Energy Market Review

December 2002 Update

Willis

Energy Market Review

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1. Introduction

It is only a few months since we published a full report on each sector of the energy market, and much of the comment contained in the July issue of the Energy Market Review still holds true.

However, there have been some significant developments in the market place, so, as we approach another busy renewal season, we thought it would be worthwhile issuing a short progress report.

This should therefore be looked upon as an interim update, and should be read in conjunction with the July issue; we intend to publish another in-depth Review in the middle of next year.

Note:
We have not provided a specific market update for terrorism coverage in this Review. At the time of writing events are moving so fast that anything we print will already be out of date. We expect, however, to issue a separate update on terrorism soon.

2. Market Overview

On the cusp

They say that a sure sign of a venerable institution being in trouble is when it builds itself a grand new headquarters building. If this is true, then a glance today at the rapidly changing London City skyline should make one pause for thought.

For, in the course of this year, the effect of the share price revolution brought about by the dramatic fall in world-wide stock markets, and which is becoming of increasing concern to the established underwriters in the energy market, has not yet generally been felt by the wider insurance community. New capital coming into the market has relieved the pressure on capacity (apart from some specialist lines) and given rise to a feeling that, whilst conditions in the market will remain firm well into 2003, the worst is over for the insurance buyer. However, as we shall see, this feeling may be premature, for we are not merely witnessing the end-game of last year's market changes hastened on by 9/11; rather, the coupling of the share price revolution with the emerging spectre of serious under-reserving for asbestosis in past years may yet cause a rapid withdrawal of capital, and lead us into a truly hard market.

The growing gulf between "Legacy" and "Non-legacy" markets

As recently as the last issue of this Review in July, the talk was about new insurance ventures and other emerging competition to the established market.

This remains a concern to established energy underwriters, though the new entrants, whilst keen to grow market share, have been careful not to destabilise the market. New capital, however, has been seriously outweighed by capital reductions. Standard & Poor's estimates that the global insurance and reinsurance market has suffered a net reduction in capital of US$170 billion over the past few years due to underwriting losses, significant claims activity, and poorly performing investment markets. *"Set against new capital of approximately US$30 billion raised over the last year, there remains a significant shortfall compared with the capital levels of previous years"* it notes.

Recent share price volatility is demonstrated by the following chart which illustrates the growing gulf in fortunes between the "legacy" companies and the newer entrants to the energy market:

Issue Name	Currency	Price: 01.11.01	Price: 01.05.02	Price: 01.11.02
Swiss Re	CHF	164.75	163.5	99.7
Munich Re	Euro	298	267	127
Scor	Euro	37.5	37.82	6.99
Zurich	CHF	286.7	288.6	138.5
AIG	USD	80.35	70.61	61.85
ACE	USD	37.47	39.69	30.88
XL CAP	USD	89.55	93.7	78.75

Source: **IDC Remote Plus and Reuters 3000 databases, prepared by askFT**

Market Overview – continued

The pressure on established markets to perform is becoming intense. Although recent claims experience in the energy sector has been generally good (see Loss Data at the end of this section), the increase in asbestosis activity combined with the summer storms in Europe has further eroded the capital bases, and consequently impacted the ratings, of many insurers and reinsurers, and some will undoubtedly be forced to withdraw from the market altogether:

S&P Rating Comparisons: A Selection of Global Insurers and Reinsurers

Carrier	Domicile	S&P Rating Pre-9/11	S&P Rating November 27, 2002	
AIG	USA	AAA	AAA	
Allianz	Germany	AAA	AA	
AXA	France	AA	AA	
Gerling	Germany	AA-	A-	(1)
Hannover Re	Germany	AA+	AA	(2)
Lloyd's	UK	A+	A	
Munich Re	Germany	AAA	AAA	(2)
Royal & SunAlliance	UK	AA-	A-	
SCOR	France	AA-	A-	(2)
Swiss Re	Switzerland	AAA	AA+	
Zurich	Switzerland	AA+	A+	

Note: (1) "credit watch developing"
(2) "credit watch negative"
Source: **Standard & Poor's**

We will refer to these and other underwriters who are saddled with the sins of the past as "legacy" markets to distinguish them from those "non-legacy" entities comprised of new capital, who are operating with a clean sheet. It is important to make the distinction for, whilst earlier in the year the agendas of the two groups were probably similar, a clear difference between them now exists. "Legacy" underwriters are, in the main, keen to tell anyone who will listen that the hard market will continue for a number of years, perhaps well into 2005.

There will be no loosening of terms, and indeed there is likely to be some residual hardening throughout the period. "Non-legacy" underwriters, however, see current rates and terms as being highly attractive. Their main concern is to gain market share without seriously undercutting prices, but they are also concerned that the attitude of the "legacy" markets may kill the goose that lays the golden egg.

Market Overview – continued

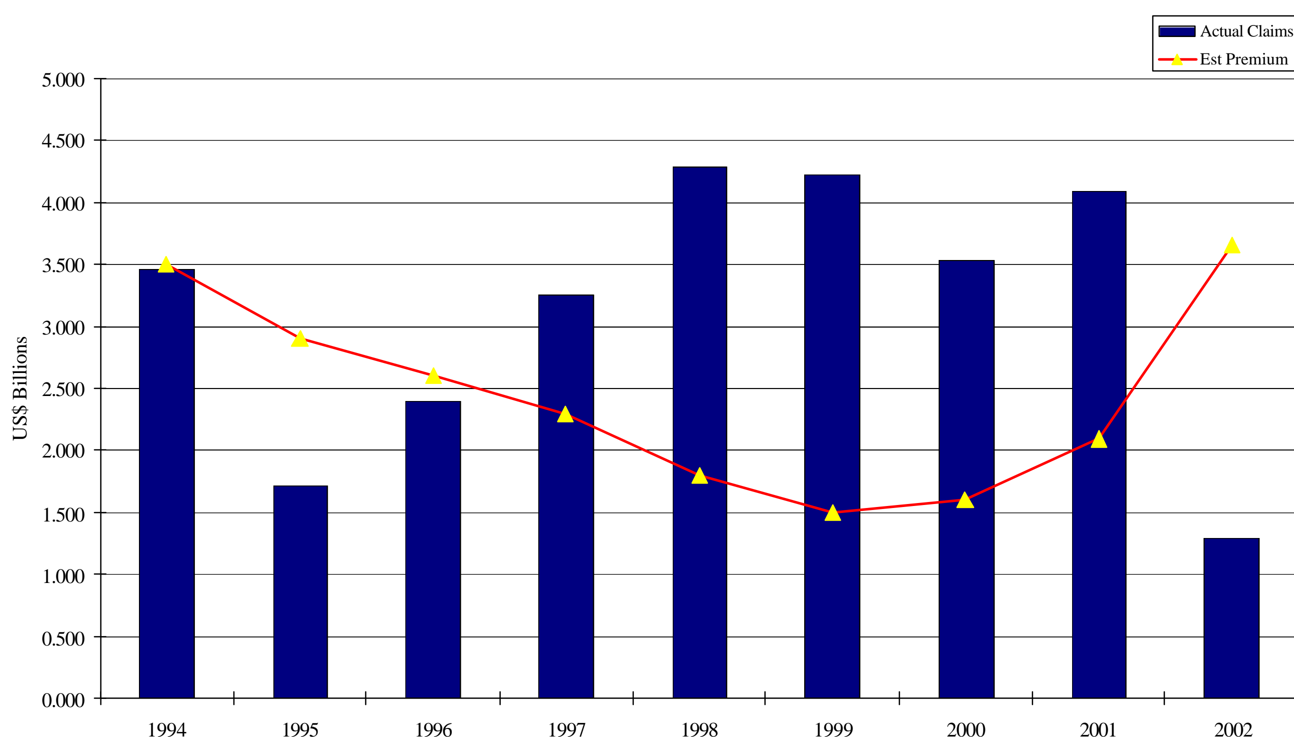
They are right to be concerned: it is unlikely that the more sophisticated clients will put up with even harder conditions, and some of the better business will leave the energy market for good. The big question is, can "non-legacy" underwriters pick up the baton dropped by the departing, or uncompetitive, old guard?

Until recently it seemed that the supply of new capital was inexhaustible. New start-ups appeared almost every month, and the capacity crisis of the last quarter of 2001 appeared to have been a short-term phenomenon. But if stock markets remain depressed or fall further, will enough new capital be available to fill the gap created by the "legacy" markets' refusal to compete?

