ACE, Liberty, XL, SCOR, Swiss Re, Munich Re and Transatlantic Re.

Brokers tend to decide on a case by case basis if the regional markets or the head office is to be utilised. It is usually the case that the regional offices have first hand knowledge of the risks and therefore are more likely to be interested in providing competitive terms.

Towards a regionalised energy insurance market? – Downstream Middle East

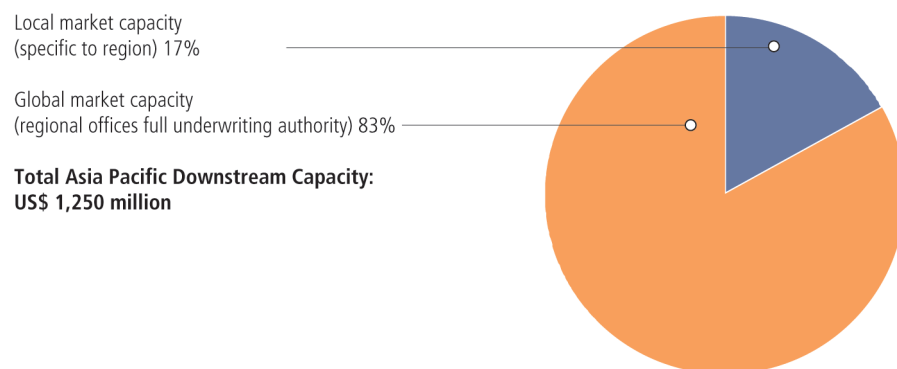


The total local capacity for downstream risks with Arab interest in the Middle East is approximately US\$250 million, which is by far the largest total of specifically regional capacity in any area of the world. However, most of the local insurers are very selective as to the risks that they write (and subsequently feed into their reinsurance treaties), and much depends on the size and complexities of the risk. The major local markets are ADNOC, Emirates Insurance, Al Ain Ahlia and Qatar Insurance Company.

Major insurers participate heavily in the broad spectrum of onshore energy risks. Traditionally, much of this business has been mandated to these "national" carriers by the state oil companies. Apart from Dubai, the energy underwriting is conducted from Abu Dhabi, Doha, Bahrain and Jordan.

Although no new players have set up afresh in the region, composite insurers such as AIG, ACE, Liberty & Allianz have now set up an energy underwriting base in the region to capitalize on the growing potential for business. These operations have full underwriting authority from their head offices and are staffed by underwriters with specific energy expertise.

Towards a regionalised energy insurance market? – Downstream Asia Pacific



Downstream total capacity in the Asia Pacific region is now very significant indeed, with most of the major players represented locally plus additional regional specific underwriting capacity. For non-critical catastrophe areas there is now as much as US\$1,250 million of capacity potentially available from regional market. Once again, the majority of this capacity comes from global carriers, who have now all given full underwriting authority to their specialist downstream energy underwriters.

The indigenous regional capacity makes up no more than 17% of the total, although these insurers are relatively active as they don't have the option of writing business outside the region.

AIG leads the vast majority of the downstream business in the region, although companies such as Scor, Liberty, ZGE and Ace take a lead position from time to time. In terms of new developments, Alba started underwriting 18 months ago and CV Starr are in the process of opening in Hong Kong. Asia Capital Re is a very significant start up in the region and obviously see huge opportunities in Asia. Furthermore, Lloyds Asia has expanded dramatically in terms of the number of syndicates supporting and many of these are actively considering energy business.

It is clear that a number of international markets are taking the view that more and more Asian downstream business is likely to stay in the regional market, and that therefore if they are not represented, they won't see it.

In December 2006, we said:

- Reinsurers are systematically splitting their portfolios by territory or peril into mutually exclusive “columns” of cover
- The market is still trying to cope with a backlog of claims from the 2004 / 2005 hurricane season
- More reinsurance capacity may be available during the course of 2007, following the creation of numerous “sidecar” vehicles
- Gulf of Mexico windstorm cover remains in extremely short supply
- The market was likely to remain in balance during 2007, with various competing forces battling to reduce or increase available supply



Still a cautious market

The reinsurance market in 2007 remains a cautious one. All the major characteristics of the post 2004/2005 hurricane market remain in place. The mutually exclusive “columns” of cover that we referred to in the last edition of the EMR have been maintained, albeit with more emphasis on peril rather than product. With a new generation of underwriting models emerging that have largely absorbed the lessons of Katrina and Rita, the need for detailed underwriting information is as strong as ever.

The January 2007 renewal season

In the last edition of the EMR we suggested that the reinsurance market was finely balanced between competing forces, allowing a fragile stability to emerge. It was in this somewhat uncertain atmosphere that the January 1 renewal negotiations got underway. No one needed to tell the direct market buyers that an early market approach, armed with the most detailed possible underwriting submission, would be essential if sufficient cover at acceptable terms was to be purchased. However, despite the fact that the reinsurance market had plenty of time to digest this information, renewal negotiations were generally protracted.

On the one hand, reinsurers were determined to maintain last year’s rating levels; on the other, buyers were equally determined to delay giving firm orders in the hope that, as time went by, their reinsurers’ appetite for their portfolio would force them to climb down from their opening positions. Brokers were therefore left to complete programmes within a very short December timeframe.

The market certainly demonstrated its ability to differentiate during the season in that whilst attractively-priced risks were generally over-subscribed, those seen as under-priced were generally shunned, with brokers facing serious challenges in completing those programmes by the end of the year. Generally clients were treated as single entities, according to size and results, rather than being treated as part of a single portfolio.

However, the January 1 renewal season showed that, in general terms, the market might be swinging slightly back towards the buyer. For US catastrophe cover, those reinsurers that were hoping to cash in on the favourable 2006 underwriting results have been disappointed by the expansion of the state-backed Florida Hurricane Catastrophe Fund (FHCF), which is now offering more than US\$30 billion of low-cost reinsurance to private insurers, a dramatic increase from the 2006 figure of US\$16 billion, effectively removing some US\$1.2 billion in potential premium from the reinsurance market. Much to reinsurers' frustration, this additional supply was created just at the time when they were seeking to capitalise on the 2006 trading conditions.

Pressure on rates begins to tell

In the same way as the direct market, reinsurers have come under renewed pressure to reduce prices after one loss free year. All other classes of marine business had an essentially stable renewal season although cracks began to be shown for non-accumulating business.

In the case of upstream energy business away from the Gulf of Mexico, price reductions have certainly been seen as the market is keener than ever to write exposures perceived to be in non-cat territories.


There has consequently been a general trend towards insurers increasing their maximum lines in this sector. The low incidence of catastrophes in 2006 has meant that there is now ample capacity available, even for peak exposures. The pressure to produce more attractive terms to the direct market has therefore now increased. In order to be seen to be holding firm, reinsurers are now prepared to provide "premium credits" (if unavoidable) so that they are not seen to be providing like for like premium reductions and so resist the negative attentions of their management and capital providers.

Brighter prospects for Gulf Wind

Upstream Gulf of Mexico prices showed a marked reduction in mid-2006 following the development of the sidecar market (see the previous edition of the EMR) and rates have subsequently stabilised around these levels.

The lack of activity in 2006 has led to a more relaxed atmosphere in the market, with the prevailing view essentially being summed up as "No wind, no problem". It is now generally true that more cover can be purchased in 2007 for the same premium spend, and that 2006 limits can now be provided for less premium than that which was charged last year. This in itself may encourage some direct insurers to increase their aggregates or Lloyd's RDS figures in the Gulf of Mexico. However, much will still depend on there being no further adverse 2004/2005 hurricane loss development during 2007. Furthermore, even more attention is being paid by reinsurers to the accuracy of the direct market's Lloyd's RDS, Gulf of Mexico aggregate figures and the underlying methodologies.

Generally the downstream Gulf of Mexico market has also increased maximum lines, which has had the effect of increasing supply and reducing rates at January 1.



There is a feeling that the mid year downstream renewals will show signs of pressure for further rate reductions, even more so than at 1 January 2007.

A wiser market

Following the hurricane season of 2005, the reinsurance market has become technically more aware and consequently has higher expectations regarding the level of information presented at renewal. We have seen a large number of requests for both windstorm CSLs and full lists of exposures including longitudes and latitudes. Reinsurers require a more detailed knowledge of the RDS methodology to ensure that an accurate reflection of risk is presented and the RMS v. 6.0 seems to be the model of choice. Overall wind aggregates have been shown to be a more important indicator to reinsurers as a permanent, accurate gauge.

Higher values

The general increase in upstream property values, especially in the Norwegian sector of the North Sea, suggests that some direct insurers may have to increase their reinsurance purchase at the upper end of their programmes in order to continue to offer a similar size percentage line on placements in 2007 to that offered last year.

Alternative Market Up-Date

The year began with a number of market commentators predicting record issuance of insurance linked transactions such as catastrophe bonds, sidecars and private placements. Optimism was driven by a continuing growth in supply of capital seeking to invest in re/insurance event risk, combined with apparent shortages of conventional reinsurance capacity. Although the FHCF decision and across the board softening in the conventional markets has led to some dampening of expectations, a recent flurry of activity

suggests 2007 will still be a year of high “capital markets” activity.

Catastrophe Bonds

The catastrophe bond market began the year quietly but in the last few weeks has seen a number of new transactions come to the market. Total issuance volume for the year is already above \$1 billion and is well in excess of the total issued by this stage of 2006 which, itself, went on to be a year of record catastrophe bond issues. Perils covered have been less focused on the super-peak of East and Gulf coast hurricane than might be expected and have included exposures such as North East US wind, US nationwide earthquake and even UK river flood. Pricing has benefited from an over-supply of investor capacity: the differing nature of individual transactions makes direct pricing comparison difficult, but there is a clear trend of tightening spreads in both new issues and secondary market trading.

Sidecars

While the cat bond market has continued to prosper, sidecar activity has reduced to virtually nothing. The targeted returns of many sidecars have been driven by Florida cat business. The anticipated cut in supply of this risk and the large amount of reinsurance capacity supported by existing sidecars and other sources of new capital has lessened demand. If 2007 proves to be a benign hurricane season, it is possible that the Gulf of Mexico/Florida sidecars may not be continued into 2008 and that the business, as renewed, will be written into the parent companies on a net basis. This reduction in capacity may provide a stabilising effect within the market.

Private Placement

The private placement marketplace has remained active supported by the entrance of new investors into the arena and increased capacity amongst existing players.

Willis' experience suggests this marketplace has become the favoured home of Florida and Gulf hurricane risk.

ILW

The ILW market had seen a general slow down in buying activity during mid-January and February, reflecting the buyer's digestion of the new Florida Legislation. The ILW reinsurer market regrouped and began offering widespread reductions in US Rates.

During early March we saw the market open up slightly as sellers of ILW capacity cut prices as the wind season approached. Several large tranches of wind capacity were sold as reinsurers looked to protect themselves against a repeat of the hurricane activity of 2004 and 2005. There has also been significant activity in the second and third loss ILW market, where clients feel that they need protection against frequency losses.

European pricing has largely held up since 1 January 2006, but this is more of a reflection of our internal tracking of pricing using US Dollar Triggers which is offset by the appreciation in the value of the Euro.

Conclusion – at full stretch?

