BOXING CLEVER...
OR SLEEPWALKING TO DISASTER?
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**Front Cover:** Inside an ice grotto showing the 'Terra Nova' ship in the distance as Thomas Griffith Taylor and Charles Wright, two members of Scott's expedition team, stand inside.
Welcome to the inaugural edition of our Natural Resources Market Review. This year for the first time we have widened the remit of our old Energy Market Review to include round-ups of the Power & Utilities and Mining & Metals sectors; this makes sense to us because not only is Willis now organised on this basis but also because so many of the factors at work in the Energy markets also apply to these sectors as well.

The second change this year is that we have included some extra Special Features within the Review that provide some thought leadership on some of the ways that the Natural Resources industries can build resilience into their companies. We do hope you will enjoy these insights into the subjects of captive management and natural catastrophe risk, while we also bring you a review of our recent Asian Energy Conference in Haikou, China and the interesting delegate opinions that resulted therefrom.

But we begin this year with an Antarctic theme, and the well-known story of the race to be the first men to reach the South Pole in 1912. While Scott’s gallant failure is now part of our folklore here in the UK, perhaps we Brits have not focussed as much as we should have done on Amundsen’s triumph. Not only did he beat Scott to the Pole, but he also came back in one piece, mainly because he planned ahead and used superior techniques and tactics to win (see our summary on the following page).

What has this famous story got to do with the Natural Resources insurance markets in 2015? Simply this: there is a comparison between the bleak trading conditions facing these insurers and the desolate landscape confronting Amundsen and Scott at the South Pole back in 1912. A combination of record capacity levels and relatively benign loss records in themselves would be enough to create a softening market environment; if we add to that the recent collapse in oil prices, low (or even negative interest rates) and reduced risk management budgets, it all leads up to the most competitive conditions we have seen for 15 years, at least in some sectors.

In the meantime the trend towards increase captive utilisation continues, while once again Oil Insurance Limited has increased its limits to absorb even more risk. So insurers have to do more than just stick to their tried and trusted underwriting strategies; there is likely to be less premium to go round in 2015 and no insurer has a “divine right” to their existing share. In the first of our Special Features this year, we have therefore analysed the characteristics of those insurers who, like Amundsen, are “boxing clever” and differentiating themselves for the competition, and those who, like Scott, may be “sleepwalking to disaster” by not doing enough to secure their existing portfolio.

In this underwriting climate, we believe that the time has come for more innovation, for new products and services to be developed to attract the interest of the buyer. At Willis, we believe that it is the London market, as the traditional innovators of natural resources industry risk transfer products, that should lead the way in this regard. Maybe the recent pledge by the UK government to work with the (re)insurance industry to attract insurance-linked securities business into the United Kingdom — a move which we in the London market would all welcome — might do something to inject some fresh thinking into the market.

We trust you will enjoy this edition of our Willis Natural Resources Market Review, and as ever we would welcome any comments or feedback you might have.
— Scott’s rations were inadequate and did not provide enough energy for the men. In particular, the rations were deficient in B and C vitamins.
— Much of Scott’s hauling was to be done by ponies, which were ill-suited to work on snow and ice without snow-shoes: their relatively small hooves compared to their weight caused them to sink into anything other than very firm snow or ice. Amundsen’s dogs were less vulnerable to the cold.
— Unlike dogs who could eat the abundant seal and penguin meat found in Antarctica, the ponies’ food had to be carried forward from the ship, vastly increasing the stores that had to be transported as Scott’s expedition moved towards the Pole.
— Had the one-ton depot been placed at latitude 80° S., as planned, Scott and his two surviving companions could have reached it on their return march. Instead the depot was placed some 31 miles short of there. Scott’s party died only 11 miles away.
— The tins of cooking fuel cached along Scott’s return route were found to be partly empty, which forced the men to eat frozen food. Shortage of fuel to melt water likely caused the men to become dehydrated. Apparently the heat of the sun had vaporised part of the fuel, enabling it to escape past the corks.
— The complexity of Scott’s transportation plan made it vulnerable. It depended in part on motor-sledges, ponies, dogs, and southerly winds to assist the sledges (which were fitted with sails). Half of the distance was intended to be covered by man-hauling (and sails whenever conditions permitted).
— Scott made no arrangements for compulsory ski training, whereas Amundsen recruited a team of experienced skiers, all Norwegians who had skied from an early age.
“Great God! This is an awful place and terrible enough for us to have laboured to it without the reward of priority.”

Robert Falcon Scott, January 17, 1912
EXECUTIVE SUMMARY

— As the global capital surplus in the (re)insurance markets continues to mount, capacity for most Natural Resources insurance markets has reached a new record high in 2015. With no sign of any significant alternative capital havens, and with global interest rates in some instances so low as to be heading into negative territory, we believe that this trend can only continue, at least in the short term. The largest capacity increases were in the Upstream (to USD6.9 billion), Downstream (to USD5.5 billion) and International Onshore Liability (to USD2.4 billion) markets.

— These latest capacity increases have widened the leadership choices open to buyers and their brokers. In particular some following markets, in a belated attempt to secure market share and premium income, are beginning to offer leading lines for major programmes, often at competitive terms. With more insurers prepared to lead, existing leaders are coming under increasing pressure to offer better deals to stay in control of their most sought after programmes.

— Meanwhile, an absence of natural catastrophes has contributed to a generally profitable year for Natural Resources insurers. Another Gulf of Mexico hurricane season has come and gone with zero damage to energy industry infrastructure, while very few other losses of any note have had any meaningful impact on our markets. As a result, the Upstream portfolio in particular has had an outstanding underwriting year in 2014, with at least reasonable results recorded in most other Natural Resources market sectors.

— At the same time, the collapse in oil prices is beginning to have a detrimental effect of premium income levels, particularly in the Upstream sector. As if increased capacity, more leadership choices and a profitable portfolio were not enough reasons to deplete available premium income, the oil price collapse is bound to have a very significant impact on Upstream premium income, with knock on effects in the Downstream and Onshore Construction markets. To make matters worse, some major buyers are cutting back on their risk management budgets; already in 2015 we have seen some major buyers dramatically reduce their policy limits and discard some of their insurers from their programmes.

— To survive these market conditions, insurers will have to differentiate themselves more distinctly to their client base. In some sectors, the current softening dynamic is the strongest we have seen for over 15 years. Natural Resources insurers will therefore be hard pressed in 2015 to match last year’s premium income levels; to make up for any shortfall, they will have to provide compelling reasons to brokers and buyers to augment their income by differentiating themselves from their competitors. These insurers that fail to do so may be looking at an uncertain future in these markets.

— In these highly advantageous trading conditions, buyers have a straightforward choice. They can either follow the market down and select the most competitive terms, or stick with their long term risk partners. Either option is likely to produce attractive terms, so a thorough consultation with their broker will be needed to determine the most appropriate way forward.
PART ONE: SPECIAL FEATURES
Which Energy insurers will win out in today’s soft market?

How can buyers benefit?

Willis Natural Resources Review Editor Robin Somerville takes an in-depth look at today’s Energy market dynamics.

“Great God! This is an awful place and terrible enough for us to have laboured to it without the reward of priority.”
Robert Falcon Scott, January 17, 1912

Those readers that are interested in Antarctic exploration will be all too familiar with Robert Scott’s diary entry on reaching the South Pole in January 1912. For those who don’t know the story, Robert Scott from Britain and Ronald Amundsen from Norway were the leaders of two rival expeditions that set out in 1911 with the intention of being the first men to reach the South Pole. The Norwegian team triumphed, and return home with all 16 members intact; Scott and his dejected team arrived at the South Pole a few weeks later, and they all perished on the return journey.

Over the years researchers have analysed the reasons for Amundsen’s triumph and Scott’s failure. Both faced the same extreme weather conditions; both had access to the same technology; both were to a large extent setting out into the unknown; both were aware of the potential risks involved. But the Norwegian team seem to have been better prepared, in a multitude of different ways, than their British counterparts. While the Norwegians could be said to have “boxed clever” to limit the risks involved in the expedition, the British team could be said to have “sleepwalked to disaster”, failing to appreciate the advantages of dogs over ponies, placing their supply depots in the wrong places, wearing the wrong clothing and, ultimately, running out of luck as bad weather closed in.

The vast majority of Energy insurers now find themselves in a similarly bleak place in this phase of the insurance market cycle.

Yes, up until now their portfolios have remained relatively robust, with premium income levels sufficiently high enough to offer a reasonable return to their capital providers. However, the overall underwriting conditions for the remainder of 2015 look distinctly unappetising from an insurer perspective. Too much capacity, increased numbers of competitive leaders and underlying macro-economic factors such as lower oil prices are combining to produce the softest market conditions in 15 years (at least in some sectors), and while some underwriting teams will make it through this soft period of the market cycle, others may well find that they will be left behind on the wayside.

So which insurers will, like Amundsen, “box clever”* and survive today’s challenging market environment, and which, like Scott will end up “sleepwalking to disaster”? In this leading Special Feature of our Natural Resources Market Review, we ask:

— What are the factors that make up today’s bleak Energy underwriting landscape?
— “Boxing clever” — how can Energy insurers differentiate themselves more effectively?
— “Sleepwalking to disaster” — which insurers might be vulnerable?
— How can buyers benefit?

To help us provide an insight into the underwriting mind set at this critical time for the market we asked the following underwriters for their own perspective on the current market situation:

— **Tom Macfarlane**  
  Senior Vice President, Energy and Engineered Risk, AIG Property Casualty
— **Nick Hodges**  
  Vice President, Oil & Petrochemical, AIG Property Casualty
— **Stephen Hawkins**  
  Senior Class Underwriter Upstream, Catlin
— **Chris Wildeee**  
  Head of Energy Property Damage, Aspen Insurance

Some of their observations are quoted directly on the following pages. We would like to thank them for their time and their willingness to give us the benefit of their expertise. However, we would point out that, apart from when quoted directly, the views expressed in this article represent Willis’ own conclusions as a result of our research and should be in no way be specifically attributed to any individual underwriter.

* “Boxing Clever” — an English expression meaning to use tactics that make your performance better that it would be without them. Not always the strongest boxer, wins; often it’s the one with the best technique and tactics.
What are the factors that make up today’s bleak Energy underwriting landscape?

Many of the factors that make up today’s bleak underwriting landscape for Energy insurers are interrelated and can be summarised as follows.

1) Cutbacks in exploration and production activity

In our analysis of why pressure is coming onto premium income streams in the Natural Resources sector, we should first of all start with the declining oil price and its consequent effect upon investment and future activity, particularly in the oil and gas sector.

The price of crude oil may have increased a little since this chart was published, but the “old normal” of USD100 per barrel characteristic of the last few years is unlikely to be reached again in the near future.

The recent collapse in the price of oil has impacted the entire upstream energy industry, especially well-developed but marginal fields such as in the North Sea. While recent alarmist prophecies of the complete demise of the North Sea oil and gas industry are perhaps somewhat premature, there can be no doubt that some projects are being mothballed or postponed, there is likely to be much less drilling activity and business interruption values are bound to come down. For example, only recently Oil and Gas UK published a report in which they stated that only 14 out of the 25 expected exploration wells were drilled in 2014 and that only between eight and 13 wells are planned in 2015 (see page 14).

The US shale industry has also been significantly impacted. The primary effect of the fall in oil prices has been a knock-on effect on the share prices of the key players in this industry. Indeed, it is thought possible by many that those shale producers who are financed by a high level of debt and cannot withstand these low prices could even go out of business.

However, the pain is being felt all over the world, far beyond the North Sea and the US shale fields. From the Barents Sea to the Black Sea, from the Canadian Oil sands to the South China Sea, from Brazil to the fledgling sub-sea developments in the Arctic Ocean, the story is the same – investments are being withdrawn, projects are being postponed, yard orders are disappearing and workers are being laid off. Meanwhile the knock-on effects on rig day hire rates and on the fortune of oil supply companies are already proving to be as equally dramatic. Perhaps only in areas where labour costs are relatively low compared to other areas of the world and where USD50 oil would still deliver meaningful returns, will the worst of the downturn in exploration and production activity be avoided.

2) Increased mergers & acquisitions within the energy industry

As if reduced exploration and production activity were not enough, the scope for increased merger & acquisition activity among energy companies which has become an ongoing trend recently will almost certainly mean a further consolidation within the energy industry. This in turn will mean less premium finding its way into the insurance markets. Moreover, another potential worry for Upstream insurers is whether some medium-capitalised companies, who are now the owners of a significant amount of upstream infrastructure in some regions, have the risk management resources and acumen to ensure that the high safety standards inherent in the working practices of the super-majors will be maintained. To date, there is little evidence of these fears being well-founded, but some apprehension in the market remains.
3) Reduced risk management budgets
More generally, there appears to be little doubt that the oil price collapse is going to have a negative effect on individual energy company risk management budgets. We have already seen several instances at Willis recently where, as a result of management directives, some of our major clients have significantly reduced their programme limits, with a corresponding dramatic reduction in premium spend.

In such situations buyers have the choice as to whether to reduce the participation of each and every insurer on their programme or to take the decision to discard a proportion of the existing market. There can be little doubt that, as 2015 progresses and we see more of the impact of these risk management budget cutbacks, we expect some buyers to opt for discards, with the result that those discarded insurers suddenly faced with the prospect of a reduced – and less attractive – portfolio.

