Energy Market Review 2018
Between a rock and a hard place?
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Insurers in each of our markets now have to navigate a tricky course between:

- continuing to invest heavily in these portfolios, knowing that the modest rate rises currently being obtained (which may in any case not last) won’t be enough to sustain long term profits according to their models; and

- scaling back to wait for better conditions to materialise, which of course runs the risk of depleted premium income and the threat of overall portfolio unsustainability.
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Notes
- Our Review uses a mixture of American and English spelling, depending on the nationality of the author concerned.
- We have used capital letters to describe various classes of insurance products and markets, but otherwise we have used lower case to describe various parts of the energy industry itself.
Introduction

Welcome to this year’s edition of the Willis Towers Watson Energy Market Review. 2017 has been an interesting year for both the energy and the (re)insurance industries, with the good news of the oil price recovery and increased activity in the energy industry being offset by the devastation and personal tragedies brought about by hurricanes Harvey, Irma and Maria.

However, as we move further into 2018 we can now say with some confidence that the apprehension felt by many energy insurance buyers in the immediate aftermath of these hurricanes has, to a large extent, been unfounded. During the last months of 2017 there were plenty of voices emanating from the global insurance markets suggesting that these terrible storms would lead to a significant turnaround in (re)insurance market conditions. That was certainly the case following such events as 9/11 and hurricanes Katrina, Rita and Ike; however, despite the 2017 storms producing well in excess of US$75 billion of insured losses, the turnaround in market conditions, while indeed bringing the softening process to a halt, has been much more modest in comparison to other market-changing events of the last decade.

Furthermore, the direct impact on the energy industry itself has been mercifully limited; although the downstream industry has seen overall losses in excess of USD$1 billion from these storms, this is a much lower figure than for previous events while the direct effect on the upstream industry was, rather astonishingly, virtually negligible.

The other reason for the modest impact on the Energy insurance markets, of course, is the ever present glut of (re)insurance capital which, encouragingly for buyers, continues to act as a dampener on efforts by (re)insurers to instigate a return to rating levels where their models indicate that long term profits for these portfolios can be sustained.

That’s why we have entitled this edition of the Review as “Between a Rock and a Hard Place?” We have posed this question because we think that insurers in each of our markets now have to navigate a tricky course between:

- continuing to invest heavily in these portfolios, knowing that the modest rate rises currently being obtained (which may in any case not last) won’t be enough to sustain long term profits according to their models; and
- scaling back to wait for better conditions to materialise, which of course runs the risk of depleted premium income and the threat of overall portfolio unsustainability.

“Despite the 2017 storms producing well in excess of US$75 billion of insured losses, the turnaround in market conditions, while indeed bringing the softening process to a halt, has been much more modest in comparison to the events of the last decade.”
In brief, here is a summary of the key findings of the Review from an insurance market perspective:

- **Capacity**: once more, capacity has crept up in both the Upstream and Downstream Property markets, to US$7.95 billion for Upstream and US$6.8 billion for Downstream. However, the recent withdrawal of Partner Re from the Upstream portfolio, together with the XL Catlin/Axa merger and AIG's acquisition of Validus/Talbot, may signal that the trend towards year-on-year capacity increases might at last be coming to an end.

- **Losses**: whereas Upstream has had one of the most benign loss years on record in 2017 (under US$1.3 billion according to our database\(^1\)), the same can hardly be said for Downstream, which has had its worst loss year for nearly 10 years (over US$5.5 billion).

- **Rating levels**: While the year-on-year broad decrease in rating levels of recent years has finally been brought to an end for most buyers, the overall upswing in rating levels has been limited in both markets, with modest increases being negotiated for the majority of programmes (clearly, this trend can be mitigated depending on individual risk profiles, loss histories, long term relationships and premium income streams).

- **Profitability**: All the indications suggest that the Upstream portfolio has benefitted significantly from the 2017 benign loss record and remains generally profitable – for now. However, it seems clear that the outlook for Downstream insurers is much less promising; although this portfolio must be viewed within the context of the wider Property portfolio, there can be no doubt that very few will have recorded a profitable year in 2017.

Meanwhile, it may well be that the worst is over for the energy industry as its recovers from the oil collapse of 2014-15. We have included an article from the Petroleum Economist's Selwyn Parker which certainly suggests that more activity can be expected in the years ahead, which may indeed provide the injection of additional premium income that the insurance markets so desperately need.

We have also included an interview with Lloyd’s PMD Jon Hancock, in which he reveals his exciting plans for an innovation laboratory to be housed within the Lloyd’s building, as well as articles on the challenges facing investors in the African energy industry, the latest developments in Enterprise Risk Management and offshore safety – a range of subjects which we trust will be of interest to those engaged in both the energy and insurance sectors.

Whether it’s in hard copy, pdf or our new “Turtl” format, we hope you will enjoy reading the Review and as ever we would be delighted to receive any feedback or comments that you might that you may have.

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\(^1\) Willis Towers Watson Energy Loss Database as of February 12 2018
Part one: special features
The clouded crystal ball – what next for the global energy industry?

Introduction – who would be an oil price forecaster?
Predicting oil prices has become a dangerous game in the last few years, with many a reputation being dented by forecasts that turned out to be too optimistic or the opposite in an historically unsettled period affected by many variables.

It doesn't help much that analysts' views vary significantly, from as low as US$40 per barrel (pb) to as high as US$65pb a disparate range that hardly makes life any easier in the C-suite.

A typical prediction – and one of the most recent – comes from Moody's Investors Service, which in January estimated a range of US$40-US$60 pb through 2018, despite OPEC extending its production cuts until the end of the year.

Exploration spending to stabilise?
Will a US$20 range between top and bottom discourage upstream and downstream investment or encourage it? According to Zacks Equity Research in a report released in January, based on exploration budgets for 2018 the indications are that activity will stay roughly the same as in 2017. Zacks believes a sustained US$60pb is the benchmark that will catalyse spending on exploration in the newer, deep-water frontiers. However in the same vein, consultancy Wood Mackenzie predicts that the majors will cut exploration spending in 2018, making it the fifth year in a row of upstream cuts.

More with less
But exploration budgets don't tell the full story. As we'll see, industry-wide improvements in efficiency and productivity since the oil price crisis mean that more is being done with less. And while some consultants such as Rystad Energy bemoan a steady decline in the rate of discoveries, identifying an exploration strike rate of 35 per cent today compared with 40 per cent a decade ago, there's still a torrent of investment for producing fields.
Good news - M&A activity fuels investment in energy industry

Even at US$40-US$60 a barrel, the burst of M&A action in 2017, especially in North America, is looking increasingly astute. As a wealth of third-party research from 1Derrick, Deloitte and others shows, this stream of CapEx will fund exploration throughout 2018 and beyond, barring major price shocks. In a reference to a hectic first quarter in 2017 in the Permian that attracted US$17bn by value in investment, 1Derrick’s chief operating officer Mangesh Hirve explained in a late-2017 report that buyers were desperate to buy a slice of what may yet prove to be the best tight oil play in the world before it’s too late.

But the money kept coming in the ensuing months. By half-year in 2017, about US$127bn worth of M&A by value had been confirmed. Another flurry of investment activity in late 2017 will lead to more upstream assets in the years hence.

All sectors of the industry – upstream, oil field services, midstream and downstream – were the beneficiaries. Although the US booked the lion’s share of the deals in 2017, Canada saw most of the rest. Its oil sands and deep-basin assets attracted a great deal of the smart money that will fund exploration for years to come.

In Figure 1 above, Rystad Energy reveals the decline in conventional discoveries that now looks like reversing

Source: UCube March 2018 and Rystad Energy research and analysis *barrel of oil equivalent
Investors look to the long term as US$50 pb may be viable

Interestingly, much of the flood of investment that will propel exploration in the near future happened as oil prices fell. As PwC’s Seenu Akunuri, the consultancy’s leader in oil and gas valuations, pointed out, these investors were thinking long-term. Their expectations are that breakeven costs will probably continue to be lower for longer, making viable a price point of around US$50.

Shale leads China catch-up

The investment into exploration hasn’t been confined to North America by any means. China’s state-owned majors are belatedly pumping resources into the development of unconventional onshore gas fields and are catching up fast on the back of technological breakthroughs that, they say, will spur production in coming years. According to China’s National Bureau of Statistics, shale gas output is rising at double-digit rates every quarter (in one month it grew by over 50 per cent, albeit from a low base) while the volume of proven reserves is expected to exceed 1.5 trillion cubic metres by 2020 as new fields are discovered, quite enough to fuel production for decades.

Insatiable demand rewrites basic economic laws

Leaving aside the impact of oil prices on upstream activities, researchers cite the relentless demand for hydrocarbons that is up to a point divorced from price. In the next five years, notes the International Energy Agency, China and India alone will rely on oil, domestic and imported, right through until 2040. As the IEA highlights, non-OECD Asia will remain the major source of growth in demand for oil for many years.

CNOOC expands exploration budget

Once again, China tells us a lot. In 2018 China National Offshore Oil Corporation (CNOOC) expects to drill 132 exploration wells in 2018 and will bring five projects to production. The major certainly isn’t trimming its exploration budget – this year CNOOC will spend between US$11.1 billion and US$12.7 billion, the company’s highest capex in four years.

Deepwater and wildcat activity lifts the gloom

Elsewhere, most of the upstream activity will be in deepwater basins such as Mexico, Brazil and Guyana where bonanza finds have been made in the last few years, encouraging new drilling. Belying gloomy statistics about the rate of discoveries being in decline, ExxonMobil hit oil off Guyana no less than three times in 2017 and has enough hydrocarbons in hand there to keep it going for years. Promising wild-catting is going on in Mexico; for instance in the country’s first offshore pre-salt well, where Pemex is drilling in the shallow waters of the Campeche Basin. Finally Egypt promises to become an important upstream focus after opening bids for various areas in the Red Sea where it’s conducting seismic surveys. The government has signed 12 new oil agreements and is set to agree a lot more in the coming years as Egypt aims for self-sufficiency in natural gas.

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Technology drives performance gains

Production costs down as loss record improves

Today’s oil and gas industry is in a better position to take advantage of rising prices than it was before the oil-price shock. As McKinsey pointed out in a report in December 2017, many upstream operators have made significant performance gains in recent years, with production costs across the sector down by 30 per cent and production losses by 15 per cent since 2014, the latter being heavily influenced by digital technologies that, for example, improve the quality of maintenance. Meantime the incidence of accidents, another heavy capital and human cost, is down by an impressive 33 per cent.

FPSOs: modernised, standardised and cost-effective

In another example of improving technologies, during the tough years the FPSO fleet used the opportunity to modernise itself. Today’s “floaters” are more durable, versatile, productive and cost-effective than even ten years ago, so are now better suited to contemporary oil economics.

And whether it’s for FPSOs or other offshore infrastructure, in the quest for greater efficiencies operators are demanding commonalities in design in a process that’s akin to assembly-line production. One of the leaders in the trend towards standardisation is Petrobras, which has been using the same conversion template in its last five FPSOs, all of them designed for a production capability of 180,000 bpd. Similarly, Italy’s Saipem is converting two FPSOs for deployment in offshore Angola in 2018, both of them designed for the same water depths and storage capability.

Latterly, FPSOs are being deployed to smaller, clustered oil pools where they are extracting hydrocarbons in a sequential process, moving rapidly from one to the other. This is far more cost-effective and efficient than constructing and perhaps dismantling a series of fixed platforms. Without these more versatile FPSOs, the pools would probably not be viable.

MaMPUs tap low margin fields

In perhaps the most extreme example of cost-effective exploration, Malaysia’s Petronas has deployed what it calls a marginal mobile production unit, or MaMPU, that will tap low-margin, offshore minimal fields where hefty capital expenditure may not be justified. The oil and gas equivalent of a pick-up truck, the MaMPU was converted from an oil tanker into a mini-FPSO in just eight months.

As Wood Group pointed out in a late 2017 report, it’s nimble vessels such as these that are helping rewrite the economics of exploration and production at a time when short-term, price-related decisions are the order of the day.

In a similar example, in late 2017 Petrobras commissioned an FPSO that will in four years’ time be anchored at the new Mero field, 180kms off the coast of Rio de Janeiro, where it will hook up as many as 17 wells. In doing so, the Brazilian oil giant will be able to spread its investment for maximum operating expenditure.

FPSO conversions reduce need for new builds

There’s also more interest in conversions – that is, of existing vessels to FPSOs. Markit expects seven construction projects will be awarded in 2018 on top of the eight contracts already under way in 2017. Because they’re faster and cheaper, conversions of (usually) VLCCs are the preferred route in the present environment. As Wood Group notes, single-hull conversions can be done at ten per cent of the cost of newbuilds and, depending on the how big the job is, can be in operation within two years.

Although there are fewer of them compared to conversions, the newbuilds are getting bigger. Demonstrating the trend, Samsung Heavy Industries-built Egina - which will start operations 200kms off the Nigerian coast in late 2018 - is the biggest FPSO yet. With a storage capacity of 2.3m barrels, her construction will consume US$3bn and will take about four and a half years.

Digital technologies improving cashflows

But generally, as McKinsey’s researchers also show, new technologies and improved ways of working are resetting top quartile performance. And that’s especially true of the digital technologies such as analytics that are sweeping through the industry. In a report in December 2017, McKinsey calculates that the introduction of digital technologies may improve total cashflows by a thought-provoking $11 a barrel across the offshore oil and gas value chain. On that basis, predicts the consultancy, digital technologies would add US$300bn a year in revenues by 2025.

