

UPSTREAM MARKET CONDITIONS DESTABILISE IN WAKE OF RECENT RIG LOSSES

MARKET HONOURS EXISTING COMMITMENTS FOLLOWING GULF OF MEXICO TRAGEDY - BUT LONG-TERM TRENDS LOOK INCREASINGLY UNCERTAIN

‘The more astute energy companies will realise that nothing lasts for ever in this market’. When we wrote these words as part of our conclusion to the Upstream section of our Energy Market Review in March, in which we described a distinct market softening in this sector, we could have had little idea that potentially the largest loss (insured/uninsured combined) in upstream market history was about to unfold. The tragedy of the Deepwater Horizon loss in the Gulf of Mexico, which was still ongoing as this Newsletter went to press, has come as a major shock to the market and has largely fragmented the apparent stability epitomised by the gradual softening that we referred to in our March publication.

And then, as if the Deepwater Horizon loss wasn't enough, the market has been subsequently rocked by the total loss of the mobile drilling unit Aban Pearl (insured for USD235 million) which sank on May 13 in approximately 160 metres of water in the Caribbean while under long-term charter to

PDVSA. Furthermore, as we went to press, Apache Corporation has just announced that a loss emanating from Hurricane Ike, which had not been expected to affect a specific layer of Apache's programme, would now be the subject of an insurance claim up to USD150 million to that layer.

These further losses have compounded the destabilising effect of the Deepwater Horizon tragedy, as any markets that might have avoided the Gulf of Mexico loss have almost certainly been involved in at least one of these incidents, thereby spreading the pain throughout the upstream sector.

It is, of course, far too early at this stage to make any definitive comments on the Deepwater Horizon disaster in terms of quantum, responsibility or specific cause of loss. However, we are aware that our clients will want to know as much as possible, not only about the loss itself but also on the potential effect of this loss and the others mentioned above on the upstream market.



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

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

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

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DEEPWATER HORIZON - THE STORY SO FAR

The following is a summarised timeline of events as they have unfolded since April 20:

April 20	Transocean reports a fire onboard its semisubmersible drilling rig Deepwater Horizon. The incident occurred at approximately 10:00 p.m. central time in the United States Gulf of Mexico.
April 22	Deepwater Horizon sinks. BP activates an extensive oil spill response and initiates a plan for the drilling of a relief well.
April 25	BP continues to assist Transocean's work below the surface on the subsea equipment, using remotely operated vehicles to monitor the Macondo/MC252 exploration well.
April 26	Transocean announces that the rig is now located on the sea floor approximately 1,500 feet northwest of the well center and away from any subsea pipelines.
May 2	Drilling of first relief well begins.
May 5	BP announces that it has stopped the flow of oil from one of the three existing leak points.
May 8 - 9	Efforts to place the containment dome over the main leak point are suspended as a build up of hydrates prevents a successful placement of the dome over the spill area.
May 13	Planning continues for so-called 'top kill' of the well, involving injecting material of varying densities and sizes (also known as 'junk shot') into the internal spaces of the BOP to provide a seal, before pumping specialised heavy fluids into the well.
May 16	The Riser Insertion Tube Tool (RITT) containment system is put into place in the end of the leaking riser. This involves inserting a four-inch diameter tube into the Horizon's riser (21-inch diameter pipe) between the well and the broken end of the riser on the seafloor in 5,000 feet of water. The insertion tube is connected to a new riser to allow hydrocarbons to flow up to the Transocean Discoverer Enterprise drillship located on the surface.
May 18	The RITT containment system is operational. It is estimated to be collecting and carrying about 2,000 barrels a day (b/d) of oil to flow up to the drillship Discoverer Enterprise on the surface 5,000 feet above.
May 20	Plans continue to develop the 'top kill' operation.
May 24	Subsea efforts continue to focus on progressing options to stop the flow of oil from the well through interventions via the blow out preventer and to collect the flow of oil from the leak points.
May 26	'Top Kill' operation begins.