Here, then, is the problem. At this moment there is enough capacity for most risks (apart, as we have said, for some specialist classes such as offshore CAR), but clients who went through the pain of major increases and coverage restrictions over the last twelve months may be being lulled into a false sense of security, experiencing as they are only modest increases or flat renewals right now. If, however, enough new capital is not made available to the industry there is a very real chance that sooner rather than later a massive capacity crunch will ensue, and what has up until now been a technical correction, albeit severe, will turn into a classic hard market.

The market is frozen by uncertainty, if not quite gripped by fear. It is clearly on the cusp, but which way is it headed? We will have to wait and see, but it is a fascinating and challenging time to be in the international energy market. We look forward to discussing the forthcoming months in retrospect, and to learn the lessons that they will teach, perhaps, who knows, over lunch at the restaurant atop London's latest landmark.

Loss Data



We are aware of only two losses over US$100 million this year, and no more than five losses over US$50 million*:

1/2/2002 – Fire & explosion at gas gathering centre, Kuwait US$150M
25/11/2002 – Fire in refinery, Morocco US$100M+
15/4/2002 – Fire in refinery, Japan US$75M
21/4/2002 – Collapse of power canal, Washington State, USA US$74M
2/3/2002 – Blowout & fire on barge, Indonesia US$51M

* Individual losses only. The total of Hurricane Lili losses is currently estimated at US$350M.

A bandwidthing comparison over the last four years shows a radical improvement in each band:

	1999		2000		2001		2002	
Loss size	**Incidents**	**Tot Val $**	**Incidents**	**Tot Val $**	**Incidents**	**Tot Val $**	**Incidents**	**Tot Val $**
$10M - $40M	43	809,707,000	61	1,099,814,000	41	656,305,000	28	563,415,000
$40M - $60M	16	800,534,000	6	276,181,000	5	222,300,000	1	51,000,000
$60M - $100M	3	226,701,000	5	381,435,000	3	276,650,000	2	149,000,000
> $100M	8	1,488,564,000	3	951,446,000	7	2,250,960,000	1	150,000,000

Source: **Willis Energy Loss Database**

3. Market Updates

This section constitutes a collection of brief updates on the principal sectors of the energy market. The feeling of uncertainty in the market over which direction it is going to take, as described in the previous section of this Review, becomes clearer when one looks in more detail at the changes taking place.

Onshore Property

Nowhere is the feeling of uncertainty about the future stronger than in the onshore market, where the gulf between "legacy" and "non-legacy" markets is visibly increasing. Here, "legacy" markets are principally made up of central European insurers and reinsurers who have acquired, or developed, large US operations over the last ten years, and the adequacy of whose reserves has recently been brought sharply into question.

Capacity

- There has been an overall increase in capacity since July. We estimate utilisable (or economically viable) global onshore capacity for US refining and petro-chemical risks to be up by about US$200 million, making a total of around US$1.1 billion. Utilisable capacity for international risks has likewise increased and now stands in the region of US$1.4 billion. This is exclusive of OIL and sEnergy which add another US$250 million physical damage and US$200 million business interruption respectively.

- This increase has been enough to stop the last 20 percent or so of the market from ratcheting up the price by holding their capacity to ransom. Over the last year even a well-supported program could often not be completed 100 percent without the participation of those underwriters commonly referred to as the "commodity market". Regardless of the quality of the risk and the competence of the leading underwriter the placing would be stuck at around 80 percent complete, leaving the client with the choice of either paying more, or self-insuring the balance, or some combination of the two. Alternatively, a mutual solution could be sought. Now, leading underwriters once again drive the programs, a clear change since June this year.

- Some of the more aggressive markets, both new entrants and well-capitalised established insurers, are pushing hard to gain market share, although, to prevent destabilising the market, they are staying within "accepted " market price and conditions. We are therefore seeing some insurers offering massive lines, and programs are often considerably over-placed as a consequence. The upshot of this is that those insurers with smaller lines are either being heavily signed down or dropped from programs altogether, leaving a question mark over their future in the energy market.

Cost

- At the time of writing, cost very much depends on whether a particular risk has been through a renewal since September 11, 2001. Most insureds have already experienced the pain of much increased rates and retentions and restrictions in coverage, and those who are now going through the renewal procedure once more are seeing more manageable rate increases, in the range of 0 to 20 percent, with few if any changes to retentions or coverage. There are, however, a few three-year deals dating from pre-September 11, and on expiry these risks are being brought into line with the current market, with attendant pain for the clients involved.

- Whilst a few risks are renewing flat we have yet to witness much evidence of price reductions; they are certainly not being generally offered, and the market says it will fight hard to resist them. So paranoid is the market about not being seen to give rate reductions that the opening shot in a renewal negotiation will invariably be a demand for a rate increase, in the expectation that this may be negotiated down to, but not below, the expiring rate.

Market Updates – Onshore Property continued

– Natural catastrophe coverage continues to be in short supply, with consequent upwards pressure on pricing.

– It is perhaps in the area of excess of loss that we have seen the biggest change. With steadily increasing capacity combined with a restructuring of insurance programs into layers, the sky-high rates of the last 12 months, which could often not be justified by the risk, have considerably reduced. Here one can say that the market has become truly competitive again, though it should be noted that rates are still well above pre-September 11 levels.

Coverage

– Most of the coverage issues described in our last Review have been addressed by the market over the last 12 months, and by and large there is little pressure for further restrictions.

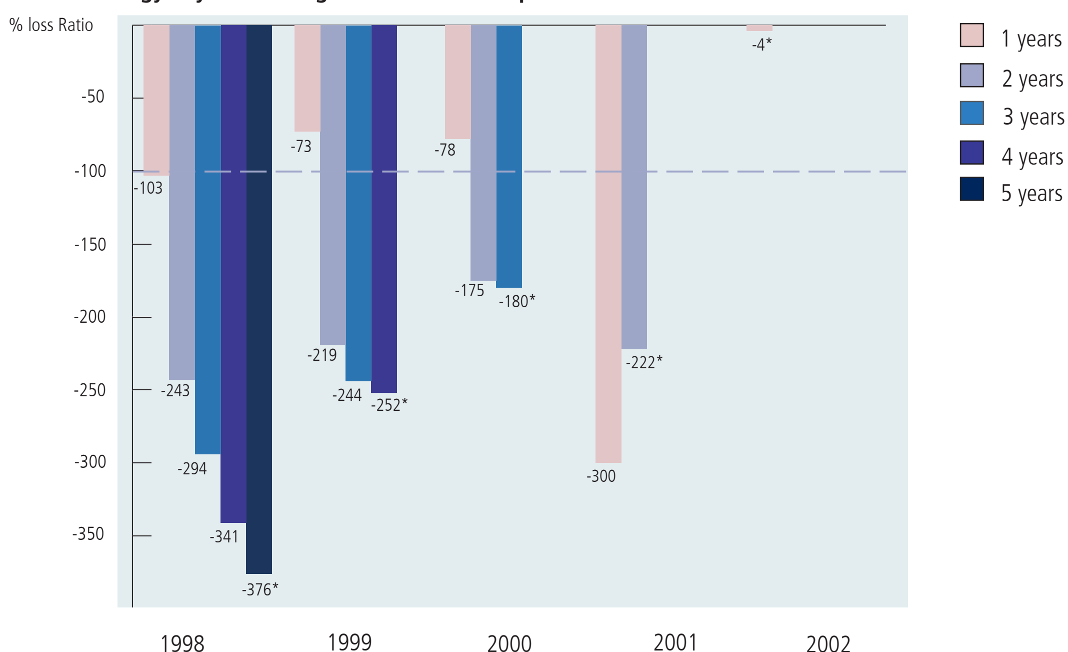
– A few adjustments are being made if they were not instituted at last renewal: for instance, 60 days waiting period for business interruption is now the norm for larger risks, and those that had 45 days imposed last time are being moved up to this level.

– Despite the cost, a greater number of clients are buying separate terrorism coverage and increased natural catastrophe limits, more often than not as a requirement of lenders than from any internal perception of these risks.

Outlook

We continue to believe that much depends on the technical underwriting result in 2002. So far the onshore loss record has been generally good, though it is too early to tell what the treaty reinsurers will make of it at the January 1, 2003 renewal date. However, as we have seen, the problems facing the "legacy" markets, and the question mark over what may or may not come in their place if there are further withdrawals from the market, means that even with an excellent year nothing can be taken for granted. Right now the only thing we can be sure of is uncertainty.