Reinsurers are resolved to maintain rates at their current high levels for Gulf of Mexico exposures but are likely to be under pressure to offer improvements in terms for 2008, albeit only if there is no major windstorm activity later this year. This focus seems to have diverted reinsurers' attention from the rest of the energy portfolio and it is apparent that the market is under pressure to reduce premiums for all risks which expressly exclude Gulf of Mexico, developing the trend which started at the end of 2006. The mid-year US Catastrophe XL renewal season will set the tone for upcoming market conditions, at which point the

hurricane season will be upon us, with reinsurers aware that a major single-unit claim may substantially threaten the profitability of both the direct and reinsurance markets for energy business.

Stretch Factor: No Discernable Stretch

In December 2006, we said:

- An unexpectedly benign hurricane season created a virtual inversion of the 2005 underwriting result in 2006
- Although more capacity was expected to enter the market in 2007, there are several units whose values are now testing the available capacity to its realistic limit. However, the market will soften for programmes that do not test market capacity
- The global panel of upstream (re)insurers remains as limited as ever, especially following the Catlin/Wellington merger
- The artificially constricted renewal season of mid-2006 forced clients to buy expensive products before the onset of the hurricane season. This scenario is unlikely to be repeated in 2007 to the same extent
- For risks free from natural catastrophe exposure, the market's appetite for risk will become more pronounced in 2007
- Rates for construction risks are generally expected to remain at 2006 levels

2007 Upstream losses to date (excess US\$1 million)

Type	Cause	Country	Land/ Offshore	PD/LIAB Actual US\$	OEE Actual US\$	BI Actual US\$	Total Actual US\$
Well	Impact	USA	Land	15,000,000	3,500,000		18,500,000
Well	Blowout	USA	Offshore		10,000,000		10,000,000
Well	Blowout	USA	Offshore		7,600,000		7,600,000
Well	Blowout	USA	Offshore		7,000,000		7,000,000
Well	Stuck drill stem	USA	Land		4,000,000		4,000,000
Well	Blowout	Argentina	Land		3,000,000		3,000,000
Rig	[unknown]	Vietnam	Offshore	1,700,000			1,700,000
Well	Blowout	Canada	Land		1,300,000		1,300,000
Well	Blowout	Canada	Land		1,000,000		1,000,000

Source: Willis Energy Loss Database

As we intimated in the previous edition of this Review, following the 2005 hurricanes the upstream market continues to fractionalise into separate sub-sectors. By far the most significant of these is the worldwide operating portfolio excluding Gulf of Mexico windstorm, but we also focus on Construction, Operator's Extra Expense and Gulf Wind and examine the individual market dynamics in these key areas.

Operating ex-Gulf Wind

Still no major losses...has the market overcooked it?

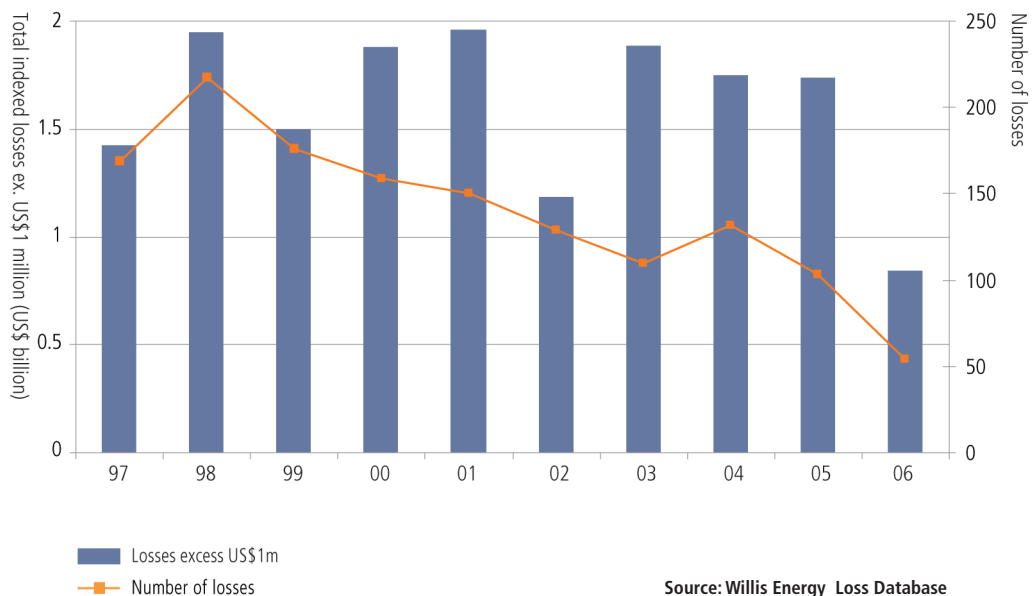
As we move towards the onset of the 2007 hurricane season, the lack of claims activity in the upstream sector is almost bewildering. Most readers will know that very little happens by halves in this market and at the moment there is virtually nothing to report by way of loss activity in 2007. In fact, the Willis Energy Loss Database report for upstream so far this year (see below) shows a grand total of just nine losses in excess of US\$1 million, with the largest of these being a very modest US\$ 18 million. This is probably the lowest figure that we have ever recorded at this stage of the year, lower even than the 11 losses recorded by our database at this stage of 2006.

If it wasn't for wind...

So perhaps buyers, brokers and insurers can be forgiven for wondering if the right prices for this sector can ever be determined by reference to historical loss experience across the portfolio. There is no doubt that Gulf of Mexico windstorm losses have comprehensively skewed upstream market statistics and masked the general loss trend for programmes free from natural catastrophe exposures. A quick glance at the data contained in the chart below, derived from the Willis Energy Loss Database, will confirm this; if windstorm figures are removed from the calculation, the actual

loss figures for the offshore sector over the last ten years show a relatively smooth variation of both indexed loss totals and number of losses, with six out of the ten years producing indexed loss totals within a narrow range just below US\$2 billion. But when losses are occurring, they are getting heavier. For 2002, the last truly benign year for the upstream sector, the average indexed loss size was US\$9,165,895; in 2006, this figure had increased to US\$15,606,825. These statistics confirm current market perceptions, and are mainly due to the increase in the value of steel, hydrocarbons and contractor day rates.

A volatile sector? – offshore losses excluding windstorm, 1997-2006





Following the 2005 hurricane season, we reported in May 2006 that the sharp hardening of market conditions that naturally followed from the record losses had a major impact on all areas of the upstream sector. But our chart shows that upstream programmes that do not feature Gulf Wind exposure should perhaps not have been so harshly treated by the market, and in reality deserved a much more modest rise in rates.

Of course, the market has been at pains to point out that the hurricane losses had to be paid for from premium increases across the sector, and the upstream market is not one that tends to underwrite by region. However, this has not prevented astute upstream underwriters from appreciating that, at 2006 rates, there is ample opportunity to make money by investing in Gulf Wind-free programmes. So it is hardly surprising

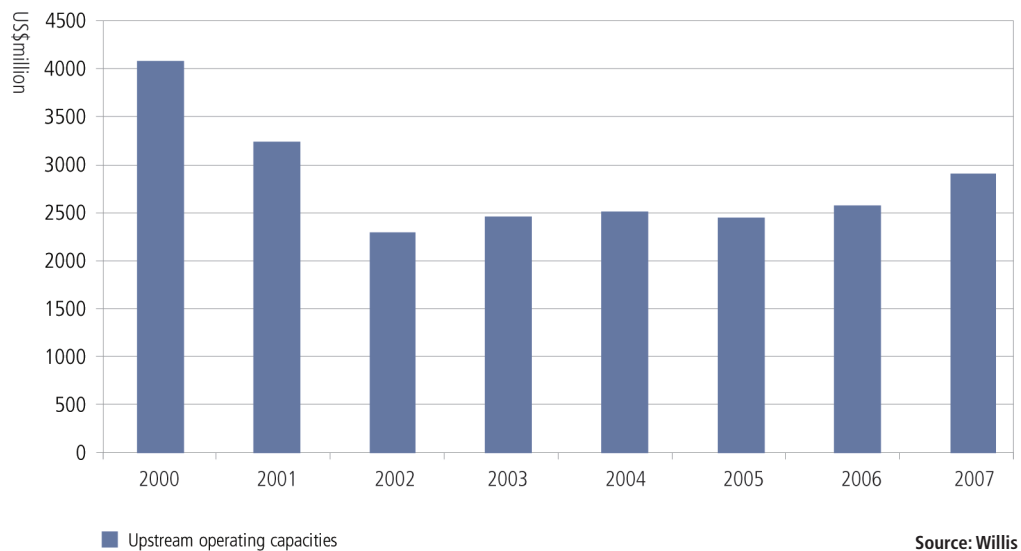
that there is now renewed pressure on insurers to break ranks and offer more competitive terms.

To top it all – the highest capacity figures since 9/11...

Another question that we raised in our last edition was whether there was still sufficient capacity in the market to absorb some of the largest exposures.

Our most recent estimate of market capacity is that there is now a total of some US\$2,900 million of upstream capacity in the market, up some 10% from the US\$2,783 figure that we advised our clients in February 2007. New players in the market include Mike Allen at Ark, Paul Calnan at CV Starr, Phillip Thorp Apps at Omega, and we understand that they are potentially to be joined by ex-Swiss Re underwriter Chris Charlton at a new underwriting venture.

Upstream operating underwriting capacities, 2000-07 (excluding Gulf of Mexico Windstorm)





As ever, it is virtually impossible to envisage a placement where every single carrier worldwide will commit its full underwriting line on a single placement at competitive terms. Our best realistic estimate of what can be achieved on a single placement in practice is therefore somewhat less than this figure, at roughly US\$2,500 million. If pure physical damage exposures only are taken into account, even this smaller figure should be more than enough to cover even the highest valued platforms.

However, the business interruption cover required by some co-venturers is very significant, and, if extrapolated into 100% terms, could in some circumstances be far in excess of anything that the current market could offer. Fortunately, such cover is only required by a minority of buyers so in reality this is not as significant an issue as it might be. So securing sufficient capacity for most programmes in 2007 does not really test a broker's ingenuity as much as we thought it might at the end of last year.

For the vast majority of upstream programmes capacity remains plentiful, and where a policy limit of less than US\$1 billion is required, serious competition can now be generated in the commercial market.

First quarter 2007 – the phoney war

By the beginning of 2007, all the conditions for a softening market were in place. However, for the first quarter of this year this pressure was mitigated by the general increase in the prices of steel, oil, gas, contractor day rates and well AFEs. These increases had two significant effects:

- It prompted the majority of buyers from both the Operator and Contractor sectors to reassess the values relating to their insurance programmes. This has resulted in some welcome additional premium

that has helped some key insurers to maintain (or even exceed) their premium income targets for the first six months of 2007 (it is important to note that between 60-75% of insurers' premium income is written in the first six months of the year).

- It resulted in several more platforms requiring as much commercial market capacity as is available following their revaluations. Indeed, we now calculate that as many as 25 platforms around the world can now be described as market capacity risks, and programmes which require the participation of the whole upstream market have naturally not been subjected to the same competitive pressures as other upstream business.

During the first quarter of 2007, this welcome additional revenue has kept most insurers on course to achieve their premium income targets for 2007 and has prevented a general breakdown in market discipline. On the whole, improved terms were certainly achieved; however, these were masked by a combination of additional income coming through on insurers' books (as a result of increased values) and by the application of Renewal Incentive Bonuses and the like, allowing insurers to justify to themselves (and their management) that the renewal was essentially negotiated on an "as before" basis.

More recently, the competitive pressures within the market have intensified to the point where the market has had to accept that actual rate reductions are now the norm. The big question is therefore this: to what extent will the market soften? Can buyers anticipate a freefall as they did in the latter half of the 1990s?