Price Waterhouse Cooper has reported that M&A in the US oil and gas industry hit ten-year highs in terms of deal value and volume in 2014:

— The record breaking year was primarily driven by a significant level of mega deals (deals valued over USD1 billion).
— Overall, there were 49 mega deals worth USD266.1 billion in 2014, compared to 24 deals worth $71 billion in 2013.
— During the final three months of 2014, there were a total of 57 oil and gas deals (with values greater than $50 million) accounting for USD128.7 billion, compared to 56 deals worth USD43 billion in the fourth quarter of 2013, a 200 percent growth in total deal value.
— Mega deals also represented 91 percent of total deal value in the fourth quarter of 2014. In 2014, there were 252 deals worth USD321.5 billion, an increase from the 187 deals worth USD117.2 billion in 2013.

Source: PWC “Fourth-quarter 2014 US oil & gas industry mergers and acquisitions analysis”
Key facts from Oil and Gas UK Activity Survey 2015

— Production fell by 1% in 2014 to 1.42 million boepd and revenues declined to just over GBP24 billion, the lowest since 1998. There was also a negative cash flow of GBP5.3 billion, the worst position since the 1970s. In 2015, production is forecast to increase to 1.43 million boepd.

— Capital investment rose to GBP14.8 billion in 2014 due to cost over-runs and project slippage but is expected to fall in 2015 to GBP9.5 – 11.3 billion in 2015. Investment in currently sanctioned projects will fall to GBP2.5 billion by 2018. Investment in new projects over the next three years (2015-17) was last year forecast at GBP8.5 billion but this year’s survey estimates just GBP3.5 billion.

— Only 14 out of the 25 expected exploration wells were drilled in 2014 and between eight and 13 wells are planned in 2015.

Source: Oil & Gas UK

If the bleak outlook for North Sea oil and gas outlined above is reflected in other major fields around the world, significantly less premium will find its way to the insurance markets in the near future.

4) Falling – and even negative - interest rates

As a deflationary factor, the oil price collapse has also contributed to the continuing pressure on interest rates and yields from traditional safe investment opportunities such as government stocks. The macro-economic reasons for low interest rates across the globe – including ageing populations and other demographic factors - are beyond the scope of this Review, but the received economic wisdom available to the layman today suggests that interest rates are not only going to stay low for the foreseeable future but in some cases have already actually become negative – an unprecedented economic phenomenon in modern times.

Given this extraordinary development, there seems to be little on the horizon to encourage capital providers currently committed to the global (re)insurance market to look elsewhere for a Return on Equity. What possible reason can there be to transfer capital out of the (re) insurance industry – where it has at least earned a generally more positive return, up until now – to other traditionally safe and solid investment opportunities where there is now no guarantee of a return at all? So if anything, we can expect even more capital to enter the (re)insurance industry in the next few years rather than expect any meaningful withdrawals.
5) Increased (re)insurance market capacity

So it’s no surprise that the global (re)insurance markets remain awash with capacity, with the total amount of capital in play increasing from about USD350 billion in 2008 to about USD575 billion today. In our January 2015 Energy Market Newsletter we referred to Willis Re’s new year market report which almost universally described a softening in both general and specific lines of reinsurance treaties in virtually every region, whether Quota Share or Excess of Loss. Willis Re estimates that the current trajectory of growth in “third party capital” suggests it could account for up to 30% of the global property catastrophe reinsurance market within a few years, representing approximately USD100 billion of capacity. This includes capital from non-traditional sources, such as pension funds, hedge funds and investment banks. Apparently, this could rise to as much as USD150 billion by 2020.

These heavily over-capitalised global reinsurance markets, combined with a glut of new capacity from non-traditional providers, have naturally increased competitive pressures in the direct Energy insurance markets like never before, with Upstream and Downstream market capacity levels now at approximately USD7 billion and USD5.5 billion respectively.

Following the recent high profile merger announcements involving Catlin and XL, Brit and Fairfax Holdings and Axis and Partner Re, some might suggest that this might serve to reduce available capacity. However, it is our understanding that while such mergers reduce operating costs and enable capital to be deployed more efficiently, it is likely that the same total amount of capacity will still be offered as was available on a combined basis before the completion of these mergers.
Recent mergers and acquisitions affecting the Natural Resources insurance markets

The mergers and acquisitions trend in the insurance industry will continue to increase if today’s soft market conditions continue to prevail.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>COMPANY</th>
<th>ACQUIRER OR MERGER PARTNER</th>
</tr>
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<tbody>
<tr>
<td>2012</td>
<td>Hardy Underwriting</td>
<td>CNA</td>
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<tr>
<td>2012</td>
<td>Flagstone Re</td>
<td>Validus</td>
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<tr>
<td>2012</td>
<td>Omega</td>
<td>Canopius</td>
</tr>
<tr>
<td>2013</td>
<td>Alterra</td>
<td>Markel</td>
</tr>
<tr>
<td>2014</td>
<td>Canopius</td>
<td>Sompo. Japan</td>
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<tr>
<td>2015</td>
<td>Catlin</td>
<td>XL</td>
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<tr>
<td>2015</td>
<td>Brit</td>
<td>Fairfax Financial Holdings</td>
</tr>
<tr>
<td>2015</td>
<td>Axis</td>
<td>Partner Re</td>
</tr>
</tbody>
</table>

Source: Willis

6) Market regionalisation and increased global competition

With capacity continuing to increase in every line of business, the softening dynamic in the Energy markets has also been exacerbated by the growth in regional underwriting. In particular, the Downstream market has become increasingly decentralised, allowing local markets without the global footprint of the major composite insurers to compete with them for the choicest regional business.

At the same time, as we reported in last year’s Energy Market Review even at a global/London market level there are generally more insurers now ready to lead business than in the past. And for those buyers for whom price is the dominant buying determinant, some eager new entrants to these markets represent an attractive choice.

7) The absence of catastrophes

Later in this Review we provide the latest updates for each of our market sectors. In brief, individual loss records for these sectors remain generally favourable, particularly for Upstream Energy business. Unlike previous years such as 2008, 2010 and 2011, overall loss records have not been sufficient to threaten the portfolio of either of the Energy sectors. So with no natural catastrophe losses of any substance to report in 2014, either in terms of earthquake, flood or windstorm, the Energy portfolios continue on balance to make healthy margins. Whereas in previous years insurers could always point to a major loss to justify a specific underwriting stance, 2014 has provided them with no such excuse to do so.

8) Increased OIL limits and use of captive insurance companies

Finally, we must also take into account the continued, and in some instances accentuated, trend of increased captive utilisation by major energy companies, together with the effect of the new OIL limits (OIL has elected to increase its per occurrence limit from USD300 million to USD400 million and the event aggregation limit from USD900 million to USD1.2 billion effective January 1st, 2015) which will provide additional pressure on premium income levels coming into the commercial insurance market (for example, we are aware of one particular project which could be regarded as a capacity risk which is 75% underwritten by captives).

The trend towards greater use of captives in recent years and the reasons behind it is examined in more detail in a separate Special Feature of this Review. But for the commercial insurance market this trend has become a very worrying one, particularly for following insurers. Far too often, from their point of view, they have seen attractive business, particularly on the Offshore Construction side, swallowed up by expanded captive participations – and this at a time when lower oil prices are casting their own shadow over future project activity.
Conclusion: a reduced premium pool for 2015 a virtual certainty!

All of these factors mean that premium income, particularly for Upstream insurers, is likely to be seriously threatened as 2015 progresses. And for those insurers who are hoping that such a dramatic fall in oil prices is bound to be followed by a significant rebound, all the perceived wisdom points to the possibility of a further fall in oil prices later in the year as the over-supply continues to be maintained. Indeed, the current supply-demand imbalance — inherent as a result of the insistence of some countries in maintaining full production at a time when the growing global economies, particularly that of China, are starting to slow down — seems to suggest that a significant long term upturn in prices is unlikely in the short term.

So there can be little doubt that these eight factors are going to have a major impact on our markets in the coming months. Although premium levels have essentially held firm for the last three or four years as a gradual softening process has quietly gathered pace, insurers can now expect levels to decline significantly.

*The unprecedented number of factors in operation at the same time in 2015 is bound to have a detrimental effect on the available premium to Natural Resources insurers.*
“Boxing clever” – how can insurers differentiate themselves more effectively?

So how can Natural Resources insurers differentiate themselves to buyers as these headwinds begin to bite?

— Somehow they must find a way to trade through this market and maintain their market share.
— Somehow they have to convince the client base to continue to include them on their programmes.
— Somehow they have to find ways to set themselves apart from their peer group and continue to have “skin in the game”.

Those readers who have studied the Energy insurance markets for the last 20 years or more will know that we have been here before at this bottom end of the underwriting cycle. In the mid-1990s, the market entered unprecedented soft conditions, as the prevalence of competitive facultative reinsurance allowed insurers to write business on virtually any terms, so long as there was sufficient premium income to be had.

We are not yet at this stage in 2015 but perhaps we are not far away.

“Risk selection is one of the key differentiators that allows us to thrive and survive over time. We are looking for a good risk culture across the organisation; E&P companies are dealing with physical risk all the time, and their awareness of how they manage this at board level is going to indicate the overall risk quality.”

**Stephen Hawkins, Catlin**

“It begins with the AIG vision, to be our clients most valued insurer. The question is: how do we actually get there? By listening to what the clients want, and with the broker as a partner, responding to that.”

**Tom Macfarlane, AIG**

At the turn of the century, not only did the inevitable underwriting losses cause this primary reinsurance capacity to burn out and fade away, but the market was hugely impacted by the fallout of a once every generation event, the tragedy of September 11, 2001. At the moment, there is no sign of significant underwriting losses, capacity has nowhere else to go, there do not appear to be any other intervening factors so the softening process continues.

In 2001 it was those experienced insurers that still had the underwriting expertise and drive that continued to offer a service and much-needed capacity to the industry. As some portfolios inevitably slide into unprofitability in the years ahead as prices continue to fall, it is likely that it will be the most experienced sector of the market that will survive this process to benefit from the upswing in the cycle when it (eventually) arrives.

So how did they manage to survive the softening process that began some 20 years ago, and what will enable them to do so again? From our conversations with our leading underwriter panel, we would suggest a number of characteristics of those insurers who are “boxing clever” during this particular phase of the market cycle.

**Intelligent risk selection and client understanding**

Let us begin with one of the most obvious starting points for insurer differentiation – the ability to select risks that they wish to invest in for the long term and, having done so, taking a genuine interest in the client in question. Twenty years ago leading underwriters generally paid much less attention to individual clients and their risks, preferring instead to rely on their portfolio knowledge and experience to enable them to underwrite effectively. However, in recent years when leading insurers have actively selected the risks they wish to underwrite for the long term, the resulting relationship between leader and client has generally paid handsome dividends for client and insurer alike.

In practice, this approach can be demonstrated by a leading underwriter in a number of ways, including:

— Making a proactive effort to understand the client’s business culture, and in particular the way in which risk is viewed at boardroom level rather than simply visiting the occasional plant or offshore platform
— Finding out what coverages the client truly requires and asking for the appropriate underwriting information so that the leader can respond (as far as possible)
— Reviewing and understanding the underwriting information provided by the client and going the extra mile to provide the coverage required
— Regular visits by the leader to the client’s key asset sites and the deployment of the leader’s engineers, working in tandem with the broker’s engineers and the client’s project/site management team
— Receiving reciprocal visits by the client to the leader’s offices in London and elsewhere
— The possible development of the leader’s understanding of the client’s risk on a cross-class basis as well as regards his own particular line of cover
It is probably fair to say that the majority of leaders of the most favoured Energy insurance programmes now fulfil a number of these key requirements. Indeed, some leaders now appoint a specific account managers for key clients across a variety of lines of business, to ensure that maximum advantage is being gained from the strong relationship being developed between the client and the insurer — regardless of the original insurer “owner” of the relationship in question. The twofold advantages of taking this more proactive stance than had been the case in the past are fairly obvious:

— The client obtains the benefit of more competitive terms and conditions on a long term basis, while at the same time being provided with effective business continuity protection
— The insurer becomes a key strategic risk partner for the client, ensuring greater loyalty and a more consistent revenue stream

Of course, this model is not the only way to cement long term relationships and it may be that these partnerships are best served by the flourishing of the original Risk Manager/Underwriter relationship. In either event, there is every chance that the strength of relationship that has been forged by this deep interaction between buyer, broker and underwriter is likely to act as a significant bulwark against extremes of softening pressure. In very general terms a significant number of our clients have indicated that they still need insurers who understand their risk in a way that other markets do not. And while there is always a temptation to turn to other attractively priced alternatives, to date it seems clear that those leaders that have formed strategic risk partnerships with major buyers look likely to have significantly differentiated themselves already from the remainder of the insurance market. Of course, even these leaders still need to respond to the current market dynamics, but over time the maintenance of these relationships tends to smooth the overall market cycle.

“We do have Account Executives to look after clients at all levels of interaction. We carry that mentality into the different lines of business that we do, so our property underwriters have very close links with our liability department and we cross-fertilise with them. We wish to carry that mind set into all our interaction with clients and brokers and look for all opportunities for AIG to increase its footprint in the insurance buying habits of all our clients.”

Nick Hodges, AIG

Quick and flexible quoting

Apart from the long-term interest shown in the client’s risk, another key differentiator for leaders is the ability to provide a reliable, responsive and of course competitive quoting service that allows both brokers and their clients to determine the price of a given risk transfer product quickly and effectively and compare it against the existing price charged for the client’s programme.

Of course, the ability to quote professionally involves a great deal more expertise than simply asking the broker for the terms of the expiring programme and then indicating a percentage reduction off those terms to secure the forthcoming renewal; it involves a proper understanding of the risk arena in question and sufficient market and product experience to indicate a sustainable price without reference to terms provided by other competitors.