“New technologies and improved ways of working are resetting top quartile performance.”
### Conclusion: a brighter outlook!

**US$15 pb breakeven!**

Because the industry isn’t the same one that entered the oil-price crisis, it’s collectively more confident about its future, even if prices rise only modestly. In the British part of the North Sea, there have been several acquisitions that seem to demonstrate that this area remains economically viable, and it is understood that that some companies have now trimmed costs to a breakeven production figure of US$15 pb.

**Old fields enjoy new lease of life**

Indeed, the death of the North Sea has been greatly exaggerated. Far from being a decommissioning graveyard, the new breakeven benchmarks being achieved by upstream operators are giving some of the more mature fields a new life, as several investments show. As Deloitte points out, nearly US$6bn was invested in the UKCS in the first half of 2017 in the form of asset and corporate acquisitions.

**UK government playing its part**

The UK government is also fully engaged in ensuring that the life of the North Sea fields is extended to their limits. Operators cannot shut down a field without the authorisation of the Oil and Gas Authority and the government body won’t sign off while there’s still hydrocarbons to be had. That level of scrutiny has served to lengthen the average life of the UKCS fields by an average of five years beyond the original plug and abandon date.

**Decommissioning will still be a major industry**

Yet the “decom” industry has years of profitable work ahead of it. In the UKCS, Oil & Gas UK estimates that between £8.5bn and £10bn will be spent on decom alone. And looking further out, the trade body’s latest report estimates £17bn will go into decom work between now and 2025.
Exploration budgets not the only factor in upstream activity

So because today’s industry is more streamlined, perhaps the exploration budget is no longer the most important indicator of upstream activity. However, for the record, there’s still plenty of exploration money in the kitty. According to Wood Mackenzie, global investment in exploration will hit US$37 billion in 2018. Although that’s down seven per cent from a year earlier and over 60 per cent below the 2014 peak, it will finance most – or even all – of the exploration that’s needed.

Selwyn Parker is a freelance journalist and a regular contributor to Petroleum Economist magazine.

All sources for this article are from:
- Moody’s Investors Service, Global Credit Research January 2018, and Global Oil Industry to Focus on Disciplined Investment, M&A for Growth in 2018
- Zacks Equity Research, January 2018
- Rystad Energy
- 1Derrick Oil and Gas M&A Review 2017
- Deloitte Insights
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- McKinsey Oil and Gas Insights, December 2017
- Wood Group
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- Oil and Gas Authority UK
- Oil & Gas UK Decommissioning Report 2017
- Care Ratings, Oil and Gas series – Exploration and Production, February 2018

“Because today’s industry is more streamlined, perhaps the exploration budget is no longer the most important indicator of upstream activity.”
Enterprise Risk Management – bringing it to life

Enterprise Risk Management is a term that has been around now for decades. But how many energy companies really understand it? What are the benefits? And why is now the time to take a fresh look at what it can do for the energy industry? Let’s start from the top...

1 What is ERM?

Enterprise Risk Management (ERM) has been defined as:

“The culture, capabilities, and practices, integrated with strategy-setting and its execution, that organisations rely on to manage risk in creating, preserving, and realising value”.

In plain English... risk may be a cause of uncertainty, a driver of strategic decisions or it may simply be embedded in the day to day business of organisations. ERM should be a systematic process to identify, assess, prioritise and manage the potential impact of all types of current and emerging risks (both on an individual and an aggregate level) on all processes, activities, stakeholders, products and services, taking into account organisations’ implicit or explicit risk appetites.

Sounds simple and straightforward? Not really...

2 Why should organisations bother with ERM?

Based on the continuous interactions we have with key stakeholders in the industry, and the extensive research that we are conducting, we know that the amount of time and money that organisations spend (and are planning to spend next year) on ERM is significant. But why?

There are numerous drivers for this; some of them are external in nature and some of them internal. But which ones do really matter, which are at the forefront of the risk professionals and top CEOs’ agendas? You raised them with us, we listened and below we provide the industry’s aggregated view.

Key external drivers

- Increasing corporate regulation requires Boards to demonstrate they have carried out a robust assessment of the principal risks their companies are facing.
- In the UK, Boards are now required to:
  - monitor the company's ERM framework – including its risk appetites
  - at least annually, carry out an effectiveness review of the ERM framework
  - report the outcomes of that review in their Annual Report (This is now regarded as good market practice across the globe.)
- Rating agencies assess companies’ ERM frameworks thoroughly, which significantly impact the overall rating process and the development of capital requirements.
- Increased activism from the shareholders demands greater transparency into Board’s decision making process, including the assessment and financing of business risks.

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Key internal drivers

- Reduced financial volatility, by managing risk at an enterprise level and by strengthening the internal control framework.
- Higher business resilience, by putting together rigorous and well tested contingency plans that cover all the plausible risk classes that organisations are facing.
- Lower operational losses, by implementing a robust and proactive monitoring process throughout the organisation.
- A risk adjusted decision making process, which enables organisations to make more informative and risk balanced decisions.
- Increased visibility of the ERM function to the Boards of Directors, by demonstrating the value that the Function adds to the organisation as a whole.
- Better allocation of risk management resources, by targeting them on areas of risk over or under exposure.

3 All right, but what does good ERM look like?

Over the past year we have seen several energy companies, of different sizes and in different geographies, trying to establish and embed robust risk management frameworks with clearly articulated organisational structures and well defined and documented responsibilities across the enterprise. This is necessary, but challenging too, because it enables organisations to:

- satisfy their external and internal key drivers
- achieve segregation of duties
- comply with general accepted risk management standards such as the updated COSO II and the new ISO 31000 which are well regarded by their stakeholders

In Figure 1 overleaf we provide an example of a well-articulated ERM framework, and its elements, that energy companies frequently use.
Figures 1 – a robust ERM framework

As mentioned earlier, establishing a resilient enterprise ERM framework can be a challenging process and it requires a clear action plan with specific improvement points and defined timelines. To do that, an assessment of the current status of each ERM element against the desired – “fit for purpose” one and the global risk management standards is required. A widely used framework from energy companies that achieves the above objectives is demonstrated in Figure 2 overleaf.

4 Got it, but how do ERM and strategy link together?

This is one of the key questions that we almost always get asked when we are interacting with C-suites from different industries. Although the industries are different, the answer is always the same - risk appetite and tolerances.

Risk appetite

An organisation’s risk appetite describes the amount of risk that it is willing to seek or accept in the pursuit of its long term objectives. It influences strategic parameters, such as the types of activities a business engages in and the time horizon for investment activities, and is a contributing factor to the overall business strategy.

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Cascading Group Risk Appetite to a Business Unit and a Risk Type level

Cascading a high level risk appetite to more granular level and allocating it to the different business units and risk types is a challenging process - the effort and time commitment that is required to complete this should not be underestimated. The outcome of this process, as shown overleaf, enables organisations to link risk directly with their strategy and assess which business decisions could breach their appetite and/or tolerance. If a business decision breaches an organisation’s appetite, then either the business decision should be amended or the risk appetite should be re-assessed and revised accordingly.

Tolerances and limits

Energy companies around the globe are trying to set appropriate risk appetites and tolerances that reflect their strategy, their business model and the environment in which they operate. In doing so, they are establishing financial and non-financial limits against which their exposure to the major categories of risk can be controlled, measured, communicated and reported. The major categories of risk typically include Strategic, Financial, Operational and Regulatory, but these categories should be tailored to fit the needs of different organisations.
Conclusion

Changes in regulations, business environment, political agenda and technology create new emerging risks and opportunities and drive organisations to adapt.

The energy sector will of course continue to grow and flourish, with companies winning and losing along the way. The role of ERM is to enable companies in the sector to become knowledgeable risk takers, maximise the value that they create for their various stakeholders and to empower key decision makers to build bolder business visions and more resilient organisations.

“Ioannis Michos is a Chartered Accountant, a CFA charterholder and a Partner in the Strategic Risk Consulting team at Willis Towers Watson.”

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Investing in African energy – managing the challenges

Introduction
Although the African oil & gas industry has had a tumultuous 48 months, the increased oil price has revived industry activity on the continent. If one looks at the Private Equity industry it might seem that they are mainly vying for investments in the renewable energy space on the continent; yet African oil and gas assets, like those globally, are still widely acknowledged as attractive targets due to their current affordability. PE firms are increasingly focused on emerging markets and large sums are currently being deployed in the energy sector, with Africa a major focus. Indeed, the Carlyle International Energy Partners (CIEP) fund alone raised US$2.5 billion of capital to be deployed in the energy sector, and is planning to raise up to another US$1 billion in a new fund.\(^3\)

Investors are further attracted by the large infrastructure investments on the continent, particularly in the transportation sector which will help improve trade for oil & gas companies. In 2017 alone over US$71.6 billion was invested in transportation and US$36.3 billion in shipping & ports.\(^4\) With the oil price seemingly stabilising, one would expect asset valuation to become a slightly easier task, which should increase investor confidence both on the buy side and the sell side and subsequently lead to increased M&A activity.

However, while this investment is pleasing to see, it does not come without its challenges.

Challenge one – operating in complex and uncertain regulatory environments
Generally speaking, regulations are becoming more complex, with a trend towards greater local ownership, while a shortage of hard currency has created cash flow concerns in certain countries.

Regulations are also becoming more uncertain. Indeed, regulatory uncertainty continues to enhance the political risk involved in engaging in the oil & gas sector in Africa, and is harming the industry’s ability to continue to fulfil its potential. This is a continent-wide issue, but to illustrate the issues we can take a look at three country examples:

- In South Africa, upstream regulation continues to be unclear; the separation of oil and gas from mining has still not occurred as referenced in the Mineral and Petroleum Resources Development Act. Only once regulatory certainty is achieved can the industry develop further.
- In gas-rich Mozambique, the new regulatory framework introduced in 2014 reduced uncertainty, but multiple problems still exist for investors. These revolve around planning uncertainties due to the state’s tendency to be involved at any lifecycle phase, local participation requirements and the obligation for resources to be used domestically which will be tough at the early stage of projects due to the relatively unsophisticated market.\(^5\)
- In Tanzania, in July 2017 the country passed two laws which permitted the government to renegotiate contracts with energy companies. As yet, we are still to see if or when renegotiations will occur, but the potential is there to significantly reduce investor confidence.

Challenge two – dealing with uncertain insurance regulation
Frequent regulatory changes and complexities are mirrored in the insurance sector. The general trend in Africa is a drive towards higher levels of local retention, though the regulations can be opaque and difficult to interpret.

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For example, if one looks at CIMA legislation regarding offshore oil, the ambiguity and complexities are laid bare. Some say that in conjunction with the CIMA code, offshore oil platforms are exempt from the 50% local retention imposed on various lines of business; platforms are said to fall under the risk classification “Marine Hull, lake and river vehicles: Any damage suffered by: a) river vessels; b) lake vessels; c) boats / ships,” which under part 6 of article 328 are exempt from article 308 of CIMA which demands the 50% local retention within the CIMA zone.

As we know, “offshore oil platforms” is a very non-descript title for the plethora of Upstream insurances one can arrange. Does this apply to all typical Upstream package coverages? Or is Control of Well and Liability (even for an FPSO) not to be given such dispensation? This exemption is based on a legacy clarification given by the CIMA regulator in 2014. Interpretation of this differs from country to country, stakeholder to stakeholder and serves to highlight the ambiguity. Logic would suggest that this loophole is limited. Where it is currently accepted in isolation without much confidence, it will most likely be shut down soon. As such, utilising a local partner is paramount in order to get full and up to date advice as to what is permissible under the CIMA code.

The 14 CIMA countries are not the only ones experiencing regulatory change. Both Ghana and Tanzania have recently seen the most radical changes in the reinsurance landscape, with strict rules on overseas cession. Taking hydrocarbon hotspot Tanzania as a case study, the Tanzanian Insurance Regulatory Authority (TIRA) has introduced new requirements relating to reinsurance arrangements for those insurers registered to conduct insurance business in Tanzania.

The changes have been prompted by the belief that there has been general exploitation of reinsurance arrangements, with a key focus on excessive use of international facultative re-insurance arrangements and 100% fronting of risks which could be partly retained locally.

In light of this, the recent regulatory changes are designed to increase retention rates, thereby increasing capacity within the country’s insurance sector, which should in turn benefit the wider local economy. Key points of the new legislation include:

- new levies for facultative placements outside the country
- a clear statement that irregular packaging of risks with the aim of externalising them is banned and punishable by law

**Challenge three – satisfying lenders’ requirements**

Local regulation and compliance is never simple in Africa (and appropriate independent legal advice should be taken in all instances); where debt finance is deployed, satisfying lenders requirements is no easy task. Insurance programmes often form part of the security package, which if not executed correctly can result in a breach of warranty under the loan agreement. Equally where there are lender requirements regarding the minimum security rating of the (re)insurance package, this needs to be weighed very carefully against the local regulations around mandatory retentions in country.