Orderly softening or complete freefall?

At the time of writing, there are two potential scenarios that may develop in the months ahead.

- The first is that rates could reduce dramatically following the recent award of two major operating programme tenders at terms which are well below current market levels. The completion of these programmes may allow the floodgates to open as other buyers understandably pressurise their brokers to deliver similarly advantageous terms.
- The second is that these highly competitive terms will not find the support they require from the following market and instead there will be what might be described as a continuation of the current orderly softening, with reductions varying from programme to programme around a current mean of 10-15%.
- Whilst there is certainly more capacity available, the vast majority of it remains in experienced and capable hands. In fact the actual number of insurers participating in this sector remains consistently small in relation to the pre-9/11 environment. These insurers will find it psychologically difficult to completely abandon the rating methodologies of recent years and, in the case of Lloyd's insurers, face the added pressure of the Franchise Board's scrutiny of their portfolio.

Our advice: take advantage of competing underwriting philosophies

Regardless of how the market develops in the months ahead, there are now undoubted opportunities for buyers to maximise the fissures that are now appearing. Perhaps the best way will be to play on the two distinct underwriting philosophies that are now operating in this market. On the one hand, there are the subscription market-focused Lloyd's underwriters who are subject to the regulatory control of the Franchise Board; on the other, there are underwriters responsible for large blocks of underwriting capacity, often located outside Lloyd's and under no sense of obligation to their fellow competitors. It seems these insurers are being actively encouraged by their management to compete more vigorously for market share.

Our own view must be that the latter scenario is probably more likely, for several good reasons:

- In today's market it is all too easy for a broker to produce a highly competitive indication – say for example a 50% reduction – from an aggressive insurer keen to make further inroads into this profitable sector. However, as some brokers have found to their cost recently, it is not so easy to find sufficient support for such indications.
- There has already been some evidence this year of leading indications being rejected by the market following the tender process, particularly in the case of one or two major construction projects. We have seen some instances of brokers' appointments being cancelled and programmes brought back to the drawing board for re-presentation to the market. This does not seem to be the actions of a market that is so desperate for premium income that it is prepared to accept business at any price.
- Recent personnel changes in the market have now muddied the situation to the extent that several underwriters are now physically located near to others who do not come from the same business environment and culture. Adroit handling of the different underwriting attitudes in London and elsewhere will be required for buyers to truly reap the rewards of what is now becoming a much more encouraging market from their perspective. In particular, advantage must be taken of the predicament of certain insurers that have elected not to invest in the Gulf Wind market and who are therefore reliant on the remainder of the portfolio to generate premium income.



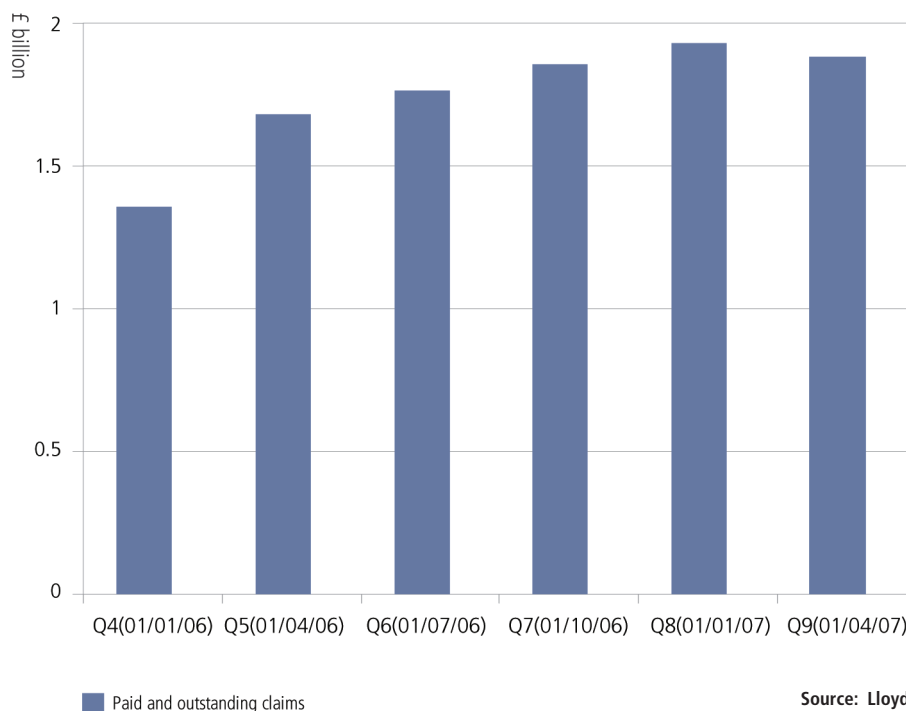
Gulf Wind

More capacity, but little downwards movement in pricing

With the new entrants to the market keen to utilise their capacity where they believe they can make the best returns, the available capacity for Gulf Wind has now increased slightly. A softening of sorts has been evident, on the basis of insurers offering more capacity for the same price as they charged last year, without offering a corresponding reduction in premium for the same limit.

Another key factor has been insurers' insistence that the value of the Katrina/Rita claims portfolio continues to deteriorate. Recently insurers have used this as a way of persuading buyers that an "as before" renewal should be considered in the same light as an actual premium reduction. However, the most recently published upstream claims statistics from Lloyd's (audit codes ET and EW) suggest that the overall 2005 year claims deterioration has not been as dramatic as insurers might suggest (see chart below). Perhaps the market will not be able to continue to rely on this factor in the months ahead.

Lloyd's Upstream (ET,EW) paid and outstanding claims, 2005 year (as at April 2007)



The recent deterioration in the Lloyd's Katrina /Rita upstream claims portfolio may not be so dramatic as some might suggest.

Another reason for pricing remaining stable has been that reinsurance costs have remained high (see the previous section of this report). The possibility that reinsurance costs may come down by the 1 June reinsurance renewal season also suggests that some softening in this key sector might be anticipated later in the year.

However, regardless of the extent of the available supply of Gulf Wind capacity, initial indicators show that there is less demand for this product than at the same time last year. Perhaps not surprisingly, buyers have looked at the rates charged – 30-40% on line – and decided that this product no longer provides good value for money. As this Review went to press, the market was still trying to establish whether the current level of demand for Gulf Wind cover is due to buyers holding back in the hope of forcing better terms, or whether they have decided not to purchase altogether.

Following our observations in the previous edition of this Review, we have not entirely been surprised by the fact that some major contractors have decided not to buy Gulf Wind coverage this year. History will judge whether or not they have made a wise decision. However, market efforts to obtain payback for Katrina/Rita will be seriously hampered if they are unable to fully utilise their capacity, not only by decisions not to buy cover but also by some recent mergers that have served to reduce the premium base for this product still further.

Finally – some market initiatives...

The buyers that remain are certainly showing signs of scrutinising the terms and conditions offered to them more closely. As a result, insurers are increasingly adopting individual approaches, recognising that they need to do something to encourage energy companies to buy. They have therefore produced a more considered, tailor-made approach. Examples include:

- Targeting a specific area with Gulf Wind exposure and writing 100% of the targeted placement at rates below the market norm
- Offering Gulf Wind cover on specific platforms

- Providing more competitive terms on excess layers, depending on platform location

The outlook for 2007

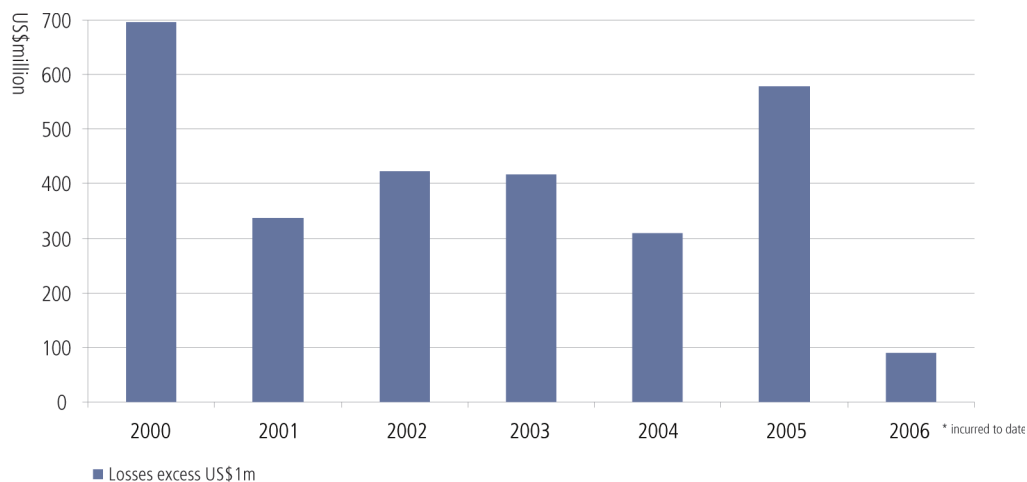
The market therefore continues to offer a limited Gulf Wind product, and the outlook for this class will clearly depend on what happens during the 2007 windstorm season. There is no doubt that an enormous amount of time and effort has been invested in producing more reliable underwriting models for Gulf Wind so that insurers have a better idea of the magnitude of potential losses, and some key market leaders are now looking at this sector in terms of a ten year rather than a single year cycle. But there is still little confidence in these new models, firstly because they have not yet been tested, and secondly because their predecessors have proved to be totally inadequate. We would suggest that there are potentially three possible outcomes that may have materialised before the end of 2007:

- If there are no losses, the revised models remain untested and the market will still have no idea if their restrictions have been effective.
- If there is one major hurricane loss, this would at least give the chance for the market to see if their models stand up to scrutiny. If they prove to be too conservative, this will certainly lead to more capacity coming into the market and prices for Gulf Wind beginning to fall.
- If there are multiple hurricane losses, similar to the 2005 catastrophes, that prove the new models to be as ineffective as their predecessors, then there is the possibility that existing capacity will withdraw and Gulf Wind will revert to being a very expensive and limited product.

To sum up, uncertainty is preventing any change in market conditions at present. However, one feature that is now without question a permanent fixture in this market is the imposition of aggregate limits. Our next edition of the Energy Market Review will provide a detailed update on the events of the 2007 Gulf of Mexico windstorm season.

Construction

Worldwide offshore construction losses 2000-2006 above US\$ 1 million



Source: Willis Energy Loss Database

Offshore Construction used to be one area that upstream insurers regarded with some caution. The assessment and rating of major construction programmes continues to be a complicated, specialised business and for many years the only respected leadership in the market was that of Tim Burrows of the Wellington syndicate and Dominick Hoare of the Watkins syndicate.

However, as can be seen from the chart above, the overall loss record in the offshore construction sector has generally improved since 2000, at a time when not only has construction activity increased (due to higher oil prices) but also when rating levels have risen to a point where they have proved to be consistently profitable (the obvious exception has been 2005 and the offshore construction losses associated with Hurricanes Katrina and Rita).



Capacity

As a result, this sector has lost much of its negative image. Available capacity has certainly increased significantly since 2002, when perhaps only US\$750 million of realistic capacity could be accessed. 2006 saw a slight softening of the market, as insurers looked to diversify into other areas of their portfolio to make up for income lost as a result of the underwriting restrictions imposed in the aftermath of the hurricanes. Furthermore new upstream capacity in 2007, as well as increases in existing insurer line structures, suggests that competitive pressures in this sector may well increase this year, albeit not to the same extent as non-natural catastrophe operating programmes.