For all its faults, the old-fashioned London market of 20 years ago did at least operate on the basis of a culture of immediate quotation turnarounds. It may have taken a broker most of the working day sometimes to work through the queue for a respected leader to be able to put a piece of business in front of him; however having done so, if he had the right information with him an immediate quote was virtually guaranteed, then and there. For good reasons, the more sophisticated analytical techniques which now drive the modern underwriting process inevitably mean that this process now takes a little longer, and indeed any underwriter who today can blithely put pen to paper on an important piece of business without the need for proper analysis and reflection is unlikely to be doing his or her job properly.

“Our ability to quote, our ability to provide outstanding service, to talk about claims, to make our wordings more transparent, provide insightful advice and sit in front of a client and speak to them knowledgeably adds value to the broker and promotes the Aspen name.”

Chris Wildee, Aspen
“What differentiates Aspen from many other insurers is that we provide attractive quotes to clients that will be carried ultimately by the market. Our focus is on creating a market that is totally sustainable for our clients across the cycle. You have to quote the price that ensures the broker wins the business but also gives you an acceptable return on capital employed.”

Chris Wildee, Aspen

“The provision of competitive but realistic quotations in challenging timeframes is a key service demanded of us by our clients. To be able to respond to these deadlines with market leading capacity is one of the most important differentiators in AIG’s strategy in this market segment.”

Nick Hodges, AIG

That being said, the lengthening of this process over the years has sometimes been a frustrating development from the point of view of both the broker and the client. Indeed, in certain quarters the quotation process has sometimes become so protracted that some brokers have elected to reduce the number of visits to those insurers who either cannot or will not respond within a reasonable time frame. Often as not, these situations are by no means the fault of the individual underwriter in question; in most cases, they occur as a result of increasingly sophisticated underwriting processes imposed by managers who have perhaps not appreciated the value of speed of response and efficient service delivery. Meanwhile other parts of the market continue to offer little by way of the ability to quote, preferring instead to reserve their capacity for business offered to them once a lead line has already been produced from somewhere else.

So those insurers that can offer a reliable 24-hour turnaround when urgent quotations are required are naturally looked on with greater favour by the broking community than those that take a more conservative approach and who place more emphasis on caution and accuracy than on speed of delivery. And in soft market conditions such as these, it’s not surprising that business will continue to migrate to insurers whom brokers wish to reward for making their lives easier. Of course, it is important to bear in mind that an efficient quotation service is not only appreciated by brokers, but also by clients. A swift quotation enables them to make informed decisions as to the future direction of their programmes and allows them to benchmark them properly, demonstrating to their senior management the effectiveness of their proposed programme.
**Proactive claims culture**

Every risk manager who has ever suffered the misfortune of a major loss – particularly one which, in the absence of insurance, might have threatened the very survival of his company – appreciates that, when push comes to shove, the ability of their leaders to respond effectively to claims when they are presented to the market is absolutely critical.

Over the years, there have been too many instances where the experience of the claims process in the Energy insurance markets has been an unsatisfactory one from the buyer’s point of view. More often than not, difficulties which have arisen in the claims process have stemmed from a misunderstanding as to the intention of the coverage provided, either from the buyer, the broker, the loss adjuster or the underwriter – or in some cases, a combination of all four. And the increased tendency in recent years of both sides in a claims dispute to bring their lawyers into the process generally does little to facilitate the prompt resolution of the situation.

The importance in a subscription market of having a leader who can drive the claims process on the market’s behalf and not seek all insurers’ agreement to everything cannot be overstated. In our experience, there is a significant correlation between those leaders who can demonstrate that they truly understand the product that the client is buying and the successful – and speedy – resolution of large and/or complex claims. Too often, when a client has made the decision to purchase a commercially attractive insurance programme from leaders who, while perhaps offering stable underwriting security as well as competitive terms, problems have occurred in the event of a major loss occurring. Not only in these instances have we found that the insurer concerned has been reluctant to admit or understand that they are liable to pay the claim, but also have no interest in any early settlement once they have accepted their position under contract. As a result, buyers have often decided that the product that they have paid for has not actually provided them with the protection – and speedy indemnity – that they thought was being provided.

Of course, there have been plenty of examples in the past where it has been the buyers’ lack of understanding of the product that has been the root cause of any problems in the claims process. But in our experience it is those insurers that have proved by the way they have responded in the event of a difficult loss that they have understood the product and appreciated the need for the product to respond properly that have been remembered by the buyer. All too often, even in these softening market conditions, we receive specific requests from clients to ensure that a particular leader remains on their programme – even if he is no longer the actual leader – as a gesture of appreciation for his part in a past claims resolution.

So while it is true that buyers will be under pressure in 2015 to opt for the most commercially advantageous terms on offer, those leaders who have already differentiated themselves by gaining a reputation for paying valid claims promptly and with the minimum of negotiation are still likely to retain their overall position on the portfolio in question and other classes.

“One of the reasons that would make clients stick with us is the way we treat our clients. By that I mean when you issue an insurance policy you are making a promise. It’s not just about the ability to pay, it’s about the willingness to pay as well.”

Stephen Hawkins, Catlin

“The best thing that a leader can ever do is to explain a policy wording to a client in the event of a claim. If you can do this, and demonstrate your intention to the client by reviewing the policy wording with him, you will get a long-term buy-in from the client in question.”

Chris Wildee, Aspen

“We are fully aware of the dangers that some of our clients face in terms of the threat to their very survival in the immediate aftermath of a significant loss. That’s why in the Property arena we do now have a claims promise, which says that if you have a substantial loss we will pay 50% of the property quantum of that loss within 7 days of our agreeing the quantum.”

Tom Macfarlane, AIG
As the market continues to soften, there seems to be little doubt that brokers will bring increasing amounts of pressure to bear on the larger insurers in the market to offer a more co-ordinated response to clients across various lines of cover. One of the consistent complaints from buyers over the years is that the process of insurance purchase should be much more simple and easy to administrate. In a hard market, the buyer has little choice but to instruct their broker to put together whatever capacity can be accessed, no matter how complicated the structure has to be to accommodate differing underwriting philosophies; however, in softening market conditions it is those insurers who can respond in a proactive manner and offer products that smooth this process who tend to differentiate themselves more effectively with the client base.

Some of the major Energy insurers are of course well aware of this and it is true that many of them do everything they can to co-ordinate underwriting activity between their Property, Construction, Terrorism, Cyber, Liability and Directors and Officers departments. Indeed, we understand that several major composite insurers are now empowering their underwriting teams to differentiate with clients on a Group relationship basis as well as on the individual risk in question.

“If clients want to access capacity through a single underwriting channel, we will always work with them and their broker on a tripartite basis.”

Tom Macfarlane, AIG

“My interpretation of the market is that clients want an insurer who can provide real value across the piece. Insurers need to be more relevant, particularly when new entrants are pushing hard to win business. To me, it’s about building strong, long-term relationships.”

Chris Wildee, Aspen

“We can’t say to clients, you must buy this cover in this way from us, you must buy Casualty, you must buy Marine – there is a question of finding out what the client wants and then see how we can add value across all lines.”

Nick Hodges, AIG

Offering a “one stop shop”

As the market continues to soften, there seems to be little doubt that brokers will bring increasing amounts of pressure to bear on the larger insurers in the market to offer a more co-ordinated response to clients across various lines of cover. One of the consistent complaints from buyers over the years is that the process of insurance purchase should be much more simple and easy to administrate. In a hard market, the buyer has little choice but to instruct their broker to put together whatever capacity can be accessed, no matter how complicated the structure has to be to accommodate differing underwriting philosophies; however, in softening market conditions it is those insurers who can respond in a proactive manner and offer products that smooth this process who tend to differentiate themselves more effectively with the client base.

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We would suggest that this ability to bring together multiple underwriting relationships emanating from a variety of different disciplines under the umbrella of an overall trading relationship with individual clients will be a vital differentiator as market conditions continue to soften. If an insurer is selected by a client to be their leader — or at least participate as a following insurer — over a number of different underwriting lines, it is highly probable that the client in question is likely to be provided with more competitive terms in exchange for the increased spread of risk and premium income offered to the insurer. Indeed, forming a long term strategic partnership over a number of lines will serve to act as a further easing of the dangers of losing the business to a more aggressive competitor purely on the basis of the price of a particular line of cover.

**Product innovation and flexibility**

One of the main features of the current softening market environment has been that, while the price of the products on offer to clients have generally been decreasing, the terms, conditions, limits and retentions on offer have been almost static over the last few years. This dynamic is in marked contrast to the soft stages of previous market cycles, where the proliferation of competitively priced primary reinsurance protection enabled insurers to “write for premium” regardless of the terms and conditions offered.

Be that as it may, we now believe that if leading insurers want to do everything they can to maximise their share of a reduced premium pool they must start to consider both more streamlined and wider coverage to the client base.

The challenging market environments in which Energy underwriters have to operate in recent years has been set out in previous Reviews and are alluded to once again later in this publication. While prices may indeed have reduced in recent years, we are still finding that the following issues have yet to be properly addressed by the market:

— **Repackaging of Onshore Terrorism cover into Property programmes.** Onshore Terrorism is still excluded from most Onshore Property policies, despite the fact that it used to be included as a matter of course by these markets only a few years ago, often for competitive terms. While most readers will be aware of how significant this risk is now in so many parts of the world, to date there has been little enthusiasm to roll this cover back into Property programmes, despite the clear commercial advantages to the client is doing so. Given that so many of today’s Property leaders have Terrorism underwriting expertise to hand within their organisation, it would perhaps only take a degree of communication and teamwork to enable this to happen.

— **Deletion of cyber exclusions.** While the fledgling Cyber market has grown significantly since the publication of last year’s Energy Market Review, we still see very little sign of the Energy markets being willing to delete the cyber exclusion (CL386) in their policy wordings—despite a gradual softening of Reinsurance market resistance to this exposure, as noted in Willis Re’s January 2015 Review. As we highlighted last year, the provision of cyber coverage does involve the consideration of the possibility of an attack involving multiple locations, thereby creating a potential aggregate problem. However, the growth of the fledgling stand-alone cyber market that offers following physical loss or damage without any imposition of aggregate limits (see last year’s Review) has continued apace, suggesting that more can be done by both Upstream and Downstream markets – even if they have to consult with their own cyber specialist underwriters in order to do so.

— **Increased sub-limits for CBI/Supply Chain risk within the Downstream market.** Sub-limits for Contingent Business Interruption/Supply Chain risk (see 2013’s Energy Market Review) are still, for the most part, too low to offer real “sleep easy” protection for most Risk Managers. While of course granting this cover can only be done on the receipt of sufficiently detailed underwriting information, it might be imagined that those clients to whom the market has been providing this cover for many years – presumably on the strength of the underwriting information sought and provided – would be entitled to be offered higher limits. While there have been isolated incidents of higher sub-limits being granted recently, in the main buyers still have to shop around different markets including the fledgling stand-alone Supply Chain Interruption.

— **A seamless product for onshore projects covering handover from Construction to Operating phases.** For onshore projects in particular, there still seems to be no inclination in either the Construction or the Operating markets to come together to provide a seamless product that not only covers the Construction risk of an individual project but also at least the first 12 months

“In lots of ways the market has been poor at innovation, but often clients don’t understand either what they want to buy. The nature of the market doesn’t help — it’s a volatile subscription market, which is a barrier to brokers developing products, because the attractiveness to an insurer is that the product is available to all clients. So insurers are in a better position to develop products in the context of the structure of the market than brokers, who tend to promote exclusivity.”

**Stephen Hawkins, Catlin**
of its operational life. Over the years we have seen disputes arise on a number of occasions when loss or damage has occurred at or around the time of the handover of the project, with both Construction and Operating markets denying liability — much to the consternation of the client. (The same dynamic does not really apply in the Upstream sector, as most joint venturers are keen to declare new projects to their operating programmes as soon as possible — in any event, it is often the same underwriters to who write both the construction and operating parts of a client’s Upstream portfolio). If insurers are truly keen to differentiate themselves from the competition, and their Construction and Property underwriters are committed to retaining their most favoured clients’ business, it seems to be logical for them to work together to produce a seamless product that might avoid such coverage ambiguities in the future.

— **Increased flexibility of aggregate limits and retentions for natural catastrophe risk.**

For several years insurers have successfully imposed aggregate retentions in the areas most susceptible to natural catastrophe risk, including areas such as California earthquake but most severely for Gulf of Mexico windstorm. Some leaders are now appreciating that, armed with additional capacity from their capital providers, there are good business reasons to relax some of the more restrictive underwriting approaches to this risk as we move into this new phase of the underwriting cycle. In 2009 our Energy Market Review highlighted the issue of Gulf of Mexico windstorm risk, and reported on the restrictions that were being imposed by the market in the wake of hurricane Ike; since then it is perhaps somewhat ironic that as general market capacity has increased, while the Downstream market has had to absorb the impact of major earthquakes in Japan and elsewhere in the intervening period there have been no energy-related loses on the Gulf of Mexico at all. As always, buyer appetite for natural catastrophe risk transfer products remains as robust as ever (especially for Earthquake) and we are confident that if more capacity is made available in this area, insurers will benefit from a significant increase in their revenue streams.

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“The insurance industry needs to provide a wider range of risk transfer products to meet the challenges it now faces.”

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**The view from Haikou (1): the vast majority of delegates at our recent Asian Energy Conference, including insurers, agreed that a wider range of risk transfer products is required from the market offset the softening dynamic in both Energy Insurance markets.**

**Energy Companies**

- Strongly Agree: 35%
- Agree: 40%
- Somewhat Agree: 15%
- Somewhat Disagree: 10%

**Insurers, Loss Adjusters and other Speakers**

- Strongly Agree: 17%
- Agree: 50%
- Somewhat Agree: 17%
- Somewhat Disagree: 8%

**Willis Asia**

- Strongly Agree: 29%
- Agree: 42%
- Somewhat Agree: 29%

**Willis London and ex-Asia**

- Strongly Agree: 14%
- Agree: 57%
- Somewhat Agree: 29%

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Source: Willis

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“There is a challenge to understand how real the cyber threat is in what is a rapidly evolving and specialist area, against understanding the limit for potential total exposure to an event or a series of events over a period of time.”