**Challenge four – managing currency risk**

The African Private Equity and Venture Capital Association (AVCA) recently surveyed 42 global PE firms with African assets and 90% of those surveyed viewed currency risk as being either important or very important to their firm. Furthermore, 78% of respondents believed that African currency risk has increased over the previous 3-5 years, and 75% stated that currency volatility has had an adverse impact on their realised PE investments. Exit strategies are always at the forefront of investors’ minds before purchasing an asset and firmly embedded in the investment strategy from the start; however, currency risk led 46% of the AVCA respondents to amend exit plans.\(^7\)

West Africa (Africa’s largest oil producing region) clearly reflects these fears, accounting for the most private exits in recent times. For example Nigeria has been badly affected by the recent low oil prices and the subsequent crash of the Nigerian Naira against the US dollar has led investors to look elsewhere. Whether this trend will continue with the stabilisation of the oil price, is yet to be seen.\(^8\)

“The general trend in Africa is a drive towards higher levels of local retention, though the regulations can be opaque and difficult to interpret.”

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\(^6\) Conférence Interafricaine des Marchés d’Assurances – the regional body of the insurance industry for 14 countries in Francophone Africa.

\(^7\) African Private Equity and Venture Capital Association, ‘Volatility and Uncertainty: how private equity in Africa navigates through turbulent times’, November 2017

\(^8\) White & Case, ‘Africa Focus. Financing Africa: Challenges and opportunities’, Spring 2018
Challenge five – effective ESG fund implementation

If there is to be increasing exit deal volumes across the region, the way Environmental, Social and Governance (ESG) has been implemented by the fund will play an important role. ESG covers a wide-ranging agenda but is effectively a set of standards used to evaluate corporate behaviour.

88% of portfolio companies now formally report ESG monitoring results to their firm which, if positive, should help to maximise exit values. Dabney Tonelli, investor relations partner at Helios Investment Partners stated the importance of ESG in Africa stating, “All of our portfolio companies in some way are making life better for people and businesses in Africa. Through our investment activity we’re developing the next generation of business leadership potential, enhancing lives through access to information and technology, creating financial security, increasing financial inclusion, improving environmental care and quality and improving governance standard.”

Poorly implemented ESG could lead to increased risk of community instability and political violence which, given the historical reputation of oil & gas companies, will increase reputational damage risk. Large-scale energy projects have a significant impact on local societies, affecting their environment, workplaces and communities. It is therefore crucial that investors manage their projects carefully, or they will face the associated risks of social unrest.

Conclusion – don’t be deterred!

Although many other risks are also firmly embedded in the African oil & gas risk landscape, investors should not be deterred. Understanding the issues is the first step; mitigation comes next. Investors can be confident that, allied with the right business and risk advisor, they can navigate these choppy waters to reap the long-term benefits of investing in this exciting region.

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Alexander van Kuffeler is Head of Africa Specialty at Willis Towers Watson.

“Poorly implemented ESG could lead to increased risk of community instability and political violence which, given the historical reputation of oil & gas companies, will increase reputational damage risk.”

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9 PWC, ‘ESG considerations for private equity firm
Offshore safety – how to ensure critical element dependability?

Introduction – identification

Any structure, plant, equipment, system (including computer software) or component part whose failure could cause or contribute substantially to a major accident is Safety Critical, as is any that is intended to prevent or limit the consequences of a major accident. In new ventures, Safety Critical Elements (SCEs) are identified as part of the Hazard Assessment process. On older plant, there may be a need to reconfirm the safety premises that were established during the original project and Process Hazard Reviews (PHRs) should be revisited on a regular basis (at least once every five years) to confirm that there has been no change to the hazard or risk.

System-by-system approach

SCE identification includes elements that participate in the detection, control and mitigation of major accidents. Confirming SCE activity requires a system-by-system approach, because some components may have this exposure and others may not. Some failures may not directly initiate a major accident, but could make a significant contribution to a chain of events that could result in a major accident – these are also SCEs.

Developing the risk profile for an asset ensures that focus is given to identifying hazards, assessing risks adequately and identifying risk control/mitigation measures.

Riser emergency shutdown valves

Riser emergency shutdown valves (RESDVs) are an essential hazard reduction measure for offshore installations; they are part of an offshore facility’s gamut of protective systems designed to ensure safe operation and they are SCEs. RESDVs are also a legal requirement under the UK Pipelines Safety Regulations 1996, which also require that the valves shall be maintained “in an efficient state, in efficient working order and in good repair”. In the UK, failure of a safety critical element such as an RESDV, whether deriving from test results or failure on demand, is defined as a dangerous occurrence and must be reported.

Health and Safety Laboratory report highlights RESDVs failures

The Health and Safety Laboratory (HSL) issued a report11 through the UK Health and Safety Executive (HSE) in November 2015 covering “Investigations into the immediate and underlying causes of failure of offshore riser emergency shutdown valves”12. This information is licensed under the terms of the Open Government Licence13.

Over a seven-year period to March 2014, the study revealed that some 180 RESDVs failed. (Reporting was sparse until mid-2009, so most of the failures happened over a four to five year period.)

Two thirds of the failures occurred during testing, which supports the importance of this activity. Considering the sample size, this represented a failure-on-test rate of around 1.2%, which is similar to the Norwegian Continental Shelf failure-on-test rate of 2.0% over a similar period14. Although the North Sea environment is harsh when compared to many offshore locations, common mode weaknesses are clearly applicable elsewhere.

“Two thirds of the failures occurred during testing, which supports the importance of this activity.”

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11 RR1072
13 http://www.nationalarchives.gov.uk/doc/open-government-licence
Figure 1 above shows the immediate failure causes of the HSL review summarised into several groupings to help with interpretation.

The majority of the tested valves had been in service for more than 20 years and although age has been defined as one of the failure causes, this merits further analysis because a well-maintained valve should function well, independent of its age. The contrary suggests that maintenance is not achieving its purpose.
Figure 2 above provides some further analysis on the underlying cause of the failures and suggests that maintenance is a primary factor, followed by plant integrity, plant and process design, and organisational culture. (These and other headings were developed by the HSL to help identify the underlying causes of incidents; further information is included in RR 1072.)

**Corporate amnesia**

Any control system can fail, but the underlying problem referred to in organisational culture is a lack of learning from previous failures – part of the corporate amnesia often referred to in safety circles. Proper maintenance and regular proof testing of RESDVs make a major contribution to maintaining safety integrity. It is clear that data recall and trending, as part of a good reliability-centred maintenance (RCM) programme, are essential to avoid failures, but too often the required feedback is missing.

RESDV failure mechanisms include:

- failure to close on demand due to inadequate maintenance/ proof testing
- incomplete closure leading to internal leakage because of incorrect valve specification or inadequate maintenance/ proof testing
- operator failure to activate a serviceable valve due to inadequate training and/ or unclear instructions
- valves rendered unserviceable by the incident, e.g. damaged by fire or explosion
- failure-to-danger of valve on loss of motive power

Operators need to record relevant measurable quantities, which for RESDVs includes failure closure times and internal leakage rates, analyse the results and feed these back into the preventive maintenance programme. The unsupported “pass” or “fail” comment does not hold water in an analytical maintenance programme.

“Any control system can fail, but the underlying problem referred to in organisational culture is a lack of learning from previous failures – part of the corporate amnesia often referred to in safety circles.”
Next steps

Proof testing
Having identified that RESDVs are SCEs and that they have a failure rate that exposes their platforms to a potentially unacceptable risk, what steps are necessary to avoid that the valve is present in a potentially failed state? This falls clearly into the regime of analytical maintenance where conditions are monitored on-line where possible and inspected/tested as necessary to provide a full performance profile.

The point of testing is to verify, so far as reasonably practicable, that each sensing device and related final element will respond within defined test tolerances so that the control circuit performs its shutdown function as specified, i.e. to tease out the offending failed elements. Depending on guideline interpretation, user experience and maintenance sophistication, there are different inspection/testing regimes in place for RESDVs; some of these are defensible, others less so.

Proof testing should be done:

- after commissioning as part of validation
- as defined by the scheduled test programme
- after any maintenance to confirm functionality
- immediately before preventive maintenance, to confirm functionality

More reliable data available
To define the scheduled test programme requires an understanding of the element’s integrity or dependability. The concept of analysing the performance of safety functions was an extension of Hazard and Operability studies in the 1970s; however, their Probable Failure on Demand (PFD) estimates were questionable because of unreliable data related to equipment and system failure. A more mature industry that has also evoked changed attitudes towards discussing losses now provides engineers with more reliable numbers.

Confirming dependability
BS EN 61508 (BSI 2002) and related international standards provide the guidance needed to evaluate and confirm the dependability of a system that has a safety function. As a result, a powerful tool has been added to the safety toolbox and its use ensures a safer offshore working environment. That is of course, as long as it is aired outside of the toolbox!

Detection and control systems
Detection and control systems are part of normal operational requirements for retaining quality as well as ensuring safety with pressure, temperature and volume levels being monitored and corrected on a frequent/continuous basis; should these be compromised, a dangerous situation could evolve. On a less frequent, through to “once-in-a-blue-moon” basis, detecting abnormal excursions that need prioritised actions to prevent dangerous scenarios is equally important. Each case has a different operational signature and it is important to understand how frequently equipment or system failure could lead to an accident.

Calculating failure and accident probability rates
If there is a frequent drift from the ideal that needs to be controlled, the accident rate approximates to the failure rate, $\lambda$ which is the reciprocal of the Mean Time to Failure (MTTF).

Where demand is low, the accident rate is a combination of how often there is a trigger and the chances that that it will not be detected i.e. the PFD, which is the reciprocal of the Risk Reduction Factor (RRF).

Introducing preventive maintenance, by proof testing the system more frequently than when it is called upon to react (proof test interval $T$), the relationship can be defined as:

$$PFD = \frac{\lambda T}{} \text{ or } = \frac{\frac{\lambda}{2 \times MTTF}}{} \text{ and}$$

$$RRF = \frac{2}{\lambda T} \text{ or } = \frac{2 \times MTTF}{T}$$

“A more mature industry that has also evoked changed attitudes towards discussing losses now provides engineers with more reliable numbers.”
Referring to BS EN 61508, (which will be the subject of a future article), Safety Integrity Levels are assigned against failure probabilities for low and continuous demands as per the table below:

<table>
<thead>
<tr>
<th>Safety Integrity Level</th>
<th>Mode of Operation</th>
<th>Mode of Operation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>On Demand</td>
<td>Continuous/ High Demand</td>
</tr>
<tr>
<td></td>
<td>(average probability of failure to perform its design function on demand – PFD)</td>
<td>(probability of a dangerous failure per hour)</td>
</tr>
<tr>
<td>1</td>
<td>/ 10^{-2} to &lt; 10^{-1}</td>
<td>/ 10^{-6} to &lt; 10^{-5}</td>
</tr>
<tr>
<td>2</td>
<td>/ 10^{-3} to &lt; 10^{-2}</td>
<td>/ 10^{-7} to &lt; 10^{-6}</td>
</tr>
<tr>
<td>3</td>
<td>/ 10^{-4} to &lt; 10^{-3}</td>
<td>/ 10^{-8} to &lt; 10^{-7}</td>
</tr>
<tr>
<td>4</td>
<td>/ 10^{-5} to &lt; 10^{-4}</td>
<td>/ 10^{-9} to &lt; 10^{-8}</td>
</tr>
</tbody>
</table>

**Process Hazard Analysis determines required SIL system**

When determining whether a SIL 1, SIL 2, or SIL 3 system is needed, the first step is to conduct a Process Hazard Analysis to determine the functional safety need and identify the tolerable risk level. After risk reduction and mitigation from the process control system and other layers of protection are taken into account, this leaves the residual risk, which is compared with the stated risk tolerance. If these do not match, risk reduction is needed and the SIL requirement is calculated.

It should be noted that the SIL requirement applies to a complete function, i.e. the field sensor, the logic solver and not just the final element. Care needs to be taken when referring to the HSL data quoted, but the PFD for the RESDVs appears to be around 3 x 10^{-2}, which complies with SIL 1 without considering the associated system elements. Current good practice suggests that RESDV systems should be rated as SIL 2.

**Conclusion: towards a full RESDV test regime?**

Current good practice for topside valves e.g. Emergency Shutdown Valves (ESDVs) On/Off Valves (XVs) and Blowdown Valves (BDVs), suggests an annual full stroke functional test, taking into consideration that such valves self-proof-test through, occasionally trip and have partial stroke testing as part of their maintenance programmes.

It should be noted that some operators are reluctant to undertake a full RESDV test regime that requires valve closure (to check internal leakage) since this may affect well-stability and recovery following the testing process. Feeder platforms routing liquids for further treatment or relaying gas for further compression/transport onshore can also suffer control problems depending on hold-up potential, time and distance.

The good news is that unplanned valve closures happen and the results of these are often recorded within Distributed Control Systems (DCS). It is important that this information is captured and credited within the maintenance records.

*Neil Stairmand is a graduate chartered mechanical engineer responsible for conducting risk control surveys and providing an engineering service to Willis Towers Watson clients.*
Lloyd’s is innovating and thriving – and committed to the Energy portfolio

An interview with Lloyd’s PMD Jon Hancock

Jon Hancock joined Lloyd’s as Performance Management Director in December 2016 where he has responsibility for performance management, capital setting and risk management in the Market. He joined Lloyd’s from RSA where he had enjoyed a career of over 25 years with the insurance company.

Willis Towers Watson (WTW): Jon, I’m sure you would agree that the London insurance market must embrace technology to remain competitive. What measures has Lloyd’s taken in this regard, and what is on the horizon?