We mentioned in the previous edition of this Review that the merger of Catlin and Wellington might threaten the capacity available for this class. We are pleased to report that Catlin has taken the view that, having inherited a well-run portfolio of construction business from Wellington, as well as some highly-experienced underwriting expertise, no major changes in construction underwriting philosophies are to be implemented. We would therefore suggest that whilst approximately US\$1.5 billion of realistic commercial market capacity was available for this class at the beginning of 2006, for mid 2007 as much as US\$1.65 billion might now be available. We are now seeing significant Estimated Contract Values (ECVs) being required, as the oil industry pushes technological boundaries, especially with regard to units located in West Africa and Brazil. This capacity increase will therefore be of real benefit to the buyer, as it will assist in the completion of the largest programmes, and furthermore will also put renewed pressure on rates for projects featuring smaller ECVs.

We should mention that this softening process has sometimes been over-egged by brokers during the last few months and, in a few isolated instances, some very aggressive lead terms have failed to find sufficient market support, resulting in the buyer replacing their broker.

New leaders show their innovative side

More recently, we have not been unduly surprised to notice an increased willingness amongst other upstream insurers to step up to the plate and provide alternatives for buyers, enabling them to leverage their purchasing power. One way of doing this has been the willingness of the market to provide major respected buyers with a "floater" construction facility, whereby cover is provided for set limits and rates with the agreement of a limited insurer leadership panel. This in itself is a sign of the inherent stability of the offshore construction market, as the largest buyers would have been unlikely to enter into such an agreement if they felt that rates were about to soften significantly.

However several issues still provide challenges for the largest projects. The policy period for major construction risks remains a significant concern for some insurers. The market also remains generally wary of "at the edge" technology, although the utilisation of independent surveyors has mitigated this to a certain extent. Accessing incremental capacity on a stage-by-stage basis, as required in line with project value build-ups once the core placement has been achieved, is therefore an essential part of brokers' marketing strategies for the larger programmes.

Furthermore, for projects featuring Final Contract Values of US\$1 billion and above there is still a real danger that if recognised leads are ignored, some of the more conservative supporting markets may decline to participate, leaving open the possibility the placement failing to optimise the capacity available.

Operator's Extra Expense – no sign of change

The stand alone Operator's Extra Expense market is perhaps one area of the upstream portfolio that has not yet shown significant signs of the market softening that is apparent in other upstream sectors, with rates, terms and deductibles remaining static. However, given the recent rise in Authorization For Expenditure (AFE) amounts, it could be argued that static retention levels represent a sign of some market softening.

AFE amounts have increased mainly because of high rig utilisation rates and increased contractor (especially rig crew) costs. Whilst the non-natural catastrophe insurance market capacity in the upstream market is in excess of US\$2 billion (see chart above), in reality for a stand alone Control of Well programme the market is considerably more restricted. This is due to the small number of underwriting entities that would be prepared to underwrite the class on a stand alone basis and the size of the percentage line that they would be willing to offer.

Conclusion – at full stretch?

Despite the protestations of all underwriters that they will never follow the market down, in the absence of any major losses there is clearly some way to go before the current market softening begins to bottom out. However we would suggest that the market will continue to soften at a steady pace – unless the 2007 windstorm season sees a repeat of the disasters of 2005.

Stretch factor: Slightly Stretched

Downstream



In December 2006, we said:

- The divergence of the market into US and non-US zones continues, as does its divergence into catastrophe-exposed and non-catastrophe exposed sectors
- For US risks, no dramatic softening of rates was anticipated in 2007, especially for programmes featuring significant business interruption values and high EMLs
- Houston is emerging as a major insurance centre for US-domiciled downstream risks
- For non-US risks, insurers will have to compete to protect their existing portfolios as a combination of increased capacity and a favourable loss record can only lead to increased market softening in the months ahead
- Traditional leaders are therefore expected to assert their leadership credentials once more

The major development in this sector is the continuing deployment of underwriting authority on a regional basis, which is covered in our featured article in this Review. We therefore see little value in embellishing what is essentially a relatively simple message: in the International sector, the market softening that we predicted in the last edition of this review has continued apace, and this dynamic has now been extended across the Atlantic to the US sector as the benign loss record since 2005 continues. The US portfolio, which as we reported in the last edition of the Review showed little signs of the softening in the International sector, is therefore starting 2007 from a higher rating benchmark than the remainder of this portfolio.

It is perhaps no surprise that many observers consider existing rating levels for non-catastrophe downstream business to be artificially high. The chart on the next page shows how the loss record in the downstream sector has improved in recent years. From the data available to us in the Willis Energy Loss Database, we have calculated the average annual downstream loss figure for the period 1992-2001 to measure the experience of the pre-9/11 market and taken the same figure for 2002-2007 to measure the experience of today's market. Windstorm losses have been removed from the data, as cover for this risk is now largely aggregated and therefore far more predictable in terms of loss quantum. Having done this, the result shows that the loss record for this class has improved significantly in recent years.

Downstream losses reported to date, 2007

Cause	Location	Country	PD/LIAB Actual US\$	BI Actual US\$	Total Actual US\$
Fire/lightning/explosion	Texas	USA	50,000,000	100,000,000	150,000,000
Fire/lightning/explosion		Russia	55,000,000		55,000,000
[unknown]		Brazil	9,000,000		9,000,000

There has been very little loss activity so far in the downstream sector during 2007. Although not yet represented on the Database, we are aware of another recent refinery incident in the United States.

Source: Willis Energy Loss Database

Downstream continued

Average of indexed downstream annual losses excess US\$ 1 million, 1992-2001 and 2002-2007 excluding windstorm (to date)



Source: Willis Energy Loss Database

Average losses (ex-windstorm) in the downstream sector have decreased in recent years – a trend that has been exacerbated by increased retentions and coverage restrictions

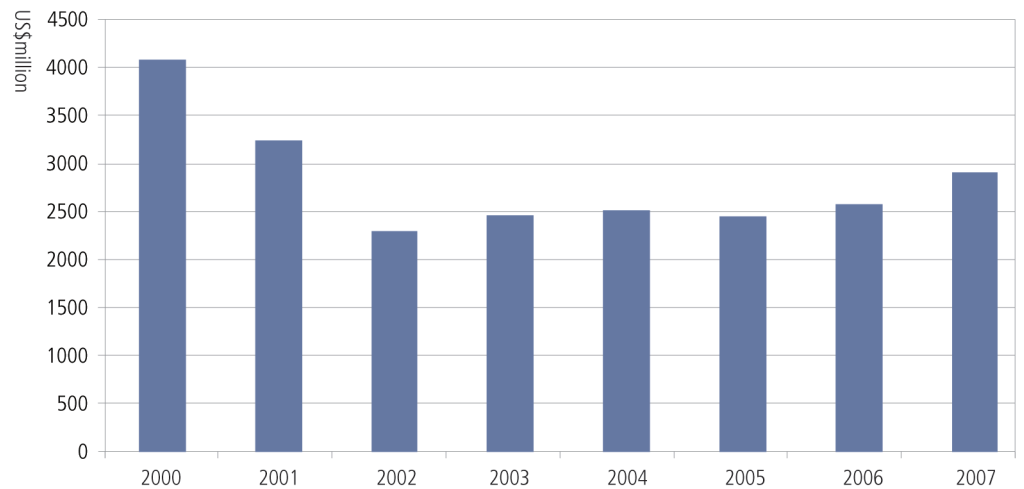
If the vastly increased retention levels are applied to the losses above, and the tighter coverage restrictions imposed by the market in the aftermath of 9/11 are also taken into account, it is perhaps not so surprising

that most insurers believe that this class can be underwritten profitably at more aggressive terms than have been the norm in recent years.



Capacity approaches 2001 levels

Maximum global market downstream underwriting capacities, 2000-07



Source: Willis

The increase in underwriting capacity in the downstream arena in 2007 has been the most pronounced for several years

As well as an improving loss record, the existing market is also being joined by new capacity. Our chart shows that there has been a significant increase in underwriting capacity in 2007 – from US\$2,487 million in 2006 to US\$ 2,918 million. Inevitably, this has served to fuel the softening process still further.

Is the market confident that they can still underwrite this class profitably as this softening process continues? We would suggest that insurers are in a much stronger position to do so than in the past. Firstly, as we have already noted insurers have maintained discipline with regard to the

coverage and retention levels provided since 2001. As rates decline below the levels charged immediately before the 2005 hurricane season, insurers can be confident that the attritional losses that characterised the market of the late 1990s can still be avoided. Furthermore they can also rely on increased investment income as global interest rates begin to rise once more, whilst reinsurance costs, as we report in another chapter of this Review, are at least static and in some instances beginning to slightly soften. And given that the issue of windstorm risk has now been ring-fenced, insurers can now be more flexible in the way they wish to develop their portfolios.

No new market leaders may stifle softening process

However, it should be pointed out that the market leadership panel continues to reflect very much the same names that have dominated this sector during the last few years. The arrival of Star Tech as a major downstream energy capacity provider has naturally given some impetus to the softening process, but to date there is no sign that they are prepared to provide lead terms for major International programmes. Furthermore, for non-US business Liberty has made a decision to wait out the current soft market atmosphere, and although other leaders have made significant investments in resources such as engineering, it is possible that others may decide to follow suit. The softening process may also be mitigated by the withdrawal of several members of OIL, as the additional premium generated to the commercial market will help to assuage the market's current thirst for premium income.

Despite these factors, there are now signs that the top three or four insurers in this class are now being challenged for their place in the market "pecking order" by a number of other insurers keen to demonstrate their leadership credentials. Recently we have seen these insurers bid for some high profile programmes, in a manner which suggests that they are prepared to offer much more competitive terms than in the recent past in order to improve their profile in the market.

Business Interruption remains a concern

One major concern for downstream insurers is whether or not the business interruption values that are currently being presented to the market are accurately reflecting the reality of the risk that they are being asked to assume. Recent claims settlements have suggested that the final business interruption figures have been considerably in excess of original estimates. This concern may express itself in the form of more specific requests for underwriting information before insurers agree to provide cover for these exposures.

Conclusion: At Full Stretch?

Despite the restricted leadership and concerns over business interruption, this is a market where rates have been kept artificially high by the losses from the 2005 hurricane season. In the absence of any major losses, buyers can expect considerably improved terms to materialise over the course of the next few months before any serious capacity withdrawals materialise.

Stretch factor: Slightly Stretched





In December 2006, we said:

- Following the 2005 hurricanes, questions are now being asked as to whether OIL still represents a cost effective and efficient purchase of capacity within an energy insurance programme
- There was a significant disparity between OIL's offshore E&P losses from the 2005 hurricanes compared to the overall gross asset base of this sector within the mutual
- The October 2006 resolution to create an additional two new business sectors for Atlantic Named Windstorm (ANWS) was narrowly defeated
- It was decided that the proposal would be re-evaluated at OIL's March 2007 AGM
- Nine members withdrew from OIL at the end of 2006
- The combined effect of member withdrawals with the application of higher retention thresholds suggests a reducing OIL premium pool for the long term

In our last OIL update we suggested that "June 1 will see some withdrawals from OIL, the majority of which are likely to come from the utility sector for whom the volatility of the OIL rating model jars with the highly regulated environment in which they operate."

We anticipated that "some members, in an effort to ease the volatility, will shift their OIL attachment points up considerably. Equally, others nervous now of the degree to which they have mutualised their losses may exit Pool B." Our general sense was "that OIL is still well supported by a large part of the current membership, keen to see it succeed, and determined to take enhanced ownership of the decision making."