Source: Transocean and BP company websites



HOW BAD MIGHT IT GET?

According to news reports and industry research, the spill could conceivably approach (or even exceed) the 1989 Exxon Valdez oil spill in terms of size.

However, reports also suggest that this time the effect of the Deepwater Horizon spill is likely to be much less concentrated than say in the case of Exxon Valdez, where the spill was constrained by cold water in a confined coastal setting. In this case the oil is lighter, and the spill has occurred in significantly deeper and warmer water, factors which should lessen the impact of the spill upon landfall. Reports have suggested that under temperatures of 15 degrees centigrade, around 40% of crude oil should evaporate over a two-day period; given the relatively high temperatures in the Gulf of Mexico, this effect should reduce the spill. It is also possible that the spill could naturally disperse over long distances, as in the case of the deliberate pollution of the Persian Gulf by Iraqi forces in 1991.

Offsetting this factor is the possibility of the spill impacting a much greater area, especially if it makes its way into the Gulf of Mexico 'loop' system, which could take the oil around the tip of Florida and into the US Eastern Seaboard.

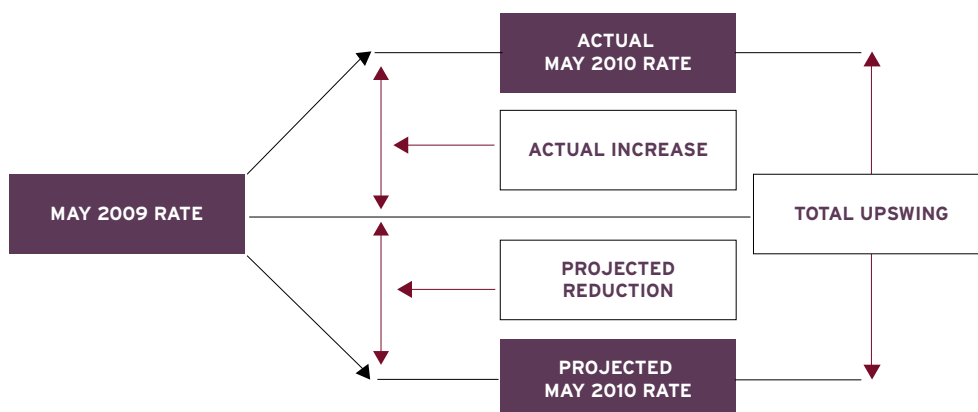
HOW MUCH WILL IT COST?

The rig itself is insured for USD 560 million. In addition, the Minerals Management Service may not release the contractor of the responsibility to remove the wreck from the seabed at some point in time (when it becomes technically possible). This might potentially mean that the contractor may have a requirement to reserve as much as 25% (USD 140 million) to the contractor's insurance market claim. However, the much more likely scenario is that it is designated a maritime grave.

All other loss forecasts relating to control of well, re-drilling, third party liability and seepage and pollution costs are highly speculative at this stage. Reports to date suggest that the total cost could eventually amount to as much as USD10 – 15 billion, although it is impossible to establish exactly how much of these costs will be recoverable from the upstream market. However, even taking into account the large element of this loss which we understand to be self-insured, it is reasonable to suggest that that total claims to the market could be well in excess of USD 1.2 billion.

WHAT HAS BEEN THE IMMEDIATE AFTERMATH?

UPSTREAM MARKET RATING SWING, MAY 2010



The actual upswing in the upstream market has been much more pronounced than it might appear at first sight.



In the immediate aftermath of the loss we found that, in general, leading insurers honoured their existing commitments and quoted terms issued (and orders received) prior to the incident, much to their credit.

However, for new business coming to the market in the aftermath of this loss, it has been clear that insurers are now suggesting that this loss has fundamentally altered the existing market environment. In general terms, insurers are no longer countenancing reductions in programme rates and in most instances are seeking to impose rate increases, particularly on drilling contractor business.