**Stephen Hawkins, Catlin**

“We do anticipate rolling out capacity for catastrophe constrained areas as we see for that for certain clients this is still an issue, because they still have windstorm, flood and earthquake constraints and we will be looking to respond to that.”

**Tom Macfarlane, AIG**
Selective use of broker facilities

The establishment of broker facilities – whereby the broker sets up a facility arrangement by which various insurers are automatically bound to accept a following line on market-led business won by the broker, regardless of the terms and conditions of individual declarations – is an inevitable feature of a softening insurance market. The advantages for the broker and the client are obvious — immediate and automatic access to additional market capacity without the need for further market negotiation. Of course, these facilities would not exist without a significant demand from insurers to participate in them, and it seems clear at this stage in the market cycle that a number of insurers have deemed it prudent to sign up to various broker facilities in order to maintain premium income.

As yet, broker’s facility capacity still represents a small proportion of the capacity that can be accessed in today’s market. However, it seems clear that the longer these soft market conditions prevail, the more likely the demand to participate on these facilities will increase. From our own experience, it is not only the following market that has expressed an interest in participating; interest has also been forthcoming from more established insurers, often with significantly higher capacity than average.

While of course there are some leading insurers who are respected enough to feel that they can continue to maintain their book without resorting to facility subscriptions, it is certainly possible that those that do may reap certain benefits in the future, not only in terms of maintaining the income derived from the facility itself but also of maintaining their own relationships with their broker partners and long term clients.
“Sleepwalking to disaster” – which insurers might be vulnerable in these market conditions?

We have highlighted the various ways in which the more astute member of today’s Energy markets are differentiating themselves and adopting underwriting strategies to combat today’s softening market conditions. What, then, are the characteristics of those insurers that are in real danger of seeing their portfolios come under increasing attack in the months ahead? We believe that it is the following market that in general terms offers less value than the market leaders and who are therefore most at risk. We have set out below the characteristics of those followers who might be most at risk in this softening environment.

Followers: culture of entitlement to existing portfolio

There are some members of the following market who have not yet perhaps woken up to the imminent threat to their premium income stream. We do detect in certain followers, particularly in London, an assumption that if the insurer in question has participated on a given programme regularly for a number of years then the offer of the subsequent renewal will be automatic. In today’s market conditions, this simple assumption could prove in the future to be an unrealistic one. With the buyer in such a strong negotiating position, and with the broker often being instructed to renew on the basis of reduced programme limits and increased captive insurer participation, members of the following market are going to have to do more to differentiate themselves and ensure they are still wanted on major programmes. Simply sitting back and waiting for the business to materialise won’t be an option as we move further into 2015.

Followers: poor service and obstructive tactics

From our analysis of those insurers who will be “boxing clever” in 2015, we can now state the other side of the equation and suggest that those insurers who have developed a reputation for poor service will also be vulnerable as the year progresses. In this instance it is not so much a case of the buyer having a particularly negative view of these insurers and it may be that some of them offer robust capacity and underwriting security. However, given the choice very few brokers are going to go the extra mile to seek out the participation of insurers who do not make themselves sufficiently available to quote or accept following lines. Moreover, some members of the following market, who cannot differentiate themselves in the same way that leaders do, sometimes try to influence the placement of some programmes by a protracted negotiation process to try and improve terms from the bottom end of the placement – a worthwhile objective in hard market perhaps, but perhaps not the most commercial approach in these current market conditions.

Followers: insufficient capacity

In these market conditions those that can offer limited underwriting capacity without any other differentiating factor are very likely to miss out on those programmes that they are relying on to help them achieve their premium income targets. Again, it is not that buyers and their brokers necessarily have anything in particular against the insurer in question; it is more the case that the rationale for including them on a well-favoured programmes where underwriting signings are already at critical levels simply becomes less and less sustainable. In any event, we believe that the relatively new market dynamic of increased mergers and acquisitions activity will account for some of these smaller insurers in the near future. And as time goes by, it will become increasingly necessary for those insurers offering only moderate capacity to find specific ways of ensuring that they continue to be invited to participate on programmes by brokers and their clients.

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Leaders: setting terms without the necessary expertise

Members of the following market are not the only insurers under threat from the softening market. We have already reported earlier in this Feature — and indeed also in our 2014 Energy Market Review — that in virtually all lines the number of insurers willing to lead business has increased significantly in recent years. This is excellent news from a buyer perspective, but there are signs that some of those purporting to lead business do not necessarily have the experience of the more established market leaders, and this can sometimes be reflected in the willingness of the following market to subscribe to placements led off by these insurers.

Leaders: price-driven underwriting for market share

Earlier in this Feature we referred to the ability of the most respected market leaders to be able to quote effectively and consistently throughout all the stages of the underwriting cycle, without reference to the existing price of a given programme. The converse of this of course is to adopt a simple strategy of undercutting the existing market price by a margin sufficient to win the business, regardless of any technical underwriting reasons for so doing, or whether he or she can justify this level of rating in the long term.

Leaders: poor claims delivery

We have addressed the critical issue of what makes a good leading underwriter from a claims perspective earlier in this Special Feature.

It therefore follows that should a leader begin to develop a reputation for poor claims service and an inability to make a decision on settlement within a reasonable time period, they too may be effectively disqualifying themselves from a significant proportion of the most sought after programmes.
This negative feature of some leaders can take time to become apparent and, given the recent benign claims record, may not be obvious to some buyers at the moment. However, the old English expression “Once bitten, twice shy” is particularly appropriate in this instance; very few buyers who have had to undergo a protracted claims process will be interested in maintaining a business relationship with those leaders who will not or cannot come to swift conclusions of the claims process.

How can buyers benefit?

So as the market slides into softening market conditions last seen in the mid to late 1990s, how can buyers maximise their negotiating position and reap the best rewards? There are perhaps two different approaches that can be taken:

— Given the reduction in risk management budgets, the price of the product is given overwhelming priority.
— Given the cyclical nature of the Energy insurance markets, buyers continue to stick with their preferred risk partners, even though more competitive prices might be available elsewhere, conscious of the need to be provided with sophisticated underwriting leadership, claims acumen and industry specialists who truly understand their risk and are in this business for the long term.

Our experience to date suggest that if the terms offered by existing leaders are within the parameters of their reduced risk management budgets, most buyers will elect to go with the second option. However, there is often no straightforward answer to this question, and a great deal will depend on individual buyer circumstances. We are very aware of the pressures that the risk management community are under in these difficult times for the Energy industry, and if price has to be the key driver, brokers will seek out and unearth the most competitive indication available just like they always have done. It may well be that a new, long lasting relationship with more competitive leaders are formed, with the Risk Manager being able to demonstrate to his Board that he or she has played their full part in reducing risk transfer costs in line with budget requirements.

However, such a satisfactory outcome for the buyer may not be guaranteed as a result of adopting this strategy. One of the differentiating features of insurance compared to other products is that its true value to the buyer can only be realised after the product has been purchased and a significant loss has materialised – only then is the product called into operation and only then can it be tested. And if in this instance the more competitively priced product fails to perform effectively, the Risk Manager will be placed in an even more perilous position with his Board than if he had purchased the more expensive — but more reliable — product.

In almost every instance, we would suggest that an in-depth consultation with their broker can help buyers determine the correct strategy. One thing is however, for certain: the choices that buyers now have the luxury of making will have a significant effect on the long term outlook for their insurance programme, for better or for worse.

The view from Haikou (2): 75% of the energy industry delegates generally supported the idea of loyalty to their preferred risk partners during this softening phase of the insurance market cycle.

“It will be better for them in the long term if Asian energy companies remain loyal to their preferred risk partners during this softening phase of the insurance market cycle.”

Source: Willis
Conclusion: surviving the return journey

In 1912, two sets of explorers faced the long walk back to safety from the desolate position of the South Pole. The team that made it had sufficient experience to survive the challenges thrown at it; the other simply did not.

As Energy insurers decide on the best way to “box clever” and survive this stage of the underwriting cycle, it seems clear to us that there remains a real danger that the commercial market and its brokers may become less and less relevant to major clients in the years ahead. In particular, the development of increasing captive participation in major programmes suggests that the most favoured parts of the portfolio are becoming increasingly out of reach of the majority of the market. If this is the case, the need for the market to go “back to the drawing board” and examine how to maintain its value is going to be paramount.

One way for insurers to differentiate themselves is to create some new or more user-friendly insurance products, and we have alluded to this earlier in this Feature. However, reduced risk management budgets mean that the market is going to find it difficult to sell new products that are going to cost a bit more, and it may be that certain lines of cover are going to need to be provided at no additional cost if the insurer concerned is going to stand out from a crowded field. However, good service, speed of response and a willingness to listen cost nothing.

For the last three hundred years, the London market in particular has forged its reputation as a place of ingenuity and imagination, of entrepreneurial drive and flexibility. It was from London that Cuthbert Heath sent his famous telegram to San Francisco in 1906, instructing his agents to pay all earthquake claims in full. It was in London that a broker visited a particular marine underwriter in 1912, reminding him that he had verbally agreed to write a line on the Hull policy of the Titanic, whereupon he immediately paid up in full. It was in London Upstream market that the first Drilling Rig Memorandum was developed, in London Upstream market where Control of Well cover originated and it was to London Upstream market where the industry turned in crisis moments such as 1988 after Piper Alpha and 2001 after the tragedy of September 11.

It is of course very much in most buyers’ interests that the market as a whole survives this phase of the underwriting cycle; nothing could be more catastrophic than a full scale market exodus, with very limited underwriting choices left open to the industry.

With this in mind, the London Energy markets should therefore lead the way in developing new solutions to make the insurance markets more relevant to the buyer. For too long, brokers and insurers have simply been offering the same products and services, sometimes at a higher price, sometimes at a lower one. If, like Amundsen, we want to “box clever”, as a market we have to be more innovative and more responsive to buyer requirements. Otherwise, like Scott we will find ourselves “sleepwalking to disaster” as the more sophisticated buyers find that they can manage the majority of their risk more efficiently without our help.
“What we are seeing is sustained growth and increasing interest by corporates in adopting and enhancing a captive strategy.”
What can the natural resources industries learn from the latest developments in managing captive insurance companies? Willis’ Malcolm Cutts-Watson investigates.

Introduction - why use a captive more in a soft market?

The captive market is currently displaying counter intuitive behaviour. Many of the traditional indicators would lead one to expect a market in the doldrums, but what we are seeing is sustained growth and increasing interest by corporates in adopting and enhancing a captive strategy. So why is this?

Traditionally a soft insurance market inhibits the use of captives as the financial advantage of retaining risk versus transferring it to insurers is squeezed by competitive market pricing. Capacity remains generally available, while low interest rates mean that premium funds held by the captive earn only a modest return. There is continued scrutiny of offshore structures (where many captives are located) which may be perceived with suspicion as tax avoidance vehicles. And finally, the global move to risk based regulation for the insurance industry (following that adopted by financial institutions) is raising solvency capital requirements and making the running of a captive more burdensome. So there must be compelling reasons for companies to go down the captive route.

Risk means different things to different people

There will always be a difference between an energy company’s perceptions of its own risk compared to that held by the market. This can translate into different pricing models and perceived value in retaining the risk (and associated premium). Large global energy players often possess stronger balance sheets than the markets and their captives hold investment grade credit ratings, thereby mitigating any counter party default risk. There can also be uncertainty as to how markets would respond to notification of a major loss. Major energy companies prefer their joint venture partners to access available market capacity whilst using their own captive to retain their proposition of any shared risk. All of this encourages energy companies to pursue a captive strategy.

Captives act to smooth operating company balance sheets

Operationally a captive adds real value as the repository of a group’s retained risk (and associated funding) thereby avoiding operating companies having to carry this on their balance sheets and facilitating the optimum risk financing strategy through cost efficient transfer of risk in excess of a group’s risk appetite. It also facilitates the collection of underwriting and loss data which allows informed decision making and improved governance of risk.

These strategic, operational and, on many occasions, financial drivers remain valid even during a soft market and are responsible for captives’ popularity.

New financial centres encourage captive growth

As at year end 2013 there were 6,342 captives recorded worldwide, an increase of 4% on the previous year. Whilst 2014 numbers are not yet available, our best estimate is these will top 6,700, representing a 6% increase. The vast majority of this growth has occurred in US States whilst the more traditional captive centers such as Bermuda, Cayman Islands and Guernsey have shown nil net growth despite a number of new formations as mature captives have been would up or merged. What the statistics do not give a feel for is the volume of premium underwritten by captives and how much of it is retained.

What we do know is that publicly available data reveals 60% of the captive market wrote USD85 billion in premium in 2013. If we extrapolate this, taking into account the inclusion of the larger captives in this sample, we can suggest that total captive premiums worldwide are now in excess of USD100 billion, some way higher than most commentators’ estimates; energy industry captives would certainly form a significant proportion of that total.
Again, capitalization figures for the total captive market are not publicly available, but working on the assumption that most captives underwrite conservatively at a margin of 33% to capital, we estimate that global captive market capital now exceeds USD300 billion.