Onshore Energy Physical Damage: loss ratio development



Source: **Lloyd's**

NB: Loss ratio is expressed before underwriting expenses.
* 9 months as at October 2002

Upstream Energy

Capacity

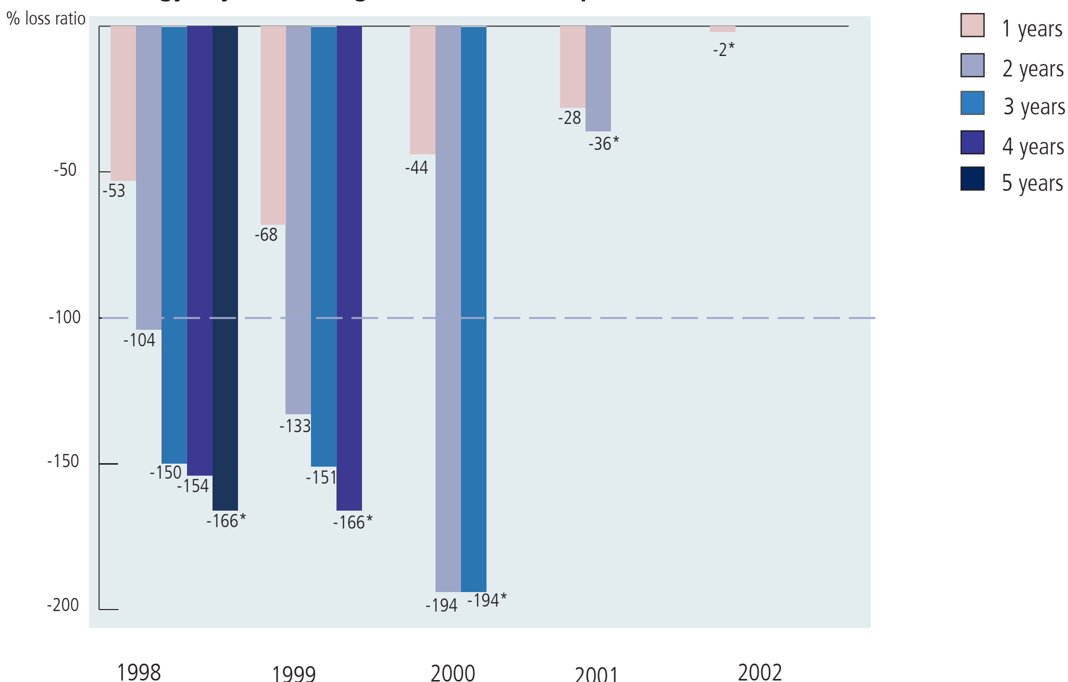
– Upstream capacity has remained more or less static since our last review and stands at approximately US$2.15 billion, exclusive of OIL and sEnergy. We exclude OIL because in joint ventures, which are highly prevalent in upstream business, OIL has a skewing effect on capacity owing to the fact that it provides between US$250 million and US$1 billion, depending on how many of the partners are members of OIL.

– Since most underwriters renew their energy specific reinsurances in either January or late June we should not be too surprised at there being little change in capacity right now. The business plans of underwriters are typically written towards the end of the year and perhaps modified in January once the result of their treaty reinsurance renewal is known. From a capacity standpoint the market is currently in a holding pattern as it waits, with a degree of nervous anticipation, to see what picture will emerge at the conclusion of the reinsurance renewal season.

– The fact that capacity is mostly unchanged means that for the majority of upstream risks supply continues to outstrip demand. Capacity today, however, is concentrated in fewer hands, and this, coupled with several years of poor loss experience, has prevented the normal laws of supply and demand from applying. Perhaps an influencing factor in this is the fact that there is far greater mobility of capital in today's market. For instance, Berkshire Hathaway alone is reckoned to account for some 13 per cent of Lloyd's energy capacity. We cannot imagine Berkshire remaining still whilst rates drop – nor, more importantly, can the underwriters that Berkshire Hathaway is backing.

– The market is precariously poised. There is still a raft of losses incurred but not paid across all classes of insurance including the energy sector, and all the issues mentioned elsewhere in this report (asbestosis, capital market dilution etc) make it almost unthinkable that capacity can increase, other than in the very short term. Whilst capacity has seemingly defied gravity in the recent past, surely this time the only way is **not** up?

Offshore Energy Physical Damage: loss ratio development



Source: **Lloyd's**

NB: Loss ratio is expressed before underwriting expenses
* 9 months as at October 2002

Market Updates – Upstream Energy continued

– With the market delicately positioned it follows that in the medium term the likely movement in capacity will be downwards. If the current downgradings we are witnessing from the ratings agencies lead to just one or two insurers withdrawing from upstream energy then the whole sector may enter a truly hard market, the like of which we have up until now only witnessed in offshore construction.

Cost

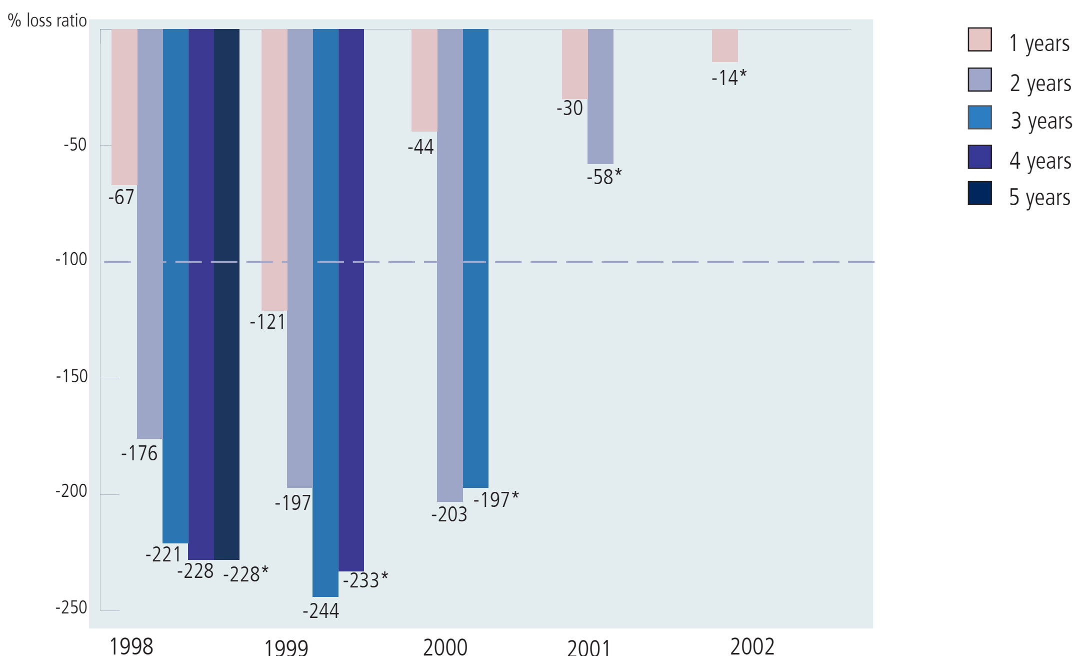
– Most accounts have now experienced a renewal in the hardening market post-September 11, 2001. There is, however, a general perception amongst the broking community that accounts renewing between September 11 and January 1, 2002 received harsher treatment than those that renewed in the subsequent period, when conditions were calmer. Underwriters on the other hand largely oppose this view, and the current renewal season is consequently fraught with emotion. Rumours of price reductions spread like wildfire, and underwriters are naturally nervous of any perceived shift in bargaining power.

– The upshot of the above is that underwriters are demanding increases whilst brokers push for flat renewals, or even small reductions. The result of most renewal negotiations is usually a compromise that will vary according to the market's perception of the risk in question.

– Multi-year policies that have not been through a renewal since September 11, 2001 are clearly due some bad news. However, very few of these policies remain, and we expect that the clients in question will by now have been fully briefed about market conditions.

– Construction All Risks remains a sub-class that exists outside the rules of the broader upstream market. Having already experienced a dramatic correction in terms of cost and coverage the emphasis is now on raising deductible levels.

Energy Control of Well: loss ratio development



Source: **Lloyd's**

NB: Loss ratio is expressed before underwriting expenses
* 9 months as at October 2002

Coverage

Coverage curtailment appears to be largely behind us as most accounts have had their wordings reviewed and coverage revised in the course of the last year or so. Underwriters appear to have stopped trying to reinvent the wheel, and are focussing on tailoring coverage to the risk with what is, in our experience, a generally responsible and pragmatic approach.

Coverage for terrorism is an obvious issue which will be the subject of a separate review. We will confine this review to a topical issue with regard to deepwater drilling, namely the Shallow Water Flow Endorsement.

Shallow water flows (SWF) have been identified by the Drilling Engineering Association as one of the top five challenges being faced in drilling in deepwater of depths in excess of 800 meters. There are at least 150 wells in the Gulf of Mexico representing SWF occurrences. Several hundred million dollars has been spent either preventing SWFs or re-mediating SWFs, hence underwriters' concern.