Jon Hancock (JH): Yes indeed, we have to embrace technology, both as an industry and as a major player in the London market, not just to manage expense ratios but also to ensure the safety and efficiency of moving data, premium and claims payments around.

I’d like to highlight five key areas where we are doing just that. One, Lloyd’s is a big supporter and driver of the London Market Target Operating Model (TOM); the collaboration between LIBA, IUA and Lloyd’s is very powerful. I know that Willis Towers Watson is also a big supporter - your Head of GB Nicolas Aubert is actively involved in this. Two, we are mandating electronic placement through PPL, a move to really accelerate adoption of this crucial way of doing business. Three, we are experimenting with artificial intelligence – we have run a specific test on Lloyd’s international access around the world. Four, we are running blockchain proof of concepts involving real time risk aggregation and risk location data on marine risks. And five, we are launching a new innovation lab in the second half of this year, to help the Lloyd’s market innovate more.

“If you look around our industry, we are not renowned for embracing technology, more for having to catch up with it. We want to be renowned for getting ahead of technology.”
WTW: Will these initiatives get some underwriters out of their “silo” mentality of always relying on tried and tested products?

JH: Yes, I’m sure they will. If you look around our industry, we are not renowned for embracing technology, more for having to catch up with it. We want to be renowned for getting ahead of technology. Let’s not forget that Lloyd’s has built its reputation as the most innovative insurance marketplace over the past 300 years. These initiatives are the next logical step in our evolution, and we will make sure we continue to innovate and provide the products our customers need.

WTW: Regarding the innovation lab, do you let the technical specialists have free reign? Are there any restrictions?

JH: We acknowledge we are not experts in insuretech but we are in insurance! We need to build our expertise with the help of technical pioneers. The lab will enable new concepts and ideas to be tested in a fast-track, fast-fail environment with the support and active involvement of the Lloyd’s market.

To facilitate this the Corporation is providing space on the fourth floor in the Lloyd’s Building, giving access to the market to start-ups, and potentially investing capital in businesses which can improve the competitiveness of the market.

WTW: Turning to how Lloyd’s conducts its business in the future, can you see the end of the “walk in” model? In today’s technologically advanced world, is “face to face” really still that important for the majority of transactions within Lloyd’s?

JH: Most market practitioners acknowledge that the world has changed, but it’s the sheer pace of change that is so noticeable. When I look back 30 years to the beginning of my career I was doing things completely differently. The difference is that my 30-year journey would probably happen in three years now! Some will resist change, others will rush ahead, and I think it’s those that move early that will be in the best position. When it comes to the “walk in” business model you must remember that face-to-face trading and placing is very efficient in some circumstances where you have really high value complex risks such as Energy.

We also need to work out what “face to face” actually means; it could in some instances mean Facetime or Skype which may be more efficient, or it could mean a physical walk in. But I can’t see any time soon where there will be no need to hold any face-to-face negotiations whatsoever. Some of it is human nature – you want the security or comfort of looking someone in the eye – but often it’s simply about efficiency where face-to-face discussion, negotiation and decision making is the best way to do business.

“Walking around with a really good tablet and having that data on that tablet saves the back, it saves the arms and it saves the shoe leather. And it’s much safer too.”
WTW: Will electronic trading change the current model?

JH: Yes it will. The London market Placing Platform Limited (PPL) initiative15 will enable much more business to be traded entirely electronically, with all the benefit that brings, and this will make the London market a better place to trade.

WTW: So the broker can have a face-to-face meeting with an underwriter but he doesn’t have to have a bunch of documents in his slipcase with him?

JH: Correct, where face to face is required. And walking around with a really good tablet and having that data on that tablet saves back, it saves the arms and it saves the shoe leather. And it’s much safer too. If a broker loses the tablet, the data within it is encrypted and it’s safe.

WTW: Data security must be a big issue on your agenda, with the new European Directive coming in?

JH: Data security is as relevant for paper as it is for electronic material. Generally it’s safer to have data in electronic format because you can protect it in different ways – a padlock on a briefcase is nowhere near as secure as an electronic padlock. Both from an insuring and operational perspective, data security should be on everybody’s radar. If we are going to get more efficient at moving data around, we have to make sure that it is in a really safe environment.

WTW: The Energy portfolio offers significant premium income to Lloyd’s syndicates, but has a reputation for volatility. How committed is Lloyd’s to the Energy sector? Can you envisage circumstances in which Lloyd’s might deem the sector to be inherently unprofitable?

JH: Yes, we are very committed to the Energy sector. If you think about where Lloyd’s has come from, we have built our business on a specialty business model. Now what we regard as specialty business has changed over the years - it’s not just catastrophe or “unusual” business but it includes specialty lines such as Energy. Specialty remains at the heart of Lloyd’s business and by its very nature brings with it additional volatility. Because it’s volatile, it is written more carefully or thoughtfully by underwriters with a different set of skills to Bordereaux-based portfolio underwriters. So the returns demanded by investors are higher because of this volatility. It’s all about understanding it; our commitment to writing volatile lines remains very high, as long as the underwriters writing it understand it and the capital providers understand that this is what they do.

WTW: But if rates get to the point where the premium income stream is insufficient to pay for operating and reinsurance treaty costs, would Lloyd’s PMD ever consider ordering a withdrawal, if only on a temporary basis? Is your commitment to the point where the market would be free to make year on year losses?

“Do I see a point in the future where I would say ‘you have to stop writing Energy’? No, I don’t.”

15 Placing Platform Limited (PPL) – a new electronic platform to support a more flexible negotiation and faster placement.
JH: I have to make the point that of course I don’t set the price, although I do see and approve individual syndicate business plans and we have a responsibility to ensure they are realistic and sustainable plans. But do I see a point in the future where I would say: “You have to stop writing Energy”? No, I don’t. I think in any sector there are good risks and bad risks, and there are good underwriters and bad underwriters. I do see a point - it happens already of course - where the best are enabled to do more and others are reigned in! With regard to the operating costs, if it is a pure commoditised product and you can’t add specialised underwriter costs onto that, you should focus your time on specialty business. The approach changes: the syndicates will continue to identify those areas where they continue to trade as specialists and which demand specialist skills, and if a particular portfolio becomes commoditised, the syndicate should either transact on that basis or not trade at all. The key is having the right expertise.

WTW: So how should Lloyd’s underwriters manage the underwriting cycle in an era of chronic over-capacity?

JH: It’s interesting to remember we haven’t had a truly hard market for nearly 20 years. We need to figure out where the specialists write specialist business with the right underwriting and risk management skills and are they backing the right policyholders who also have the right risk management skills? If some of the business now falls away because it’s become uncompetitive and too risky to continue to provide the breadth of cover required at the price demanded, then that is OK. In fact it’s a good thing. That is a fact of life. If there is too much capacity, then in some areas we must choose not to play. Instead, we should identify the areas where we can play.

WTW: There has been a great deal of comment recently about the withdrawal of certain insurers from sectors such as Coal Mining, citing moral hazard etc. Can you see Lloyd’s adopting a similar outlook for environmentally sensitive sectors such as Energy?

JH: Lloyd’s Corporation recently announced its coal exclusion investment policy, as applies to segregated assets within the Central Fund (approximately 75% of funds). This will come into force from 1 April 2018. In terms of underwriting certain classes, these are decisions for the syndicates in the market to make.

WTW: In the new world order governed by increasing technological efficiency, how can Lloyd’s continue to differentiate itself, not only from other London insurers but from insurers from other markets such as Dubai, Singapore and New York?

JH: Firstly what should we be doing that’s new? That would be technology and innovation, which we covered earlier - enabling us to do business better. Secondly, what are we doing well? We need to trade on our well-earned reputation for technical expertise, innovation, security - we have such a strong brand. One of the things that has really blown me away since joining Lloyd’s is seeing the power of the Lloyd’s brand from the inside. Thirdly, in terms of competing against the rest the world, that’s rather different from competing against the rest of the London market -which in my view is still the only true insurance hub in the world - as we need to develop different ways of servicing policyholders. Generally the things that we are renowned for is having that expertise and that professionalism so let’s make sure we direct it at the business where we really need to be specialist and expert, and do that all around the world even where there is insurance expertise and where there are growing centres. As the specialist hub, Lloyd’s has a huge amount to offer.

WTW: Are you confident that Lloyd’s can continue to be successful and trade profitably in an era of continual over-capitalisation?

JH: Yes I’m confident we can. There are some things we just need to carry on doing because we do them well but there are also some things that we need to change. Where we are commoditising business, we must make sure we have a model that responds to that and where the business is specialist, we must make sure we respond to that differently. Where specialist underwriting is required, let’s make sure Lloyd’s remains the market of choice.

“Where we are commoditising business, we must make sure we have a model that responds to that and where the business is specialist, we must make sure we respond to that differently.”
WTW: Do you see Lloyd’s insurance products continuing to be offered in traditional silos, or can a package approach (Property, Liability, Terrorism, D&O, EL etc.) be more attractive to clients and help differentiate the Lloyd’s market?

JH: I think packaged policies are perfectly right and proper, and something we should do more of. In the specialty markets in which we operate, there is still a need for single line policies in many circumstances but policyholders often prefer the packaged approach for a variety of reasons: simplicity, continuity, coverage, price, etc. And if you look at the way the market has evolved, rarely are there single line specialist syndicates any more. If you go back 25 years or so, we had a series of single line syndicates at Lloyd’s – now there are less of these and most are more general. All the syndicates have got better at working between different underwriting teams; in any case, many are already multi-class. We have improved naturally but there is definitely an opportunity to be braver on specialist products and to package them better – however, we must always understand that if it is a specialist risk we must have specialist underwriters who understand the component parts, so the package can be fitted together to give the right cover at the right price.

WTW: Finally with regard to Brexit, how does Lloyd’s envisage trading after March 2019?

JH: It’s a challenge that I and Lloyd’s wish we were not dealing with, but our response to it is as good as it possibly could be. We are establishing a subsidiary in Brussels, an insurance company which will be regulated and supervised by the Belgian regulator. This means brokers and clients will be able to access Lloyd’s after the UK leaves the EU. Our subsidiary will be open for business from 1 January 2019. There is a lot of work to do between now and then, but the team managing this have done a great job engaging with the market, including with brokers and coverholders, to make sure we continue doing business in Europe after Brexit, as efficiently as possible.

“We must always understand that if it is a specialist risk we must have specialist underwriters who understand the component parts, so the package can be fitted together to give the right cover at the right price.”
Part two: the Energy insurance markets in 2018
Upstream

Introduction

Conditions in the Upstream market have been uncomfortable for insurers for several years now. In previous editions of this Review we have explained how the Upstream premium income pool has been whittled away over time due to a combination of a number of factors, including excess capacity, lower oil prices and increased captive retentions.

Upstream HIM losses negligible

For years, insurers have been concerned about falling rating levels and finding a means of continuing to write this portfolio on a profitable basis. Following the 2017 Gulf of Mexico hurricane season, it was widely assumed (but not by all) that increased reinsurance costs resulting from record windstorm losses would lead to a definite Upstream market turnaround; however, not only were there virtually no direct Upstream losses from hurricanes Harvey, Irma and Maria (HIM), but there were also no severe increases in reinsurance market rating levels, except for Whole Account programmes featuring significant Hull exposure.

Gentle market upswing

Despite this, underwriters have been under significant pressure to raise rates across the board from their own management, whose overall portfolios have taken a big hit from the 2017 hurricanes. As a result, the softening process has been brought to a halt and a modest upswing in rating levels has become the norm.

But can this turnaround be sustained? How long might it be before softening pressures re-assert themselves in this market? Let’s have a look at our market data to identify the underlying trends that are shaping today’s underwriting conditions.
While 2017 saw a significant flattening in the rate of increase of overall Upstream capacity, if anything the rate of capacity increase in 2018 seems to have increased slightly. This is largely (but not entirely) due to two new start-ups beginning in 2018 who we understand are intending to enter the Upstream market for the first time in many years, as well as there being no withdrawals other than Partner Re. Our research now indicates that there is almost US$8 billion of “theoretical” (i.e. what insurers state is their maximum) capacity - yet another record level at a time when premium income streams continue to decline.

Realistic maximum stays the same

In terms of what might be realistically achievable in the market (rather than relying on insurers’ stated theoretical maximums) we consider that the same figure that we used last year, US$6.5 billion, remains the most that any buyer can realistically hope to purchase for a single programme. It should be pointed out that such a limit would be expensive to purchase (as it would require the participation of most of the market to achieve it) relative to more modest programme limits.

So again, although we have suggested for several years that some insurers might decide that enough is enough and withdraw from this sector at some stage, our capacity figures confirm that once more we have seen no signs of any withdrawals during 2017.

No end to capacity surplus in sight

Why does capital continue to flow into this market? As we have pointed out before in previous editions of this Review, insurance remains a safe haven for capital in this low interest rate economic environment, and on a macro level any lost Insurance Linked Security capital as a result of the 2017 Gulf of Mexico windstorms was easily replenished. What’s more, the Upstream sector remains one which contains an unusually large number of programmes featuring attractive levels of premium income – even in this soft phase of the underwriting cycle. And to top it all, the Upstream market has just had one of its most benign years on record, leading to what appears to be a profitable portfolio for 2017.
As can be seen from Figure 2 above, in terms of catastrophic losses the market has found that the number of such losses has been steadily reducing. Only two such losses have been recorded by our Database to date in 2017, while in contrast there were ten such losses in 2015 and four (including a very large BI loss offshore Africa) in 2016.