**Total Captives Worldwide**

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<th>Year</th>
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<td>2013</td>
<td>6,342</td>
</tr>
<tr>
<td>2014</td>
<td>6,700**</td>
</tr>
</tbody>
</table>

*Restated **Willis Best Estimate

**Source: Business Insurance Survey published March 2014/Willis**

**Emerging trends impacting the captive market**

**Captive expansion in Asia**

Interest in captives has exploded in Asia, and in particular China where state owned enterprises are embracing the captive proposition as a solution to the challenges faced by rapid investment in assets outside China and the desire to consolidate insurance purchasing. The captive is an effective tool to capture key management information to enable the creation of an optimum risk financing strategy, one which incorporates the most cost efficient balance of retained/transferred risk and supports both centralised decision making and the insurance purchasing process. This is of huge value and many newly-formed energy company captives are initially not retaining any risk but acting as a conduit to the markets whilst collecting this key data for future analysis. We therefore expect to see continued announcements of captive formations in the region.

**The need to demonstrate value**

Owners of captives are facing an increasing challenge (both internally and externally) to demonstrate the value the captive delivers. This scrutiny would appear to be legitimate, in light of demands for capital elsewhere in the company and the fiscal authorities’ interest in related party transactions. Captive boards and shareholders need to develop a set of metrics to measure strategic, financial and operational value generated by the captive and promote the role of the captive to all stakeholders. For newly formed captives, it is the responsibility of the Board and shareholders to create a clear road map for the captive to follow to ensure the captive strategy is properly aligned to its parent’s business needs and the captive is being utilized to its full potential. A template of such a road map is shown in the diagram overleaf.
Increased regulatory oversight is leading to better management and governance of risk

The generally increased regulatory oversight of the insurance industry in recent years includes that of captives. In Europe, Solvency 2 is leading the charge but other jurisdictions are adopting their own risk based regulatory regimes. Initially there was resistance from captive stakeholders to captives falling under the same regulatory system as commercial carriers but as the date of implementation of Solvency 2 (January 1, 2016) approaches we have detected a marked change of attitude — the certainty of adoption has focused minds, and robust implementation plans are now well underway. Solvency rules for general insurance are now well understood, and captive boards have had adequate time to amend their business plans to ensure compliance with the new requirements.

The value in properly understanding all the business risks a captive faces (and how these are managed) is now being recognized by captive stakeholders. The investment in creating an individual risk management and governance framework for each captive is increasingly being seen as a worthwhile exercise and provides further evidence of the value that a captive delivers. However, increased detailed reporting to regulators and other stakeholders remains a challenge.

Whilst it is expected that the industry will develop solutions for regulatory compliance to the new regime, it is difficult to see any real value created by the enhanced reporting demanded in the regulation, and furthermore at the same time it inevitably adds cost; in our view it all amounts to is increasing demands on captive management teams. Captive owners will need to assess what expertise is required to ensure that best operational practices are being adopted and decide whether this is delivered more effectively in-house or through external appointments. Again this will add cost, but the value generated by operating the captive efficiently and understanding its risks should outweigh the cost downside.

Growth in micro captives

Whilst not directly relevant to energy companies, the growth in micro-captives demonstrates that the value of captives is not limited to only the largest organisations. Protected cell companies, where a series of segregated underwriting accounts operate within one corporate entity, are now established corporate structures and represent the fastest growing segment in the captive marketplace. We can see a role for such a vehicle for an energy company with diverse business interests and

Source: Willis
The emergence of the capital markets as a source of increased capacity SPVs to facilitate the transfer of insurable risk to the capital markets. This technology has further evolved with the use of protected cells as protecting the interests of the different parties. business partners as a means of segregating and funding risks whilst protecting the interests of the different parties.

To date, this has primarily been accessed by insurance carriers who have securitised a portfolio of insureds’ risk as an alternative to traditional reinsurance. Many of these transactions are prefunded, thereby removing any credit default risk and so the risk bearing capacity of these micro-captives could be significantly increased. To date these transactions have focused on natural catastrophe risk, as the ability to model and price the risk already exists. Subject to modelling capabilities, there is no reason why the range of risks could not be extended to a basket of all risk property protection.

It is quite possible that in the near future it will become more common for energy companies to access (re)insurance protection from the capital markets via their own captive directly, or buy collateralized reinsurance from an SPV or cell company. To do this, the capital markets investors will need to be comfortable with the absence of a commercial carrier to settle claims. In addition, the cover will become more useful if it expands beyond well modelled named perils (natural catastrophe risk) to include the broader coverage found in an all risk cover.

Broader, emerging risks
Captives are writing a broader range of risks, including emerging risks that the insurance market may be reluctant to underwrite. Cyber risk is the obvious example but supply chain risk, environmental impairment and even reputational risk are covers now being written by captives. In many cases the captive is acting as an incubator, holding risk until the market has sufficient data to model, price and accept the risk. In other cases, the captive board is comfortable retaining the risk and forms part of a predetermined increase in risk capacity as part of execution of a strategic roadmap. Increasing the spread of risk in a captive leads to more efficient use of capital as the divergence and non-correlation of risks offsets any additional solvency requirements.

Increasing choice of captive domiciles and associated competition
Almost every month it seems that another jurisdiction is announcing it is setting itself up as a captive domicile. US States and Caribbean islands form the majority of new entrants, but the shift in economic power eastwards has seen Hong Kong and mainland China enter the fray. Given the increasing concentration of Asian companies in the Fortune 1000, we can expect to see significant growth in domiciles in the region. Singapore, Hong Kong and mainland China (in particular the Free Trade Zones) should all benefit.

All domiciles are under pressure to adopt international core principles of insurance regulation to meet and maintain world economic bodies’ accreditation. However, the key to achieving a competitive advantage will be how domiciles implement a proportional response and adopt a pragmatic interpretation of global standards in response to the unique risk characteristics of captives, where consumer protection and threat of market instability are much lower than the commercial segment. The classic bifurcation remains; onshore domiciles offer reputational protection but presents a more onerous regulatory regime compared to the greater flexibility of operating offshore with its associated reputational concerns.

Bermuda has developed an innovative proposal to respond to these challenges by suggesting onshore style regulation for commercial carriers and a lighter touch regime for captives. If this tactic proves acceptable to the EU, we should expect to see this regulatory model replicated elsewhere around the world.

Implications for captive owners
So what should owners of existing or future captives make of all these developments?

— Captives continue to be a valid risk financing tool and should be considered as an integral part of any review of the company’s risk financing strategy and implementation of its global insurance programme.
— The capture of quality underwriting and loss data in a captive has never been more important, as this enables informed insurance purchasing decisions and differentiates the risk to the insurance market.
— The choice of location, corporate structure, risks and (re)insurance programme structure to be included in the captive business plan have never been more critical, providing the greatest opportunity for success. Captive owners should prepare a 3-5 year roadmap to ensure key strategic, financial and operational drivers are achieved and the captive’s operations are realigned to the group’s business needs on a regular basis.
— Captive owners should expect challenge. They should therefore establish KPIs against each of the key milestones of the roadmap and should monitor the captive’s performance in achieving them. They should be prepared to engage with critics and promote the captive internally by articulating the value that their captive generates.
— To maximize their chances of success, captive owners should deploy a combination of the analytical capabilities, market awareness and captive utilization advice available from their broker or consultant.
“Captives are writing a broader range of risks, including emerging risks that the insurance market may be reluctant to underwrite.”
“The industry has undergone steady improvements in risk management techniques led by a technological quantum leap with the introduction of new analytical and modelling capabilities, as well as a market and regulatory solvency requirements that became the norm.”
How do companies build natural catastrophe resilience into their risk management strategy? Geoff Saville of our Willis Research Network explains.

Introduction – using history to prepare for natural catastrophe risk
Thankfully, few of us are likely to be impacted by natural catastrophes more than once or twice in our lives – that’s more than enough – but for some parts of the world, natural hazards can be more frequent and severe. The underlying risk of a wide gamut of natural catastrophes, however small, is with us every minute of every day. Mark Twain once said: “Apparently there is nothing that cannot happen today” while musing on the infinite possibilities to which we are presented in life.

Most of life is not particularly risky, and as such we have designed our lives to deal with most situations. However, rare events such as natural catastrophes are outside of our normal experience, and often outside of living memory. In the realms of risk management, we generally try to take reasoned and appropriate action to be ready for the vast majority of what might occur. Anything beyond that for which we can reasonably prepare requires extra consideration by planning for worst case scenarios and installing back-up plans. How prepared we choose to be for any particular event depends on the resources available, application of relevant science, and risk appetite.

The variety of natural catastrophes calls for a range of different levels of preparedness through a variety of risk management strategies.

In a world where the extremes are changing and where the tails of the distribution of possibilities are starting to “wag”, we need to understand what history can tell us about natural catastrophes in terms of damage, impact and loss, while at the same time try to tame the uncertainty of the future and better account for what is yet to come.

Growing awareness of natural catastrophe threat
Unprecedented losses due to natural catastrophes in the 1980s and early 1990s put the global insurance industry under more pressure than ever before: droughts, hurricanes, windstorms and the like accumulated losses that the industry was simply not able to handle. Hurricane Andrew in 1992 was the final straw which resulted in a number of insolvencies in the key insurance markets of Europe and North America. Since then, the industry has undergone steady improvements in risk management techniques led by a technological quantum leap with the introduction of new analytical and modelling capabilities, as well as a market and regulatory solvency requirements that became the norm, leading to the current state of a multi-pronged approach to dealing with the impacts of natural extremes in the industry.

Urbanisation, deforestation and environmental degradation will all help to explain the increase of frequency of natural disasters. Better communication and monitoring (through land-based and remote sensing satellite equipment) also play a part in the increase in awareness of severe events. Most of the increase in frequency of disasters is found in climate-related events, with the scale of disasters also growing.

Catastrophe resilience tools
Three key tools enable improved resilience and sophisticated risk management against catastrophes:

— Catastrophe modelling for re/insurance, which mixes information about the hazard itself with the geographical spread of exposure at risk (portfolio of assets), the vulnerability of the exposure to the hazard in question (essentially how it is damaged by wind, flood, fire etc.) and then finally the financial aspects of determining the best reinsurance cover. This provides financial support for those who incur losses when natural catastrophes occur if they can afford insurance the premiums.

— Taxation and government incentive schemes can provide support to reduce the socio-economic impact of disasters. For example, the National Flood Insurance Program in the U.S. aimed at reducing the impact of flooding on private and public structures by providing affordable insurances for property owners, and helping communities to create and maintain floodplain management regulations.

— A third approach to building resilience is through engineering, that is, designing buildings, structures or systems to be resilient to catastrophic events.

Architects and designers have always given consideration to extreme events, but their success generally depends on the ability to quantify the level of risk of any given peril. This is only really validated when fail-safes are triggered and if a building or system receives minimal damage or disruption.
during an actual event. In facing the potential for a future with more frequent hurricanes, more widespread floods and more intense or longer lasting droughts, we must address the issue of whether we are able to appropriately represent a changing landscape of risk from natural catastrophes.

The threat from population growth

On top of changing frequency and severity of natural hazards, we also have an ever-growing population, along with rapid urbanisation in new parts of the world. More than half of the world’s populations now live in towns and cities, and by 2030 this number will swell to 5 billion urbanites. Much of this urbanization will occur in Africa and Asia, which will require careful risk management in terms of resilience to natural catastrophes, security of food, scarcity of water and demand for energy. There are arguments for either case when considering whether our population is more resilient if concentrated in cities rather than in rural communities spread more sparsely.

One thing is for sure: the vulnerability of these growing cities (in number and size) will require a greater understanding of natural extremes that affect them due to the growing exposure at risk. Research in the science of extremes and development of new risk management strategies will help to alleviate the severe impacts, and the value of insurance in this process is becoming more important than ever before, but regardless of what is learnt and implemented over the coming years and decades, naturally occurring disasters will inevitably continue to happen. Moreover, due to a changing climate and exposure landscape, extreme events will occur in potentially new and unforeseeable ways, perhaps with unprecedented severity and devastating impact. This sobering thought is the realistic and pragmatic side of insurance, and the driving force behind international efforts by the United Nations and other international public and private organisation towards disaster risk reduction.

Engineering for Climate Extremes Partnership encourages collaboration

The Engineering for Climate Extremes Partnership (ECEP) embraces a pragmatic approach. Accepting that all systems will fail at some level, and the importance of assessing the impact of failure in an uncertain future, are both key considerations of the ECEP. The partnership is a collaboration between public science, government, society and private organizations facilitated by the National Center for Atmospheric Research’s (NCAR) Regional Climate Section. The vision of ECEP is described as:

“An interdisciplinary partnership bringing together engineering, scientific, cultural, business and government expertise to develop robust, well-communicated predictions and advice on the impacts of weather and climate extremes in support of society.”

By exploring approaches to increasing resilience to climate extremes, this partnership is directly relevant to the insurance and risk management world.

Projects already underway at NCAR (some of which benefit from support through the Willis Research Network) are focussing on the challenge of quantifying and accounting for the risk of extreme events, through the development of data libraries, risk management tools and effective communication strategies. Hazards being considered include tropical cyclones, extra-tropical cyclones, tornadoes, drought, and wildfire and involve applying new open science to understanding of extreme event impacts and developing new best practice in a variety of industrial and governmental contexts. ECEP support ranges from government research funds and academic institutions to social or cultural organisations and commercial companies. This broad range of stakeholders will steer the research, ensuring industry and societal relevance.