As our chart on the previous page shows, the actual upswing in pricing/desk rating has been far greater than may initially appear. Most buyers could have expected a reduction in their insurance spend in May 2010, whereas most of them actually experienced a rise in rating levels. So for example, a buyer that has been charged a small increase is likely to have experienced a larger overall rating upswing from what they had expected/budgeted for.

HOW HAS THE DEEPWATER HORIZON LOSS AFFECTED DEMAND FOR CONTROL OF WELL AND LIABILITY INSURANCE?

Since April 20, brokers have been inundated with requests to price and obtain increased cover for liability and control of well risks, a trend which is being driven by top energy company management concerns in the wake of the disaster.

Given the circumstances, it is likely that the recently launched Chrysalis product (Catlin, O'Farrell, WR Berkley), which provides USD100 million of unscheduled cover for interest excess of OIL, may now become more attractive to buyers.

It could be argued that in some instances the extent of the increased demand for cover may be an over-reaction. The Deepwater Horizon loss resulted from a well that featured a combination of a high pressure, deep water and a high Authorization for Expenditure (AFE). Many operators around the world do not generally have acreage that combines all the above features, and therefore the likelihood of them 'mirroring' this event is somewhat remote. Buyers and their brokers perhaps need to analyse individual risk portfolios in some detail before simply going out and buying/placing as much insurance as possible.

CAN THE UPSWING IN RATES IN THE UPSTREAM MARKET BE SUSTAINED?

Upstream insurers have been quick to describe the Deepwater Horizon loss as a market-changing event. For the Physical Damage/Control of Well sector, this is yet another incident that has changed the course of the market. However, the true market-changing dynamic will continue to take place in the liability arena. It is possible that the market may start to reject liability cover within packages and that the 'stand alone' specialist market will become a far more active arena. The way this class is written will certainly be fully reviewed, with specific attention being paid to the potential clash between contractor and operator limits/policies being offered.

From an offshore property perspective, we can certainly say that the loss has shifted the market trend. However, to answer this question properly, we would refer readers to a timeline outlined below. This highlights the likely key events during 2010 from an upstream energy market perspective and the considerations which will impact insurers' decisions as to how to treat this class in the future.



Late June/ early July	<p>July 1, reinsurance renewal season Onset of Gulf of Mexico hurricane season.</p> <p>Some insurers' reinsurances renew at June 1. Some may have missed the impact, while others will be impacted immediately.</p>	<p>Most upstream insurers will have written approximately 75% of their income for the year. There is likely to be less pressure to compete for market share, but no withdrawal of capacity yet either.</p> <p>It is therefore possible that over-supply of capacity may dampen the level of market increases.</p>
June to December	<p>Underwriters seeking support for 2011 from both management and reinsurers.</p>	<p>Fresh underwriting stances may appear in anticipation of increased reinsurance costs and increased retentions, as well as Solvency II capital requirements.</p>
October/ November	<p>Gulf of Mexico hurricane season winding down.</p>	<p>Implications for January 1 renewals:</p> <ul style="list-style-type: none"> - If the windstorm season has not had a major impact on the market, then there will be less pressure on markets to withdraw. - However, if major hurricane or other losses have been sustained by the market, then this could prompt a significant market reaction.
November/ December	<p>Insurers seek fresh reinsurance terms for 2011, mindful of Solvency II increased capital requirements.</p>	<p>Decisions made as to:</p> <ul style="list-style-type: none"> - Changes in capacity offered for 2010 - Election to withdraw
January 2011	<p>Extent of capacity changes evident in market.</p>	<p>Any significant depletion of capital will clearly exacerbate any remaining hardening dynamic.</p> <p>However, in the unlikely event of capacity levels remaining essentially unaltered, competitive pressures may re-assert themselves for non-capacity business.</p>



WHAT ARE THE CHOICES FACING UPSTREAM INSURERS AT THE END OF 2010?

STAY IN?