<table>
<thead>
<tr>
<th>Type</th>
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</tbody>
</table>

Only two losses over US$100m have recorded to date in 2017 - less than in 2016 and significantly less than in 2015

Source: WTW Energy Loss Database as of February 12 2018 (figures include both insured and uninsured losses)

As can be seen from Figure 2 above, in terms of catastrophic losses the market has found that the number of such losses has been steadily reducing. Only two such losses have been recorded by our Database to date in 2017, while in contrast there were ten such losses in 2015 and four (including a very large BI loss offshore Africa) in 2016.

“Just at a time when underwriters are being instructed by their managers to raise rates across the board, the Upstream portfolio is currently looking in good health.”
Even more significant from the market’s perspective are the overall loss figures for 2017 excess of US$1 million (Figure 3 above). It can be seen that the figures for 2017 are currently the lowest in recent memory and are less than a third of the corresponding figure for 2015. As a result, the gradual decrease in premium income that the market has been experiencing since 2012 has not generally resulted in underwriting losses in 2017; instead, just at a time when underwriters are being instructed by their managers to raise rates across the board, the Upstream portfolio is currently looking in good health.

The January 1 renewal season

Disappointment for some leaders

Insurers have begun 2018 with mixed feelings. In the immediate aftermath of the 2017 Gulf of Mexico hurricanes, some leaders were certainly giving the public impression that it was only a matter of time before a significant market upswing would take place during December as the full impact of over US$100 billion worth of hurricane losses impacted the entire Property & Casualty portfolio. As a result, and bearing in mind the losses sustained by their organisation on the rest of their portfolios, some of these leaders began to take a more aggressive stance at the end of 2017 in an attempt to generate the turnaround that they had been predicting.

No dramatic market turnaround

Three months on, we can say that these leaders have been somewhat disappointed. Yes, there have been reinsurance treaty rates increases, but these have been milder than predicted, with virtually all quota share reinsurance programmes being renewed intact. As a result, while there has certainly been a halting of the softening process, in terms of an upturn this has proved to be quite gentle.

While welcome news for the market, such a modest upturn hardly represents a dramatic change in market conditions and those leaders that had originally quoted much more punitive terms in the immediate aftermath of the hurricane season have quickly found that such stances have not been sustainable, apart from some programmes requiring full market capacity or with a significant natural catastrophe component.
Restricted leadership options help reinstate the “false equilibrium”

As the market softening has ground to a halt, in overall terms the numbers of leadership options open to buyers has reduced, allowing the existing leaders to maintain the modest upswing that we have seen for the last few weeks. In this market climate, there are precious few underwriters prepared to undercut existing programme leadership panels, despite the theoretical increase in capacity.

Readers with long memories will remember a similar “false equilibrium” during the years 2008-14, when despite increased capacity rating levels in the Upstream market continued to rise. Then, as now, Upstream insurers were able to seize on significant market losses (for example hurricane Ike and the Gryphon A disaster) to keep prices rising – mainly because the leadership options in the market were restricted to a handful of respected individuals.

Although in recent years the leadership panel had widened since that era, we are now finding that the options open to buyers and their brokers have once again become more restricted, because markets are currently able to hold their position.

Figure 4 – Upstream profitability 1996–2017

Incurred Ratios (premiums v paid & outstanding claims)

The 2016 year of account looks profitable for Upstream insurers – both the 2016 and 2017 data to date reflect the benign nature of the overall 2017 loss record

“OEE” – combination of EW, EY and EZ Audit Codes
A more realistic market?
Furthermore, with the pressure of previous years’ unrealistic premium income targets now significantly eased, it could be said that Upstream insurers are perhaps now in a more realistic position than they were in the recent past. Figure 4 on the previous page shows the latest Lloyd’s Incurred Ratios (i.e. written premiums versus paid and outstanding losses) figures for Upstream lines of business since 1993. Last year we suggested that for some insurers to be sure of being profitable, the Upstream portfolio needed to be below 50%, given today’s operating costs and relatively low premium levels). It can be seen that both 2016 and 2017 currently fulfil that criteria (although the 2017 figures in particular are still relatively immature at this stage). Perhaps the atmosphere is now not quite as gloomy in the Upstream market as might be expected.

2018 market conditions
The premium income challenge remains
But for how long can the existing leadership panel sustain the current gentle increase in rating levels? Not only is there marginally more capacity in the market, but the premium income pool continues to remain under threat. The threat is fourfold:

1. Recent high profile mergers/takeovers within the upstream energy industry, leading to a consolidation of insurance programmes;
2. Continued increased use of captive insurance companies, now taking an even larger share of the most sought after programmes;
3. Higher retentions taken by some significant local insurers; and
4. A potential increase in insurer consolidation, following the recent withdrawal of Partner Re, the purchase of XL Catlin by Axa and the takeover of Talbot/Validus by AIG.

Although insurers can expect to see some increased premium income in the form of more E&P activity given the recent higher oil prices (see Selwyn Parker’s article elsewhere in this Review) and possibly an uplift in new Construction business, the effect of these four factors is more than likely to offset any premium income gain from higher oil prices.

What’s more, any increased premium revenue to the market will depend greatly on which company is involved in any increased E&P or construction activity; if the company concerned is a large one with a significant captive and/or OIL participation, then the net effect on the commercial market’s premium income levels is likely to be reduced.
Is Gulf Wind the answer?
Some insurers that do not already do so might be tempted to augment their existing premium income streams by entering the highly specialised Gulf of Mexico Windstorm (Gulf Wind) market. There can be no doubt that following the 2017 season Gulf Wind is going to be a significantly more expensive product for the upstream industry than it was last year. The Gulf Wind renewal season does not generally begin until late March so it is a little early to say how attractive this portfolio might be to the direct Upstream market, but it would be a very brave underwriter who would be able to predict the profitability of the Gulf Wind portfolio from year to year.

Can Cyber augment the Upstream premium income pool?
In previous editions of this Review we have described how long it has taken for genuinely plausible Upstream Cyber products to be created and offered by the market, and indeed the slow take up of the first fledgling products that have been on offer to the buyers. We are pleased to report a more sustained take-up of these products by our client base during 2017, particularly from some companies keen to demonstrate to their shareholders that they have bought as much cyber protection as possible. This is obviously a part of the market that can only grow in the years ahead. However, despite the year-on-year increases in cyber product take up, we are still a long way from the position whereby cyber income might form a meaningful part of the overall upstream premium income pool.

What about the impact of previous years’ claims?
One final consideration for Upstream insurers as they take stock of the recent uplift in overall rating levels and positive Incurred Ratios is the potential for cash calls resulting from the finalisation of previous years’ claims. A study of our Database charts from year to year often suggests that claims can significantly deteriorate some considerable time after the loss and before final settlement is negotiated and agreed; it is understood that there are a number of Upstream losses from 2015/16 that have not yet been finalised which do indeed have the potential to make a major inroad into the 2017 (or even the 2018) premium income pool. Should that prove to be the case, the minor market upswing in rating levels currently in play may be insufficient to prevent the portfolio from becoming unprofitable again.

“It is understood that there are a number of Upstream losses from 2015/16 that have not yet been finalised which do indeed have the potential to make a major inroad into the 2017 (or even the 2018) premium income pool.”
The outlook for 2018

**Managements’ orders: no reductions!**
So what can buyers expect as we head further into 2018? There can be no doubt that for the moment, the market is in no mood to generally offer improved terms to buyers from those provided in 2017 and virtually every Upstream underwriter is being encouraged to maintain this stance, not least from their own management.

**Hardening momentum to run out of steam?**
However, we think that it is still possible for the softening process to re-assert itself later in the year. A glance at Figure 5 above shows that supply (underwriting capacity) remains at record levels, at a time when the pressures on premium income levels remain as onerous as ever. Meanwhile despite the recent uplift, overall rates remain at historically low levels.

**How to replace lost premium?**
Those insurers that elect to withdraw from programmes that they believe are being renewed on terms contrary to their own philosophies will therefore still need to answer the burning question that will be at the back of their minds: how to make up the lost premium income that will inevitably result if their own underwriting stances are not matched by those of their competitors.

One way or another, no underwriter can stay in business if their premium income stream does not allow them to pay for their operating and reinsurance costs, and once that position is reached, then either the original underwriting stance has to be abandoned or the underwriting operation has to close down. Naturally, history teaches us that it is the underwriting stance that is usually abandoned first.

From our market soundings to date, it seems that there are a variety of different approaches being adopted by the market at the moment. It is clear than some insurers are under more pressure than others to maintain underwriting discipline; it will be up to the brokers, working carefully with their clients, to identify the most competitive section of the market and deliver an optimum result.

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**Figure 5 – Upstream capacity versus rating levels, 1993–2017 (excluding Gulf of Mexico Windstorm)**

Once again Upstream insurers are attempting to defy the laws of supply and demand as the latest upswing in rates coincides with another increase in capacity.

Source: Willis Towers Watson
Conclusion: between a rock and a hard place?
Notwithstanding the positive underwriting results in 2017 we still think that Upstream insurers are caught “between a rock and a hard place” as we move further into 2018. On the one hand they can’t be seen to break ranks and solve their premium income issues by increasing their market share by being more competitive; on the other, if they step back from the most sought after programmes early in the year they will have to find a way to make up for it later.

It will only be later on in the year that we will see whether or not the current leadership panel can hold the line that has been established since the aftermath of the 2017 hurricane season – or whether the line will break, ushering in a fresh round of competitive underwriting.

Paul Braddock is Head of Upstream Energy at Willis Towers Watson.

“IT will only be later on in the year that we will see whether or not the current leadership panel can hold the line that has been established since the aftermath of the 2017 hurricane season.”

Upstream underwriter movements 2017-19

<table>
<thead>
<tr>
<th>Underwriter</th>
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<th>To</th>
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<td>Marsh</td>
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<tr>
<td>Alison Clarke</td>
<td>Zurich</td>
<td>Unknown</td>
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<tr>
<td>Amy Goillau</td>
<td>Arch</td>
<td>Antares</td>
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<tr>
<td>Brian Limage</td>
<td>RKH</td>
<td>Allianz</td>
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<tr>
<td>Elliot Lyes</td>
<td>XL Catlin</td>
<td>Axis</td>
</tr>
<tr>
<td>Marina Moore</td>
<td>Starstone</td>
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<td>Phil Poetter</td>
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<td>Steve Warren</td>
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<tr>
<td>Chris Wildee</td>
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Introduction

2017 – a challenging year for the Downstream market
While the Upstream market had the good fortune to experience a benign loss year, the same cannot be said for the Downstream market. With rating levels consistently at the bottom of the spectrum for several years now, a difficult situation for insurers has been exacerbated by one of the worst loss years in recent times. No wonder the pressure on underwriters to increase rates in this section of the market is even more intense than for their counterparts in the Upstream market.

2018 – a year of transition?
So how will market conditions play out as we move further into 2018? Will this be the year that some insurers decide that enough is enough and withdraw from this market, or will the competitive pressures of over-capitalisation continue to ensure that prices remain at the record low levels enjoyed by buyers for at least the last five years?

Capacity

Although the rate of increase is beginning to tail off, the Downstream portfolio continues to attract new capacity into the market.

Source: Willis Towers Watson
Overall capacity up again once more, apart for North America

Notwithstanding the Gulf of Mexico hurricane season and the rising tide of Downstream energy losses around the world, the macroeconomic forces that have been in play since the onset of the global financial crisis continue to feed capital into the insurance and reinsurance markets. As Figure 1 on the previous page shows, any hopes that insurers in the Downstream sector might have entertained of a change in this dynamic at the start of 2018 have generally been dashed. Our chart shows another rise in overall capacity levels, this time to nearly US$7 billion for International markets and a very slight reduction to US$4.1 billion for North American markets.

Does the theoretical capacity total matter?

These figures should, of course, be treated with some caution. They represent only what the insurers themselves state that they can theoretically offer, not what they will actually deploy in practice. So the figure is only useful in terms of measuring the year-on-year change, rather than as a guide to what might be achievable for any given piece of business. What we can say is that if there is more supply available within the market, underwriters’ ambitions for meaningful rate increase are likely to crash up against the harsh economic laws of supply and demand - no matter what the conditions in the market are and no matter what the prospects are for writing this portfolio on a profitable basis.

“The Downstream market is very regionally diverse and there is no doubt that buyers in some regions are likely to have the advantage of significant local insurance capacity to increase the options available to them.”
Maximum realistic capacity depends on region and risk profile

In Figure 1 we have also provided an estimate of the maximum realistic capacity available, taking into account our own experience of what each individual insurer has actually deployed during the last 12 months. On this basis, we have estimated that our 2017 figures of US$4.5 billion for International markets and US$2.3 billion for North American markets should be maintained this year.

Even these figures, however, should not be viewed by all buyers as necessarily indicative of the programme limit that can be achieved for their own programme. The Downstream market is very regionally diverse and there is no doubt that buyers in some regions are likely to have the advantage of significant local insurance capacity to increase the options available to them. On the other hand, those programmes that have assets featuring a concentration of exposure at a single site, significant natural catastrophe exposures, or a relatively negative risk profile or loss history, will inevitably attract less interest and underwriting capacity than others. In some instances, programme limits of as little as 50% of our stated maximum figure may be a struggle to achieve.