The phenomenon first occurred in 1985 and, according to a report from Fugro Geoservices, Inc., approximately 70 per cent of all deepwater wells have experienced shallow water flows.

Shallow water flows occur whilst drilling in over-pressured sands. SWF sands are shallow over-pressured unconsolidated sands encountered before pressure control is in place on the wellhead assembly. Water may flow into the wellbore if the pore pressure is not balanced by the mud weight. If the mud weight is too highly overbalanced, the sands may fracture, resulting in lost returns and loss of well control. The margin for wellbore pressure may be less than 100 psi for shallow depths below mudline in deepwater wells.

One of the best known incidents of Shallow Water Flow was in the Mississippi Canyon area (3,800 ft water depth) of the Gulf of Mexico where the SWF caused the loss of the wells at the first Ursa TLP site in 1998. The sediments at Ursa contain massive sands that are pressured above a normal seawater gradient at a very shallow depth below mudline.

The problems associated with drilling shallow water flow zones are not all solved but much has been learned during the past 10 years. The lessons learned by operators are substantial and have led to successful drilling of major projects in over-pressured sands. Due to this phenomenon, underwriters have started to impose the following exclusion:

Shallow Water Flow Exclusion Clause

This policy specifically excludes any and all loss or damage caused by or resulting from a "shallow water flow" as that term is understood in the Oil Gas Industry. For the purposes of this exclusion, "shallow water flows" shall include flow of water and/or formation material from wellbores, or from the outside of casings, which flow originates in formations at depths of less than 2500feet below the water bottom, and which occur or commence prior to the installation of the blow out preventer.

Outlook

In the last issue of this Review we expressed our concern at the increasing loss of business to the market. This warning has perhaps gone unheeded in a market seemingly awash with premium caused by the combination of rate increases and a boom in construction. The fact remains however that the underlying risk pool continues to shrink.

OIL continues to attract new entrants, and the cost of insurance continues to attract attention at board level. Renewals in the rapidly hardening market post-September 11 may have left clients reeling with shock, but they paid the increases demanded of them, as there was often too little time to make the radical changes to corporate risk management philosophy required to adequately contain cost. Faced with a second renewal in a hard market the insurance buyer is looking for ways to save money, and is much better prepared than a year ago.

Currently, both the market and the clients are cushioned from their worst nightmares by the albeit weakened, but still robust, oil price. Our concerns about capacity are real, and are detailed in more than one section of this Review. But what happens if the oil price were to drop at the same time as capacity goes into retreat? Our concern is that the normal laws of supply and demand will bring irresistible pressure to bear on the market to apply further rate increases until they reach a point where many clients cannot or will not pay, and will leave the market for good – not a scenario most market participants would care to contemplate.

Market Updates – continued

International Liability

Harsh trading conditions persist as liability markets continue their drive towards profitability. A demanding end-of-year treaty renewal season is underway. There has been less influx of new capacity into the liability sector than for other classes but ample capacity remains available for most insureds. Continued rate increases and pressure on coverage is expected to remain for the foreseeable future.

Whilst some insurers renewed their treaties in April and July, the vast majority of Insurers renew at year-end. Insurers are now in the midst of their negotiations for their 2003 account and the early signs are that this will be every bit as difficult as the December 2001/January 2002 treaty renewal season.

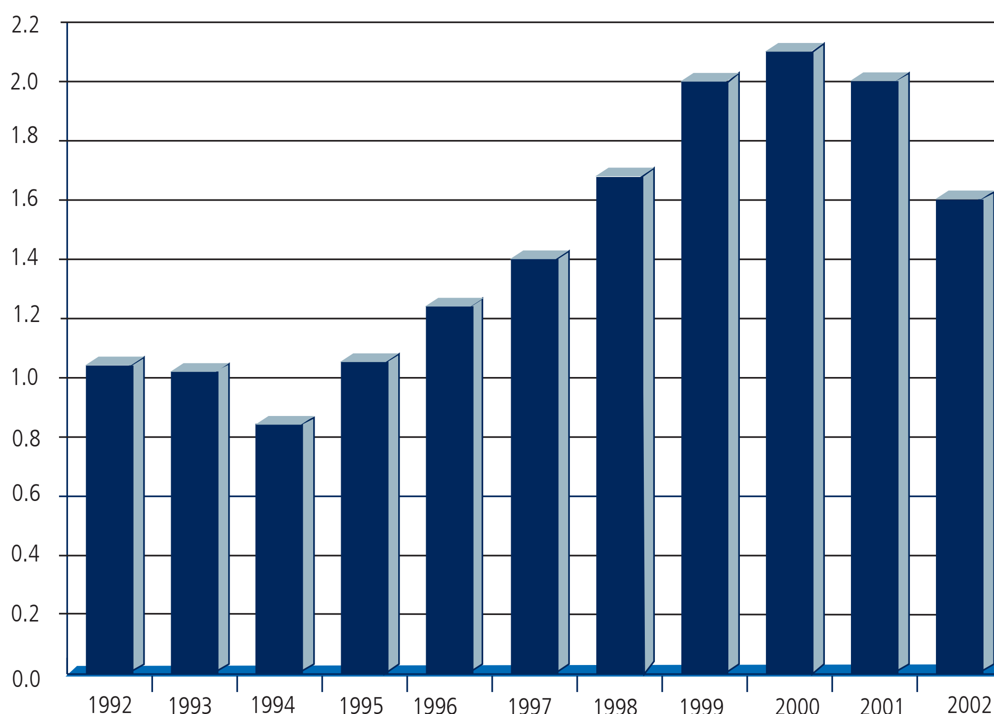
New capital has entered the insurance market although much is directed at property or higher excess liability business and it has not been sufficient to compensate for restrictions in capacity experienced by many existing insurers.

Capacity

Total liability market capacity has fallen from approximately US$2 billion in 2001 to a current estimated level of US$1.6 billion.

Whilst there remains ample for the needs of most insureds it should be borne in mind that this is the maximum theoretical global liability capacity. Many insurers have limitations for certain types of activity or territory and much of this capacity is also only available on a claims made or occurrence reported basis. It is also important to differentiate between primary and excess market capacity.

Global Liability Capacity US$(billion)



Market Updates – International Liability continued

Primary Market

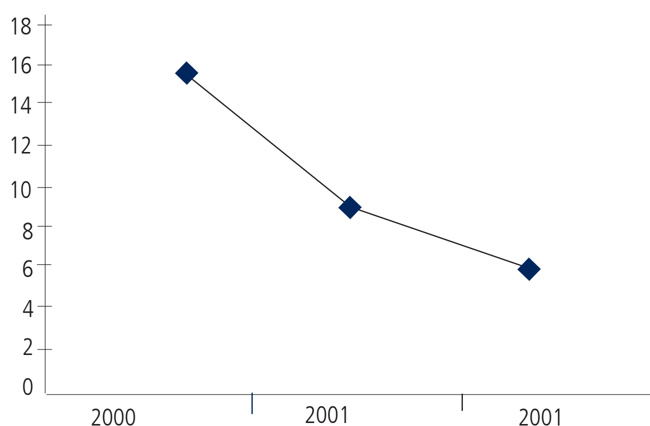
The contraction in the limited market able to write primary business has continued throughout 2002. This is due to a variety of reasons:

- A number of primary insurers are no longer prepared to write 100 percent of a primary program and prefer to quota share with other carriers, to spread their exposure.

- Several insurers have already reached their projected premium income limits for the year and have ceased writing any new business in order to reserve remaining capacity for their existing renewal account; these markets include Marketform, Abacus and R.J. Wallace syndicates in Lloyd's and The Underwriter Insurance Company. Whilst some of these are now looking again selectively at new business the impact on primary capacity has been significant.

The graph below illustrates the contraction of the mainstream primary market that has occurred since 2000, thereby reducing competition and fuelling further pressure on primary pricing:

Number of mainstream primary insurers



Excess Market

Excess capacity has been less affected by the market contraction over the past few months, although this situation may change from 1 January 2003. There is still market readily available to support excess layers at the "right" price and conditions. Indeed, with the arrival of the new Bermudian capacity such as Arch, Endurance and most notably AWAC, there is generally sufficient excess capacity for those insureds prepared to pay for it. The only exception possibly being companies in the Pharmachem industries where many insurers have pulled out or severely restricted their line size.

Whilst 2002 has certainly not witnessed the same number of failures among liability insurers as 2001 there have been a number of downgrades in insurers' security ratings and this has contributed to the reduction in the options available to fill some of the larger excess programs. The lowering of the Gerling Re's rating to BBB and their recent move into "runoff" being one of the higher profile cases.