Little impact of Gulf of Mexico hurricane season

Spread of global legislation requiring higher insurance limits for drilling contractors and E&P companies?

Increased demand for control of well and liability insurance

Sustained market hardening backed by increased premium flow and spread

PULL OUT?

Significant Gulf of Mexico hurricane claims

Increased reinsurance costs

Punitive Solvency II capital requirements

Influence of Lloyd's Franchise Board

Prices for non-capacity business still insufficient for capital to be deployed effectively

NOVEMBER/
DECEMBER 2010

Upstream insurers may face an interesting dilemma later this year

This chart shows the different considerations that might face upstream insurers as 2010 develops. There are clearly a number of competing factors that might influence insurers and their managers either to remain in this market or to withdraw:

- **The Gulf of Mexico hurricane season:** in what is forecast to be an active season, it will be interesting to see how well the revised underwriting model stands up to any major activity.
 - **Increased reinsurance costs:** it seems likely that reinsurance market will harden as a result of recent major losses.
 - **The impact of government legislation on control of well and liability policy limits:** all the signs are that in the U.S. companies will be forced to carry much higher levels of insurance for deepwater drilling activities in the future. It is certainly possible that other governments/legislative bodies may follow suit. This will mean an increased demand for these product lines, with the inevitable higher rating levels producing fresh premium income and spread for the market.
 - **The impact of Solvency II on European insurers' capital requirements:** with the need to demonstrate increased capital on insurers' balance sheets, some may take the view that the upstream market's inherent volatility makes it too risky an environment in which to invest.
 - **The influence of the Lloyd's Franchise Board:** there can be little doubt that Tom Bolt and his team will be extremely vigilant in monitoring Lloyd's insurers' business plans for this class in 2011.
- In conclusion, only time will tell where the new market benchmark will eventually settle. Willis will continue to monitor the situation and keep our clients fully advised of any further developments.**



WILLIS HURRICANE INCOME PROTECTION II ('WHIP II')

INNOVATIVE HURRICANE RISK TRANSFER COVER FOR GULF OF MEXICO ENERGY COMPANIES

PRODUCT FEATURES

Willis Structured Risk Solutions – Financial Products, has developed a new index-based insurance solution for Gulf of Mexico hurricane risks. **WHIP II** provides indemnity to owners of Gulf of Mexico assets who suffer a Business Interruption (BI) or Property Damage (PD) loss incurred as a result of the eye of a Category 2 or higher hurricane passing through a circle (standard radius is 100 miles), the radius of which the client chooses. Payouts are subject to a Daily Limit, which the client chooses, as well as an agreed aggregate limit for multiple hurricane events. Each hurricane event triggers coverage for 14 consecutive days. The client chooses how to allocate the proportion of BI or PD, up to the Daily Limit, for each of the 14 days of coverage per event. The coverage term is for the entire hurricane season.

WHO IS IT RELEVANT TO?

Owners of Gulf of Mexico assets who require hurricane risk protection over and above that provided by the commercial insurance market and Oil Insurance Limited.

WHY IS IT DIFFERENT?

Unlike a traditional insurance product, no physical damage loss needs to be sustained to make a recovery under the BI portion of the coverage. Instead, once the product is triggered, all costs incurred by the purchaser directly as a result of the hurricane are recoverable up to the daily and aggregate limit provided, without the application of any deductible. These costs may include, but are not necessarily limited to:

- Evacuation expenses
- Standby charges
- Rig hire charges
- Re-drilling expenses
- Business interruption/loss of production income
- Well head damage (not excluded)

- Replacement cost valuation used
- For major property damage, the client can choose to use all 14 days per hurricane event for PD up to the Daily Limit. Alternatively, if there is no PD they can use the entire Daily Limit for BI; or, combine the two for each Daily Limit.

However, unlike a conventional catastrophe bond, the buyer must be able to prove the loss as this product is designed and priced to recognise the traditional insurance principle of indemnity. The product can be customized based on the specific information and risk transfer requirements provided by the buyer.