The concept of “Graceful Failure”

One of ECEP’s initial priorities is to study the concept of ‘Graceful Failure’. In broad terms, catastrophic failures are normally those associated with rigid structures, complex systems or tightly interconnected dependencies. Conversely, a Graceful Failure emphasises adaptability and improvisation in an emergency, for example with flexible structures, non-complex systems, loosely interconnected networks of dependence. In real terms, Hurricane Katrina may be considered an “Ungraceful Failure” as exemplified by the breaching of the levees protecting New Orleans which were designed for a potential category 3 hurricane – even though Katrina reached category 5, it weakened to category 3 as it made landfall at the coast. Its large size combined with the local bathymetry and long term loss of wetlands led to a storm surge of over 30 feet in places, as Katrina approached the shore. Compounding factors such as inadequate evacuation procedures and the failure of levees and critical pumping systems resulted in catastrophic consequences. NOAA’s (the National Oceanic and Atmospheric Administration) event reports indicate that 80% of the city of New Orleans was flooded and nearly 2000 deaths attributed to the storm. In the energy industry, an EIA report (U.S. Energy Information Administration) states that, as of the 31st of August, Gulf of Mexico oil production was reduced by over 1.371 million barrels per day (91.45% of total production) as a result of the hurricane. In the same region, a real world
example of graceful failure might be the 2011 Mississippi floods where 31 flood-gate bays of the Morganza Spillway were opened to divert potential flood waters, preventing a major flooding event for the cities of Baton Rouge and New Orleans.

Recent ECEP Projects
A highlight of ECEP is a Willis Research Network (WRN) collaboration between NCAR and the Wharton Risk Management and Decision Processes Center that combines expertise in the field of climate science and economics to develop a deeper understanding of the drivers of hurricane losses. This led to development of a Cyclone Damage Potential (CDP) index (led by Dr Greg Holland, WRN Senior Scientist and NCAR Section Head, and Dr James Done, Willis Research Fellow), which has been shown to accurately represent the damage potential of tropical cyclone. The key parameters area of damaging winds, forwards translation speed (how fast the storm is moving) and maximum wind speed. The index is appropriate for offshore and coastal surge damage.

The CDP provides easily assessed indications of the relative damage potential for individual storms or collections over basins and seasons. For actual damage assessment and prediction the CDP is modified by local circumstances such as: the density of structures or the insurance portfolio risk in the storm path; the location of vulnerable facilities relative to the track; and the engineering quality of these facilities.

The value of the index is illustrated in the figures below that show a far richer texture to spatial damage potential for current climate (top figure below) that is masked by a mere consideration of tropical cyclone intensity (bottom figure below). The CDP highlights the major damage pathways (blue arrows) and highlights regions such as the Yucatan and North Carolina as damage hotspots that are not immediately apparent using storm intensity alone.

The benefit of this is to better explain the relationship between measurable hurricane characteristics and damage. It improves upon other measures such as the Saffir-Simpson hurricane wind scale in explaining total economic damage, according to Dr Holland. For offshore exposure, the CDP index explains 90% of the impact to oil and gas rigs in the Gulf of Mexico. Projects within the WRN are planned to expand and develop this CDP index for other applications in other territories.

Another project currently in ECEP is the Combined Drought Risk Index (CDRI), a tool to aid decision-making based on the probability of exceeding a drought threshold.

All of these activities are part of the ECEP Global Risk Improvement Program, which is developing a series of tools for risk management, engineering design and community planning that will be maintained in the public arena for general use and specialist modification.

More information on these projects and ECEP may be found at www.ecep.ucar.edu or by contacting the Willis Research Network at www.willisresearchnetwork.com.

Modelling natural catastrophes
It is hoped that the projects linked to Willis through the WRN, such as ECEP, will merge with and improve upon current methods for quantifying risk in the re/insurance world. There are two principle methods to account for future natural catastrophe risk:

— One method, used in catastrophe modelling, is to look at historical records and extrapolate to build a bigger set of events using statistical techniques. Catastrophe modelling uses statistical extreme value theory to create probabilistic models which aim to appropriately model the tails of a distribution of possible events. The process involves modelling the number of events per year and after which a distribution of the severity (measured by various hazard parameters or indices) is considered. In this way, a small set of real data can be sampled and resampled to create a large catalogue of simulated events.

Source: Willis Research Network
— Another approach is to use a physical model which leverages our scientific understanding of the physical world and its extremes, representing them on a global three dimensional grid, and then allowing that model to run forward in time. Models such as this are called dynamical models, or General Circulation Models (GCMs) and are also run multiple times to produce an ‘ensemble’ of model results. This allows us to build an idea of the spread of potential outcomes, and understand the extremes, or ‘tails’, of the distribution of possibilities, as well as the most likely outcomes given a starting condition. However, these models are computationally very expensive and as such are generally the domain large academic institutions or national meteorological services.

These modelling different paradigms both have their own strengths and weaknesses, but it takes expert knowledge of how they work, along with application of cutting edge science and new modelling capabilities to be able to push the analytical capability of the industry forward. This is a key driver of the WRN.

Willis Research Network collaborations
Blending together industry knowledge and requirements, with academic excellence and cutting edge research is exemplified through a number of WRN projects. Collaborations and funded partnerships within the WRN are helping to push Willis’ analytical capability forward, for a wide range of insurance needs. An example of an ongoing theme is through the link to Professor David Stephenson and Dr Ben Youngman, experts in applying statistical modelling techniques to weather and climate data at the University of Exeter. They are working with closely with Willis analysts to develop new ways to better represent the nature of how extreme storms tend to cluster together in time and space. Such clustering of extreme events can dramatically increase or decrease annual losses in a given year when compared to a benchmark that uses the assumption that extreme storms are distributed at random.

Our challenge – building a connected approach
Research into building resilience to natural disasters is constantly progressing and developing in response to increased threat to vulnerable communities, industry market forces and changing technology. The remits of risk managers and design engineers require greater analytical capability, with more bespoke solutions (potentially helped by the advent of open catastrophe modelling frameworks such as Oasis) which are now being tackled through the closer relationship between public and private entities as collaborators. Research and modelling capabilities also influence policy decisions on a global scale, with changes in the pipeline regarding disaster risk reduction policy for businesses beyond simply applying insurance mechanisms.

The challenge faces us all – how do we deal with natural catastrophes in a multi-faceted, changing environment? We believe that by combining expertise, resources and applications, through multi-disciplinary partnerships like ECEP, collaborations through networks like the WRN, and support structures from public and private sector initiatives, we can build a more resilient future in the face of our changing climate and reduce the humanitarian impacts and financial costs of natural catastrophes.

Acknowledgments:
Thanks to a number of Willis Associates for their feedback in producing this article. Special thanks to Dr Greg Holland and Dr James Done for their advice, contribution and permission to use ECEP images.

Further reading:
www.willisresearchnetwork.com
www.ecep.ucar.edu
www.unisdr.org
www.noaa.gov
www.ncdc.noaa.gov/extremeevents/specialreports/Hurricane-Katrina.pdf
www.eia.gov/special/disruptions/hurricane/katrina/eia1_katrina_083105.html
“Collaborations and funded partnerships within the WRN are helping to push Willis’ analytical capability forward, for a wide range of insurance needs.”
Willis’ second Asian Energy conference took place in January in the city of Haikou, capital of Hainan Island off the south coast of China. 120 delegates from the Asian energy and insurance industries gathered for two days as a series of speakers articulated their own perspectives on modern methods of analysing energy industry risk. Conference Facilitator Robin Somerville reports.

Asian energy companies do not currently use the opportunities provided by modern analytical techniques to help them manage their risks more effectively. That was one of the key findings when 120 delegates gathered at the Haikou Marriott Hotel, China in January to attend Willis second Asian Energy conference. The conference featured some highly experienced and erudite speakers from the Asian energy industry community as well as risk managers from outside the region, loss adjusters and local insurers, together with Willis personnel from throughout Asia, London and Canada.

Opening the conference, Willis Natural Resources Head Alistair Rivers outlined several ways in which sophisticated actuarial techniques were now being used to good effect by energy industry risk managers.

“Take the example of a company that currently retains USD20 million as a deductible on their property insurance programme” said Mr. Rivers. “A detailed analysis of their loss records reveals that a good culture of risk management within the organisation actually means that the company rarely suffers many losses below that sum, but it is prone to the occasional big bang loss potentially running into hundreds of millions of dollars.

“A clearer understanding of this picture could lead the organisation to conclude that in fact it would be better off increasing its deductible to USD50 million – thereby retaining more risk on its own balance sheet, which is strong enough to absorb the low frequency, smaller scale losses. This buying strategy could save the company significant sums over the long term while also maintaining the same level of protection afforded by the insurance markets for one-off catastrophic losses”, he concluded.

Over the course of the three day event the delegates were treated to presentations on subjects as diverse as Health and Safety risk management, the regulation of captive insurance companies in China, the growth of the Chinese Energy insurance market, successful claims resolution strategies and a full global insurance market update, as well as the latest developments in using analytics to manage energy risk.

As ever at Willis Energy conferences, the deployment of interactive voting technology (kindly sponsored by Talbot Validus) enabled an effective two way communication to be established between the delegates and the speakers. Some of the key findings from this process included:

— 80% of energy industry delegates said that they thought energy companies did not currently maximise the opportunities provided by modern analytical techniques.
— 78% of energy industry delegates thought that USD40 oil would be the greatest challenge facing the industry this century
— An overwhelming number of delegates – including 92% of insurers - thought that the insurance industry should provide a wider range of products to clients.
— 75% of energy company delegates agreed that every Asian energy company should form a captive insurance company.
— Only 20% of energy company delegates agreed that the old maxim of buying as much insurance at the cheapest price was still the risk manager’s main function.
— 80% of delegates agreed that Asian energy companies do not currently take full advantage of today’s modern analytical techniques.
— 75% of energy company delegates said that they would prefer to remain with their preferred risk partners during the current soft market conditions.

To download presentations from this event, as well as viewing a video montage and assorted conference photographs, please visit the conference webpage on willis.com: http://www.willis.com/Client_Solutions/Industries/Energy/AsiaConference2015/
Over 100 delegates attended Willis’ second Asian Energy Conference in Haikou, China last January

Willis China’s Deputy CEO Wise Xu opens the conference

Debating the key issues facing the Chinese insurance market (from left to right): Mr Kamal Tabaja, Chief Operating Officer, Trust Re, Mr. Guo Hua, Head of Fire lines and Reinsurance Department, Huatai Property & Casualty Insurance Co., Ltd, Mr. Ma Changjun, Head of Oil & Gas Division, Special Risks Department, PICC., Mr. Zhao He, Director of Energy, Ping An Insurance (Group) Company of China, Ltd and Mr. Wise Xu, Deputy CEO, Willis China
When asked the question by Conference Facilitator Robin Somerville, the response was overwhelming across the board – a significant majority of delegates thought that the insurance industry needed to provide a wider range of risk transfer products to meet the challenges it now faces, including 92% of the insurers present.
“Asian energy companies do not currently use the opportunities provided by modern analytical techniques to help them manage their risks more effectively.”

“For Asian energy companies, managing a captive insurance company effectively is more important in reducing their overall cost of risk than buying the most competitively priced insurance products.”

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Source: Willis

A moment’s reflection during the analytics panel debate: (left to right): Ms. Zhao Hong Ling (CNOOC), Mr Malcolm Cutts-Watson (Willis Global Captive Practice) Mr Roberto Benzan (Husky Energy), Mr Charles Barder and Ms Jen Ning Tan (Willis Global Solutions Consulting Group)
Charles Taylor’s John Donald makes a telling point during the claims session, closely watched by Chaucer’s Tony Gates (left) and Willis’ Alan Long (right)

The conference Karaoke competition (kindly sponsored by Trust Re) produced a superb performance from Trust Re’s Luo Xing Chen (left) and Willis’ Jin Xixi (right)

Willis’ Justin Blackmore (extreme right) expresses an opinion during the global market debate. Listening are his colleagues Mike Newsom Davis (left) and Simon Wynn (right) while Talbot Validus CEO David Hawksby (centre) appears to keep his own counsel
PART TWO: NATURAL RESOURCES INSURANCE MARKET REVIEWS
Introduction

In last year’s Energy Market Review we pulled no punches when pointing out that all the conditions in the Upstream market were in place for a period of sustained softening. We pointed out that increased capacity, a better than expected reinsurance renewal season, a reasonable loss record, the emergence of more competitive markets and the continuing profitability of the portfolio were combining to put increased pressure on the market to reduce prices. While we were not quite sure where the new market “floor” would emerge, we felt that the softening process would have some way to go yet before any market upswing would become evident.

Market softening fuelled by lower oil prices

Well, our prediction of increased market softening has certainly materialised during 2015; perhaps the only thing that has surprised many in recent weeks has been the intensity of this process. As we have already outlined, the recent fall in oil prices is perhaps the besetting reason for the escalation of this process.

Much of the dilemma facing the Upstream market, and the ways in which buyers can benefit from the current situation, has already been discussed in our leading Special Feature of this Review. In this chapter we will therefore focus specifically on some of the issues facing the Upstream market within the context of our usual issues of capacity, losses, profitability, specialist sector round-ups and the outlook for the remainder of 2015.

Capacity

Upstream Operating insurer capacities 2000-2015 (excluding Gulf of Mexico windstorm)

The amount of capacity now in play in the Upstream market bears little relation to the amount available only five years ago.

USD billions

Source: Willis
The relentless rise continues

For the ninth year in a row, we can report an increase in underwriting capacity for the Upstream market, with the overall theoretical total now standing very nearly at USD7 billion. At this level, even the very largest Upstream assets could in theory be placed in the commercial insurance markets; although in practice of course not every insurer will put out their full underwriting line, such a programme would almost certainly involve the participation of captive insurance companies. Our usual rule of thumb is that the realistic – i.e. what can be placed in practice – capacity level is usually around 80% of the theoretical total, so our chart shows that the most favoured programmes can now attract about USD5.9 billion of Upstream underwriting capacity – more than double the theoretical amount that was on offer only a decade or so ago. And such is the force of today’s softening dynamic that insurers cannot be as selective as they were in the past. It may therefore be that during the course of the year the ratio between these “theoretical” and “realistic” amounts narrows as insurers begin to consider putting out their maximum lines more frequently.