History seems to have proved our predictions to be correct, and in this issue of the Review we would like to examine recent events leading up to the recent withdrawals from OIL and consider its future.

On March 22 the shareholders of OIL voted on three significant resolutions

1. Adopting two additional business sectors to take effect from June 1 2007, bringing the total number of sectors to 10. The new sectors being:
 - Atlantic Named Windstorm ANWS (Onshore)
 - ANWS (Offshore)
2. Incorporating a Top Up Pool for ANWS perils. The Top Up Pool is a mechanism designed to provide additional aggregation limit for ANWS events that exceed OIL's aggregation event limit, either by:
 - a. mutualising the incremental risk above the aggregation limit to members electing to participate in the Top Up Pool, or
 - b. by potentially purchasing additional limits from the reinsurance market (or utilising an alternative risk transfer vehicle)

- To allow the OIL Board to set different aggregation limits for different perils

The first two resolutions passed with the required 75% vote whilst the third resolution failed.

Immediately following the shareholder vote, OIL's Board of Directors voted to increase the aggregation limit for all risks/sectors to US\$750 million effective June 1, 2007.

In the aftermath of the vote, 12 shareholders elected to withdrawal from OIL and not renew their policies effective June 1 2007. In addition, OIL said one member proved ineligible for continued membership due to its merger with a non-OIL member. Collectively these shareholders had assets representing 9.5% of the weighted gross insured assets by OIL immediately prior to withdrawal.

If the weighted gross assets per sector are represented graphically (see our charts below) the withdrawals appear to represent very little change in the overall demographic of the pool. However, as we shall see the effect of the withdrawals may be far-reaching.

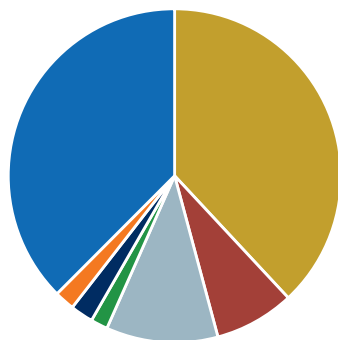
The effect of the windstorm resolutions being passed is that for the second policy period of 2007 (commencing June 1) OIL provides up to US\$250 million per occurrence (US\$750 million in the aggregate per occurrence) of Atlantic Named Windstorm coverage in return for a premium determined by the weighted gross assets declared to the pool, as well as the coverage profiles elected.

By May 9 all members were required to declare their coverage profile for the second policy period, and following this declaration OIL's management were finally able to assess the premium required to carry the risk burden.

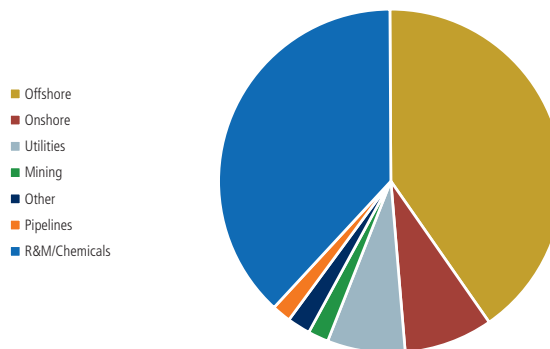
Following these developments, the most significant points to note are:

- Shareholders were only allowed to opt out of ANWS coverage for 2007. With effect from January 1 2008, OIL will return to the mutual mechanism, but with two additional sectors (making ten sectors in all).

Weighted Gross Assets Pre June 1 Withdrawal



Weighted Gross Assets Post June 1 Withdrawal



Source: OIL

The effect of the 12 withdrawals on OIL's asset base has been insignificant - except for the utility industry.

- The default ANWS retention was US\$750 million. For Shareholders with an ANWS deductible above US\$10 million, OIL allowed the deductible to be brought back down a minimum of US\$10 million without the “other insurance” warranty being imposed.
- If a member elected an ANWS limit of less than US\$250 million, OIL required a warranty that they had not purchased insurance excess of OIL.

The windstorm coverage could be attached at any point from the minimum deductible levels, and as a guide OIL suggested the following credits might apply for the windstorm sectors:

Limit	Attachment point	ANWS Onshore credit (applied to US\$ 10m attachment point premiums)	ANWS Offshore credit
US\$250 million	US\$100 million	65%	55%
US\$250 million	US\$250 million	72%	65%
US\$250 million	US\$750 million	90%	85%
US\$100 million	As above options	65% further credit on above options	9% further credit on above options

Members with ANWS exposures, together with their brokers, then needed to perform a cost/benefit analysis to review the benefits of sharing in an OIL ANWS US\$750 million limit for an adjustable premium as opposed to purchasing a dedicated commercial market limit for a fixed premium.

The following factors made this analysis difficult:

- OIL’s rating formula, which could only offer an estimate of the premium which would in all likelihood be changed
- The timing of the decision, bearing in mind the onset of the 2007 hurricane season

- In the case of some members, the renewal dates of their commercial market OIL wrap programme

On 25 April, as members were coming to their conclusions, Standard & Poor’s (S&P) placed OIL’s “A-” counterparty credit and financial strength ratings on CreditWatch with negative implications. In their opinion, the number of shareholders exiting OIL in 2007 was significant enough to raise concerns about the stability of the mutual’s membership base and the strength of its competitive position in its chosen niches. S&P further commented that it “believes the recent exits partially reflect OIL’s challenge to meet the different needs of its diverse membership base, which after a period of expansion in the past five years includes members with high severity/low frequency-type risks such as oil and gas companies, and members from sectors with higher frequency/lower severity – type exposures such as utilities.”

The agency went on to state that “in the past, OIL has made significant efforts to address the different needs of its membership. . . .The combination of the recent exits and amended rating and premium plan could lead to changes on the prospective volatility of OIL’s insured portfolio that need to be evaluated.”

S&P also indicated that it expects to resolve the CreditWatch in the next three months, following discussions with OIL’s management team about its competitive position, portfolio volatility, and capitalisation. In the event that S&P does decide to lower the ratings on OIL following its review, such a downgrade is not expected to exceed one notch.

So just what can we expect now from the management of OIL? Some industry observers have suggested that OIL may consider the following possibilities:

- Prospective rather than retrospective underwriting, for example building up considerable reserves by increasing “going-in” premiums to prevent a repeat of 2005, when as readers will remember, OIL had to make two significant cash calls
- Differential rating, based on the perceived quality of the risk
- Restructuring of the coverage offered, to reflect the individual requirements of members
- Re-engaging the commercial reinsurance market to protect OIL’s underwriting result for 2007/2008

Whatever actions are taken by OIL’s management in the next few months, there will undoubtedly be supporters and detractors of what is decided. One thing we can say for certain is that all eyes will shortly once again be on the membership, as the next deadline for withdrawal looms on September 30, 2007.





In December 2006, we said:

- The gradual softening in rates has continued during 2006, as market conditions allow clients to pursue their own objectives freely
- Insurers are continuing to provide the best terms for the best-presented programmes
- Larger, capacity-driven programmes, particularly in the US, have received smaller price increases and the market for these risks is therefore more stable
- There has been some loss of excess capacity following the downgrading of OCIL and the loss of Gerling
- Coverage offered remains consistent, with capacity for failure to supply and EMF remaining fairly tight
- The market softening in 2007 is expected to be carefully controlled, although if current trends continue overall underwriting deficits may be possible in 2008
- Realistic market capacity remains at US\$1-1.2 billion, and any major change in the market is at least two years away

Favourable market conditions for buyers maintained

Pricing conditions in the onshore energy liability market are currently very favourable to insurance buyers. The Gulf of Mexico hurricane losses at the end of 2005 failed to adversely affect the international liability market and there have not been any major, market-impacting liability loss events in 2006 or 2007 to date. This factor, combined with an abundance of liability capacity and affordable treaty reinsurance costs, has resulted in softening liability market conditions throughout 2006 and into the second quarter of 2007.

Wide underwriting differentiation as US business targeted

Rate reductions of 5% to 10% set the benchmark for the energy sector in 2006, and much the same pattern is being repeated in 2007. These average figures conceal some wide variations, with reductions for high quality programmes occasionally reaching as high as 20%.

Conversely, rates for some less favoured programmes have actually increased. Such increases have generally been restricted to US programmes where there is some residual nervousness amongst insurers, particularly in relation to exposures located in the southern states. In contrast, general industrial risks are seeing even greater reductions, with the benchmark being 15% to 20%.

A softening market is not always so evident when it comes to coverage conditions. There is still close scrutiny of wording and certain exclusions are not removed easily.

No major changes anticipated in 2007, but market may steady during 2008

We cannot readily identify any potential drivers of change in market conditions during 2007. There is every indication that the current market softening will



continue. Insurers remain well capitalised. There has been an absence of losses that would have any serious impact on insurers' capital. There is indeed some possibility of an acceleration of the downward slide towards the end of 2007 as insurers compete for a falling revenue pool.

However, there is some possibility that early 2008 may see a steadying of the market. There has recently been something of a disconnect between direct rates and reinsurance treaty costs. If this continues in the next treaty renewal season, falling direct rates may meet rising reinsurance premiums as well as increased attritional losses. The latter are always present and in our view must at some point create a floor under the market when set against the lower revenue of a softer market.

Energy sector remains volatile as regional underwriting strengthens softening process

The energy sector does have some features that tend to make it more volatile. The number of lead markets is relatively small and there is a finite premium pool. A catastrophe involving a major refinery or pipeline which involves a liability claim that exhausts all the layers on a large placement could shift sentiment.

Regional variation is becoming an important factor. In certain territories a saturation of local capacity has fuelled competition, leading to significantly higher than average rate reductions. This process has been influenced by an expansion of global operations by a number of insurers such as QBE and Catlin. They are seeking to access markets directly, relying less on business flowing into London. Other insurers who already have a global footprint are allowing their local operations more freedom to underwrite and are in some cases increasing the capacity available.

Effective marketing strategies vital

In a fast moving market with significant regional variations, careful planning of marketing strategies is vitally important. Careful balancing and co-ordinating of marketing to London, Continental European and global markets will pay dividends in terms of maximising cover and minimising cost.


If current trends continue we may see a situation where rates have dropped to the point that attrition losses will produce underwriting losses and insurers or their reinsurers will call a halt to the rate slide. For now the advantage in this market lies with the carefully prepared buyer.

In planning a placement, current market conditions are allowing clients to pursue their own objectives freely rather than having to be bound by those of their insurers. These can include:

- Economic purchase of higher policy limits
- Flexibility
- Improvements in cover, for example deletion of terrorism exclusion
- Improvements in programme security, by moving to higher rated carriers

Lower prices at the expense of service?

Pricing of capacity is obviously important. However, quality of cover, service and security are also essential elements of an effective insurance programme. We are now encountering situations where significant pricing differentials are leading to the breaking of long-term relationships with trusted providers who have been delivering quality service. This is critical at primary level but is still an issue that requires careful consideration



when making price driven changes to excess programmes. Service standards and expectations therefore need to be clearly agreed with new participants in programmes.

Secure liability placements are ideally built around a core of insurers with whom the insured has built a long-term relationship. A cautious approach to new capacity providers is sensible, particularly where there are alternatives. However judicious use of the “spot” market can play an important role in introducing competitive leverage.

The value of cheap capacity?

