

BETWEEN A ROCK AND A HARD PLACE?

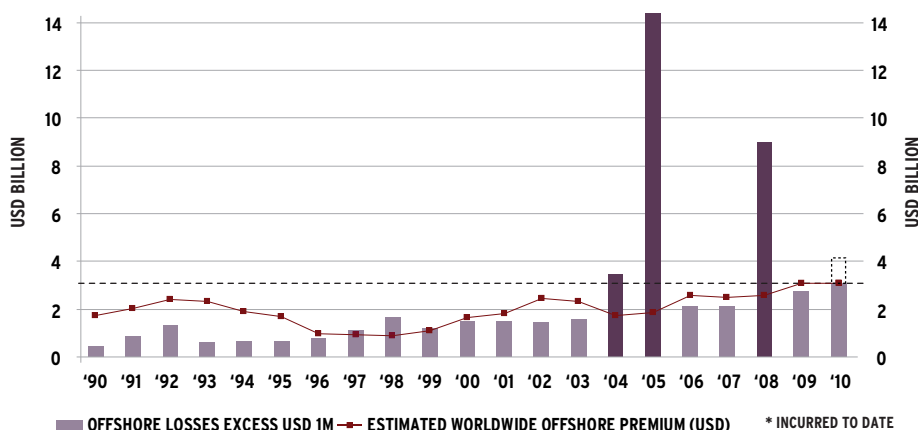
As 2011 capacity levels are expected to at least match those of 2010, insurers' attempts to stem any softening process in either the upstream or downstream markets look set to be thwarted

As we near the end of the 2010 Gulf of Mexico hurricane season, energy insurers in both upstream and downstream markets are looking forward to 2011 with mixed emotions. On the one hand, the potential nightmare scenario of a major windstorm loss has seemingly failed to materialise; on the other, so has the likelihood of the much anticipated withdrawal of capacity following the Deepwater Horizon loss. Furthermore, the initial reports from the key recent reinsurance meetings in Monte Carlo and Baden-Baden suggest that rates are likely to soften across the downstream reinsurance board; and with no further major upstream or downstream losses to report since Deepwater Horizon, insurers in both markets are coming to terms with the fact that underwriting capacities in 2011 are set to match those of 2010.

Where does this scenario leave energy insurers? In essence, between a rock and a hard place.

UPSTREAM - A RETURN TO Q1 2010?

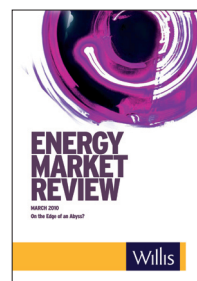
WELD OFFSHORE ENERGY LOSSES 1990 - 2010 (EXCESS OF USD 1M)
VERSUS ESTIMATED GLOBAL OFFSHORE ENERGY PREMIUM INCOME



2010 is going to be to be the worst non-windstorm affected underwriting year of the last two decades

Source: Willis Energy Loss Database as at November 9, 2010 (figures include both insured and uninsured losses)

The chart above shows both insured and uninsured losses; in 2010, the figure includes USD 2.56 billion for the Deepwater Horizon loss (although these figures exclude most Third-Party Liability losses, which of course will eventually result in a much larger figure, given the USD 20 billion fund established by the Operator). On the face of it, it seems to explain why upstream insurers have been insisting for some time that a harder market climate will be essential if this portfolio is to be underwritten profitably in the future. It shows that 2010 loss figures already point to it being the worst year for non-windstorm-generated offshore losses for at least two decades. Upstream underwriters will inevitably seize on this statistic to demonstrate the need to maintain the market rating environment that has resulted in the wake of the Deepwater Horizon tragedy.



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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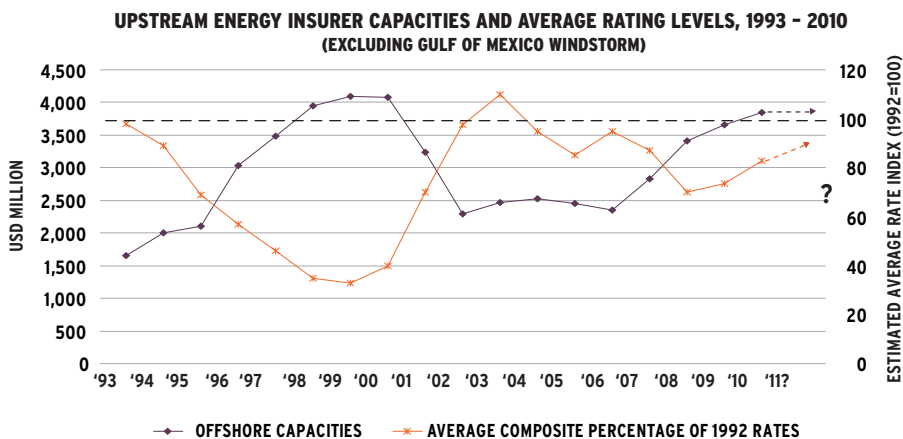
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In normal circumstances, this would result in some capacity withdrawals and a continuing hardening of the market, but these are not normal circumstances. Why?