Coverage

Restrictions in cover are being imposed by most of the international market as insurers retreat to "core coverage" with attempts by market leaders to exclude "peripheral" coverages from liability policies (including *inter alia* professional indemnity and pure financial loss cover). Insurers' immediate focus will be on getting what in their view is the right price for the cover currently being written.

Current coverage issues

Terrorism: This remains a general exclusion although certain carriers have some flexibility to include cover depending on the territory and occupation involved.

Electromagnetic Fields: Exclusion of EMF's is commonly required for the telecom/mobile phone industry. It is also an issue for insureds in the power generation and distribution industries although coverage for such insureds can generally still be obtained subject to a Claims Made form, aggregate limit and exclusion of diminution in property values.

Pollution: Sudden and Accidental pollution remains readily available, but limits are commonly now quoted on an aggregate, rather than a per occurrence basis.

Policy Trigger: A Claims Made or Occurrence Reported trigger is increasingly required by insurers for Chemical and Downstream Petrochemical risks, due to the long tail nature of their exposures.

Policy Form: Insurers are now less willing to quote new business following local forms and increasingly require a recognised London form e.g.: PCA 86 or PCA 94.

Pricing

The average rate increase charged by liability insurers for petrochemical risks over the past 6 months is 30 percent to 40 percent. Where loss records have deteriorated, exposures have increased significantly or expiring premium is deemed to be markedly below market average, the increases can be significantly greater and accounts coming out of long-term deals have also suffered badly as insurers seek to bring pricing in line with current levels. Increases of 100 percent to 300 percent in these instances are not uncommon.

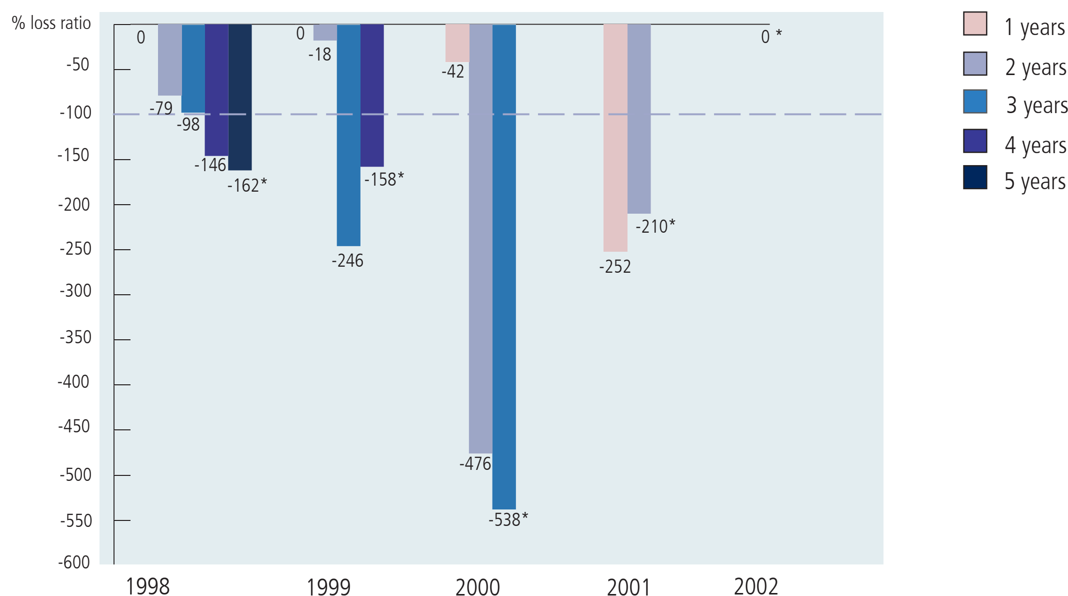
The most dramatic liability rate increases have been experienced by insureds in the pharmaceuticals sector where large industry losses and a resultant shrinkage in market capacity have resulted in some insureds experiencing increases of 400 percent up to 800 percent.

Is there an end to the hard market in sight?

Most liability market commentators do not believe that we will see an early end to the prevailing hard market conditions. There is certainly nothing in the evidence before us that would encourage any hope of a significant softening of the market in the near future.

On an optimistic note however, there was no market meltdown after September 11, 2001 as some feared, and the ensuing re-evaluation of underwriting practices and greater emphasis placed on market security should help to ensure the continuation of a robust and healthy liability market in the future.

Onshore Energy Liability Claims Made: loss ratio development



Source: **Lloyd's**

NB: Loss ratio is expressed before underwriting expenses.
* 9 months as at October 2002

North American Casualty

The North American casualty market continues to perplex buyers in its treatment of risks. In our last review we discussed the difficulties that many insureds are experiencing with respect to the mechanics of placing a risk. While matters have not improved much, there has been some progress, although for larger insureds renewals go to the wire, and beyond.

Primary placements may find more insurers willing to entertain risks, but the appetite for true risk transfer has lessened. Insureds must plan for mandated higher retentions, and should also assess additional retentions to offset market increases. General conditions for the North American market are unlikely to improve until the health of the wider financial market takes a turn for the better, but even that will be tempered by the trend towards larger losses.

Worker's Compensation

Our last Review detailed the increasingly intrusive nature of reinsurance in the workers compensation programs of energy insureds. While some reinsurance capacity appears to be returning, this is mostly in the higher excess layers. Within deductible programs insureds should expect to see increases creeping into double digits, whilst Insurers' fees continue to climb at about the same ratio.

Primary

Premium increases for automobile and general liability coverages are being maintained, but the rate of increase appears to be slowing down. We are seeing increases ranging from 20 percent and higher, the magnitude of the increase based on factors including loss history, exposures, and trends.

Renewals for insureds with heavy automobile liability exposure, though, are another story. The market for this risk has shrunk dramatically in the last 12 to 18 months and only a few markets – including specialty – remain. Furthermore, umbrella carriers require higher per occurrence retentions for automobile liability. Insureds should consider alternatives excess of the primary including buffer layer, fronts, or even self insurance.

Insurers continue to monitor coverage, they provide through General Liability, most important issues being:

Terrorism – there are various wordings available which allow exceptions on a risk by risk basis

Mold and Mildew – certain insurers are mandating exclusions for both direct and consequential damages if they perceive any exposure.

Health Hazard

Professional Liability

Pollution liability – remains difficult to obtain/maintain any coverage in a general liability policy as insurers are pushing their own policies for stand-alone environmental coverage. A broad range of products now exists, and the premiums charged are surprisingly competitive.

Asbestos – retrenchment to the absolute exclusion.

Excess Liability

Within the last 12 to 18 months energy insureds have seen the number of markets willing to participate in the lower excess/umbrella area (usually within the first US$10 million to US$25 million) substantially reduce. This is, for obvious reasons, the area which causes the most consternation in the placement of energy risks. In the mid to high excess liability layers there is more capacity, and competition is going some way to reducing the average level of increase being sought by the market. Even so, average increases for entire excess liability programs range from 30 percent to more than 100 percent, with insureds often being able to negotiate a reducing level of increase only in the higher excess layers. Several renewals as of late have seen tremendous increases, particularly for those insureds who have recently experienced large losses.

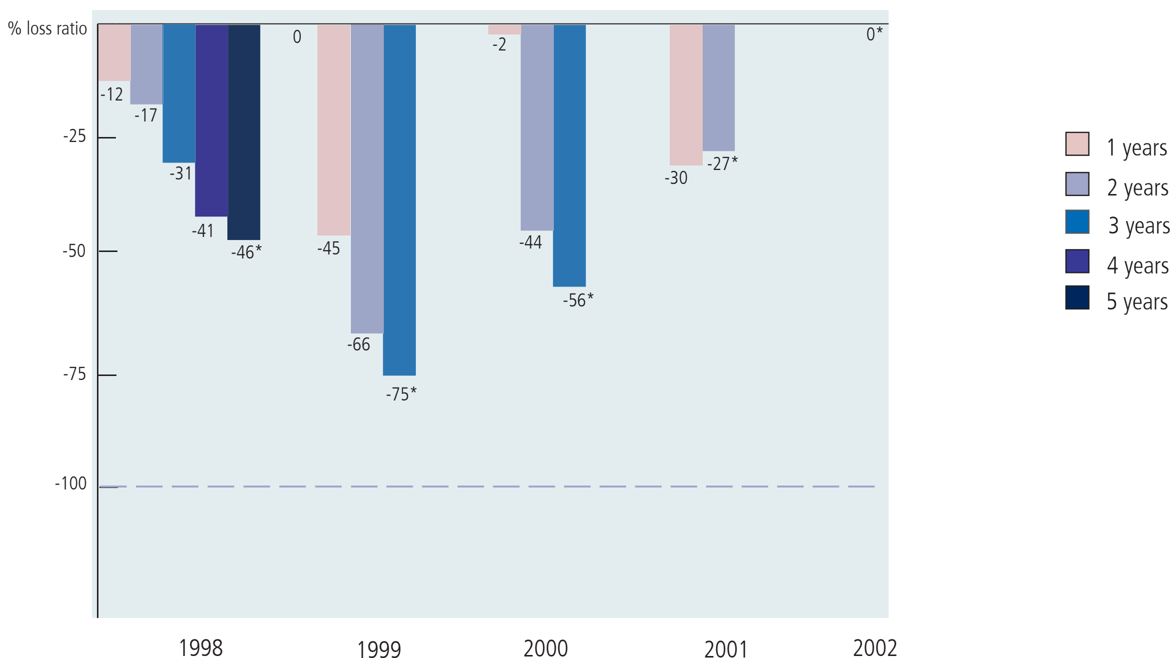
Functional overall capacity remains at approximately 70 percent of the high point it reached in the late 90's, standing today at around US$1.3 billion. However, insureds who purchase the full market capacity are likely to run into opportunistic pricing.