Careful goal setting and planning of the placement strategy is essential to capture the maximum benefits from current market conditions whilst maintaining valuable long-term relationships. The cheapest capacity could in the longer term prove to be an expensive choice. Whilst we see no immediate prospect of reducing capacity, history tells us that the business will become unprofitable and capacity will fall in the longer term. The relatively small number of lead energy markets means that any future adverse development in capacity will be accentuated. At this point, we believe that the value of long-term relationships will generally become apparent.

Underwriting issues – corrosion and site maintenance

Despite competitive market conditions, insurers remain focused on cover issues and the quality of risks. The energy sector does indeed have significant liability exposures as illustrated by major events such as the Toulouse explosion and more recently the Buncefield loss in the UK. From insurers’ perspective, falling pricing means that the quality of their underwriting is key to maintaining profitability in the longer term.

Quality of site maintenance is, not surprisingly, seen as an important issue for sites with a fire explosion or environmental exposure. Property surveys are a valuable source of information and can be used to demonstrate that a risk is well managed. Conversely, where a property survey highlights problems it is important to be able to demonstrate that corrective action is in progress. Insurers will decline risks where critical maintenance or plant improvement is outstanding. Offsite pipelines are a particular concern.

Corrosion problems have generated plenty of publicity and produced a number of incidents over the past few years. Pollution is a specific concern – pipelines may often run in remote areas with little exposure to third party property damage or injury in the event of a leak and explosion. However in most countries pollution laws are continually tightening. In most cases, a spill in a remote area will have to be cleaned up. The cost of doing so may be very high because of the remoteness of the area and its associated logistical problems.

Multinational programme issues – regulation and premium tax

Increasing focus on tax and regulatory issues is beginning to have a very significant impact on multinational programmes at both primary and excess levels. This can be particularly complex in the energy sector which may have widely-spread operations-some in territories which have recently evolved insurance regulation and taxation regimes.

The catalyst for the increased emphasis on the correct handling of tax and regulatory issues was the Kvaerner case in 2001. The European court of justice held that within the European Union member states were entitled to charge tax on premium in relation to risks located in their territory, and so the way in which the insurance programme is placed and invoiced may not

affect the buyer's obligation to pay tax. For example, a company headquartered in France may pay 100% of the premium on excess layers centrally. However, the tax authorities in the Netherlands may still require tax to be paid in relation to risks located in their country. Although the judgment related to the European Union, similar issues may arise elsewhere.

Local insurance concerns

A further concern is the relationship of global excess programmes to local insurance regulation. In many parts of the world, non admitted insurance is not permitted, and typically, excess layer programmes are issued to the parent company. In the event that a claim occurred in a country that does not permit non admitted insurance, difficulties could well arise in relation to claims adjustment and settlement, with possible regulatory or tax consequences.

The position is further complicated by the different fiscal and regulatory position of various insurers, and indeed whether or not they have the systems in place to calculate and pay tax to the appropriate tax authorities.

It is clearly very important to ensure that an insurance buyers' premium allocation and insurers' processes align with the regulatory and tax requirements in the countries in which the insured operates. Unfortunately, there is never a single solution that can apply to all cases.

The importance of the issue is now generally recognised and improved processes are being developed by the insurance industry to ensure compliance. However, the scale of the task should not be underestimated. A large global company may have risks located in one hundred countries all of which may have different requirements.

Local issues –the Zurich approach

Zurich has recently taken the lead in introducing a new approach to addressing these issues, based around a proprietary database of taxation and regulatory information. This allows the mapping of a client's global footprint onto the local taxation and regulatory issues. Zurich says that this enables both the client and the insurer to demonstrate compliance. Zurich is a key player in the energy market and their stance will have a significant impact.

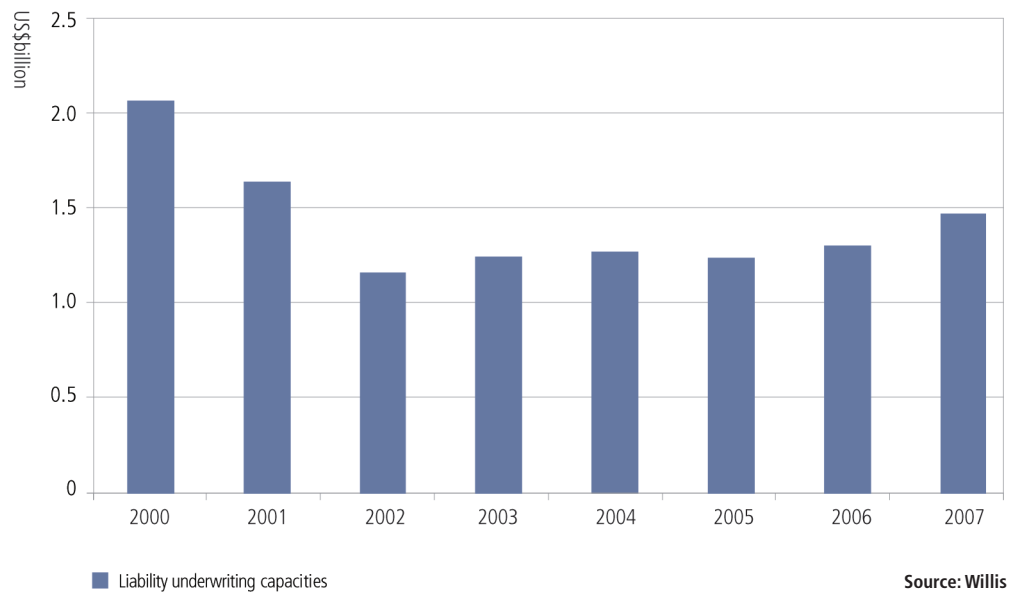
We expect other global insurers to develop their own approach to tackling the issue. One difficulty already being experienced is bringing together different industry views of the appropriate way of handling the problem.

Planning premium allocation and collection is becoming a key part of the renewal strategy for multinational energy businesses. Early discussion is vital as in some cases programmes may need to be restructured to meet regulatory requirements.



Conclusion – at full stretch?

Liability market capacity, 2000-2007



Our latest chart above demonstrates that capacity continues to flow into the liability market. For most industry sectors more than enough capacity is available to achieve required limits. However, capacity for individual risks in the Energy sector is lower; some insurers avoid the sector or cannot provide cover where there is significant US exposure.

Within the overall figure for 2007, we estimate overall energy capacity at approximately US\$1-1,200 million.

To achieve this in one programme, a mixture of follow form and occurrence reported forms would have to be accepted by the buyer. In practice, even large buyers are buying lower limits than are theoretically available, leaving plenty of competitive leverage in brokers' negotiations with insurers.

However, as we have mentioned we believe that the market may well stabilise during 2008.

Stretch factor: Significantly Stretched

Onshore Construction

In December 2006, we said:

- The onshore construction market remained stable during 2006, with capacity static and the leadership panel consistent
- Some fresh capacity is anticipated in 2007, which may lead to some softening of rates
- There is scope for negotiating broad policy coverage
- Deductible levels remain static
- Lender demands continue to be a key driver on project financed deals
- Demand for significant Delay in Start-up cover is likely to increase

Market Overview

Whilst the onshore construction market remains somewhat more stable in comparison to the operational energy market, the absence of any significant natural catastrophes in 2006 has prompted the first real signs of softening during the first quarter of 2007.

The market has enjoyed a sustained period of good underwriting results and this competitive market remains very positive with a particular appetite for well-managed risks utilising proven technology and experienced Engineering, Procurement and Construction (EPC) contractors in locations with little or no natural catastrophe exposures.

In particular, substantial market appetite exists for quality business encompassing a high degree of advanced risk management and quality control. This is particularly the case for energy projects located in regions with little or no natural catastrophe exposure.

Leadership stable but mid-market entries drive increased capacity

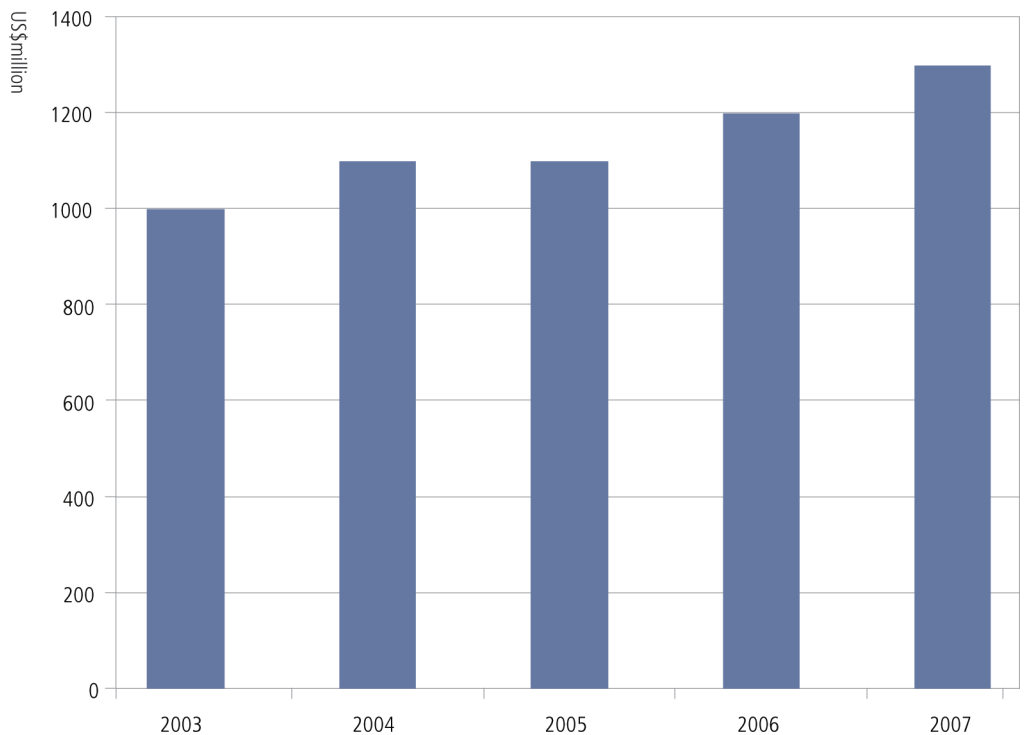
The overall market leadership panel remains broadly similar to that of the past few years, although welcome mid-market capacity started to return during late 2006 and early 2007. Significant market developments include:

- Lloyd's insurer, Alba Syndicate, is offering between US\$ 30 to 50 million from their Singapore office
- Infrasure, based in Switzerland, has a capacity of US\$ 30 million and is now showing a considerable appetite for energy business
- Gerling is keen to expand its portfolio of international business
- New Lloyd's entrants Chaucer Syndicate and WR Berkley entered the market in the first quarter of 2007



- Aspen Re, a relatively new entrant to the market, is set to provide significant capacity on an excess of loss basis
 - The O'Farrell Syndicate is now also actively underwriting onshore oil, gas and petrochemical business, with a new PML capacity estimated to be approximately US\$40-50 million
 - New marketing opportunities are developing in the Bermudan insurance market. Leading markets such as Montpelier Re, Ironsure, Ariel Re and Max Re are now expanding their portfolios to long-term construction business, and this change in philosophy has introduced approximately US\$ 150 million of new PML capacity.
 - Some European carriers have re-entered the market following upgrades in their security rating, notably SCOR, Infrasure and Gerling
- Following these recent developments, we now currently estimate total capacity for 2007 is likely to be in the region of US\$ 1.3 billion on a Maximum Probable Loss (MPL) basis, an increase of some US\$100 million on 2006.

Onshore construction capacity for energy business, 2003-07



Source: Willis

Deductible levels remain consistent, with insurers challenging current levels of deductible for faulty part coverage (as per the LEG/3/2006 form), where process technology may be new/unproven or where significant "scale-up" issues arise.

