

IN LIMBO - BUT FOR HOW LONG?

CONTINUED OVER-CAPITALISATION SUGGESTS UNDERLYING SOFTENING DYNAMIC, DESPITE RECENT LOSSES

As the 2011 Gulf of Mexico hurricane season approaches, the middle of the year is perhaps a good time to take stock of how the energy insurance markets have reacted in the aftermath of recent losses, and to examine how market dynamics might develop as the year progresses.

In our Energy Market Review in March, we suggested that, notwithstanding the effects of the Tohoku earthquake and Macondo oil spill, 'The energy markets will remain over-capitalised and in theory at least, competitive pressures will continue to persist.'

To date, we have to say that there has generally been precious little sign of softening. Why has this been the case?

- **The natural catastrophe loss record.** On July 14, 2011 Munich Re stated in a press release that 'An exceptional accumulation of very severe natural catastrophes makes 2011 the highest-ever loss year on record, even after the first half-year. Already, the economic losses of approximately USD 265 billion up to the end of June easily exceeds the total figure for 2005, previously the costliest year to date (USD 220 billion for the year as a whole)...altogether, the loss amount was more than five times higher than the first-half average for the past ten years.'
- **A relatively high frequency and magnitude of both onshore and offshore losses.** Both sectors have suffered a loss of over USD 1 billion this year, in the form of the Canadian oil sands loss and the Gryphon A incident in the North Sea. We will outline these losses later in this newsletter.
- **The potential for a more expensive reinsurance market.** On July 1 Willis Re reported that, despite the injection of USD 1.2 billion of new capital into the reinsurance market, the July 1 reinsurance renewal season saw those energy insurers who did renew/refresh their reinsurance at this time generally found that their treaties paid increases - anything from flat to 10% for downstream business, but up to 50% for upstream business, depending on loss record. While only a small percentage of energy insurers renew their reinsurance treaties at July 1, this development does perhaps indicate the probable response of the reinsurance market to renewing their energy treaty portfolios at January 1, 2012.



The Willis Energy Market Review (EMR) newsletter provides its readers with a round-up of news affecting the energy insurance arena.

The newsletter should be treated as a supplement to the Willis Energy Market Review, which is published in April each year.

Where information has been obtained from external sources, this is indicated at the end of each item.

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- **Increased management pressure.** As a result of the three factors outlined above, pressures from insurer management seem to be more aligned than before. Consequently, the majority of insurers are holding the line on rating levels.

So while both upstream and downstream markets remain over-capitalised, both upstream and downstream markets are now basically in a state of limbo. The key issue is how long this state of limbo will last, and what direction the markets will take as we move closer to 2012, when the reality of any change in reinsurance market dynamics may become evident.

DOWNSTREAM MARKET

Have recent BI losses prompted a King Canute moment?

Downstream losses (insured and uninsured) excess of USD 10 million, 2011 (to date)

Source: Willis Energy Market Database, July 22, 2011

TYPE	CAUSE	LOCATION	COUNTRY	PD USD	BI USD	TOTAL USD
Oil sands	Fire/lightning/explosion	Alberta	Canada	710,000,000	2,000,000,000+	2,710,000,000
Chemical	Earthquake	Kashima	Japan	11,000,000	162,600,000	173,600,000
Gas plant	Windstorm	Oklahoma	USA	50,000,000	100,000,000	150,000,000
Petrochemical	Fire/lightning/explosion	Louisiana	USA	20,000,000	108,000,000	128,000,000
Chemical	Earthquake	Soma	Japan	36,000,000	35,000,000	71,000,000
Gas plant	Fire/lightning/explosion	Texas	USA	50,000,000		50,000,000
Refinery	Ice/snow/freeze	Texas	USA	7,300,000	36,000,000	43,300,000
Gas plant	Mechanical failure	Texas	USA	16,000,000	13,000,000	29,000,000
Chemical	Mechanical failure	Louisiana	USA		25,000,000	25,000,000
Petrochemical	Supply interruption	Bahia	Brazil	25,000,000		25,000,000
Chemical	Fire/lightning/explosion	South Carolina	USA	25,000,000		25,000,000
Gas plant	Windstorm	Alabama	USA	9,000,000	4,000,000	13,000,000
Petrochemical	Collapse	Texas	USA	10,000,000		10,000,000
TOTAL				969,300,000	2,483,600,000	3,452,900,000