Insurers continue to recognize the impact of retroactive dates on excess liability programs, and there is some pressure in the market to begin to move retro dates on excess liability policies forward from the mid '80s and early '90s to, in some cases, current year inception. We expect to see increased attention to this over the coming months.

Other excess liability issues include:

– MTBE and other oxygenates
– Known losses
– Renewal indications are subject to best terms and conditions in the market place
– Pressure on pollution time reporting requirements
– Terrorism
– Other exclusions as in the primary area.

Onshore Energy Liability All Other: loss ratio development



Source: **Lloyd's**

NB: Loss ratio is expressed before underwriting expenses.
* 9 months as at October 2002

4. Bermuda

The continued stream of new capacity that has become available over the last few months has enabled Bermuda to establish itself as a premier market for energy risks.

Since our July review, the following constitute some of the more significant developments:

Axis
To improve access, Axis have now established their subsidiary in Dublin. We have also witnessed a steady increase in their utilised capacity, in particular on the larger energy accounts.

The focus for Axis continues to be first party, with a clear aversion to casualty exposures.

Endurance
Having started with a pure US focus, we are expecting some opening towards international risks over the coming months.

AWAC
Continuing with the same underwriting philosophy, we have witnessed AWAC steadily increase their position, and they have now built capacity up to US$12.5m for property which can be utilised within the first US$100m of a program.

Awac have also opened a subsidiary in Dublin in order to improve their European platform, although the energy centre of excellence seems likely to remain in Bermuda.

Arch
After focusing on casualty alone, Arch have now identified energy first party as a key focus and have been building their teams in the USA and in London where a contact office has now been opened.

Everest Re
This is another example of new capacity coming on stream since our last Review, and is additional to capacity available out of the Everest operation in New Jersey.

Other Developments
The above demonstrates that Bermuda continues to be a vibrant market for energy accounts for both property and casualty and, whilst we have focused purely on the 'start-ups', it should be noted that Ace and XL continue to maintain very strong positions on the island in both the casualty and excess property sectors.

Finally, the number of energy risk managers and CFOs visiting the island and building relationships to ensure that they tap the available capacity is a clear demonstration of Bermuda's new position of eminence within the global market.

5. Oil and sEnergy

Continuing hard market conditions have meant that there has been no let-up in interest in the Bermuda-based mutuals, Oil and sEnergy. The following is a snapshot of where they stand today.

OIL

- Since July membership has increased from 74 to 77. Utility companies, which until little more than a year ago were ineligible, now account for 24 percent of the total membership, the largest proportion by industry sector. This eclipses Integrated Oil at 20 percent and E&P at 16 percent (with the other sectors combined making up the balance of 23 percent).

- Of the 77 members, 76 are on a replacement cost basis.

- The minimum eligibility requirement has been amended to US1billion of Unmodified Gross Assets (US GAAP) and minimum credit ratings of BBB (S&P) or Baa (Moody's) have been reaffirmed.

- In September, Standard & Poor's removed OIL from credit watch and reaffirmed their A+ rating (Outlook Negative)

sEnergy

- sEnergy came into being at May 1, 2002, and membership remains unchanged at 12.

- In September sEnergy amended the capital requirements for new members from US$6million to US$5,000. President & CEO Jack Wesley was quoted as saying: *"We recognize that .... having to make a significant capital investment .... may be too high a 'barrier to entry' for many prospective members of sEnergy."*

- To offset the reduction in "up front" capital contribution new members will have to put up a US$1.75million additional premium per year for the first three years (US$5.25 million total).

- In a move to strengthen the balance sheet we understand that sEnergy has approached the investment banking community with a view to arranging a standby credit facility with pre-arranged long-term payback through financial reinsurance or bonds or other financial instrument.

6. Lloyd's

Having raised significant levels of new capital at the start of 2002, Lloyd's reached a mid-year high of £12.5 billion (US$19.5 billion). Capacity projections for 2003 are encouraging, with an estimated increase of between 10 and 20 percent.

Trading conditions remain very positive. Gross written premium in the first half of 2002 increased by 30 per cent as compared with same period in 2001. Increased rates have been supplemented by tighter terms and conditions, higher deductibles and tougher underwriting practices across all lines.

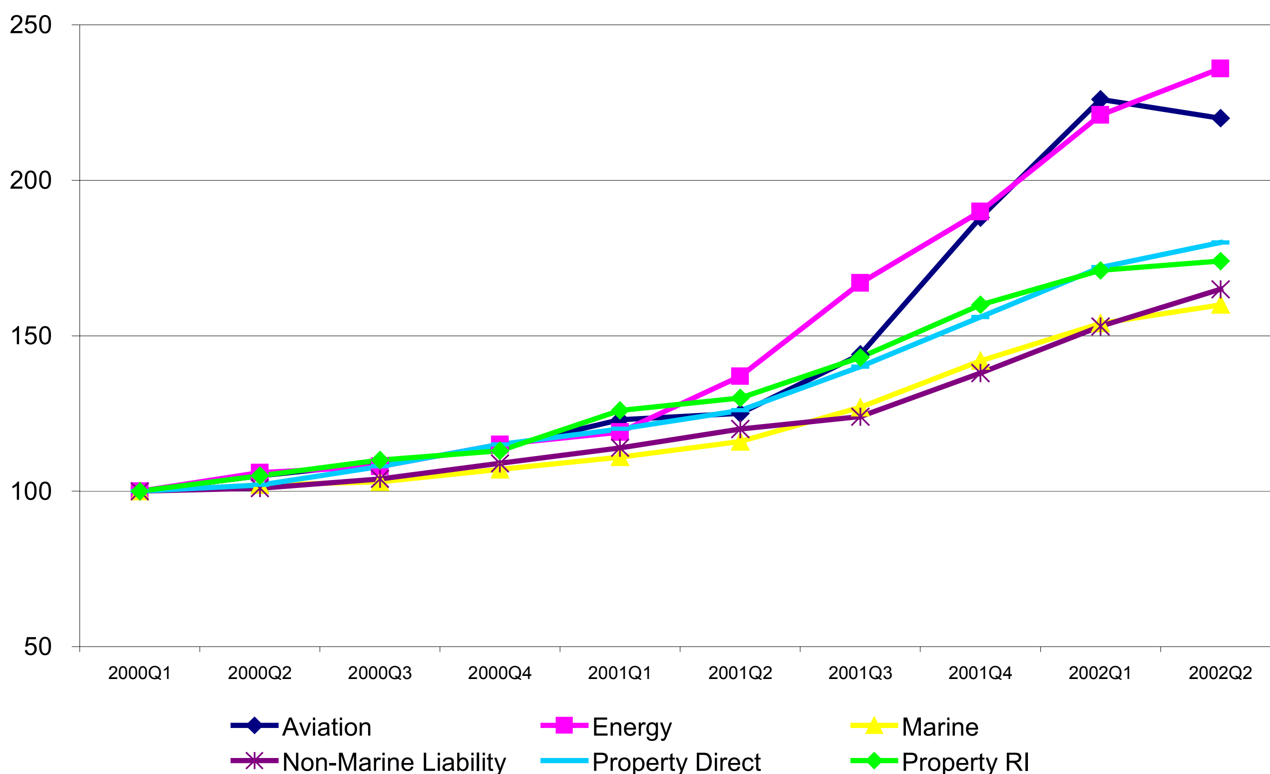
In the July issue of this Review we reported on the formation of the Chairman's Strategy Group to oversee reforms urgently required to maintain the market's appeal to investors. Since then, the CSG proposals have received the support of the Lloyd's membership, and implementation is now underway.

