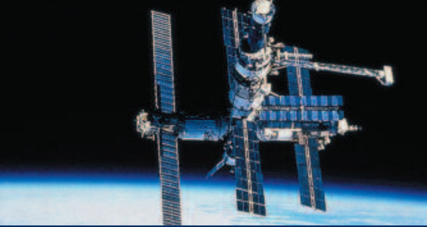

Marketplace Realities 2007
& Risk Management Solutions

Environmental
November 2006

In 2006, we have seen the continued emergence of several trends in the Environmental insurance markets: the establishment of new market drivers, the rise of new risk exposures and changing underwriting appetites.

Overall, the Environmental market has maintained the moderate but steady growth pattern that we have experienced in recent years. This $2 billion to $3 billion market, however, is being propelled now by a new set of drivers that include:

- The routine application of Environmental insurance to a wider array of properties (including non-industrial sites) and transactions (both M&A and real estate)
- The burgeoning brownfield and military base redevelopment markets
- New demands for greater financial disclosure of Environmental liabilities
- The trend towards insured, fixed-price cleanup projects

As the market develops, we are seeing a gradual change in underwriting profile, with less emphasis on one-off, long-term, project-specific placements and an increasing proportion of short-term, renewable programs. It is clear that this market has now evolved from that of a specialty niche product line into a mainstream purchase, addressing a wide range of circumstances and needs.

Nevertheless, the relative immaturity of the market is still evident. Loss trends from long-term policies written in the past decade or so continue to come to light. This has prompted a general tightening of terms and conditions and a fundamental reassessment of certain product lines such as Cleanup Cost Cap. Carriers are accentuating profitable underwriting and strongly encouraging shorter-term, renewable policies. They are also addressing new areas of exposure from emerging contaminants to the challenges presented by new regulatory initiatives.

Marketplace Conditions

Global Environmental capacity remains plentiful (approximately $400 million) and relatively stable. Once at levels over $100 million, leading carriers such as AIG are currently comfortable maintaining a capacity for single placements of $50 million. This is largely a result of weaker demand for higher limit programs and the associated cost of unused reinsurance protection, rather than any fundamental change in risk appetite. Certain other carriers have been able to increase their capacity. For example, ACE increased its capacity for single Pollution Liability placements to $50 million as it continues to grow its Environmental business segment.

Environmental insurers have been participating more and more in layered programs, which are designed to build capacity above and beyond that which is available from a single insurer. As rising financial disclosure expectations force companies to take a harder look at large existing liabilities, we expect the demand for major programs requiring higher limits may well increase.

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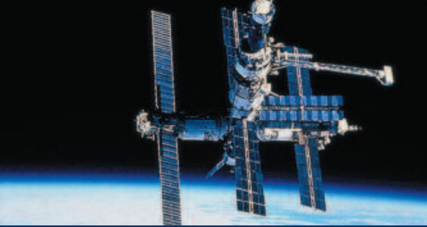


The most critical market question for Environmental insurance buyers in the current climate is not limits or rates (which have been relatively steady), but rather how to best manage increasingly restrictive terms and conditions. Due to past carrier losses, new scientific advances and new regulatory initiatives, buyers can now expect:

- Pressure to reduce policy periods
- New coverage restrictions for certain key issues, such as mold, certain building materials (with the potential to cause mold) and emerging contaminants such as perchlorate or perfluorochemicals (PFCs)
- More demand for location-specific information on portfolio placements
- Increased underwriting scrutiny of areas of regulatory interest such as vapor intrusion of underground contamination into buildings
- Ongoing difficulties in obtaining attractive options for environmental surety needed for project work or operations of regulated facilities

Carrier Preferences

Changing carrier appetites can be seen clearly in three product lines.

- **Cleanup Cost Cap** underwriters have experienced unacceptably high loss rates and they continue to introduce mechanisms to incentivize contractors – such as loss sharing or co-pay provisions. There has been a progressive tightening of policy terms and certain insurers have introduced minimum premium thresholds and up-front engineering or commitment fees. Some insurers will only offer their Cost Cap products to a limited group of preselected contractors. However, having introduced the new controls and restrictions outlined above, most Cost Cap insurers are tentatively expanding their books.

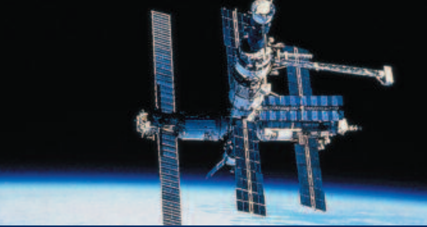
- **Professional Liability** programs, especially for large environmental service firms, have been another source of significant losses for the Environmental carriers. Insurers have been and will continue pulling back from accounts with a significant component of traditional design engineering (i.e., non-environmental) exposure.

- In contrast, construction-related products such as **Contractors Pollution Liability (CPL)** insurance represent a growth area targeted by all the major carriers. Mold and completed-operations exposures are two of the main coverage drivers.