- Because the figures include both insured and uninsured losses, the chart inevitably masks the actual loss ratios incurred by upstream insurers.
- With a significant amount of the final Deepwater Horizon bill either self-insured or recoverable by reinsurance, and the outcome of future cost allocations by the U.S. courts still somewhat off, no upstream insurer has yet been impacted 'beyond the point of no return' so as to withdraw from the market (with the single exception of the Omega Syndicate).
- The vast majority of the potential final Deepwater Horizon loss is likely to fall upon the liability market. As we have previously acknowledged, this loss will be market-changing to the liability arena; however, from a Physical Damage/Operators Extra Expense underwriter perspective, the loss has certainly been containable but this market has benefitted from the overall resulting rating upswing.
- Since the Deepwater Horizon loss, insurance has 'leapt onto the radar' of energy company management, with insurers receiving considerably more

interest in increased limits/coverage since the middle of the year. As a result, some insurers could even be forgiven for thinking that, in purely commercial terms, the loss is not all bad news. Rather than a series of attritional losses which might have impacted their retentions more dramatically, a single high severity loss such as this one is much more easily recoverable from the reinsurance market, while at the same time providing insurers with the 'excuse' to raise rating levels across the board.

- Furthermore, insurers are encouraged by the potential prospect of much higher minimum insurance requirements being imposed in the Gulf of Mexico following new legislation from the House of Representatives in 2011 (see our August and October 2010 EMR Newsletters) and the inevitable ripple effect that this would undoubtedly have globally.
- This is a sophisticated market. Insurers are well aware that to withdraw after a bad underwriting year, only to find their competitors benefitting from the resulting market upswing, is in many ways the worst of all worlds. So in general terms every upstream insurer is essentially playing the same game – waiting for someone else to withdraw.



Is the upstream market in a false equilibrium?

Source: Willis

The result of all these factors is that the upstream market can be fairly described as being in a state of false equilibrium (see chart above). What is striking about this chart is the way that the market cycle has smoothed since the days of the last truly soft upstream market in 1999. However, this smoothing cannot be taken too far; when we look at the prospects for 2011 we can see that if capacity levels remain roughly as they are for 2011, and the upstream market were to continue to harden in the aftermath of Deepwater Horizon (as it has been doing until



very recently), then the orange rating level line would 'overtake' the blue capacity line. Past history suggests that this can't be maintained for very long at a time of static capacity.

There are, of course exceptions to every rule, especially where capacity is less plentiful and where different dynamics holds sway. Stand-alone Operators Extra Expense programmes will continue to attract relatively higher rates than the rest of the portfolio, as will Construction All Risks insurance for projects requiring a large percentage of the available market capacity; furthermore, so will the entire Marine Liability portfolio for the reasons explained in this article.

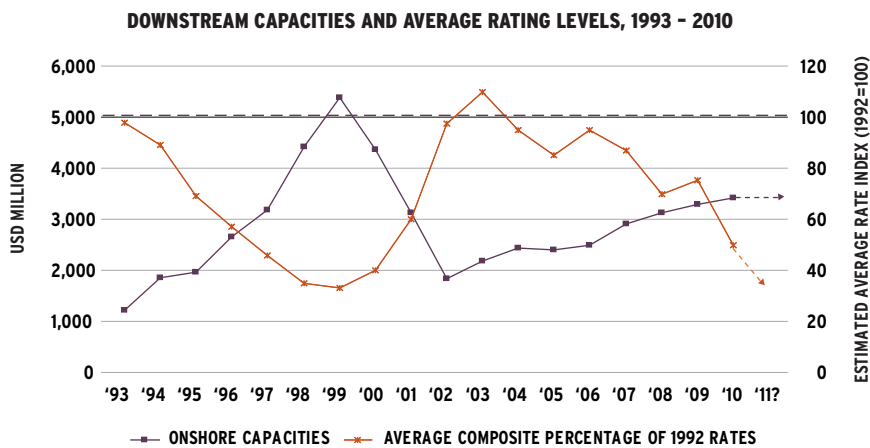
There is also no doubt that the Lloyd's Franchise Board, having very publically stated that in their opinion the upstream portfolio is inherently unprofitable, will be wanting to examine Lloyd's insurers' upstream underwriting plans for 2011 in some detail.