Existing market responsible for most of capacity increase

Such a significant capacity increase suggests the possibility of a greater influx of new competitors within the Upstream arena. While there have indeed been one or two new entrants during the last two years, the majority of 2015’s increase has come from the existing market. Last year we indicated that pressure on underwriter “signings” had increased, devaluing individual insurers’ projected premium income; as a result, some of the most significant market players have attempted to offset this development by increasing their capacities, sometimes by as much as 100%. This of course has only served to exacerbate the problem; these insurers have found, possibly to their consternation, that they have not been the only one of their peer group to have thought of adopting this strategy.

So as a result, we now have the steepest rate of increase that we have ever reported for this class of business at a time when:

- Lower oil prices are reducing the opportunities for premium income growth
- Losses are the lowest for a decade
Losses

Upstream losses in excess of USD50 million, 2013

2013 produced several losses of not that were large enough to dent underwriting profits without affecting most insurers’ reinsurance programmes.

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<th>TYPE</th>
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Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

Upstream losses in excess of USD50 million, 2014

It has been the almost complete lack of significant Upstream losses that has contributed the most to the acceleration of the softening process in 2015.

<table>
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<tr>
<th>TYPE</th>
<th>CAUSE</th>
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<th>PD USD</th>
<th>OEE USD</th>
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Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)
2014 a continuation of an improving picture

The loss records above USD50 million in the Upstream sector during the last two years recorded by our Willis Energy Loss Database are set out on the previous page.

It can immediately be seen that while 2013 produced eight loses in excess of USD100 million, to date we have only been notified of one, a blowout offshore Central America which has just scraped above the USD100 million mark; while in 2013 there were a total of 16 losses above USD50 million, in 2014 there were only six. (The figures for 2015 are of course too immature to be germane, but perhaps we should point out that our Database has already recorded one major loss this year which may result in a figure of more than USD50 million.)

It is perhaps worth pointing out that last year we thought that the 2013 loss record was relatively benign compared to 2012, which in turn was a much better year than 2011, the year of the Gryphon A loss. Before that of course we had the appalling tragedy of the Deepwater Horizon blowout so the loss picture in Upstream is a story of gradual improvement over four years.

When studying the recent loss record in Upstream, the following key points should be borne in mind:

— A complete lack of catastrophic losses reduces any rationale from market leaders to insist on maintaining rating discipline, removes any apprehension from much of the market as to whether to write more aggressively or not and, if the benign loss trend continues, suggests that previous rating norms can be safely abandoned in the pursuit of additional premium income
— Fresh pressure will be brought to bear on the Excess of Loss Reinsurance market if their programmes have run completely clean in 2014
— The lack of catastrophic losses does not stop some programmes, featuring high frequency, low severity risk profiles, continuing to remain relatively unprofitable for the market

Profitability

The market continues to make hay – for now

There are two ways in which we can try to measure the profitability of the Upstream market; one is by comparing premiums to losses in overall terms and the other is to rely on Lloyd’s own statistics to give us an overall indication of the overall global picture. Using either methodology, it seems abundantly clear that Upstream insurers are currently enjoying a highly profitable portfolio — but a portfolio which can only come under savage attack in the months ahead for the reasons already discussed in our leading Special Feature of this Review.

Upstream Losses v Premiums 2000 – 2014 (adjusted for inflation)

Losses are down – so static Upstream premium income levels will soon come under attack.

USD billions

Source: Willis/Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)
The chart above displays the 15 year history of the Upstream market in somewhat crude terms as it plots overall inflation-adjusted loss totals – both insured and uninsured – against our own estimates of global Upstream premium income. Right now, it looks as if 2014 could result in the lowest inflation-adjusted total so far this century. The chart also shows that, even in the profitable years for the market following 2008, overall loss totals in our Database have always at least matched overall premium levels; while the figures for 2014 are not yet completely mature, it seems almost certain that, for the first time this century, premium levels will outstrip even the combined insured/uninsured loss total.

**Premium levels still holding up – but for how long?**

Last year we indicated that there was a possibility of 2014 premium levels being somewhat less than those of 2013, and that we were surprised as the softening at the beginning of 2014 had not yet really begun to materialise. However, as the year progressed the Lloyd’s statistics on which our global premium estimates are based then changed later in the year to indicate a relatively consistent premium total. The gap between insured and uninsured losses and premiums for 2014, which this chart indicates, demonstrates not only the current profitability of this class but also the challenges ahead for Upstream insurers as they seek to do what they can to offset the current softening dynamic.

**Lloyd’s Upstream Incurred Ratios 1993 – 2014 (as at Q4 2014)**

Lloyd’s Upstream portfolio generally makes money when there are no Gulf of Mexico Windstorm losses, and 2014 was no exception.

A profitable book for six years

This chart which we have developed from the statistics provided by Lloyd’s shows another way of looking at Upstream underwriting profitability. These official figures show incurred ratios, i.e. the ratio between premiums received and paid and outstanding claims. The historical record of these statistics is of interest because they show a very volatile picture in the years up to and including 2008, the year of Hurricane Ike, a picture which then changes dramatically for the next six years.

For each of these six years since 2008 the Lloyd’s proportion of the Upstream market seems to have made an overall underwriting profit, as the Incurred Ratios have been well below the 80% that most insurers accept is the maximum that they can sustain before incurring an overall loss to their portfolio. Even in 2010, the year of the Macondo blowout, the Incurred Ratio for Lloyd’s insurers only reached 70%; in 2014, with only one loss over USD100 million to trouble them, it is hardly surprising that underwriting profits continue to remain buoyant. Given that Lloyd’s makes up at least 55% of the global Upstream market, we can therefore say for almost certain that the rest of the market is likely to have recorded similar statistics for their own Upstream portfolios.

It is therefore little wonder that conditions in this market have become increasingly competitive. But why, if the market has essentially been in profit since 2009, is it only now in 2015 that we are discussing such a significant market softening?
Why the floodgates have opened in 2015

Those readers who have studied our reviews of the Upstream market over many years will know that we always try to provide as accurate a picture as possible of the prevailing market conditions and present a balanced view from the perspective of both the insurer and the buyer.

However, in 2015 the softening market dynamic has become so acute that we have been forced to use somewhat more dramatic imagery to provide our readers with the full reality of what we are now seeing in the market. One leading insurer recently remarked that it was like watching a house fall off a cliff – we prefer to use the breaching of a dam as a better indicator of what is going on.

The breaching of the dam: Upstream market dynamics, 2008 – 2015

The Upstream market started to soften two years ago but it has taken the collapse in oil prices to finally bring an end to the market’s resistance. However, retentions and policy wordings have remained intact, unlike rating levels. (Please note that the difference in rating levels shown below is purely for illustration purposes and should not be taken as technically accurate.)

1. 2008-2013

- Ike, Macondo, Gryphon A, Sandy
- Stable reinsurance market
- Restricted leadership
- High oil prices, leading to increased construction and drilling activity

2. 2014

- No catastrophe losses
- More capacity
- More leaders
- Continued use of captive insurance companies/OIL

3. 2015

- Lower oil prices, leading to reduced:
  - Risk management budgets
  - Rig day rates
  - Drilling activity
  - Construction projects
  - Insurance programme limits
The dams holds: 2008 – 2013

Our image starts with a well-structured, ordered dam that is keeping in the water at the top — representing the competitive pressures brought about by increased capacity levels. This was the situation from the period following hurricane Ike in 2008 to the end of 2013. The image shows a number of factors that kept the dam steady which were:

— **The impact of previous catastrophe losses** – as we articulated in past Reviews, the effect of historical increases in capacity have been offset by market reaction to major catastrophic losses, bringing about an apparent supply/demand anomaly.

— **A stable reinsurance market** – the reinsurance market for Upstream risks only began to soften significantly at the beginning of this year. Before this time, reinsurance costs had remained relatively stable, which in turn acted as a brake on any softening dynamic.

— **Restricted underwriting leadership** – for a long time following hurricane Ike the leadership panel in this market remained restricted to the most experienced underwriters in the market, limiting the opportunities for competitive pressures to exert themselves.

— **A healthy premium income stream** – high oil prices, increasing asset values and significant construction project activity, as well as a demand for higher OEE and Pollution Liability limits from buyers following Macondo, had generated a healthy premium income for upstream insurers in the years 2008 — 2013, as our statistics on the previous pages show.

The dam is breached: 2014

However, the dam began to be breached last year as a result of the following factors:

— **The absence of catastrophe losses.** As already indicated, the unusually benign loss record since 2013 has robbed the market of the rationale for holding up the softening process used in previous years.

— **More capacity.** Regardless of market conditions, capital needs feeding. So long as overall capacities increase, so will competitive pressures, at least in the long term. Some might suggest that a significant amount of this capacity is not realistically accessible on a day to day basis, and there is some merit in that view. However, with the exception of the few years after hurricane Ike we have always found a correlation between increased capacity and lower prices.

— **An increasing number of insurers willing to lead business.** Last year we referred to three distinct classes of leaders; the established panel, other experienced insurers that were beginning to compete and those less experienced underwriters who were beginning to “bubble under”, seeking to challenge the establishment from the outside to gain more market share. Now we can say that these divisions have somewhat blurred as more aggression has now been evident from all three of these sectors. Since last April, with more programmes out to tender than ever before, existing leaders and their brokers have found it increasingly difficult to withstand assaults from other competitors, who are keen to go to previously unknown lengths to secure additional premium income.

— **Pressures on signings.** Last year we indicated that a serious problem of over-subscribed placements was beginning to materialise, and now we can report that this process was taken one stage further during 2014. With virtually every insurer (maybe apart from the leader) for the most popular programmes now becoming increasingly disappointed by their reduced net line and premium income, some buyers are taking matters in to their own hands an abolishing the signing issue by deciding which insurers to keep on their programme and which to discard. Meanwhile insurers are swiftly discovering that they have to lead business if they want to resolve their signings issues.

— **Continuing use of captives and higher OIL limits.** The continuing use of captive insurance companies, particularly on major programmes that supposedly should test the overall commercial insurance market capacity remains a particular challenge for the following market, who are often looking for orders to the market for some of the most prized pieces of business are reserved essentially for the programme leaders and a few insurers specified by the client.

The dam gives way: 2015

But these factors alone were not enough to prompt a full scale market softening. Only now in 2015 can we say that the dam has been well and truly breached by the fallout from lower oil prices, and their knock-on consequences.

In our leading Special Feature of this Review we describe the effect of these macro dynamics on the insurance market, but the issue of lower oil prices is particularly significant for the Upstream sector. Lower oil prices mean more oil and gas industry mergers and acquisitions, less exploration and production activity, lower Business Interruption values, lower rig hire day rates, less deep water wells being drilled and less construction projects being given the go-ahead.

Closely related to the oil price collapse is the issue of reduced risk management budgets. Clearly, lower oil prices mean less revenue for energy companies and equally clearly, the pressures to control cost endemic in any business faced by falling revenues are being felt by Risk Management departments in energy companies all over the world. As a result, a handful of the largest buyers of Upstream insurance are now cutting back their programmes and electing to buy significantly reduced programme limits, even perhaps in some instances accepting that some top level exposures may be left uninsured, particularly platform “clash” exposures and other remote risks. This means less premium flowing into the market.
Gulf of Mexico windstorm

Something has to give...
Back in 2009, following the devastating impact of hurricane Ike we devoted our Special Feature of our Review to an examination of the issue of Gulf of Mexico windstorm (GOM Wind) examining whether or not it really was an insurmountable risk management problem. In particular, we outlined the steps taken by senior Upstream market leaders to mitigate the effect of these losses on the Upstream portfolio, in particular the imposition of quite severe aggregate limits on the cover provided and the significantly increased self-insured retentions that were going to be applied. Any fears that such measures would result in reduced demand for GOM Wind were, for the most part, lessened during the next few years; although some very large buyers did indeed elect not to purchase this cover following these developments, most buyers with less financial muscle had little or no alternative but to continue to buy the product, conscious of the need to reassure Boards and shareholders that they had transferred the risk as effectively as they could.

Not a single underwriting loss for six years!
Since Ike of course, those Upstream insurers who have continued to invest in GOM Wind have had a highly successful return on their investment. The Lloyd's audit codes for Physical Damage and OEE from GOM Wind, set up in the aftermath of Hurricane Ike, have yet to record a single paid or outstanding loss during the last six years, while the premium paid to the market continues to represent a significant percentage of those insurers' overall portfolio.

It should therefore be of little surprise to the reader that other Upstream insurers are finally considering investing in this lucrative sub-class, although perhaps with a slight degree of trepidation that the coastlines of Louisiana, Mississippi and Texas are due another visit from Mother Nature at some stage. For the moment however, the pressing need to make up for lost premium income is resulting in competitive pressures that maybe even exceeding the norm in the remainder of the portfolio. It seems that not only are prices plummeting in this sub-sector, but we are also now seeing a gradual relaxation in the application of the aggregate limits imposed in 2009.

Are existing underwriting models of much help?
Notwithstanding these competitive pressures, it seems clear that existing insurer windstorm models, however much of a help they may be in identifying risk and the aggregate exposure to individual insurers, are still untested and therefore of very limited assistance in determining the probability of damage to Upstream energy infrastructure in the Gulf – unless perhaps insurers take a very long term (25 year) view. The difficulty for these insurers who have tried to take this approach is that today's competitive pressures are distorting the effect of the last eight years' profits; other insurers are feeling braver and perhaps are “taking a view” on GOM Wind – perhaps because they see this sub-sector as an easy answer to the problem of lost premium income elsewhere.