As the chart shows, the downstream market has already sustained four major losses so far during 2011, with by far the largest of these being the Canadian Oil Sands Upgrader fire. Although the final loss has still to be finalised and not all the Business Interruption (BI) amount is insured, the overall loss has still caused the entire market to pause for thought – especially as this is the second such loss from the Canadian Oil Sands within the last five years. The chart also shows that of the losses excess of USD 10 million, over 70% of the total figure consists of BI losses. There is certainly an expectation in the downstream market that there will be continued BI losses coming through the system in the next three to four years.

There is no doubt that the downstream market underwriters recognises this significant loss – and the other losses that have materialised so far during 2011 – as a rationale for instigating a fundamental change in market conditions. Indeed, there have been several examples recently of well-known downstream market underwriters publically stating that any further softening in this market must stop. However, given the current over-capitalisation of this market, perhaps they should remember the story of the Anglo-Saxon King Canute, who famously forbade the tide to come up the beach where his throne was located but was forced to concede defeat when the laws of nature ensured his throne's inevitable immersion in the waves.



The current situation – where excess capacity meets a deteriorating loss record – reminds us somewhat of the situation following hurricanes Katrina and Rita in 2005 when any upswing was negated within six months as overall capacity levels continued to be maintained.

As a result, in order to ensure sufficient premium income to meet their targets, downstream insurers now find that they must continue to compete for business without necessarily showing a reduction in base rating. So despite the marked increases in losses and potentially increased reinsurance costs, the market has remained essentially flat in recent months, with some programmes paying modest increases and others achieving modest premium reductions – despite insurers’ resolute public pronouncements.

Looking ahead to 2012, there are perhaps three basic scenarios that may develop in the downstream market, depending on how

the overall loss record and reinsurance market dynamics develop:

- There are no further significant losses, no capacity decides to withdraw and insurers are forced to compete in 2012 once again to maintain or enhance market share.
- Further losses prompt a further increase in reinsurance rates and net retentions, causing insurer management to conclude that the class as it currently stands is unsustainable, resulting in significant capacity withdrawals and the onset of a truly hard market.
- The existing market will essentially continue to participate in this class but with reduced overall capacities and line sizes to take into account any increased reinsurance retentions/treaty cost in 2012. This will still result in decreased capacity for 2012 but the effect of any market upswing will be more limited than if there was a full scale market withdrawal.

UPSTREAM MARKET

As we noted in April, upstream capacity is now at a record high, which of course continues to make life difficult both for insurer management and regulators such as the Lloyd’s Performance Management Directorate (PMD) in its efforts to ensure that the overall portfolio remains profitable from a Lloyd’s standpoint. It is interesting to note that the PMD has gone on record in the past to maintain that various sections of this class (for example, offshore energy liabilities) cannot be underwritten profitably – and yet several syndicates can point to significant underwriting returns for this class over many years. This issue simply serves to remind us that upstream energy can often be a more complicated portfolio than other lines of business, and that any generalisations about underwriting returns can often be misleading and challenged by individual insurer track records.

Notwithstanding this, capacity for classes such as these is only a fraction of the overall capacity for upstream risks. Following the Macondo loss there has been an increased focus on the Marine Liability and Operators Extra Expense portfolios, which will certainly extend into 2012. Those classes have seen significantly increased demand for their products as energy companies have sought to purchase higher policy limits. This dynamic shows no sign of altering as such a ‘market within a market’ for these classes remains. Consequently, the supply and demand dynamics remain in insurers’ favour and so the market for these classes is more robust; in the short term at least it is therefore unlikely that these classes will show any signs of softening.