They are now specifically focusing on the way insurers are underwriting/rating marine liabilities, particularly those associated with drilling.

However, the Franchise Board cannot completely ignore the realities of upstream market dynamics. The continued availability of relatively cheap reinsurance capacity, despite talk of reinsurance rates hardening in 2011, means that upstream insurers can still stand a good chance of writing this portfolio at a profit. And if the reinsurance market is likely to pick up a significant proportion of the bill for a major incident such as Deepwater Horizon, incidents such as this will continue to work to the direct market's advantage, in the absence of significant attritional losses within their portfolio.

So in general terms the dynamics point towards being 'back to square one' for most upstream insurers, which could be interpreted as a reversion to March 2010 market conditions – a softening market, with too much capacity chasing too little business. Time will tell if any hardening of the reinsurance market will check this process.

DOWNSTREAM - TOWARDS THE SOFTEST MARKET FOR 20 YEARS?



Are we heading for the softest downstream market in nearly 20 years?

Source: Willis

As the chart above shows, the situation in the downstream market is somewhat different from the upstream sector in that there has been very little by way of losses such as Deepwater Horizon to prevent the continuing softening process. We are now at a stage whereby rating levels are generally now as low as they were at the depth of the last truly soft market in 1999, with every indication that they will go even lower in 2011.



But is this a truly valid comparison? Has the downstream market actually got to the point where current rating levels will no longer deliver a profitable portfolio? The following factors suggest that there may still be some way to go before the sector starts to record an overall loss for the year:

- In 1999, the minimum available retention levels were considered lower than those provided by the current market. Insurers would argue that today's retention levels have been impacted by inflation, but even accepting that this is an issue for Physical Damage, in Business Interruption terms Waiting Periods have definitely increased.
- As a result, the degree of attritional losses to the market was considerably greater, which may well have contributed to negative Incurred Loss Ratios (for Lloyd's at least) of up to 300%. By contrast, the corresponding figures in recent years have been generally been less than 70% – certainly sufficient to secure a limited underwriting profit.
- The overall downstream loss record has improved considerably since 1999. Many observers would put this down to improved risk management practice and the input to energy companies' risk management practice from insurers' engineers that has increased markedly during the last decade.

2010 DOWNSTREAM LOSSES - GLOBAL

CAUSE	LOCATION	COUNTRY	PD/LIAB USD	BI USD	TOTAL USD
Earthquake	Talcahuano	Chile	80,000,000	80,000,000	160,000,000
Fire/lightning/explosion	Connecticut	USA	100,000,000	45,000,000	145,000,000
Fire/lightning/explosion	Alberta	Canada	84,200,000	-	84,200,000
Fire/lightning/explosion	Washington	USA	25,000,000	25,000,000	50,000,000
Mechanical failure	Turin	Italy	33,823,000	8,455,800	42,278,800
Mechanical failure	Chiayi County	Taiwan	26,215,890	7,900,665	34,116,555
Fire/lightning/explosion	Kent	UK	1,257,300	21,374,100	22,631,400
Fire/lightning/explosion	Kentucky	USA	15,000,000	-	15,000,000
Mechanical failure	Izmit	Turkey	7,500,000	6,800,000	14,300,000
Mechanical failure	Limon Province	Costa Rica	4,250,000	6,000,000	10,250,000
Mechanical failure	Texas	USA	8,000,000	-	8,000,000
Fire/lightning/explosion	Rio de Janeiro	Brazil	7,150,000	-	7,150,000
Fire/lightning/explosion	San Roque	Spain	4,854,000	-	6,254,000
Mechanical failure	Louisiana	USA	4,000,000	1,050,000	5,050,000

Source: Willis Energy Loss Database as at November 9, 2010 (figures include both insured and uninsured losses)



However, one should bear in mind that in 1999, downstream insurers had the following factors working in their favour:

- In 1999, cheap primary reinsurance was available in abundance. This enabled a significant number of insurers who bought this protection to write for premium income, safe in the knowledge that ultimate underwriting losses would be borne elsewhere (although in reality several insurers had problems recovering their initial claims outlays).
- In 1999, interest rates were at a level that enabled insurers' fiduciary income to contribute to the making up of any rating shortfalls.
- In 1999, in general terms the cost of administering and managing a portfolio of downstream business was considerably cheaper than it is today.