Lloyd's financial strength market rating has recently been affirmed "A - Strong" by Standard & Poor's which has also confirmed Lloyd's as the world's sixth largest reinsurer, with net written reinsurance premiums increasing by 45 per cent in 2001.

We believe that all the above, coupled with the ring-fencing of earlier years within Equitas, puts Lloyd's firmly into the "non-legacy" bracket of global insurance and reinsurance markets, with positive implications for its ability to compete successfully in the energy market, both now and in the future.

Lloyd's Premium Rating Index

As illustrated by the graphic below, using Q1 2000 as a base (100), significant rate increases have been seen in respect of all key classes of business at Lloyd's:



Source: **Lloyd's**

7. Directors' & Officers' Liability

The continual downwards re-forecasting of profits together with a rash of corporate scandals have created a difficult time for directors and officers, their insurers – and even their brokers!

In recent years the frequency of securities litigation in the United States has greatly increased, with the number of cases growing from 122 in 1996 to 483 in 2001. Significantly, securities fraud litigation against foreign issuers has grown from 6 to 48 cases in the same period, an increase of over 600 percent.

The average settlement value of US security class action increased from US$7 million in 1996 to over US$17 million in 2001, whilst accounting allegations cost on average 280 percent more to settle than suits without such allegations.

The main reasons for these wholly unpredicted trends are as follows:

- Restatement of profits
- Proactive steps taken by the SEC in the wake of the Enron and other scandals
- Higher stock valuations have led to a greater backlash from investors when expected earnings targets have been missed.

From the underwriters' standpoint the situation has been made worse by two major developments over the last 12 years or more of soft market conditions:

- "No skin in the game" – in other words, with the elimination of any requirement for coinsurance by the insured coupled with steadily reducing deductibles, corporations have had increasing reason to settle suits.
- Whilst rates continued to plummet, coverage was broadened as entity coverage was extended to the corporation itself. Corporations hitherto unable to buy insurance in their own right suddenly acquired cover, and settlements again took off. Now, in the United States, bankruptcy trustees are targeting the D&O policy as a corporate asset, rather than merely treating it as a policy for the protection of directors and officers.

Conditions in the current market are hard, and are set to get tougher. We expect to see restrictions on coverage, with the future of entity coverage being seriously in question. We further expect deductibles to increase and exclusions to be tightened up, especially where the corporation reimburses the directors and officers.

It would seem that the way out of this dire situation is for both insureds and insurers to remember who D&O insurance was originally set up to protect – the directors and officers themselves – and to concentrate on providing policies that protect them in their own right. This is, after all, the major concern of every director of a board, particularly of the non-executive directors, and coverage for the individual director and officer should be left intact.

The market should strive to give individuals the broadest cover, clearly ring-fencing them from the exclusions and limitations of the "corporate" side of the policy, whatever that may in future constitute. For without adequate protection for the individual director and officer, the best candidates will be loath to take up senior corporate appointments, and industry needs bright people to sit on its boards.

8. Enterprise Risk Management & the Utility Sector

Risk management is undergoing significant changes and elevation in corporate stature and culture as evidenced by the formation recently of the position of Chief Risk Officer (CRO) in many organisations. Departments once managed individually and separately, such as procurement, treasury, trading and insurance, among others, are now increasingly being managed, as for risk, under the auspices of the Chief Risk Officer.

In many companies where the CRO position is not yet implemented, corporate risk management committees have been formed to identify, assess, dispense responsibility to manage those risks, and to measure and audit those risks on an on-going basis. Corporate governance pronouncements have helped to fuel this process globally, as has recent, highly visible corporate scandals and their impacts on some of the world's largest corporations.

Boards of publicly traded companies and their senior executive officers are being increasingly held responsible for knowing and sharing with the public the material risks faced by their organisations. Shareholders of these corporations are becoming increasingly demanding that the material risks be economically and strategically mitigated as evidenced by share price volatility in the equity markets, particularly when earnings targets are not met. Enterprise risk management (ERM) is an effort to achieve a common understanding and measurement of all risks of the corporation and to find an integrated means of systematically managing those risks. ERM is achieved through a balance of financing techniques with operational and strategic changes and processes. By developing a comprehensive understanding of the firm's risks, competitive advantage can be achieved by controlling or leveraging the risk position, and therefore, safeguarding against "earnings surprises" can be more readily achieved.

The energy market is undergoing changes of its own, from deregulation in many countries, to volatile fuel prices and the impact of environment regulations, such as those necessitated should the Kyoto protocol be implemented. At the same time, the demand for power is escalating, with some countries reporting double-digit increases. To meet all of these increasing demands, substantial capital resources will be necessary, but with this comes significant financial risk.

For example, to meet the ever-increasing demands for electricity, utilities are building new power plants and upgrading older, less efficient power plants. However, because electricity cannot be stored, generation is built for peak demand plus some operating reserve. Through a combination of adverse weather conditions and generator outages, a utility may find it necessary to import excess generation capacity from another area of the country. Depending upon the extent of the outages or weather conditions (e.g. a widespread heat wave during a time of widespread planned maintenance outages), the spot market price of electricity could be orders of magnitude higher than normal.

This combination of extremely high requirements for power importation coupled with extraordinarily high prices could spell financial disaster for many economically strapped utilities. Add to this situation the following:

– volatile nature of commodity prices such as natural gas, fuel oil and coal
– increasing environmental regulation and its attendant costs
– counterparty and credit risk
– the move toward more competitive energy markets and the need to compete on price

Enterprise Risk Management & the Utility Sector – continued

Thus utilities are finding it increasingly necessary to understand and manage risks from a centralized perspective.

The key requirement to being able to achieve some of the objectives of ERM is for the Board and key senior executives to embrace the tenets of ERM and to drive its implementation from the top. This often involves the formation of a corporate risk management committee or the installation of a CRO, who is beholden to the Board. Either of these structures makes it possible for the necessary corporate resources to be marshaled within the organisation and ensures buy-in of all the constituent parties with applicable interests.

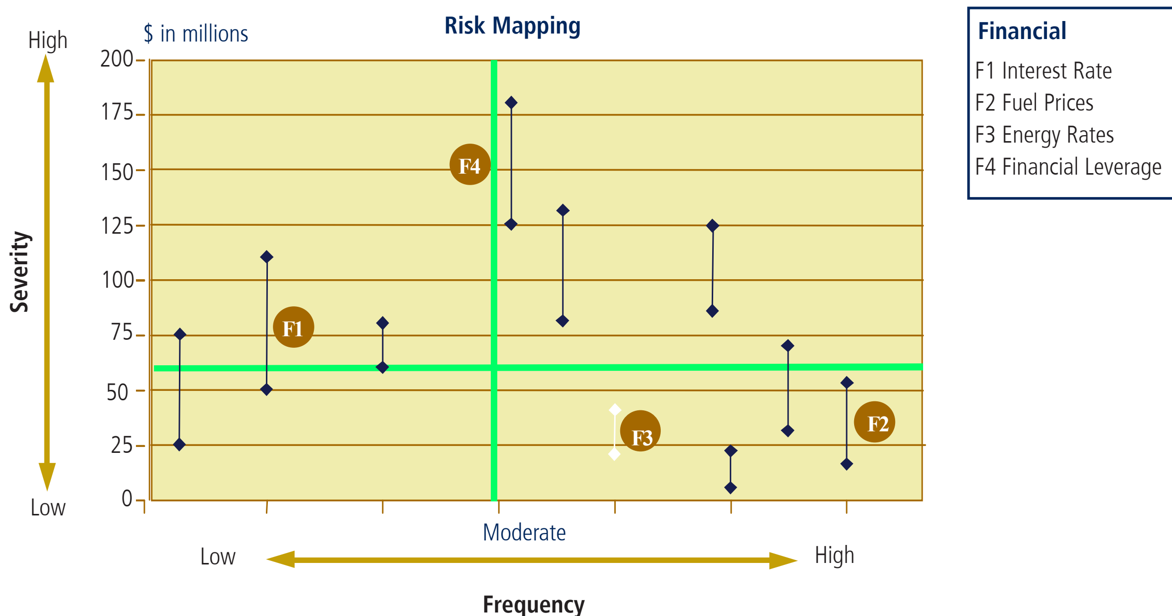
The first step in ERM, following a board-level or executive level mandate, is to engage in a process of risk identification, which often leads to the creation of a risk map.

This stage of the ERM process involves some combination of questionnaires, workshops and key interviews that cut across the numerous organisational divides of the organisation.