Some buyers who need very high insured limits, and/or need to insure their assets to their full reinstatement value, may purchase additional capacity (at a price) from outside the conventional Downstream insurance market to ensure they have access to sufficient capacity.

Therefore, the amount of capacity actually available to buyers will vary considerably, depending on a variety of factors. However, there is certainly just as much capacity available to buyers as there was last year – something that is likely to frustrate attempts by insurers to raise prices by more than a modest degree during 2018.
### Figure 2 – Downstream losses excess of US$100m, 2015-17

<table>
<thead>
<tr>
<th>Type</th>
<th>Cause</th>
<th>Region</th>
<th>PD US$</th>
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</table>

Apart from the US$1bn + losses from Harvey, Irma and Maria, the Downstream market has been beset by major losses from elsewhere in the world in 2017.

Source: WTW Energy Loss Database as of February 6 2018 (figures include both insured and uninsured losses)
Number of major losses continues to increase

The statistics for Figure 2 on the previous page have been collated from our Energy Loss Database as of February of this year and make depressing reading for Downstream insurers. No fewer than 13 losses in excess of US$100 million were recorded for 2017, more than in 2016 (9) and considerably more than in 2015 (3). It can be seen that four were Gulf of Mexico windstorm losses, although Hurricanes Harvey, Irma and Maria (HIM) caused much less damage to the Downstream portfolio than Hurricane Ike in 2008 or Hurricane Katrina in 2005.

It could get worse...

Of far greater significance to the Downstream market has been the degree of non-natural catastrophe claims made against the market. We understand that some of these losses (including the major ones listed in Figure 2) have the potential to deteriorate significantly so the final statistics for 2017 may eventually be even worse for the Downstream market than they are at the time of writing.

Furthermore, we understand from market feedback that in the case of at least one of these major losses the overall gross loss total was significantly in excess of the insurance limits purchased. This illustrates the importance of ensuring that asset values are regularly reviewed and updated, and the correct values reflected in the Estimated Maximum Loss (EML) calculation on which an insured limit is likely to be based. (Since the risk engineers who calculate the EMLs are not infallible, it will usually be prudent to allow a margin above the EML when deciding on the limit of coverage to buy.)

“Of far greater significance to the Downstream market has been the degree of non-natural catastrophe claims made against the market.”

Figure 3 – WELD Downstream losses 2000 – 2017 (excess of US$1m) versus estimated global Downstream premium income

The 2017 loss record has been truly catastrophic for the Downstream energy market – the worst for nearly 10 years.

Source: Willis Towers Watson/WTW Energy Loss Database as of October 24 2017 (figures include both insured and uninsured losses)
Overall loss total worst for 10 years

If we shift our focus from the major losses to the overall loss picture for the Downstream portfolio (Figure 3 on the previous page), we can see the full impact of the 2017 loss year on this sector of the market. It can be seen that 2017 was the worst overall year for Downstream losses this century, apart from the hurricane-affected years of 2008 (the year of Hurricane Ike) and 2005 (Katrina, Rita, Wilma).

Meanwhile the estimated global premium income for the Downstream sector is still at approximately US$2.1 billion; although not all of the 2017 losses will result in claims to the insurance market, this premium income stream still represents less than 50% of the overall current 2017 loss total.

The situation at January 1, 2018

Market holding firm for increases, but some insurers disappointed

Given the recent loss record, it is little wonder that the market softening of the last four years or so appears now to have finally bottomed out. Almost without exception, during the January 1 renewal season underwriters were under instruction from senior management not to provide any reductions in rating levels. As a result, notwithstanding any increases in underwriting capacity, modest rate increases were the norm, as well as some limitations on the amount of sub-limited cover available for coverages such as Contingent Business Interruption.

This has generally been a disappointment to most Downstream insurers, as during the last quarter of 2017 several were suggesting that the market turn in 2018 would be more pronounced. However, as reported elsewhere in this Review, the abundance of capacity in the reinsurance market has kept underwriters’ rating ambitions in check and ensured that the upturn in the Downstream market has been modest.

“The abundance of capacity in the reinsurance market has kept underwriters’ rating ambitions in check and ensured that the upturn in the Downstream market has been modest.”
How long will it hold?
It is difficult to forecast how long underwriters’ rating discipline will last. Experienced market observers can point to similar circumstances in the past where initial underwriting discipline has faltered in the face of competitive pressures brought about by the continued existence of excess underwriting capacity; it remains to be seen whether the pain of recent underwriting losses can strengthen insurers’ determination to hold the line.

No withdrawals limits any rating upswing
At the moment, there is no sign of any other insurer following the lead of Axis some 12 months ago and announcing a withdrawal from the market. Instead, we can report a relatively stable underwriting dynamic in the market, with leadership positions still taken by virtually same insurers as last year and with their capacity augmented by new underwriting teams at Axa and Zurich. These insurers are likely to prefer to build up their portfolio gradually over the next 12 months or so rather than to challenge existing leadership positions during 2018.

A cautious start to 2018
During the first quarter of this year we have seen most of the smaller Downstream insurers taking a distinctly cautious approach; most are waiting for the larger more established leaders to show their own underwriting stances. It is likely that following the April 1 renewal season we will be able to determine how the overall market position has changed (if at all) from January.

Increased use of “vertical marketing”
In the meantime, it has become clear that optimum terms and conditions can only be delivered to buyers in most instances if “vertical marketing” strategies are deployed. Given the choices on offer to most buyers, as well as the variety of underwriting philosophies currently being deployed in the market, the best way for clients to benefit is to distil an optimal blended price from a variety of different markets rather than for brokers to simply obtain ground-up Quota share terms from a recognised leader and persuade other insurers to follow the lead (as would be more common in a classic subscription market such as Upstream). While these separate blocks of cover from insurers tend to have their own set of terms and conditions, there is generally little difference in the actual coverage provided, thereby avoiding the potential headache of a claim that is covered by one part of the programme and not by another.

Will long term relationships be tested?
2018 is also likely to be a year where long term relationships between buyers and insurers will be tested. With most major insurers currently committed to securing improved terms (from their perspective), some buyers are likely to put pressure on brokers to look for alternatives, the objective of course being improved terms from the buyer’s perspective, compared to those on offer from the incumbent leader. At the same time, some insurers are now offering to renew existing Long Term Agreements (LTAs) with a built-in price increase in the second policy year, regardless of risk profile changes or a clean loss record. Perhaps it’s not surprising that to date we are not aware of any buyer who has actually entered into such an arrangement.

Wide disparity in regional rating levels
We have reported for several years now on the variety of underwriting philosophies adopted by the largest global carriers with regard to underwriting this portfolio from various regional hubs. Now we are finding that, with very few exceptions, any attempt by these major global carriers to maintain consistent underwriting stances across these various regional hubs has to all intents and purposes been abandoned.

“Experienced market observers can point to similar circumstances in the past where initial underwriting discipline has faltered in the face of competitive pressures brought about by the continued existence of excess underwriting capacity; it remains to be seen whether the pain of recent underwriting losses can strengthen insurers’ determination to hold the line.”
Instead, we are finding wide varieties in underwriting approaches from the major hubs, which include Miami, Houston, London, Dubai and Singapore. Indeed, we have seen several renewals recently where terms have been offered by a global carrier from their regional hub office that would have been anathema to their London market counterpart. There can be little doubt that most regional markets tend to offer more competitive terms than the international market, although most major Downstream programmes will almost certainly need the participation of the London market if they are to be completed successfully at optimal terms and conditions.

"We are finding wide varieties in underwriting approaches from the major hubs."

**Expansion into London continues**

Furthermore, several significant Downstream insurers that might previously have been labelled “local capacity” have now set up a base in London and/or expanded their remit to write a truly global portfolio. The existing London market will therefore continue to come under pressure, not only from their own regional hub offices but also from regional insurers investing in the London market.

**The outlook for 2018**

**Figure 4 – global Downstream capacity versus estimated average rating levels, 1993–2018 (excluding Gulf of Mexico Windstorm)**

Is this the turn of the tide for the Downstream market – or will increased capacity continue to limit the recent upturn in overall rating levels?

*Source: Willis Towers Watson*
The Downstream market has experienced many twists and turns of the underwriting cycle during the 25 years that we have recorded the data for the chart in Figure 5 above. It can be seen that year-on-year capacity increases have been the norm ever since the tragic 9/11 events of 2001, apart from one year (2012) following the Japanese earthquake and tsunami and Thai floods. This momentarily brought a pause in the injection of fresh capital into the market, but since then the tale has been a simple one – a remorseless increase in capacity that has stifled attempts by Downstream insurers to move rating levels into more profitable territory.

**Still between a rock and a hard place!**

So will it be any different this time? It’s true that the pressure to underwrite to meet increased premium income targets, so typical of a softening market, has eased, at least in the short term. But as underwriters and brokers look around the market, things are still very much the same – no-one has withdrawn, every carrier has mouths to feed.

**What would it take to persuade insurers to withdraw?**

Nevertheless, some leaders are saying that conditions are now unsustainable, given the rapid deterioration of the loss record in 2017. That may well be the case; however, until more insurers decide, as Axis before them has done, that it is time to withdraw, then it seems that little can be done to stop rating levels continuing to be suppressed – regardless of whether 2018 continues in the same vein as 2017 and produces a similar level of losses.

What will it take to prompt a more widespread market withdrawal? We have asked this question several times in this Review over the last few years, and to date the only answer has been that it will not be underwriting results alone. It is of course possible that another loss year on the scale of 2017 may be enough to convince some insurers that enough is enough, but only time will tell.

**The buyer’s opportunity**

In the meantime, we have alluded to how brokers’ expertise in vertical marketing will help buyers find their way to optimum terms in a market where prices are inching upwards, but still depressed by historical standards, and where over-capitalisation is almost bound to keep a lid on significant rating increases and minimise the impact of any individual market withdrawals.

“As underwriters and brokers look around the market, things are still very much the same – no-one has withdrawn, every carrier has mouths to feed.”

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**Graham Knight is Head of Downstream Natural Resources and Head of Risk Management & Engineering, P&C, Willis Towers Watson.**

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### Underwriter movements, 2017-18 (London except where stated)

<table>
<thead>
<tr>
<th>Underwriter</th>
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<th>To</th>
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</thead>
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<tr>
<td>Harry Booth</td>
<td>Axis</td>
<td>Markel</td>
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<tr>
<td>Danny Dallago</td>
<td>Zurich</td>
<td>Helvetia</td>
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<td>CV Starr</td>
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<tr>
<td>Adam Williams</td>
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<td>Lancashire</td>
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International Liabilities

The theme of our Energy Market Review is “between a rock and a hard place”. This theme and many of the analogies are equally applicable to the Liability market: it is a fact that in-between a rock and a hard place one usually finds a number of strong and often conflicting currents. This has been very much the case in the Energy Liability sector over the past 6 months.

Influencing factors
There have been a number of currents shaping Liability market conditions, namely:

- Supply of direct capacity
- Treaty market conditions and the impact (or lack of) on the direct market from the 2017 Gulf of Mexico Windstorm season
- The variety of alternative leaders
- Loss ratios
- Regional variations and anomalies
- The increasing demands of compliance, sanctions and industry regulation
- Buyers appetites
- Changes in legislation impacting liability exposures.
- Market sentiment and attitude of Insurers management to their Liability book

Global International Liability capacity
In terms of capacity, global Liability capacity continues to be abundant. The total theoretical capacity remains constant at approximately US$3.3 bn.

Figure 1 – International Non-Marine Liability capacity, 1995-2018

Source: Willis Towers Watson
As we have seen in previous years, realistic capacity is approximately 50% of this figure as:

- Many insurers write less than their published maximum capacity
- Some insurers cannot write Energy business
- Some only write Onshore Liability exclusively or Offshore exclusively
- Some are unable to cover US domiciled exposures
- Some only write on specific forms (e.g. Occurrences Reported rather than follow form Losses Occurring)

This still puts the approximate maximum realistic capacity (without accessing the ILS or non-traditional capacity providers) at approximately US$1.65bn.

**Pipeline losses prompt major carriers to reduce Primary lines**

A notable feature of the current market is that some of the major global carriers have significantly reduced the amount of capacity they are prepared to deploy on a Primary basis.

In the past certain carriers were prepared to offer up to US$100m for a Primary limit. Typically, the maximum primary commitment offered by the larger insurers is now US$50m, with many carriers offering significantly less. This is driven by a desire to spread their risk throughout a liability programme and to avoid being the only carrier to be hit by one major primary loss. In the Energy Liability market we have seen in particular a series of pipeline pollution losses over the past few years, notably in Latin America, North America and Europe. This has been the catalyst for some insurers to review their Primary commitment generally and in some cases, to withdraw from the sector.

Balancing this has been the willingness of many of the smaller companies and Lloyd’s syndicates to drop down to primary level or increase their own primary participations. The net effect is a reduction in the average primary size but also a healthy choice of primary market lead options.

**Flat rating environment – but insurers have doubts about the long term**

This “damp squib” (from a carrier perspective) has translated through to the direct market, where the default renewal pricing is basically flat - but with upward pressure on pricing for those programmes with exposure increases or deteriorating loss records.

However, direct Liability insurers remain concerned about the viability of their portfolios over the long term. The steady increase in the size of average awards, a spate of losses in certain sectors (for example pipelines, tailings dams and bushfire losses, as well as some significant losses in the Auto Liability sector) have put pressure on the profitability of many individual carrier portfolios.