So despite the maintenance of overall capacity levels, the overall atmosphere in the market following the Japan earthquake and the Gryphon A loss has resulted in the forging of a much tighter consensus among underwriters. This has allowed insurers to resist any significant market softening in 2011.

So far, any upswing in the reinsurance market in the middle of 2011 has had minimal impact on the upstream market, due to the small number of upstream

The chart below shows no let up in the deterioration of the upstream loss record since Macondo.

Upstream losses (insured and uninsured) excess of USD 10 million, 2011 (to date)

Source: Willis Energy Market Database, July 22, 2011

TYPE	CAUSE	COUNTRY	LAND/ OFFSHORE	PD USD	OEE USD	BI USD	TOTAL USD
MOPU	Heavy weather	U.K.	Offshore	460,000,000		500,000,000	960,000,000
Rig	Capsize	Mexico	Offshore	160,000,000			160,000,000
MOPU	Mechanical failure	USA	Offshore	150,000,000			150,000,000
Well	Mechanical failure	Norway	Offshore	104,540,000			104,540,000
Well	Blowout	Nigeria	Land		22,400,000		22,400,000
Well	Blowout	USA	Offshore		22,000,000		22,000,000
Well	Blowout	USA	Land	8,200,000	10,600,000		18,800,000
Well	Blowout	USA	Land		16,000,000		16,000,000
Well	Blowout	USA	Land		13,000,000		13,000,000
Rig	Earthquake	Japan	Offshore	12,430,000			12,430,000
Rig	Fire/lightning/explosion	Nigeria	Offshore	10,000,000			10,000,000
TOTAL				905,170,000	84,000,000	500,000,000	1,849,170,000

Although we have seen four losses over USD 100 million already during 2011, by far the most significant upstream loss sustained so far in 2011 has been the Gryphon A loss in the North Sea. This loss has served to renew market apprehensions about insuring large Floating Production, Storage and Offloading units (FPSOs), especially with regard to the Business Interruption (BI) exposure; while Gryphon A was a relatively old unit, there is now a focus on FPSO starting operations.

As we move into the second half of the year, it will be interesting to see how this trend develops. In the last few months we have witnessed instances where some insurers have chosen not to renew some programmes featuring FPSO BI, and larger rises being imposed for such

insurers that renew their programmes at this stage of the year. That being said, there can be little doubt that insurer management teams are tracking this class very closely, with one eye firmly on what might be awaiting them at January 1, 2012, when most upstream reinsurance treaties renew. This factor will undoubtedly be used by the market as a defence of their determination to maintain or harden their current underwriting stance as we approach the year end.

exposures. In our view the market cannot afford to simply not offer cover for this exposure, although insurers are now bound to be more selective about which risks they insure.

In the meantime, existing market conditions look set to continue for a while yet. Approximately 80% of the upstream portfolio is underwritten in the first six months of the year, and so to a great extent insurers can therefore 'sit on their hands' as the year continues to progress, rather than to compete for business. Historically, upstream insurers have spent much of the next few months 'talking up' the potential impact of the January 1 reinsurance renewal season; the last thing they want is to set a downward trend in advance of this date.



Be that as it may, with overall capacity levels so high, in theory it is still possible that upstream insurers might eventually have to compete aggressively for business later in the year. Much will depend on the following factors:

- The extent to which the upstream market runs out of reinsurance aggregate reinstatements for the remainder of 2011. The Gryphon A loss occurred early in the underwriting year, meaning that a number of upstream insurers were forced to buy reinstatement cover before the end of the first quarter; it is perfectly possible that some of the free reinstatements cover has now also become exhausted. The terms for this cover would be hugely penal in the event of further reinstatements being required.