Key Market Drivers

There are a number of factors that will shape the profile of the onshore construction insurance market as we move through 2007, which can be summarised as follows:

- **Reinsurance treaty issues**
Insurers will need to manage their exposure accumulations at sites where they already underwrite existing risks through their property portfolio. This is particularly the case in natural catastrophe-exposed regions where the underwriting of construction as well as property risks may breach their reinsurance treaty restrictions.
- **Unified lenders' clauses**
The market is currently driving for standard lenders' clauses so as to reduce time spent in agreeing these for each and every project.
- **Longer project periods**
An increase in the size of projects and the consequent increase in the length of construction periods have caused a degree of overload and strain in the specialist EPC contractor sector. Consequently, insurers are paying particular attention to the quality and expertise of EPC contractors selected to work on upcoming energy projects.
- **Inflation**
An increase in the price of raw materials has seen contract values increase, thereby further stretching PML requirements.

- **Demands on EPC capacity**

There are concerns in some quarters of the market that Quality Assurance/Quality Control (QA/QC) may possibly be compromised, due to the demands on EPC contractors and their resources.

- **Project delays**

The overloading of materials and equipment suppliers and vendors has meant that project delays are becoming more common.

- **Heavy civil engineering**

This sector is continuing to experience continued heavy losses, and insurers are consequently particularly cautious of this type of work.

- **Contract certainty**

Contract certainty regulations imposed on the insurance industry in the UK by its regulator, the Financial Services Authority (FSA) require all terms of insurance to be known and agreed by the insurer and the insured prior to the contract of insurance taking effect. All markets remain fully committed to this issue.

Insurer options open to buyers

The tables on the following pages outline the key leading and supporting markets that Willis would consider for onshore energy construction placements, together with their financial strength rating and capacities. It should be recognised that many global market centres feature some of the same carriers, but these will be limited to business within their dedicated region and are more often than not limited by size and/or type of account they can underwrite without referral to head office. Our aim here is to provide a comprehensive summary of global markets options that we have at our disposal.

Contractors' All Risks/Erection All Risks (CAR/EAR) Markets

The choice of leading insurer is fundamental to a successful placement. In particular the leading insurer must be:

- Accessed at the right point in order to leverage the broadest coverage at the best price
- Competitive
- Of first-class security and meaningful capacity
- Credible and command the confidence of support markets
- Able to offer "value added" services apart from price and coverage
- Open to creative placement solutions
- Claims efficient
- Transparent and supportive, offering a true partnership with the client.



Potential leading insurers

Company	Standard & Poor's Rating	PML Capacity (US\$)
Allianz	AA-	125,000,000
Liberty International	A	100,000,000
Munich Re	A+	100,000,000
SCOR	A-	100,000,000
Swiss Re	AA-	100,000,000
Zurich	A+	75,000,000
AIG	AA+	70,000,000
Beazley Syndicate (Lloyd's)	A	50,000,000

Potential supporting insurers

Company	Standard & Poor's Rating	PML Capacity (US\$)
StarrTech	A+	200,000,000*
ACE	A+	100,000,000
Aspen Re (Excess of Loss)	A	75,000,000
Chaucer Syndicate (Lloyds)	A	50,000,000
Ironsure	(AM Best) A-	50,000,000
MARP	A+	40,000,000
Millennium Syndicate (Lloyds)	A	40,000,000
O'Farrell Syndicate (Lloyds)	A	40,000,000
Alba Syndicate (Lloyds)	A	30,000,000
Hannover Re	AA-	30,000,000
Generali	AA	30,000,000
Gerling (re-entered after rating upgrade)	A+	30,000,000
Infrassure	A-	30,000,000
Partner Re	AA-	30,000,000
Tokio Marine Global	AA-	30,000,000
XL	A+	30,000,000
Axis	A	25,000,000
Catlin Syndicate (Lloyds) (now including Wellington)	A	25,000,000
ARCH	A-	20,000,000
Ariel Re	(AM Best) A-	15,000,000
Max Re	(AM Best) A-	5,000,000

Excess Third Party Liability

Potential leading insurers

Company	Standard & Poor's Rating	PML Capacity (US\$)
DAC Syndicate	(Lloyds) A	75,000,000
ACE Europe	A+	50,000,000
AIG	AA+	50,000,000
Zurich Energy	A+	50,000,000

Potential "Support" Markets

Company	Standard & Poor's Rating	PML Capacity (US\$)
AWAC	(AM Best) A+	50,000,000
Liberty Mutual (Europe)	A	50,000,000
QBE	A+	35,000,000
Aegis Syndicate	(Lloyds) A	20,000,000
Brit Syndicate	(Lloyds) A	20,000,000
Catlin Syndicate	(Lloyds) A	20,000,000
CNA	(AM Best) A+	20,000,000
Newline Syndicate	(Lloyds) A	20,000,000

Conclusion – at full stretch?

After a sustained period of positive technical insurer results in the downstream construction market since 2000, we are now glad to report some softening in market conditions. Whilst none of the new carriers has taken an aggressive position as leaders, their capacity has had the effect of reducing the dependency on existing lead markets and thus facilitating the completion of more aggressively-priced placements that might otherwise have stumbled.

However, although we have seen more downward pressure on rates as claims experiences have improved, insurers have tended to keep deductibles high as these have been a key factor in improving the claims record for this class.

Similarly the coverage offered has not changed significantly. Broad-form coverage was still available in the harder phase of the market cycle and whilst there is some opportunity for enhancements in cover, many buyers are relieved to see downward pressure on premium expenditure rather than seeking to use the same premium spend to buy wider cover.

The downward cycle is not as dramatic as in some other markets, such as onshore property. This is largely due to the longer tail nature of the construction market and the impact of new entrants in the mid-market, not in the leadership. As an example, rates on similar risks might have eased by 15-20% in the last 12 months.

Where will this cycle move? There is probably still more opportunity for further rate reductions, but insurers in the downstream construction market have learned the hard way through previous cycles. They are certainly wary of chasing rates down to levels that proved unsustainable in the bottom of the last cycle

in 1999-2000. To a great extent, the future depends on the treaty reinsurance market and the catastrophe losses sustained in that market, since most downstream construction insurers are heavily dependent upon treaty reinsurers. Most of these leading treaty reinsurers, including Munich Re, Swiss Re and SCOR, are also influential contributors in the downstream construction sector. They therefore have a close appreciation of the direction of the market and can exert pressure where and when required.

There is still a great deal of volatility in the market. Although in our estimation total PML capacity exceeds US\$1.3 billion, total market premium volume is somewhat less than this figure. Several markets are committing themselves to unlimited each and every loss PML lines, which significantly exceed their net premium volume.

Volatility is also evident in the increasing demands for Delay in Start-Up (DSU) coverage. The increased limits being provided and the nature of this exposure certainly contribute to this volatility, although this coverage has been a feature of the downstream market for many years and the experience has been relatively benign.

The main leaders in the market remain familiar. They are tried and tested in the market, particularly with regard to claims service. These insurers view their participation in the downstream construction market as an essential offering to their global clients, and are therefore resilient enough to trade through the phases of the market cycle. If market conditions were to soften to such a level that these carriers withdrew their capacity, not only would the market harden in an irregular and unpredictable manner, but some of their expertise and value might be lost to this sector for ever.

Stretch factor: Significantly Stretched



In December 2006, we said:

- 2006 was a year of stability in the power market
- Some rate reductions were achieved for programmes not exposed to natural catastrophe perils
- Programmes exposed to natural catastrophe perils saw price increases and coverage restrictions
- Some insurers were concerned that economic corners could be cut due to increasing deregulation and liberalisation
- There was no solid consensus among insurers over the market's future direction, although there were signs at the end of the year that insurers may be willing to compete for business in 2007

BI Losses from gas turbine technology cause concern

In our last review of this sector, we stated that 2006 allowed underwriters to catch their breath and take stock. While this was certainly true from a catastrophe perspective, with a benign windstorm season, the same cannot be said from a risk perspective, with a continuation of high frequency and high severity losses from fire and machinery perils.

The on-going failures experienced with combined cycle gas turbine technology are of particular concern to the power market. The series of compressor failures during 2006 has continued into 2007 and as a result, certain critical spares that had been available globally have in some cases been exhausted and the waiting period for certain machinery components will therefore be lengthy.

As a result, in the majority of these losses the physical damage portion has been outweighed by the business interruption portion. Business interruption therefore represents a much higher increase in exposure than in the past and will be scrutinised in far greater detail by the market.

Greater scrutiny of underwriting information Power underwriters are now far more selective in participating in programmes featuring certain technology exposures and continue to closely monitor gas turbine developments, looking closely into the root cause analysis post-loss. It is vital that underwriters are able to review a comprehensive level of underwriting information that details:

- the availability of spares
- the lead time required to source or design specific critical component parts

- the mitigating factors, such as liquidated damages, that apply through contractual service agreements

In response to these concerns, some gas turbine manufacturers have taken the step of presenting details of their latest design measures to the market, and importantly, sharing the results of their units' global operational experience.

New entrants prompt market softening despite losses

Despite the extraordinary run of losses in the sector, which have included other types of fire and/or boiler explosion incidents to power generation plants as well as combined cycle gas turbine plants, there have not been any withdrawals of capacity from the market; in fact quite the opposite has occurred.

Following the excellent 2006 underwriting results in the non-marine sector generally, there have been a number of new entrants into the market, many of whom have an appetite for the power sector.

Although none of this new capacity is capable of leading placements, it represents significant support to the existing well-established lead carriers that remain committed to the sector. This has had the effect of applying pressure for 'market share' on risks that have been loss-free. Consequently, we are seeing the market soften, not only on pricing but also, where there is a business case, coverage and sub-limits as well. The market is generally holding firm on deductibles, although many buyers are re-investing the premium savings achieved on their renewals by buying down their deductibles through niche, non-energy markets.

Conclusion – at full stretch?

As the market continues to soften, we have seen the re-emergence of long term agreements under which some buyers have opted to lock-in the market for 24 (and in some cases 36) months. Although these agreements do allow for cancellation from either side, this can normally only be triggered in the event of limited and specific changes such as an extremely adverse loss ratio or a significant change in the insurer's reinsurance treaty protection.

Stretch factor: Significantly Stretched





In December 2006, we said:

- Recent losses in the Middle East and Latin America had an uneven effect on the Terrorism market
- The emergence of Lancashire Re as a major lead has increased pressure on rating levels
- This has contributed to further increases in capacity, although with the exception of Lancashire the panel of leaders for this class remains broadly similar
- More insurers are now offering longer policy periods, although the market remains firm on retention levels and policy coverage
- At the time of writing, TRIA was set to expire at the end of 2007
- The need for detailed, accurate underwriting information is crucial in securing the very best terms for the market
- Pressure on the terrorism market is now being applied by the general property market, so the insurers will have to walk a tightrope between charging sufficient money for the risk and allowing the property market to absorb more of this class of business

Increased demand maintains premium flow as market softens still further

In the previous edition of the EMR we commented on how the terrorism market was continuing to soften, so there were fears that this specialty market might become swallowed up by the general property market. As this edition goes to press, we can at least report that this possibility is still some way off. The nightmare scenario for this specialist market, whereby property insurers simply include terrorism coverage for no additional premium across the board, has not yet materialised, although they are beginning to include terrorism cover for small sub limits (typically US\$20-50 million) at terms with which the specialist market cannot compete.