That being said, the prevalence of capacity and the better than expected treaty renewal season have countered the attempts of many insurers to move the market upwards.

**The flight to quality – insurer focus on risk differentiation and risk adequacy**

In order to improve their profitability many insurers are therefore overhauling their books, deliberately shedding unprofitable or poorly rated business and focussing on risk quality.

We are therefore seeing an increasing trend towards risk differentiation and risk adequacy, although the approach taken by insurers can differ; some carriers look at existing rate adequacy when considering renewal (how a given risk benchmarks against its peers) while others focus more on rate movement (historic rate changes on the account). This can lead to some inconsistencies on renewal approach across the market. However, all place increasing emphasis on information, risk prevention and exposure base change; those buyers that can articulate their risk mitigation measures, track record and demonstrate a positive risk profile will always be favoured.

**Geographic disconnects still a feature of this market**

Insurers are increasingly looking to apply consistency in their offering across their regional offices worldwide. However, differing local treaty markets, treaty renewal dates and market drivers still conspire to result in geographical variations in market conditions. For example, Australia remains competitive, but some recent losses in the Natural Resources sector (particularly bushfires) have moderated the still competitive conditions. Latin America also remains competitive locally, both in terms of pricing and also in terms of less exacting information, which can cause a challenge when international capacity is required.

“We have not seen the wholesale market hardening in treaty rates (including casualty treaty rates) that was predicted by some pundits after the 2017 windstorm season.”
Larger programmes still require international capacity
A strong driver for price remains the size of the insured company and the limit required. Smaller energy operations that purchase modest limits often have a wide range of local market options available, whereas the larger, more complex insureds (particularly those multi-territory risks purchasing significant limits) will typically have to access International Liability capacity, where pricing and information requirements are more exacting. Again, this is where a planned considered and strategic approach to the markets plays dividends.

Limit considerations
Energy insurance buyers continue to face an increase in the quantum of their liability exposures through:

- Increasing average awards
- Higher contractual indemnity demands
- Increasing economic activity in the Natural Resources arena
- Broadening of their geographic footprint (particularly when involving North America)
- Increased regulations: e.g. European Environmental Directives, increased statutory liability limits for Offshore E&P activities in certain regions (e.g. Mexico), increases in statutory Nuclear Liability Limit requirements in certain countries (e.g. UK) etc.

As a result, after working with their broker to benchmark their limit and analyse their exposure, we have seen a number of insureds review and increase their limits.

The outlook for 2018
We have seen how conflicting currents have dampened insurers drive and ability to push rate upwards, but declining loss ratio and tighter margins have equally forced insurers to become more selective.

While we do not foresee any dramatic hardening in the market in 2018, neither do we see a return to the widespread soft conditions of previous years. In short, there may well be strong currents in between “a rock and a hard place” but when the sand finally settles there is often a flat bottom. That is where the Liability market appears to be now.

This is at least allowing buyers to focus on ensuring they have the broadest coverage the best pricing result and most appropriate conditions in a market that is relatively stable. Not such a bad place to be, perhaps.

“There may well be strong currents in between “a rock and a hard place” but when the sand finally settles there is often a flat bottom. That is where the liability market appears to be now.”
North American Liabilities

The North American Energy Liability outlook for 2018 is tempered by the buffeting of the effect of natural catastrophe losses on the reinsurance markets, coupled with the projected loss amounts that will come from the large California wildfires and various losses (not necessarily energy related) taken by the retail insurance market. As underwriting results were felt and then published at the end of 2017, insurers opined that the soft market that had lasted for more than half a decade was over and that renewals and other transactions had to correlate more directly with those results. In short, the market would push for an end to reductions, hold the line on renewals, and find increases in rates and premiums.

Stable rating environment

This is what we expected in 2018; however, without a “market event” that would keep the results “front and center”, there will be a strong push by buyers to return to the way they have been treated in the past. Then again, we believe that the North American Energy Liability market currently has the strength to hold the line and maintaining flat renewals; only the most compelling exposure reduction will allow for any recognition for a decrease in rates.

In 2017, there were notifications of pollution events and circumstances after the hurricanes, but whereas similar events after other dominant hurricanes became “market events”, we believe that this does not apply to any of the 2017 events. The market still is wary of Western Canada midstream operations, and buyers involved are being asked to consider retentions for pollution to create meaningful premium differential.

Wildfire and environmental risk highlighted

Buyers with risks in California will be questioned about wildfire exposure; while in recent years they have had to detail exposures with pipelines, gas storage, rail transportation, trucking, autonomous driving vehicles and even drones, in 2018 they will be asked about more expansive matters. These will include global warming and climate change, and exposure to the growing movement against the use of plastics easily moved on to waste. Energy companies now are facing suits by municipal, state and federal governments (and aligned citizens) for the companies’ role and part in bringing about climate change. Insurers are also assessing their exposure to their client’s involvement with thermal coal.

“Without a “market event” that would keep the results “front and center”, there will be a strong push by buyers to return to the way they have been treated in the past.”
Capacity stable – but opportunities for new carriers to step up to the plate?
As far as Excess Liability capacity is concerned, in the US it remains stable compared to 2017. Insurers such as CV Starr, Westchester and others are taking lead opportunities formerly tightly held by AIG and Zurich. If the buyer is able to access Lloyd's capacity cover-holders, pricing and conditions for local efforts can be beneficial.

Meanwhile AIG has advised its underwriting staff that the maximum liability capacity it wishes to deploy on any one Insured is US$100m. For their US/Canada, Bermuda and London/Europe operations, aggregate limits will be subject to review; this will cause enough buyers a problem to the extent that we expect an opportunistic entrant to step up. It seems that Liberty Mutual and Ironshore have merged smoothly in the US, with senior underwriters determined to maintain market share while minding overall exposed limits. In Canada, they have committed to maintain capacity offerings to current insureds.

In Canada, capacity remains static, with Chubb, XL Catlin and Liberty (and at times Zurich) being played as leads, often competing with Lloyd’s offerings. When higher Excess Liability limits are desired, capacity available in Lloyd’s, London, Europe, and Bermuda can be accessed. In both Canada and the US, the matter of Auto Liability excess attachments continues to impact lead excess renewal discussions. Capacity for Midstream Energy risks has diminished in part or moved from insurers General Liability desks to Energy specialists.

Marine Liabilities
With the prospect of reinsurance driving retail behaviour, the pundits looked to the results of the February 20 International Group placement renewal as a prognosticator for any impact. This immense program was placed in a timely fashion, notwithstanding some claims development over 2017 and the uncertainty of the natural catastrophe impact and wildfires in general. Rates showed a very small reduction, in comparison to a retail market push to hold renewal rates and premium flat at a minimum.

Push for rating increases – but flat conditions result
As in the other Liability market segments we detail herein, leaders in the Marine market pushed for increases in early 2018. This was short-lived, but the market has been able to keep renewals flat, and at this time they have been mostly successful. There continues to be an over-abundance of capacity in this segment, although “capacity risks” will be treated differently from smaller placements.

Increased demand from LNG exporters
We have seen increased Liability demand for operations associated with the export of LNG, especially in the United States and Australia. The recovery in oil and gas prices has opened a seemingly pent up desire for offshore construction; from a Liability standpoint, the Marine (and Energy) market is competing vigorously for this class, yet programs requiring broad loss of use cover capacity are still encountering marketing difficulties.

Environmental International Liabilities (EIL)
The global EIL market in 2018 remains a niche sector across the world. The USA continues to lead the EIL premium volumes on a global scale, owing to the longer period of pacing this class of business. Outside the USA, other regions are closing the gap to the established market in the USA and Canada.

Capacity
Capacity continues to be readily available within the EIL sector, with 15 insurers now offering EIL products alongside conventional lines (Casualty/Property/Marine/Financial Lines).

Company markets are able to put individual lines down to £50m on both a primary and excess basis. Other insurers are routinely putting down £20m any one line in the London and EU markets. Capacity is often available across markets (geographically speaking) meaning that New York can participate on an Excess layer where the Primary is in London as long as there is sufficient ‘ventilation’ between layers.

“We have seen increased liability demand for operations associated with the export of LNG, especially in the United States and Australia.”
The start of 2018 has seen facultative insurance placed in London by the Willis Towers Watson EIL team for Primary risks in Brazil. This application of alternative capacity for sensitive risks is a trend we expect to see more of for larger, “heavy end” exposures in developing nations; this is common in Latin American countries that are enjoying a rapidly evolving regulatory regime. Primary insurers are using London capacity to reinsure these overseas exposures.

Losses
Environmental incidents are continuing to happen around the world; many remain uninsured if they are caused by gradual pollution or are as a result of legacy issues.

The condensate oil tanker *Sancti* that collided and sank early in 2018 is a recent marine loss that has had an impact on the marine environment. Human error is likely to blame and full extent of biodiversity damage is yet to be assessed. Other claims include two incidences of illegal pipeline tapping causing loss of containment in the UK; one loss was diesel and the other petroleum spirit. While the clean-up was routine the potential losses could reach significant levels when Business Interruption is factored into the calculations. It must also be remembered that many pollution issues remain confidential to the buyers and many losses go unreported.

Market news
Recent developments in the EIL market in London can be summarised as follows:

- There are currently 12 environmental insurers in the London market, namely AIG Europe, Aspen, Argo, Beazley, Chubb, Liberty, QBE, Zurich, XL Catlin, Navigators, Channel Syndicate and Liberty, to which can be added AXA Corporate Solutions based in Paris.
- Ironshore have closed the UK book and the underwriter, Alan Shaw, has joined RSA to lead the underwriting of EIL risk in the UK and EU. With Wayne Harrington leaving Navigators to join CFC MGA, there is a bit of a void within the London offering this year.
- Allianz have added to the team in London, with Kate Carret joining from QBE.
- Channel Syndicate have boosted their team, with the flagship hire of Nick Bennison from Marsh. Nick brings a massive amount of experience to an already very competent, market-leading Lloyd's Syndicate.
- Some additional insurers have recently demonstrated interest in providing additional capacity within Lloyd's (Brit, CV Starr) or on Company paper (Aspen Insurance). Aspen also have Lloyd's market availability.
- The Australian domestic market continues to be dominated markets such as XL Catlin, Chubb, AWAC, AIG, Liberty and the Channel Syndicate. Indeed, the Lloyd's insurer, led by Jim Finnemore, continues to be a constant presence in the geography. With a natural resources and energy focus, the Channel offering is consistently leading innovation in offshore insurance and complex business activity coverages.

Evolving legislation around the world
EIL is still the niche sector it has been for the past 30 years but we are seeing legislation evolve at an increasing rate in recent years:

- **Biodiversity and Natural Resource Damage** (NRD) is one element of coverage that is now commonly being included in legislation outside of the USA and EU. It is a common principle in Australia and New Zealand and has been for nearly a decade. The development has been the assumption of NRD into law into the Asia Pacific region and parts of Africa.
- **Mexico** is now including EIL insurance in many permits and this is driving demand into Miami and London. In these placements the local Environmental Protection Agency and regulator is an additional Named Insured, which in itself is creating demand for EIL. No insurance equals no permit; this is a ground breaking development for the market and one that all insurers are keen to capitalise upon.
- **Ireland** has seen recent development around post closure obligations and IPPC permitting rules. Insurance products are going to continue to of relevance, especially for onshore energy installations and permitted decommissioning.
- **M&A activity** in the energy sector is buoyant, with many large transactions being placed in London and further afield. Africa has seen one of the largest EIL placements in recent years complete in 2018. Including production and distribution assets, this deal provided lender sufficient coverage to assume the assets of a global principal.

“Environmental incidents are continuing to happen around the world; many remain uninsured if they are caused by gradual pollution or are as a result of legacy issues.”
What is covered by EIL?
EIL can be tailored to meet the specific needs of each client and can address a range of costs resulting from a pollution event or environmental damage, including:

- Emergency response costs
- Investigation costs
- Clean-up costs
- Primary, complementary or compensatory remediation costs (NRD)
- Indemnifications to victims of injuries or distress
- Indemnifications to victims of property damage
- Indemnification for disruption caused to neighbouring activities
- Own-business interruption costs
- Legal fees
- Public relations costs
- Civil sanctions

Benefits of EIL
Why are more energy companies buying EIL?

- Environmental insurance can help to facilitate a smooth transaction by removing a potentially large liability from a company’s balance sheet, either from a seller or a buyer side. It can also be designed to cover all pollution conditions, as no distinction is made between sudden & accidental and gradual pollution.
- Environmental insurance can provide cover for pollution conditions occurring within site boundaries (on-site) or beyond site boundaries (off-site, including impacts on environmental receptors) with no third party claimant required.
- Environmental insurance can provide coverage for inherited liabilities coming from all historical pollution conditions.
- Environmental damage can be the result of occurrences other than pollution conditions: physical damage from over-abstraction of groundwater, the use of heavy machinery or fire can all trigger statutory environmental obligations. Environmental insurance is designed to cover the resulting costs of such events, including Biodiversity damage.
A good year in 2017

During 2017, Oil Insurance Limited (OIL) performed well across several fronts. Its top line written and earned premium was US$396 million for the year – the lowest level of premium it has charged since 2002. Unlike commercial insurers, who attempt to maximize premiums written, OIL’s premium levels ebb and peak with the level of losses in the mutual – when losses are low, so are its premiums and vice versa.