- The effect of the 2011 Gulf of Mexico windstorm season.
- Any measures that the Lloyd's PMD may insist on if Lloyd's insurers are going to continue to write this class in 2012.
- The cost of reinsurance protection at January 1, 2012, as upstream approach their treaties for the first time since the recent spate of natural catastrophe losses.
- The impact of Solvency II on individual insurers' upstream portfolios.

So will upstream insurers be able to charge more for their products or will continued over-capacity force rates down in the long term?

WILL CROSS-CLASS UNDERWRITING BECOME A REALITY?

While the upstream market – and its current leadership – is largely dominated by Lloyd's, in contrast the downstream market is not only more regionally diverse but is also more heavily weighted towards the large composite insurance company market. In our April Energy Market Review we suggested that it may be possible for these composite insurers to augment their overall income by offering package deals that included upstream energy as well as cargo, D&O, liability and other assorted risks at a discounted rate in light of the increased spread of risk and premium income.

While we at Willis have seen some signs of this trend beginning to gain some momentum, it remains to be seen whether or not it will signal a serious inroad into the overall upstream portfolio. Currently, there seem to be two schools of thought on this:

- One is that such is the widening gap between Lloyd's insurers and the composite insurance company market – brought about at least in part by the

attentions of the PMD – can only mean that the opportunities for composite insurers to package upstream business with other energy risks are bound to increase.

- The other is that while some efforts have indeed been made in the past by downstream insurers to incorporate aspects of the upstream book by cross-class packaging, such inroads have been fleeting at best and have never amounted to a fundamental change in the way that energy risks are marketed. Indeed, when such insurers have been faced with an unacceptable level of losses from such business, history shows that insurers have quickly abandoned such strategies.

In the meantime both markets remain in a state of limbo, while insurers from both markets apprehensively wait for news from the Gulf of Mexico in the months ahead.



WILLIS AWARDED A.P. MOELLER-MAERSK PROGRAMME

We are pleased to announce that A.P. Moeller-Maersk, the world's largest shipping and ports group and one of the world's large international energy groups, has just awarded the transformation and placement of their businesses' insurance programmes to Willis as lead adviser and broker. Willis has had limited involvement with Maersk, and we will take over these global programmes from long-time incumbents Aon and Marsh after a hard-fought competition. Millers, also a long-time incumbent, will co-broke with Willis who will lead.

Team members from Willis Global Specialties (including Energy), Willis Global Solutions and Willis U.K. and Ireland formed a 'one-flag' unit that provided what the client describes as 'an entirely new strategic' capability from a broker. The Maersk team went on to say that "Willis is best-positioned to support our overall strategic direction and transformation program and best understood where we wanted to go." Willis will be providing ERM services, risk analytics, and overall change programme

management (transformation services) in addition to broking services as Maersk transforms from tactical, decentralized and fragmented programs to a strategic, centralized and coordinated programme. Willis has been appointed for three years with options to renew in years four and five.

Martin Sullivan, Chairman of Willis Global Solutions, said of the historic win, "We are changing the dynamics for strategic prospects and clients by integrating risk analysis, strategy and risk management advice with our broking capabilities. Maersk isn't the first time we've done this, but it confirms, in a clear way, that we've got a powerful approach."

Joe Trotti, CEO of Willis Global Specialties, commented that "by listening closely to the client, we knew that Maersk was asking us to fully deploy our strategic approach... Our marine and energy broking power won us the right to compete, and our strategic and analytic tools differentiated us in a major way. We are really pleased to be working with this great company."

NEWS ROUND UP

- On July 6 **Beazley** formally announced they had appointed **Matthew Holmes** to head the company's energy team in succession to **Paul Dawson**, who resigned as Energy Underwriter for the Lloyd's operation of Beazley to join the **Hardy** underwriting group). Holmes has resigned from the **Catlin** energy team and is expected to join Beazley when contractual obligations allow.
- **QBE** has announced that **Peter Burton**, until now in charge of their Singapore operation, is to return to London to be Head of Energy. It is understood that QBE's onshore construction specialist **Bob Knight** is to take over in Singapore.
- **Brit** has announced the appointment of **Brian Randall** as Director of its new Energy & Power division, who will take up his role on October 1, 2011. Previously Randall was energy underwriter for Watkins Underwriters at Lloyd's and has worked in the energy markets for over twenty years, with experience gained across upstream and downstream business as both broker and underwriter.
- **Frank Streidal** has been appointed head of Upstream Energy at **Zurich London**.