Average rate reductions for Terrorism placements in 2007 are in the order of 15-20%, depending of course on the individual risk profile of the buyer. The reason for the rapid softening of market conditions is simple enough. Since 2001, claims have been few and far between, with the Madrid train bomb of 2004 at US\$ 35 million being the largest loss of any real significance. Other market losses have included the Madrid Airport bomb at EUR 30 million, as well as losses in Sri Lanka and an attack on an army base in Cali, Columbia. However, these have not had any measurable effect on market conditions, and so the pressure to increase premium income from this line of business continues apace.

However, the market continues to maintain overall premium income levels due to increased demand for this product, especially from the construction sector where lenders' requirements for the purchase of Terrorism insurance has kept insurers' order books relatively full. The issue of policy period for construction risks, which prevented a large section of the market from writing this area of the portfolio in the past, has

now largely been negated by the market's ability to provide approximately US\$ 500 million of Terrorist capacity for a 36 month period. So as long as the construction market remains relatively buoyant, the prospects for the market remain reasonably bright – in the absence of any major losses.

Capacity over-supply continues

Capacity remains plentiful in the global Terrorism market. It is estimated that over US\$1,300 million is now available to buyers worldwide, and given that the average limit purchased is in the region of US\$100 million, the scale of the over-supply is clear enough. However, capacity for Terrorism Liability remains relatively limited at approximately US\$ 200 million.

Further supporting capacity from Lloyd's has joined the established market practitioners in the form of Novae, Advent, Hardy and St Paul. None of these recent joiners are looking to establish themselves as market leaders, but their participation in most programmes has fuelled the softening process still further. Meanwhile Lancashire Re has pulled back from taking lead positions on placements, possibly to avoid criticism from fellow insurers of forcing prices down still further. However, given that they are generally willing to support other leads from smaller insurers with a US\$100 million line, the general effect of this development may be to enable other highly competitive lead indications to be completed when perhaps they might not have been a few months ago.

Conservative insurers expand their book

One major consequence of this trend has been for conservative insurers, who used to be reluctant to participate in programmes featuring property located in politically sensitive areas of the world such as Indonesia, the Philippines and Nigeria, to expand their portfolio into these regions in order to boost premium

income. This has left the new entrants with only this volatile part of the overall portfolio to participate in, as the remainder has now been over-subscribed by the existing market.

Lexington may threaten Lloyd's North American business

One of the clearest signs of a softening market has been the dramatic increase in the capacity for this class for Lexington (AIG) who have increased their maximum line from US\$100 million in 2006 to US\$ 250 million in 2007. It is understood that this has been achieved by means of a reinsurance arrangement for which Lexington have already paid a handsome premium. It would therefore be reasonable to suggest that the company may be looking to increase its market share by a significant margin, in order to ensure that this will have been money well spent by the end of 2007.

This would undoubtedly have a significant effect on Lloyd's North American terrorism revenue, as for the last few years Lloyd's has traditionally written many placements for a typical limit of US\$150 million excess of Lexington's primary US\$100 million layer. Now that Lexington's capacity has increased to US\$250 million, this will almost certainly result in this portfolio of business being lost to Lloyd's. Consequently, Lloyd's insurers will have to look even closer at their non-North American portfolio to find ways of augmenting their existing premium income, which will naturally increase competitive pressures still further.

TRIA likely to be extended

Meanwhile, TRIA is still due to expire at the end of 2007, with a recent republican party-biased presidential working party having suggested its abolition. However, given that the Republicans have recently lost control of the Senate, it is our view that TRIA is instead likely to be extended. As we indicated in the previous edition of the EMR, given the high attachment point of US\$100 million



the only real exposure to the cover provided by TRIA remains the small spread of key real estate located in New York and Chicago.

Sabotage Defined

Generally, the coverage afforded under a Terrorist policy remains unchanged. However, the standard Terrorism policy wording T3T3A has now metamorphosed into LMA 3030. The major difference between the two wordings is that the peril of sabotage is now specifically defined and included in the coverage provided. Under the old form, it used to be difficult to prove whether a loss was caused specifically by sabotage or by terrorism, whereas the new wording removes this difficulty and the potential for disputes to arise in the event of a loss.

Conclusion: At full stretch?

The current Terrorism market has only been in existence since 9/11 and is therefore a relatively immature market. Given the lack of major losses, it has never really been tested and so it is difficult to determine exactly how long the current cycle will last.

Given the leading role that Lloyd's insurers play in this market, one factor that may eventually break the current market softening is the attentions of the Franchise Board. At some stage, especially in respect of programmes featuring benign locations from a Terrorism standpoint, rates on line will become so marginal that many insurers will have no choice but to walk away from this sector. However, this prospect is still some way off for programmes from the more volatile areas of the world, where rates on line can still certainly be justified at present.

One certain way that the current conditions could be brought to a halt is by the occurrence of a major loss of say US\$ 300 million, spread across 20 or so

individual insurers, but in the absence of such an eventuality, we would suggest that there is still some way to go before this market eventually turns.

Stretch factor: Slightly Stretched



Directors and Officers Liability



In December 2006, we said:

- Global D&O capacity is greater than ever, with excess of US\$ 300 million commercially available
- The London market has experienced a flatter market cycle than at previous times, with a gradual softening now gaining some momentum
- This has in part been fuelled by Zurich, who are happy to provide coverage on a primary US\$ 10 million basis
- In North America, upwards premium adjustments are anticipated for companies facing claims activity, although rates are competitive for attractive business
- “Hot button” issues for 2007 include the extension of non-rescindable coverage to Insuring Clause A&B , thresholds for personal conduct exclusions and tailoring global programmes to fully balance the need for local policies

Overview

The D&O market both in the USA and elsewhere in the world still shows no sign of hardening.

In fact, rates on some accounts have seen some fairly healthy reductions over the past 3 months. In the UK, insurers are under constant pressure to increase their premium budget and a number of them are becoming increasingly aggressive in order to increase their market share.

Will this trend continue?

There has been a number of changes in the Companies Act, the most important being that companies are allowed to indemnify their Directors in an increasing number of circumstances. This has given insurers increasing confidence in reducing premium rates as there is now a far greater chance that the company reimbursement deductible will apply.

The new companies act does, however, introduce the US concept of Derivative Actions. These actions have to be approved by the UK courts, so it is not anticipated that it will open the floodgates for this sort of action. What it does mean, however, is that this type of claim will fall on Side A of the policy as the company will not be able to indemnify the Directors and Officers and therefore no deductible will apply.

A Derivative Action is a claim brought in the name of the company by a third party. This could be a shareholder or someone who believes that the Directors are not managing the company properly. The Directors and Officers of BP have recently had a Derivative Action brought against them for alleged negligence in their oversight of pipelines in Prudhoe Bay. The action was brought in October 2006 and the case is ongoing.

It is important to note that any award will go back to the company and not to the third party claimant.

Global Settlements

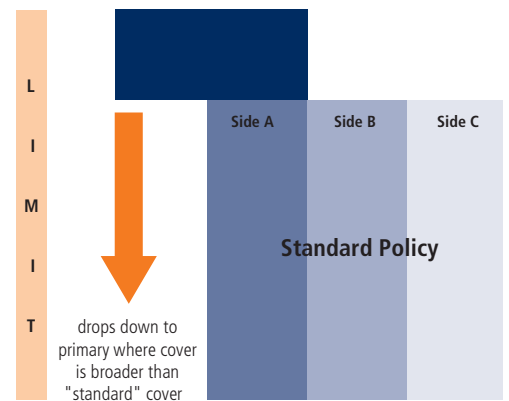
Another recent development is the concept of global settlements on D&O claims. Up until recently the US lawyers would bring a shareholder claim for the benefit of the US shareholders only. It was then up to the other shareholders to bring claims in their own country, but this is no longer the case. Today, if the company has shares traded in the United States, then the whole value of shares traded needs to be taken into account. This is because the lawyers in other countries where the company has shares traded would join in the claim made by the US lawyers to form a global claim.

This of course has a huge impact on the potential size of any claim where the client has shares traded in the United States. The largest European D&O claim to date was a global settlement in November 2006 against the Directors and Officers and the company of Royal Ahold for US\$1 billion.

Side A DIC

Because of the potential for an even array of claims against the Directors and Officers there are now a larger number of insurers keen to quote for Side A DIC (Difference in Conditions) policies.

This is a policy that sits excess of the conventional policy but covers Side A claims only – a claim that cannot be reimbursed by the company. It can also provide Difference in Conditions (DIC) cover that “drops down” to the ground where the cover provided by this policy is broader than the underlying.



The areas where coverage is broader on the Side A DIC policy are:

- It does not contain a pollution exclusion
- It is a non-rescindable policy
- It has limited Insured v Insured exclusion
- It provides dedicated coverage for the Directors and can be amended to provide coverage for the non-executive Directors only if required

The take up of this policy has not been as great as expected by the insurers, mainly because it is still seen as a expensive in comparison to the rates payable on underlying policies.

Another reason why the take-up has not been as good as expected is that insurers have been willing to broaden their standard D&O policy thus making the Side A DIC policy less attractive.

Areas that insurers have broadened are:

- Making their policy non-rescindable.
- Providing broad coverage on pollution claims, as some insurers' forms do not even have a Pollution Exclusion as standard.
- No Insured v Insured exclusion, except in the USA.

We believe that the cost of these policies are likely to reduce in future making them far more attractive to clients.

What about claims – are insurers making money?

We have debated the issue of whether the soft market will continue. If the current economic trend continues, with most companies still showing good profits and with the economy not showing a sign of downturn, then there is less likelihood of claims being made against Directors and Officers. Currently most insurers are making a good profit on European and UK D&O business so unless there is a influx of new claims this trend of fewer claims is set to continue.

In the USA the market is similar, except the profit margins that insurers work to are not so great and there is always a steady flow of new claims. This has the effect of making less impact, should there be any premium adjustment upwards in the UK. This said, the market is currently seeing rate reductions of about 5-10% for what insurers consider to be the right risks. A large number of US buyers already purchase some level of Side A DIC cover, about 80% compared to approximately 20% in the UK, so we do not expect to see this number grow significantly. Furthermore, some companies with strong balance sheets are purchasing Side A programmes only.

Last year was another record-breaking year for claim settlements although the number of securities claims notified has dropped to a 10 year low. The main claims focus currently centres on the large number of

companies that have been sued based on allegations of stock options timing manipulations. To date, there have been 29 Security Fraud Class Actions and over 150 Shareholder derivative lawsuits brought against the directors and officers and their companies. It is too early to say whether these claims will have an impact on D&O premiums, but as the market is still showing reductions in rates after paying out the largest amount of D&O claims last year, it appears quite minimal.

Considerable amount of time is being spent on reviewing insurer wordings and it is possible to have insurers agree specific coverage improvements that a few years ago would have seemed impossible. These include:

- Coverage for Joint Venture companies
- Pollution Coverage for Shareholder Claims

Conclusion – at full stretch?

The D&O market shows no signs of hardening. Rates remain competitive – especially for excess layers where the rates are falling further than the primary layers. Unlike some other market sectors, insurers are also broadening their wordings.

There is much discussion with clients on the need for local policies for different territories to satisfy local regulatory requirements. Many of the larger insurers have new facilities which are able to cater for the clients' requirements in this regard.

We may even see the introduction of multi-year policies if the market continues to soften. The major factor affecting rates is the number and severity of claims – which for the UK at least there has not been either the number or severity that had been expected.

Stretch factor: Slightly Stretched



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