WHAT ARE THE BENEFITS?

- Covers costs and expenses incurred as a result of a major hurricanes which are usually excluded from conventional insurance policies.
- Costs are significantly below comparable cover provided by today's traditional commercial insurance market.
- Highly rated insurance company, with Standard and Poor's AA-rating.
- Can be used to augment existing risk transfer programs – since there is no deductible whatsoever, this makes a great deductible buy-down solution.
- Can be customised to suit specific requirements.
- Clarity of cover and payout.
- Automatic payment if product is triggered, subject to presentation of proof of related loss.
- Flexibility to allocate costs based on whether PD or BI is of greatest concern.

FURTHER INFORMATION

This product is **exclusive to Willis** and capacity is limited and subject to change at any time. We anticipate a high demand during the early part of the 2010 hurricane season. Please contact **Ron Baron** at our Willis Houston office (+1716-625-1038, ronald.baron@willis.com) for further information.



NEWS ROUND UP

- **Torus** has acquired the direct and facultative (D&F) arm of **Glacier Re** for an undisclosed sum. The purchase of Glacier Insurance, a subsidiary of the Glacier Group, is expected to be completed this month, subject to relevant regulatory approvals. Glacier Insurance has branch offices in Zurich, Cologne and London, and its portfolio includes aviation, space, property, energy, war and terrorism and marine risks. As part of the acquisition, Glacier Insurance's 40 underwriting and operational staff will join Torus and all its branch offices will be retained.
- Meanwhile Torus' push for diversification has taken another step after the company revealed it has appointed **Demian Smith** to spearhead its entry into the marine insurance market. Smith joins the Bermuda – headquartered insurer from **Navigators' Lloyd's syndicate 1221** where he was the responsible for marine and energy liabilities. The move into the marine insurance market is Torus' latest bid to expand its Global Specialty platform which was launched last September.
- In acknowledgement of their being part of the **Flagstone Re Group, The Marlborough Underwriting Agency Limited** has announced that the name of the company has been changed to **Flagstone Syndicate Management Limited** and that the pseudonym of syndicate 1861 has also been changed from **'BRM'** to **'FSR'**.
- **Zurich** has increased the number of fully empowered industry specialists in the Middle East region with the appointment of **Tejal Bartlett** as Underwriting Manager for Onshore Energy Property. As part of the Zurich Global Energy team, she will be providing onshore property insurance programmes for companies in the oil, gas, petrochemical, natural resources, mining and power generation industries.
- **WR Berkley** has taken further steps to build its Lloyd's platform by appointing **Louise Nevill** to set up the marine division of Syndicate 1967. Nevill, who will take the position of head of marine, joins from Talbot Underwriting, the Lloyd's arm of Bermudian (re)insurer Validus.
- At the 2010 Annual General Meeting of Oil Insurance Limited, Bermuda on March 24 shareholders voted on a new slate of directors for the 2010 – 2011 year. Following the AGM, **Trygve Imsland** was elected Chairman of the Board and **Mark Wilson** was elected Vice Chairman.
- **Canopus** has announced the promotion of **Mike Duffy** and **Stephen Gargrave**, Heads of Global Property and Marine & Energy respectively, to joint Active Underwriters of Syndicate 4444. In this capacity, Duffy and Gargrave will be responsible for all aspects of the day-to-day running of the Syndicate's underwriting.
- **ACE Bermuda** has promoted **Judy Gonsalves** to the position of Executive V.P. She will continue to head up ACE Bermuda's Excess Liability department with responsibility for management and development of ACE Bermuda's and ACE Bermuda International's book of business. The company has also appointed **Allison Towlson** as Regional Executive and Chief Operations Officer. In this expanded role Towlson will be responsible for underwriting operations and enhancing the efficiency of the day-to-day operations of the company.
- **Chaucer Syndicates Limited** has announced the appointment of **Ian Noble**, presently with Brit Insurance, as Professional Indemnity Class Underwriter for Chaucer Syndicate 1084. He will join Chaucer in November to lead the Professional Indemnity account of Syndicate 1084's new International Liability Division to be launched in the fourth quarter of 2010.
- **Gary S. Kaplan**, previously president of the construction business unit of Zurich North America Commercial, has been appointed to the new position of executive V.P. and North America construction leader for **XL Insurance**. Based in New York, Kaplan will report to **Dennis Kane**, CEO of XL Insurance's North America property/casualty unit.