- **Mark Stacell** is to join **Statoil** as Insurance Manager Americas. Educated as a Biologist and Attorney, he previously worked for nine years as a conservation scientist in Texas, followed by two years as a practicing attorney. He then moved on to Marsh, working some 4½ years in their environmental brokerage group in Houston. Since leaving Marsh he has been with CITGO Petroleum as Assistant Risk Manager and Claims Manager for some six years.
- **Hiscox** has announced that it intends to increase the capacity for its **Lloyd's Syndicate 33** by GBP 100 million (USD 159 million) in 2012, taking capacity to GBP 1 billion. Hiscox will submit a final plan to Lloyd's later in the year, partly dependant on how active is this year's Atlantic hurricane season.
- **Chartis** have announced that they have doubled their capacity for construction projects from the Global Energy Property unit. With this increase in capacity, insureds will now be able to access up to USD 250 million of PML (Probable Maximum Loss) capacity for construction projects, complementing Global Energy Property's USD 250 million capacity for operational energy and manufacturing risks.
- **Chaucer's Global Energy Practice** has announced the appointment of a **Business Development Management Team** to provide expert technical underwriting and risk management support to its underwriting team. Chaucer said that the seven-strong team, led by newly appointed Divisional Underwriting Manager **Gary March**, brings together energy and nuclear insurance knowledge and expertise, including business analysis, modelling, wordings and policy administration.
- **Liberty International Underwriters (LIU)** and **Liberty Syndicates** have launched a joint initiative to provide **war and terrorism** insurance capacity for **Middle Eastern** risks. LIU will distribute its product through Middle Eastern brokers and provide customer service from its regional office in the Dubai International Financial Centre backed by reinsurance capacity and expertise provided by Liberty Syndicates in London.
- LIU will offer this cover to onshore energy-related risks, industrial units and urban risks.
- **Antares Syndicate 1274** at Lloyd's has announced that **John Potter** has been promoted to Marine Hull, Energy and Liability Account Manager. Antares said that Potter will take the role that **Jonathan Battle** held prior to his appointment as Active Underwriter of Syndicate 1274. Potter will be joined by **Rebecca Avery**, Assistant Underwriter, who recently joined Antares from Axis Capital.
- **Graeme Rayner** has been appointed head of underwriting, property/casualty, for **Mitsui Sumitomo** at Lloyd's and will join the company in August. He has 21 years of experience and will join from QBE Insurance (Europe) where he has been managing director of commercial business.
- On June 13 **Ascot** announced the appointment of **John Karns** as an Underwriter in Houston. Karns has 19 years of experience in the U.S. Energy market, most recently as Assistant Vice President with Navigators Insurance Group.
- **Don Harrell** has been appointed senior vice president of the marine unit of **Liberty International Underwriters**. Based in New York, he will oversee LIU's marine operation in the U.S., Latin America and Canada.
- **Aspen U.S. Insurance** has announced the appointment of **Ken Cornell**, Executive Vice President, to lead Aspen Specialty's Environmental Liability team. He will be based in New York and report to **Mario P. Vitale**, President, Aspen U.S. Insurance. Cornell, with 26 years of insurance experience focused entirely on Environmental business, joins Aspen from Allied World Assurance Company Limited.
- **Keith Jurss** has been appointed Senior Vice President, Professional Liability, **Willis Construction Practice** based in Chicago, reporting to **Paul Becker**, Construction Practice leader, Willis North America. Jurss was previously senior vice president and team leader in the Willis Environmental Practice.