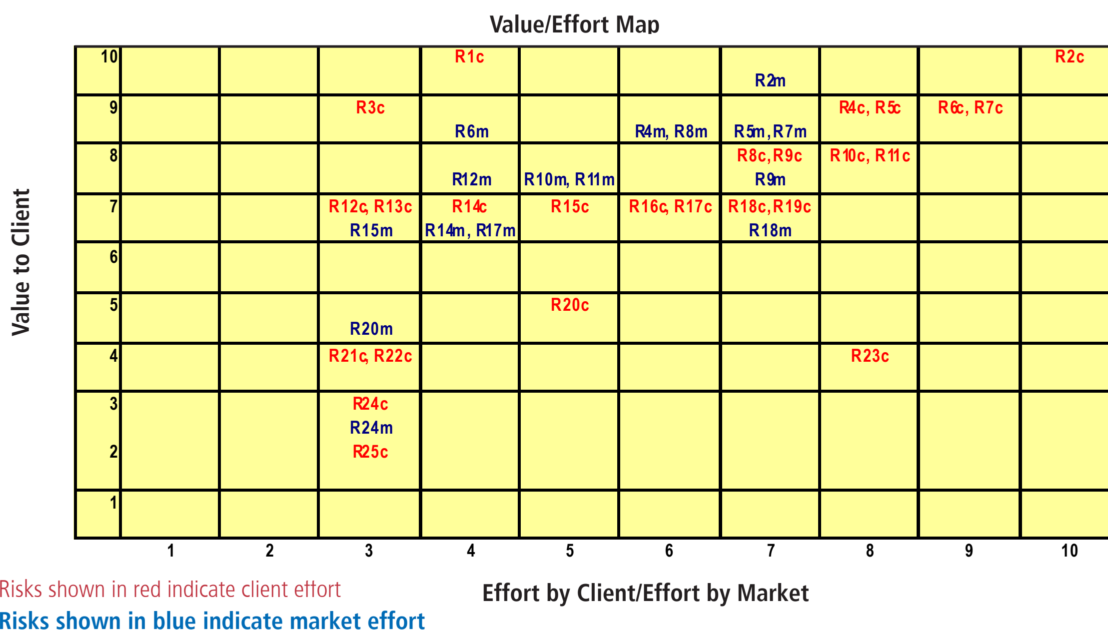
In order to ensure that a consistent response is achieved, a common framework regarding the definition and measurement of risk is introduced and utilized throughout the questionnaire, workshop and interview process. Normally the questionnaires are addressed to the broadest base of employees, the workshops are utilized for the management level of the key functions of the company, and the interviews are reserved for the highest senior executive. Following this process, the risks are ranked and mapped on various dimensions such as likely frequency of occurrence, probable range and possible severity (magnitude), and potential volatility.

One important consideration in this exercise is to develop a preliminary understanding of the data available for potential future quantification. Often companies have not collected nor maintained sufficient internal data to complete an in-depth quantification. The end product of the risk mapping process is a qualitative understanding of the major and lesser risks facing the organisation and an understanding of the potential financial impacts of each. This "catalog of risks" provides a roadmap to the next step, an in-depth assessment and quantification of the key risks, as a starting point, and of all material risks, as an end point.

The following grid is an example of a risk map drawn on frequency/severity scales.



The following grid is one that we have found helpful in determining the prioritization of risks for the more detailed risk quantification and strategy stage.



This grid summarizes the anticipated value of addressing each risk (on a scale of 1-10) versus the anticipated effort required (on a scale of 1-10). Effort required may entail risk complexity and data availability. Effort required by the market indicates potential risk transfer effort. The quantification of risks involves analyzing the data in an effort to arrive at commonly accepted metrics that "measure" the risk in differing and meaningful ways, including notional exposure, volatility, value-at-risk (VaR), earnings volatility, earnings VaR, risk adjusted return on capital (RAROC), economic value added (EVA) and correlation to other risks, among others. These risk metrics and the methodology used to create them will provide for a continuous, consistent, proactive and rigorous framework for risk assessment and decision making for all parts of the firm.

Often mathematical models are constructed that permit the risks to be simulated via Monte Carlo, especially in concert with material correlated risks. Such models are a key to the successful modeling of the risks in an integrated manner and their potential treatment within a portfolio. For risks that are less quantifiable (e.g. intangible risks), scenario analyses might be an appropriate method to gauge financial impact.

Ultimately, the value of ERM lies in the management of the material risks in a consistent and coordinated manner, whether the solutions are financial or organisational. Financial solutions include insurance, reinsurance, capital instruments and credit lines. Organisational solutions are often taken to address and manage the risk at its source through a combination of contingency planning, accountability, divisional realignment, communication and risk control.
Enterprise Risk Management is fundamentally driven by the concept: "from change management to performance management". Because of the drastic changes facing the energy sector and the unknown challenges that already exist, enterprise risk management processes are a natural fit with this sector. The 1996 Harvard Business Review states that "Corporate Governance is not, at its core, about power; it is about finding ways to ensure that decisions are made effectively". In turn, an enterprise risk management approach is not simply a process to identify and quantify risk, but a framework to allow companies to navigate changing currents with strategic and comprehensive approaches to risk. Because of the diverse nature of risk relating to the energy sector, and the unusual way that these risks are often positively correlated, the energy sector has been and will continue to be a leader in enterprise risk management initiatives.

9.People and Places – News in Brief

Positioning and repositioning amongst the players in the energy market continues unabated. In the last few months in Lloyd's alone Beazley has floated on the stock exchange, Catlin has raised over £500 million (US$775 million) to buy out its Names to become an exclusively corporate capital vehicle in 2003, whilst FR White has withdrawn from the energy sector altogether and transferred its book to Liberty International. Such activity, repeated across the global energy market, has led to significant movements in people between insurers and brokers:

- ACE Global Markets in Lloyd's has greatly strengthened its energy team with the addition of Roger Giddings, Mairead Ni Chochlain, James Miller (all ex-Zurich) and Peter Stow (ex-Aon)
- Ellis Whitehead and John Parsley have left Aon in Houston
- Claire McDonald has been appointed head of energy underwriting at Allianz in London following the departure of Martin Baines, whilst Chris Charlton has joined as an offshore underwriter from Hannover Re
- Rob Woods and Paul Dawson have left Aegis
- Mark White has joined the energy team at Ascot as an offshore underwriter
- Nick Hodges left Gerling to join Zurich Global Energy in London. Richard Pursey and Alan Roberton also left, and have joined the energy team at Liberty International in London
- Maurice Purslow of Zurich Global Energy is relocating within the company to New York from Hong Kong in the new year.
- Simon Marshall left Zurich to join Millennium Syndicate
- Anne Plumb has moved from Swiss Re in Singapore to head up the IOI subsidiary of Swiss Re in London
- Kashe Sambhi has left the property department at Swiss Re in London to join IOI
- Ton van Everdink has transferred from the energy team at Munich-American RiskPartners in Munich to underwrite treaty reinsurance in the Middle East
- Peter Godfrey, formerly of Wellington, has joined GE Frankona Re as an onshore underwiter
- Nick Jones and Andrew Roland have left Faraday to join Les Rock at RAC Syndicate
- Alex Wilmott has left Euclidian to join Global Special Risks
- David Sharp has resigned from Marsh to join Charles Taylor Consultants
- Lesley Harding (ex-Swiss Re) has joined Arch to head up their newly established London office

People and Places – News in Brief continued

International Liability spotlight – London market news

– AIG's London operation has stopped writing primary international liability business and is focussing on excess of loss. This does not affect their primary abilities on UK domiciled accounts.

– AWAC has applied for a licence to allow their London contact office to underwrite business as a branch of their recently authorised Irish company. They expect to receive the necessary authorisations before the end of 2002 and Fiona Marry has been recruited from XL as a liability underwriter.

– John Murphy, Alistair Herbert and Glen Marshall have joined Brit Holdings from Abacus, to develop a liability account. They have commenced writing a primary and excess book with a line size of US$7.5m per risk.

– Following Gerling's reduction in underwriting capacity from US$90m to US$50m they are currently restricting their line on energy business to US$25m.

– R J Wallace syndicate, Lloyds:

- David Constable will succeed Bob Wallace as "active underwriter" with effect from January 1 2003
- Jeremy Fage has been promoted to board level and will be responsible for the International liability account
- Denis Burniston has resigned and a successor is being sought as head of UK liability account.
- David Pratt and Mark Hunt have resigned to join Abacus syndicate

– Bob Pattern joined Starr Excess from Ace this summer as Senior Vice President and Casualty Manager.

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