It is therefore quite likely that rates are now at a level whereby – in theory at least – underwriting losses can be expected to materialise in the short as well as the long-term. In the meantime, it is probable that a number of downstream underwriters will continue to be expected by their management to grow their revenue streams at the same time as increasing their profitability as the market softens still further.

Determining the best strategy in such a situation will not be easy. One option for insurers might be to 'compress' their lines so that they write more of the area of the risk spectrum that offers the most premium, i.e. the primary sector; however, that in itself would also lead to those insurers paying out a much higher proportion of incurred losses. Another option might be to increase their capital and then make a reduced return, but this too will be costly. It will be difficult to expand their portfolio any other way as most insurers are already subscribing to the business they wish to underwrite. One further option for insurers would be to 'take a view' on offering a combined line over several disciplines – for example Downstream, Upstream, Third Party Liabilities and Directors and Officers' Liability – to favoured clients at discounted terms – in order to maximise their leverage to create additional premium income.

CONCLUSION - BUYERS CAN ONLY BENEFIT - FOR NOW!

As the January 1 renewal season approaches, it's perhaps little wonder that the atmosphere in both markets remains anxious. For the moment, buyers are in an excellent position to drive home improvements to their risk management programmes and develop their relationships with the hungriest insurers still further.

However, there is always the possibility in these markets of an abrupt turnaround. In the upstream sector, there are a significant number of exposures that now require full market capacity, while cover for any increased insurance policy limits in the Gulf of Mexico for OEE and Casualty certainly won't come cheap. In the downstream sector, rates are now at a point where if a significant run of losses were to materialise – as in 2001 – today's profits would rapidly turn into tomorrow's losses.

In the meantime, the options available to insurers in both sectors continue to look somewhat limited. In driving a course between 'a rock and a hard place', they will need to use every bit of their underwriting flair and skill.



EX-UIB BOARD DIRECTOR MIKE LACK JOINS WILLIS ENERGY

Willis Energy is delighted to announce the appointment of Mike Lack as an Executive Director in our London downstream team. In his new role, Mike is responsible for handling a wide range of downstream energy programs, reporting to Justin Blackmore, Managing Director, Willis Energy Downstream.

Mike has over 40 years' experience in the insurance industry. He began his career in 1970 at Wigham Richardson & Bevington Ltd in 1970 before being appointed Placing Broker and Account Executive for Lavy Hancox & Carter two years later. Following a ten year spell at Cayser Steel Bowater, during which time he relocated to Oman, he joined Marsh & McLennan Middle East Ltd. in 1985 as Senior Broker in order to form a Non Marine Energy, Property and Casualty Division dealing with International Direct/Reinsurance

Non Marine Business. Mike was then involved in the initial formation of UIB and subsequent purchase of Marsh & McLennan Middle East Ltd, where he was appointed as a Main Board Director and Managing Director of the Energy and Property/Liability Division.

We are particularly pleased to welcome someone of Mike's pedigree and experience to Willis Energy. In particular, it is unusual for a Board Director of such a well-known broker to join a broker in such a capacity and we are pleased that Mike has been convinced of our potential. Mike's vast experience in handling programs from such diverse regions as North Africa, Japan, Europe, Thailand and Indonesia will be invaluable to our downstream energy team.

NEWS ROUND-UP

- As we intimated in our leading article, **Omega's** energy team has resigned from the company. The team was led by **Philip Thorpe-Apps**, backed by **Seb Weaver** and **Bruce Rogers**. It is understood that Omega's energy operation, which was launched in 2007, has written primarily offshore business and had represents less than 10 % of the premium written by Omega Plc.
- **SCOR** has confirmed that the Lloyd's Market Franchise Board gave its '**in principle**' approval to the creation of **Syndicate 2015** on November 1, 2010. Final arrangements and approval could lead to the commencement of underwriting as early as January 1, 2011 on a risk inception basis. SCOR will be the sole capital provider of Syndicate 2015, the initial stamp capacity of which is £75 million. It is understood that the envisaged portfolio has a strong focus on shorter tail lines coming from markets outside the U.S. and excludes reinsurance treaty business.
- The management team of the new syndicate includes **Richard Harris**, **John Byrne** and **Tom Corfield** (Active Underwriter).
- Loss adjuster **Axis International** has expanded in South America with the opening of offices in **Ecuador** which will provide adjusting services for industrial all risks, energy and power, construction and engineering and financial institutions risks. The new operation is headed by **Renato Zambrano**, managing director for **Axis Ecuador**. The offices are located in Guayaquil and Quito.
- Veteran Scandinavian underwriter **Verner Rydning** has joined the **Swedish Club** and is to head up their new Oslo office which we understand will underwrite property and Loss of Hire risks on offshore mobile units and FPSOs.
- **Lloyd's** has announced that it will open a representative office in Russia in 2011. Lloyd's said that a dedicated country manager will enable Lloyd's to better understand and explore opportunities in the Russian market, however the office