From an underwriting perspective, the company incurred US$384 million in case reserves & loss expenses and a further US$83 million in IBNR, producing an underwriting loss of US$71 million for the year. Based upon these numbers and how OIL’s Rating & Premium Plan works, the company expects its written and earned premium for 2018 to decline by about 12%.

Modest HIM losses following 2010 changes

It is important to note that despite the severe windstorm season in the Gulf of Mexico, Florida and the Caribbean produced by hurricanes Harvey, Irma and Maria (HIM), OIL’s losses from those same storms were modest in comparison to its windstorm losses in 2005 of US$2 billion and 2008 of US$750 million. While final adjuster reports are not in, OIL is expecting its total exposure across all three storms to be less than US$150 million. The significant difference is a direct result of changes the company made in 2010 to its windstorm product when limits were reduced and mutualization amongst windstorm members was increased. These changes inspired the members to self-insure and/or purchase coverage elsewhere and in the process deleverage OIL’s windstorm exposure. This will be further improved in 2018 when OIL’s elimination of Offshore Gulf of Mexico windstorm coverage kicks in.
Robust net investment earnings

Perhaps the most important point to make about OIL’s performance is its robust net investment earnings of US$679 million, which roughly equates to a 10% annual return across its portfolio. These returns were made possible by the company’s strategy to invest approximately 50% of its portfolio in equities and fund of funds in the hedge fund space. Since 2013, OIL has distributed US$1.45 billion in dividends and premium credits to its members because of this strategy. Overall, OIL made US$588 million of Net Income during 2017, which in comparison to traditional insurers in the Energy sector was quite good.

Initiatives for 2018

Looking forward into 2018, OIL has several initiatives on the go. Commencing in 2018, the company hired Alan Brooks (a recently retired Marsh energy broker) as a consultant. Mr. Brooks will help OIL position itself with medium to large energy companies who use the London market as a core component of their property insurance programs. The company has also kicked off a targeted marketing approach to power companies in North America and UK/Europe as part of their effort to re-attract large institutionally owned power and utility companies to become members of OIL. In addition, OIL is focused on the significant level of decommissioning that is planned in the North Sea given that its coverage is seamless relative to the stages of an asset’s life. Literally, OIL can insure every single stage from exploration, development & construction, production/operation, decommissioning and beyond for Property, Control of Well and Third Party Pollution.

OIL is a Bermuda based energy mutual that offers its members up to US$400 million in net Property, Control of Well and Sudden & Accidental Third Party Pollution coverage. Should your company have an interest in learning more about OIL, please contact your local WTW representative or Joe Seeger, EVP & MD on Joe.Seeger@WillisTowersWatson.com.

George Hutchings is Senior Vice President & Chief Operating Officer of Oil Insurance Limited.
Onshore Construction

Introduction: “Same, same” - but different!
“Same, same, but different” - a common phrase used in certain cultures with alarming accuracy despite its contradictions. If one has spent any time in South East Asia, this phrase will resonate for it is used both on the street and in the boardroom. Its meaning can be hard to grasp for the uninitiated but it could be argued that insurance buyers and brokers in the current market would inherently understand it.

The market held its breath in December...for what?
A great deal has happened in the past 12 months. While the rest of the world may have felt that the events in the Gulf of Mexico and US were a world away, the ever globally connected market place simultaneously held its breath during December 2017, and come January 2018 the global Construction market was still “same, same”.

Capacity stable – so business as usual
There was no change to the unprecedented market capacity. The now well established hubs of Singapore, Miami and Dubai had not diminished one bit and London remained as the global connection point and thought leader and main capacity provider. Price did not change overnight and nor has it shown any sign of hardening since. Exposure to Natural Catastrophe risks remain an underwriting concern, but so have general risk dynamics as you would expect. Relationships remain, as do low commodity prices and investor reticence. Credit is still hard to secure. Same, same.

So on the face of it its business as usual, and on the most part it still is. However, the devil is in the detail and in this, the softest Construction market cycle to be seen for many years, the difference is very much in the cumulative detail of the transaction.

The broker as the differentiator
A soft market is an interesting time for any intermediary. As is often the case, a wealth of choice is sometimes detrimental to the transaction. If we factor in unprecedented capacity levels across accessible global trading hubs it is often confusing for the buyer as to who to choose to partner with. Early engagement with your broker is a key differentiator. Effective buyers have always valued the input their specialist brokers can bring in all facets of contract negotiations. As the contracts relevant to the construction project are in essence its foundations it’s an essential but sometimes overlooked part of a successful project delivery.

Developing the coverage baseline – towards sub-limit removal?
In partnering with clients to build these foundations we collectively develop the required baseline for policy coverage. This is a critical moment. An introspective review of what the parties view as the norm is required, as whilst market dynamics may indicate premiums may fall no further, experienced intermediaries are pushing for even wider coverage and the removal of sub-limits where possible. Insurers are responding to these requests for clients where they believe there is the opportunity for an equitable relationship managed by a knowledgeable broker.

Going to market – timing is crucial!
An increasingly common mistake is to go to market early and across multiple brokers. It’s a logical step for any purchaser in a theoretical market place. However, reality is more Keynesian, and such an approach, being unappreciative of market dynamics, can often be detrimental to the desired outcome.

The go to market strategy is therefore another key area that we encourage clients to focus on in a collaborative way with their intermediary. Whilst specific risk dynamics will allow a specialist broker to identify suitable markets across the globe, one must also be particularly conscious of the existing relationships and experience of the parties involved. As a continued soft market can often hide potential issues it’s also useful to take a moment to review these client/market relationships at this stage with your experienced intermediary.

“In this, the softest Construction market cycle to be seen for many years, the difference is very much in the cumulative detail of the transaction.”
Specialist hubs provide the best marketing options

As regards the marketing strategy; for the most part it’s easy to assume that the best solution lies within the local hub. Globalisation of available capacity is now well established and given where we are in the pricing curve, this has for the most part been an effective solution over the past few years.

However, capacity is increasingly agnostic to geography. The market’s reach is truly global and rates potentially at their uniform lowest. As such, major brokers should now access all applicable hubs in a considered way. Save for naïve market access before strategies are set, experienced specialist intermediaries are well experienced at matching risk and appetite across all applicable hubs, often in ways that surprise our clients.

Moving away from “bind and forget”

Post placement, an increasingly worrying trait of the current market cycle is the propensity for a “bind and forget” view that may be attributed to all parties to the policy; post-placement activities are as important as pre-placement. Invitations for site visits, timely and detailed project information updates, regular two-way communication between parties, though leadership and updates from intermediaries. These are all “value addeds” to the relationship post placement and help bind relationships between clients and markets that will only ever benefit all parties in the event of a claim. These relationships will also transcend policies, building effective influence in the market place benefiting any future placements.

Conclusion – “Same, same” means the broker is the differentiator

So to finish – it’s “Same, same” when it comes to Onshore Construction market conditions - but to get the best for your risk it’s the differentiators, the details, that an experienced intermediary can bring to your business that will truly get the best results alongside the most competitive price.

Philip Callow is an Executive Director at Willis Towers Watson’s Construction division in London.
Terrorism and Political Violence

Market update – slowdown in softening process

During the first half of 2017 the Terrorism and Political Violence market followed a similar trend of recent years - the over-capitalisation of the global insurance market and low market loss ratios continued to cause a softening of the market and decreasing rates. However, due to the majority of the Terrorism and Political Violence market having strong ties into their “All Risk” Property counterparts, often with either linked or shared treaty reinsurances and with the 2017 Atlantic hurricane season being the worst seen since 2005, the second half of 2017 and the start of 2018 has seen a slowdown in rate reductions, with much of the market holding rates flat for now and some rate increases in “higher risk” territories.

However, with the treaty reinsurance season generally not seeing as severe widespread increases as initially expected (see Willis Re 1st View January 2018) and with a number of initial loss estimates recently being lowered (albeit with many insurers still reporting combined loss ratios in excess of 100%) the likelihood of the market generally holding rates flat on loss free accounts or in “lower risk” territories for the remainder of the year is ever decreasing.

Is your current purchase still appropriate?

Whilst the Terrorism and Political Violence market and the risk landscape continue to change, insurance buyers in the energy industry should continue to consider whether their current purchase is appropriate. This could include, for example, whether buying through government pools provides sufficient coverage, or if either a full stand alone Terrorism and Political Violence policy or Difference In Conditions/Difference In Limits/Excess policy would provide more appropriate coverage for their needs. This can also include altering limits and deductibles compared with “All Risk” coverages where, for example, recent losses and different risk factors may force higher retentions or lower limits in order to balance premium spend but this may not be as prevalent within or impactful upon rating and pricing within the Terrorism and Political Violence market.

Terrorism and Political Violence activity

Whilst the last three years have recorded steady increments in the number of Terrorism and Political Violence events globally, the majority of actual attacks against the energy industry have been mostly seen in the Middle East, Latin America (notably Colombia), Africa and Central Asia, where the legacies of ongoing conflict perpetuate themselves. Whilst the last three years have seen increased attacks in Europe and North America, these have mostly been in city centres and have targeted mass casualties rather than infrastructure.

Is your cover appropriate for your operations arena?

Insurance buyers should also continue to consider whether the perils they currently buy are appropriate for the changing risk environments they may operate in. For example, in recent years events in Egypt and Turkey have highlighted how quickly insurance needs and buying habits can change rapidly. Many buyers in Turkey, both in and out of the energy industry, tried to renew their insurance policies, increasing their coverage from Terrorism only to include full Political Violence towards the end of 2016 and the start of 2017. At that time, the market faced a very challenging period of managing demand (for both current demand and to hold reserves for expected demand in the year ahead) against available capacity and basic economics states that this also therefore affects pricing.

Strikes & riots a real threat to the energy industry

Along with terrorist attacks and both global and localised conflicts, the threat of strikes, riots, civil commotions and protests remain as an ever-present risk to the energy industry. For example, US President Donald Trump has pledged to remove “roadblocks” to oil, gas, and coal developments and threatened to end climate and clean energy spending. In particular, he has pledged to revitalise the coal industry and this is likely to face opposition from environmental activist groups. Furthermore, many new construction projects globally will continue to face environmental activism and local opposition, including those where land disputes and population displacement may arise.

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Bearing this in mind, insurance buyers should, as much as is reasonably possible, given what are sometimes such unforeseeable events, continue to use everything available to them to try and foresee their potential exposures and ensure that their insurance programme is sufficiently designed around this, and not just waiting until their traditional renewal period.

**Cyber terrorism**

In numerous previous issues of the Energy Market Review, we have discussed the market beginning to respond to physical damage following “cyber terrorism”. Whilst available capacity for Physical Damage following a cyber-attack has grown over the years to around US$400 million (with some insurers now having reinsurance protection on what was previously a “net line” offering) it is maybe still not as readily available or as broad in coverage as insurance buyers would be hoping.

Insurers will usually only cover a cyber-attack that fits the market standard definition of Terrorism (being politically, religiously or ideologically motivated) rather than extending to any malicious cyber–attack. They note specifically that many “All Risk” Property insurance policies will likely have similar coverage that would only exclude politically, religiously or ideologically motivated cyber-attacks as a part of their more general Terrorism exclusions.

Some very limited capacity may also be available from the cyber insurance market for resultant Physical Damage, but insurance buyers may still generally struggle to find one clear policy with meaningful capacity for Physical Damage following cyber-attacks.

However, one consortium of Lloyd’s Syndicates has been running for a number of years now, providing US$200 million of affirmative primary capacity for Physical Damage and Business Interruption following malicious cyber-attacks (whether or not politically, religiously or ideologically motivated), with a specific focus on the energy, power and heavy industry sectors.

This consortium can also extend its coverage to include similar extensions as may be found in the more traditional cyber insurance market, including Business Interruption in the absence of Physical Damage along with Mitigation Expenses and Guidance, Incident Response and Extortion coverage, and Legal Liability coverages. Whilst insurance buyers may already have some coverage for cyber-attacks under their “All Risk” Property insurance policies and can also obtain coverage under a “traditional” Terrorism insurance policy they may therefore want to consider exploring such an alternative for extra certainty and breadth of coverage.

“Whilst the Terrorism and Political Violence market and the risk landscape continue to change, insurance buyers in the energy industry should continue to consider whether their current purchase is appropriate.”
Impairment of Access

Finally, with the threat of strikes, riots, civil commotion and protests remain being an ever-present risk, it is important that insurance buyers review what coverage they may or may not have. Whilst many may have some form of coverage in their “All Risk” Property policy or a stand alone Terrorism and Political Violence policy, this will most likely not include any coverage for Business Interruption due to site access being prevented or hindered by strikers or protestors in the absence of Physical Damage.

In response to this, Willis Towers Watson and a leading Lloyd's Syndicate have recently collaborated to offer a new and exclusive policy wording covering Impairment of Access. This Impairment of Access coverage uniquely responds whether or not Physical Damage has occurred from an act of protestors, riot, strike, civil commotion, malicious damage, sabotage and/or terrorism and whether or not the Impairment Of Access was due to an act at the insured's site or within a pre-agreed radius or access route (whether or not the insured was the intended target of such act).

“Impairment of Access coverage uniquely responds whether or not Physical Damage has occurred from an act of protestors, riot, strike, civil commotion, malicious damage, sabotage and/or terrorism and whether or not the Impairment Of Access was due to an act at the insured’s site or within a pre-agreed radius or access route.”
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