News Release

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THE WILLIS COMMENTARY ON…

Energy Sector Insurance: Change, Challenge And The Future

New York, NY, October x, 2004 – Although there are many niche insurance markets for energy risks, the lion's share of underwriting capacity resides in the commercial insurance marketplace – a marketplace that comprises two distinct types of risk: single-site and aggregation. 'Single-site risk' virtually defines itself: value-at-risk at one location for a given insured. 'Aggregation risk' includes:

- Concentrations of exposures (people and/or physical assets), within a defined geographical area, that may be subject to such 'nat cat' perils as flood, wind or earthquake, or to an act of terrorism.
- Accumulation over time of liability arising from specific perils, products or operations.

Cost, availability and terms of risk transfer for energy risks, as well as the long-term future of the marketplace, depend upon the behavior of these types of risk. To better understand the forces at work, we need to take a brief historical perspective.

Perspective

For over a generation, cyclical forces, natural catastrophes and shock losses have shaped, battered and transformed the commercial insurance marketplace. We weathered the capacity crunch and extreme premium inflation of the late 1970s for primary and excess casualty lines. Particularly hard hit were buyers of products liability, medical malpractice and other long-tail liability risk. We recall the lack of capacity for North Sea platforms in the early 1980s, the widespread hard market of the mid-1980s, and the nat cat losses of the late 1980s and early 1990s, as Hurricanes Hugo and Andrew and the Northridge Earthquake captured the headlines. Already in 2004, the US sustained multiple punches from Hurricanes Charley, Frances, Ivan, and most recently Jeanne, midway through a predicted active hurricane season. In the energy sector, large losses occurred in clusters from the late 1980s onward. The new millennium witnessed the beginning of a string of revelations of corporate fraud and malfeasance on a grand scale. Then came 9/11.

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Throughout this period of time, carriers around the world were forced to deal with enormous losses generated by products and exposures for which little or no premium had been collected – because their exposures were undervalued or they were not intended to be covered in the first place. Examples include asbestos, silicone breast implants, certain pharmaceutical products, mold and environmental claims.

Despite these daunting events and losses, the marketplace managed to right itself after each crisis, to soldier through and stabilize – although with fewer insurers and reinsurers and with notable and persistent changes. We experienced the advent and growth of large retentions, captives and other risk funding and special purpose vehicles, claims made and occurrence reported forms, tighter policy wordings, catastrophe risk modeling and revamped underwriting regimens.

Anatomy of a Cycle

All parties – insurers, insurance buyers, brokers, bankers and everyday consumers of products and services – have been directly and indirectly impacted by the evolving marketplace, and their respective responses have changed the way we do business, the cost of doing business, and how we manage and finance risk.

In many ways, however, the basic behavior of the insurance business remains the same. When post-'crisis' returns are perceived to be attractive, fresh capital pours in to take advantage of growing and cresting premium rates, thereby rebuilding capacity. The 1980s, 1990s and 2000s have given birth to ACE, XL, Mid-Ocean, Axis, Arch, AWAC and many others. Meanwhile, many of the older, established 'legacy' companies enter receivership, merge, or reinvent themselves (e.g., Lloyd's and Equitas). The cycle is reborn, and until the next crisis, it's a new chapter of 'business as usual'.

We see nothing on the horizon to indicate that the next ten years will see anything different in the fundamental behavior of the life cycle of the marketplace. Yes, the names of the companies will change and the underwriters will change and the pundits will change, but the inherent nature of the process will remain the same. Forces that create financial travail for some create opportunity for others, and a new generation of capitalists will be attracted by the prospect of entrepreneurial rewards in the property / casualty arena. The question each time will be: can they get it right?

Change, Challenge and the Future

The two types of risk defined above – single-site and aggregation – are becoming ever more divergent.

Remarkably and with a few exceptions (LNG Plants, silicon chip manufacturers, certain high rise buildings, etc.), the peak single-site property exposures in real PML terms are lower today than 20 years ago. In the energy sector, clients are buying similar limits, and there is little pressure on capacity. As respects third party liability, although limits purchased are somewhat higher, only a few companies in a few industries are pushing for more capacity. Single-site risk therefore does not pose a problem for the marketplace.

For aggregation risk, however, growth of exposures will continue to accelerate, far outpacing inflation and the ability of today's insurers to fund for them.

If the marketplace today were to sustain a new round of catastrophe losses, would it be able to stabilize, as it has after every crisis over the last 25 years? Would it be able to continue to cover aggregation exposures on the basis it does today?

As the lines of single-site and aggregation risk exposures continue to diverge and obtaining sufficient funding for aggregation risk becomes more difficult or simply impossible for the commercial insurance marketplace, where will insurance buyers find coverage or contingent capital for their aggregation risk? Can we reasonably expect to see new generations of venture capitalists, growth of private sector mutual insurance arrangements and stepped-up government intervention? Do the growth of aggregation risk, heightened interdependencies and other risk-concentrating phenomena create 'natural monopoly' conditions for funding aggregation risk? Will government take on an expanded role as the insurer of last resort? Will tort reform be enacted to limit historical and/or going-forward exposures?

For Energy risks, it is safe to assume that between the commercial marketplace and the mutual pools, the single-site business will continue as before, and supply and demand forces will continue to drive a cyclical marketplace. For aggregation risk, the marketplace will continue to lose ground. As that happens, affirmative answers will be reached for many of the questions posed above, and solutions will necessarily be achieved.

Those firms that recognize the inevitable incapability of the marketplace to handle aggregation risk will lead the way in developing and promoting alternative risk funding strategies.

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