- **Kay Smith** has been appointed property underwriting manager by **XL Insurance (Bermuda)** with responsibility for managing a team of five and the underwriting activities of XL Bermuda's book of general property excess business comprising large multi-national companies.
- **Swiss Re** has announced that that **Sharon Ludlow** has been named CEO of Swiss Re in Canada and head of its **Canadian and English Caribbean** operations, effective June 1. She will succeed **Jean-Jacques Henchoz**, who will relocate to Switzerland to explore new opportunities internally with Swiss Re.
- Effective April 1, **Scor** has announced a number of senior appointments. **Philippe Trainar** has been appointed Chief Risk Officer of the Scor group and is to join the executive committee, replacing **Jean-Luc Besson** who is to retire. **Michel Dacorogna**, head of group financial analysis and risk modelling, has been appointed deputy CRO. **Frieder Knüpling**, currently head of actuarial and finance, will also join the group's executive committee from July 1, 2010 as deputy CEO of Scor Global Life. He will replace **Norbert Pyhel**, who is to become CEO of the Cologne Hub on July 1, 2010, replacing **Dietmar Zietsch**.
- Markel International has further strengthened its Marine and Energy Division with the appointment of **Daniel McCarthy** as an underwriter within its Hull and War team, which is headed by Jason Page. McCarthy, most recently marine hull underwriter at **Allianz**, has over ten years' experience in marine insurance.
- **Victoria Keeble** has joined **ACE UK** as Environmental Risk Underwriter, reporting to **Wayne Harrington**, UK & Ireland Manager. Keeble previously underwrote environmental business at **AIG** and **Certa** and earlier worked in environmental consultancy with **Laing** and **WS Atkins**.
- **Richard Pexton**, former CEO of **Heritage Underwriting Agency PLC**, has been appointed CEO and joins the **Omega** board. He replaces **Richard Tolliday**, who has ceased to be a director of the Company. This development comes shortly after the special general meeting of shareholders which overwhelmingly voted to make major changes to the Board as supported by major investor **Invesco** and others.
- **Ariel Holdings Ltd.** has appointed **George Rivaz** as Chief Executive Officer in succession to **Donald Kramer** who will continue to serve as non-executive Chairman. Kramer was involved in the formation of Ariel in 2005.
- Effective July 1, **Damien Sullivan**, presently CEO for **ACE's Australia and New Zealand** business, has been appointed president and CEO of ACE Asia Pacific, succeeding **John Bassetto** who is retiring from ACE but will serve as senior adviser to ACE Overseas General. Sullivan, based in Singapore, will manage and develop ACE's property/casualty, accident and health, and personal lines insurance operations in the 12 countries comprising the region.
- On the April 12, **Oleg Tronev** took over as General Director of Kapital Insurance Company. He has worked at Kapital (formerly Lukoil Insurance) since 2000 and has worked in recent years as Deputy General Director of Kapital Re and in last two years as Deputy General Director of Kapital Insurance Company, with responsibility for its oil, gas and power business.
- We understand that **Andy Winwood** has resigned from Aon and in due course will be joining the Risk Management team at **Saudi Aramco**, based in Dhahran. In a circa 20 years career, he has held a number of senior Energy, Power and Utility positions, the majority of which involved client servicing responsibility.
- **Lloyd's China** has been granted a licence by the China Insurance Regulatory Commission (CIRC) to write direct insurance in addition to their existing reinsurance licence.