Other notable market developments include the recent entrance by Berkley into the market and the complete exit of Quanta. Berkely Specialty Underwriters will be targeting environmental contractors and consultants as well as property pollution risks. Quanta's Environmental underwriting activities were stopped earlier in the year and were later placed in runoff due, in part, to underwriting losses in other lines of business caused by the 2005 hurricane season.

Legal and Regulatory Action

The influence of the Sarbanes-Oxley Act (SOX) and the ongoing demand for greater corporate transparency continue to drive the tightening of disclosure rules for Environmental liabilities. Public companies are now in their first year of implementing the requirements of FIN 47 (FASB Interpretation Number 47) which addresses conditional asset retirement obligations. FIN 47 mandates that companies may not wait until they actually retire an asset to acknowledge the associated costs, such as future cleanup obligations. They must recognize the costs on their balance sheet as soon as the numbers can be



reasonably estimated. The early impact of these rules is mixed, as some firms have disclosed major increases in environmental liabilities while other disclosures have remained relatively unchanged. The longer-term consequences of this rule have yet to become apparent. Also unclear are the preferred approaches firms will take to address newly disclosed liabilities. Although disclosure is required, funding or insuring for potential future liabilities is not. We anticipate firms with likely near-term asset retirements involving significant environmental expenses will be exploring options to cap their total exposures through insurance-backed solutions. Such approaches will not only improve the quality and certainty of their financial disclosure but also create more options for sale or redevelopment.

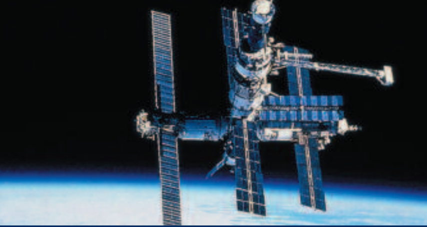
Global warming is not only receiving a tremendous amount of media attention; its potential to cause large losses through weather events is now one of the main long-range concerns for the insurance industry. At this time, it is difficult to predict the nature and scale of all the various liabilities that climate change could create. Some recent developments suggest possible areas to watch. In September 2006, the state of California sued six leading automobile manufacturers because of their products' contribution to global warming and resulting pollution and erosion problems. The lawsuit cites the creation of a "public nuisance" from carbon dioxide emissions. The insurance industry has started to respond to other global warming-related exposures. Examples are novel insurance programs that guarantee the financial subsidies associated with the earning of carbon emission credits from certain qualifying projects that are designed to reduce carbon emissions.

Several other regulatory issues bear watching:

- Recent regulatory initiatives could mandate additional activities at many contaminated sites, increasing the likelihood that regulators will **reopen previously closed sites.** For example:
  - The Environmental Protection Agency (EPA) is currently reviewing the effectiveness of institutional controls – e.g., legal mechanisms such as deed restrictions that are used to minimize the potential for human exposure.
  - The EPA and several states have issued guidance documents for reevaluating the health risks posed by subsurface vapor intrusion.

- **Natural Resource Damage (NRD)** claims continue to be a looming regulatory concern for both clients and Environmental insurance markets. While the Federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) provides the basis for NRD, administration of NRD falls to individual state trustees. In addition, each state has its own legislation affecting the administration of NRD, and there has been no real coordination of the federal and the state programs. To make matters more confusing, each state pursues NRD claims with varying degrees of aggressiveness. Since the Environmental insurance marketplace closely tracks federal and state regulations, the availability of Environmental insurance for NRD claims is often determined by the location of the property in question. NRD submissions will continue to be evaluated on a case-by-case basis.

  A recent development that created significant interest in the insurance community was the announcement in June 2006 that the Department of Justice reopened one of the highest profile NRD settlements in US history – the Exxon Valdez oil spill in Alaska. In accordance with the "re-opener" provisions in the original $900 million settlement, the Department of Justice and the Alaska Department of Law have presented Exxon with a request for additional funding of approximately $90 million.



- **Emerging contaminants** are substances that are currently unregulated, but that may be subject to increased regulatory standards in the near future. A good example is perchlorate, a common contaminant on defense-related facilities that until recently had been lightly regulated.

Strategies for Tomorrow

As we reported in April, insureds should expect challenging renewals with increasing restrictions on terms and conditions. Careful, strategic program design and marketing will be paramount to avoid erosion of valuable coverage.

For new placements, it will be important to carefully match coverage needs with the current appetites and offerings of the market. As Environmental insurers become more selective, purchasers that are able to combine innovative program design with high-quality underwriting presentations will derive maximum benefit.

FIN 47 makes it clear that, beginning this year, companies must reserve for asset retirement obligations despite uncertainties as to the time or method of settlement. Many companies will be looking for options to help mitigate the impact of FIN 47 on their financial reports. These options might include the accelerated cleanup of a contaminated site, sale of non-performing sites or operations, and/or use of risk transfer arrangements such as Environmental insurance or liability transfer alternatives to bring resolution to cleanup obligations.

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