will not be a base for underwriting. **Lloyd's Russia** is expected to open mid – 2011, subject to regulatory approvals. Over the past three years, Lloyd's premium income from Russia has increased from USD 108.4 million in 2007 to USD 167.5 million in 2009, ranking Russia second amongst the BRIC economies, behind Brazil. The major classes of business written as reinsurance from Russia are energy (USD 58 million), aviation (USD 54 million) and marine (USD 33 million).

- **Peter Ignell**, previously V.P. of **Chartis'** Global Marine and Energy property group in Chicago, has been appointed vice president of **Ironshore Insurance Services**, based in St. Louis, Missouri. Ignell, who has 25 years of underwriting, management and engineering experience, will manage the wholesale property operation and develop strategic underwriting and market direction for Ironshore's team of wholesale underwriters.
- **Chaucer Singapore PTE Limited**, the Asia office of Chaucer Holdings PLC, has appointed a new Property Facultative team to underwrite risks for Chaucer Syndicate 1084. Chaucer has appointed **Patrick C Y Lim** (who has over 16 years of underwriting experience, including most recently with Liberty International Underwriters as Assistant V.P. and Head of Property for Asia) as Property Class Underwriter and **Jessie Yuen Fooi Yee** (most recently a Property and Casualty Underwriter at Chubb International) as Assistant Property Underwriter. The team is considering risks with inception dates on or after October 15.
- **C.V. Starr & Co Inc.** has announced the opening of its French branch of Starr Underwriting Agents, Ltd. located in Paris and the appointment of both **Nicolas Berg** as Regional Manager Europe, Starr Casualty, and **Olivier Decombes** as Regional Manager Europe, Starr Tech.
- **ACE Global Markets** has announced key appointments as part of a restructuring of its Marine team in London. **Mike Reynolds** has been promoted to Class Underwriter for the Marine Hull and Marine

Liability Account, reporting to **Andrew Williamson**, AGM Product Line Head, with responsibility for the performance of the Marine Liability, Hull, Yacht and War classes.

- **Torus** has appointed **Michael Kuprianczyk**, previously Chief Underwriter Financial Lines in Switzerland for Allianz Global Corporate & Specialty, as Senior Underwriter, Professional Lines, based in Zurich and reporting to **Marc van der Veer**, Chief Underwriting Officer, Specialty Europe. Torus said that Kuprianczyk will further bolster the provision of senior local expertise for the insurer's growing Continental European client base for D&O as well as Professional Indemnity coverage.
- **Africa Re** has launched a new subsidiary, African Takaful Reinsurance Company, commonly known as **Africa Retakaful**. The new company is the Retakaful arm of Africa Re Group, fully owned by Africa Re and licensed in Egypt under the Investment and Free Zone Law. Africa Retakaful is to be fully compliant with Sharia'a rules and standards to provide Retakaful protection for all Takaful and Sharia'a compliant clients. The new company is expected to accept business from all regions in Africa, Middle East including GCC countries and Asia.
- Effective 9 December, **Chubb U.S.** has promoted **Mark Korsgaard**, presently worldwide third party claim manager, to the position of worldwide claim officer. Korsgaard joined Chubb in 1981 as a claim examiner and has managed Chubb claim operations in several offices, including Boston, Phoenix and Westchester and also served as worldwide casualty claim manager and worker's compensation claim manager.
- **Gina Anderson** has been promoted to Senior V.P., Excess Casualty, Diversified Industrial Practice Leader for the **Endurance Risk Solutions** unit of Endurance Specialty Holdings, Bermuda. Anderson, who joined Endurance in 2002, will be responsible for managing, developing and growing the Diversified Industrial segment.