Meanwhile buyers can now take advantage and secure improved levels of cover at a reduced cost. History suggests that when the next major windstorm strikes, those insurers who are in this class for the short term will quickly withdraw, leaving the established players to pick up the pieces as the underwriting cycle starts all over again.
“It seems clear that existing insurer windstorm models, however much of a help they may be in identifying risk and the aggregate exposure to individual insurers, are still untested and therefore of very limited assistance in determining the probability of damage to Upstream energy infrastructure in the Gulf.”
Offshore Construction

Offshore Construction insurer capacities 2000 – 2015 (excluding Gulf of Mexico windstorm)

Offshore Construction market capacity has continued to increased in line with the Operating Portfolio – all but the very largest projects can now be covered with ease.

USD billions

Source: Willis

More apprehension, but less spread of risk

In last year’s Review we indicated that this sub-sector had been softening more significantly than its Operating counterpart, which perhaps explains some markets’ reluctance to consider further rating reductions in what is still considered by many experienced underwriters a challenging part of the overall portfolio.

However, our capacity chart above tells its own story – given the macro-economic environment in which the market is operating, it is probably not surprising that capacity has increased by almost the same amount as for the Operating sector. Of course, this does not necessarily mean that rates for Offshore Construction are bound to reduce this year, as if the leadership panel continues to be restricted then some elements of market discipline will remain. But we are aware of new leaders who have just emerged in this sub-sector who are keen to lead Offshore Construction business, particularly as by definition it is new business to the market and does not require the leader to undercut any existing rates.

Market impact

Lead markets in the sector continue to be focused in the London Lloyd’s and Company markets, with the leading European Company market capacity now increasingly being represented by a dedicated underwriting presence in the London market.

An increase in market capacity, combined with a perceived uncertainty as to the frequency of new opportunities, has somewhat inevitably continued to drive down already softening premium levels. The emergence of alternative market leads, particularly in respect of smaller projects, has further suppressed premium levels in the sector. The Watkins Syndicate, which has traditionally lead a considerable share of this portfolio, publicly stated at the end of 2014 that Offshore Construction rates had become unsustainable; however this seems to have done little to halt the overall softening process.

With both Lloyd’s and Companies market underwriters remaining under pressure from capital providers to maintain and grow premium income levels, only a significant downturn in the Offshore Construction loss record is likely to dramatically force up premium levels.
Pessimistic premium income forecasts as projects put on hold

Meanwhile, the likelihood of widespread cancellations or postponements of many planned projects, particularly those involving deep water or sub-sea infrastructure, as a result of the recent fall in the oil price, is likely to revise existing underwriting strategies and encourage the market to compete more aggressively for the rather more limited selection of projects that do indeed get the go ahead to proceed.

During the third quarter of 2014 the Energy Industries Council (a Trade Association) reported that a total of only 40 major EPC, FEED and SURF contracts were awarded across 35 upstream developments. This represented a 41% decline from the second quarter of 2014. However, the Energy Industries Council reported an improvement during the fourth quarter of 2014 with 64 major EPC, FEED and SURF contracts being awarded across 53 upstream developments.

The Insurance industry normally receives relatively short notice of new projects. Accordingly, the decline in activity during the third quarter of 2014 resulted in a reduced number of new projects being shown to the broking and underwriting communities during the fourth quarter of 2014.

In fact, the decline in oil price, combined with certain high profile geo-political factors, resulted in a number of major projects being placed in abeyance during the fourth quarter of 2014 which had otherwise been expected to be presented to the underwriting markets.

Offshore Construction loss record deterioration, 2007 – 2013 (Losses Occurring basis)

Historically most Offshore Construction losses don’t get reported to our Database for at least a year after their occurrence.

USD billions

Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

In terms of the overall Offshore Construction loss record, it is too early to say whether 2014 will turn out to be any better or worse than 2013, on the basis that most losses are not reported to our Database until at least a year after they occur (see chart above). From our chart, it seems likely that 2014 may turn out to be as bad a year as 2013 or 2011 (the worst years for Offshore Construction for the last seven years) but in any event as can be seen from the tables below the losses incurred by this sub-sector have very little impact on the overall Upstream market dynamics.

Sourced from the Willis Energy Loss Database, the above statistics are based upon losses that would be recoverable under the standard market policy form, should they have been insured. During the third quarter of 2014 we also understand that a substantial, USD1 billion plus claim was formally submitted to Offshore Construction underwriters. With coverage yet to be determined, the loss does not currently feature in these claims statistics. Accordingly, at this time, the above detailed loss record does not constitute a deterioration sufficient to trigger an immediate upswing in Offshore Construction premium levels.
Offshore Construction losses in excess of USD10 million, 2013

Offshore Construction losses for 2013 were modest and did nothing to change any softening dynamic in the market.

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<th>REGION</th>
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Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

Offshore Construction losses in excess of USD10 million, 2014

To date, the record for 2014 has been even more modest.

<table>
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<tr>
<th>TYPE</th>
<th>CAUSE</th>
<th>REGION</th>
<th>LAND/OFFSHORE</th>
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<tr>
<td>SSCS</td>
<td>Faulty design</td>
<td>Offshore</td>
<td>Europe</td>
<td>10,622,000</td>
</tr>
</tbody>
</table>

Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

“The decline in oil price, combined with certain high profile geo-political factors, resulted in a number of major projects being placed in abeyance during the fourth quarter of 2014 which had otherwise been expected to be presented to the underwriting markets.”
The outlook for 2015
Upstream capacity versus rating levels, 1993 – 2015 (excluding Gulf of Mexico windstorm)

The rate of capacity increase has accelerated since last year — as has the rate of overall market softening. But in comparative terms, Upstream rates have still some way to go before reaching the historically low levels of the late 1990s.

A market in freefall?
For a final perspective on where the Upstream market is heading in 2015, we thought we would reproduce our 22 year old chart which maps underwriting capacities with average rating levels. As ever, a note of caution should be sounded when viewing this chart — there are naturally some programmes that will attract premium reductions of less than the estimated average reduction indicated, and some that may achieve considerably more. The chart shows that we are seeing significant reductions in 2015 with some programmes, particularly those featuring Gulf of Mexico windstorm exposure, achieving considerably more competitive results from a buyer perspective.

In our opinion, there are two particularly important features of this chart. The first is the old supply/demand anomaly that existed in the market between 2008 and 2014, which is shown on the chart by both lines increasing from 2008-2013. This did much to hold up the softening process that should have started much earlier, given that capacity continued to increase year on year since the aftermath of hurricanes Katrina and Rita in 2005. Now that this anomaly is at an end, and the dam has truly burst, there is no way of knowing exactly where the market floor will materialise at the end of the softening phase of the cycle.

Are we heading back to the late 1990s?
The second important feature is the relationship between where average rating levels now find themselves in 2015 and where they ended up at the bottom of the last soft market in 1999. As the chart shows, there is still some way to go before we reach where the market finally ended up in 1999, and it may be that this more refined and sophisticated market will not be forced to plumb the depths of those days. In the late 1990s, the market was characterised by extensive facultative reinsurance, and until now our position has been that, in the absence of the same extent of such facultative reinsurance, a new, higher market “floor” would be established.
However, conditions are now such that it seems that we may be on course for the introduction of more facultative reinsurance, as insurers pursue the hitherto unimagined strategy of offering competitive facultative reinsurance to the direct market so as to make their premium income budgets.

If this dynamic truly takes hold, and the portfolio remains relatively loss free, we may find that we do not reach this market floor for some time yet. Instead, we can see nothing to prevent a full scale competition to secure premium and market share until at some stage, the portfolio at last slides into unprofitability. Only then will we finally be in a position to predict what might happen next.

A case of premium starvation?
The perceived wisdom is that capacity is here to stay, regardless of underwriting losses, due to the macro-economic reasons stated earlier in this Review. However, one dynamic that the market has rarely, if ever, experienced is premium starvation, by which we mean some insurers end up for whatever reason being entirely discarded by brokers and buyers, having pursued underwriting strategies that have led them to “sleepwalk to disaster” (see the leading Special Feature of this Review). While this may sound a little far-fetched, we do believe that some insurers are in danger of not only failing to meet their premium income targets, but even failing to generate any meaningful premium at all if this trend continues. While some will turn to writing facultative reinsurance others will have to face the inevitable – the closing down of their portfolio and the withdrawal of their capacity.

The current spate of mergers and acquisitions in the insurance industry (see our leading Special Feature) may account for some of these more unfortunate insurers. Of course if major losses do materialise at any time during this period, this will hasten this process - eventually the market floor will be found, and those insurers astute enough to have survived the fallout will be able to take full advantage of the next stage in the underwriting cycle.

In the meantime, it really is a case of “sink or swim” for Upstream insurers as they do what they can to survive these virtually unprecedented conditions.

Can the market maintain its relevance?
In our leading Special Feature of this Review we remarked that the collapse of the market would be by no means in the interests of the vast majority of the energy industry.

In our January 2015 Energy Market Review Newsletter, we called on the Upstream market to consider developing wider, more innovative and buyer-friendly products to attract the attention of the buying community. Some market observers believe that there is no appetite amongst buyers for new products and given the cutbacks in risk management budgets, this may well be the case. However, for some insurers, unless they think again about how to differentiate themselves as the battle is joined with their peer group for what remains of the global upstream premium income pool, 2015 may be the year in which they are “drinking in the last chance saloon”.

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“We can see nothing to prevent a full scale competition to secure premium and market share until at some stage, the portfolio at last slides into unprofitability.”
“Some insurers, particularly those who can offer little to brokers and buyers by way of differentiation, are going to face some serious challenges to stay relevant as the pressures begin to mount.”
Introduction

In last year’s Review we discussed in some detail the onset of the softening process in the Downstream market, and now in 2015 we focus on how that trend has continued in the intervening 12 months. As we set out in the leading Special Feature of this Review, there are so many factors that are conspiring against this market at present that it seems that something will have to give at some stage – the only question is when. Although the softening dynamic is not quite as intense as in its Upstream counterpart, the overall loss record has not been quite so benign in 2014 and some insurers, particularly those who can offer little to brokers and buyers by way of differentiation, are going to face some serious challenges to stay relevant as the pressures begin to mount.

As in Upstream, the reinsurance renewal season has been a relatively problem-free one for the market, leaving direct insurers with some leeway in which to continue to chase the business.

Capacity increases again – at a faster rate

Global Downstream insurer capacities 2000-2015 (excluding Gulf of Mexico windstorm)

*Downstream may not be softening as rapidly as its Upstream counterpart, but increased capacity across the board will continue to put pressure on the market.*

Source: Willis
Natural resources Market review 2015

Since a low point some thirteen years ago Global Downstream market capacity* has increased year on year, except for a small reduction from 2012 to 2013. Now in 2015 we have found that the rate of increase has in itself increased; the jump from USD4.6 billion to USD5.4 billion is the largest rate of increase this century and will inevitably add fuel to the softening process. Just as in the Upstream market, most of the capacity increases have come from existing markets, all fuelled by the consistent pressure to stay ahead of the game and maintain their market signings, share of the portfolio and premium income targets.

**New capacity pushes up available programme limit potential**

However we have seen the appearance of some new start-ups, notably Berkshire Specialty who can now offer USD500 million of fresh capacity to an already competitive market, and other smaller insurers such as Pioneer and Nationale Swiss, who have already made their mark on the market. We have found that in general terms, the newer the insurer is to the market, the more amenable they usually are to the improvements in the programme that brokers have been seeking to negotiate on behalf of the buyers, particularly in North America.

In realistic terms, we believe that a non-North American buyer who wishes to purchase an overall programme limit of USD4.5 billion could now do so (although we do not believe that such high programme limits are sought in practice) while in North America, despite the overall theoretical capacity increase, we still think that USD2.5 billion is probably the maximum that can be achieved.

Meanwhile, in Downstream it really does seem that the rich are getting richer while the poor are getting poorer. Most of the capacity increase in 2015 can be attributed to the major composite insurers, who now have the financial muscle and economies of scale to exert even more influence over this portfolio than they have done in the past.

**Further consolidation possible**

Of course, the recent trend towards more mergers and acquisitions in the insurance industry, which we highlighted in the leading Special Feature of this Review, may mean that there will be some consolidation of this record capacity in the near future; after all, it’s unlikely that if two major insurers merge the newly merged company will be able to offer the combined capacity that was offered by both of them prior to the merger. However, we do not believe that any capacity reduction brought about by insurer consolidation will have any meaningful effect on market conditions. If the market can offer USD4.5 billion for a sought after programme, and the highest limits sought are in the region of USD3 billion, will it really make much impact if say USD250 million is lost in any consolidation process during the remainder of 2015? Perhaps not.

**Losses**

The 2013 and 2014 loss records in excess of USD50 million recorded by our Willis Energy Loss Database are reproduced overleaf. While 2014 has seen the first USD1 billion loss since the Canadian Oil Sands incident some three years ago, the overall loss record seems to be a gradually improving one, as only seven losses have been recorded excess of USD100 million last year, compared to nine in 2013.

**BI element of losses continues to be significant**

As has become the norm in recent years, Business Interruption (BI) continues to be the major the proportion of most major losses, and the amounts for both years are indicative of the kind of oil prices that used to be the norm in recent years. In particular, in respect of the USD1 billion loss in Eurasia the BI proportion is likely to be in excess of 80% of the overall loss total.

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*By Global Downstream we mean those Downstream insurers that can write business emanating from any region, so it excludes those insurers who only write on a regional basis; clearly totalling all the regional markets up and adding them together would give a misleading impression. For some regions, the overall total capacity available may therefore be a little more.
### Downstream losses in excess of USD50 million, 2013

2013 produced several losses of note – but none sufficient to prevent the continuation of the softening process.

<table>
<thead>
<tr>
<th>TYPE</th>
<th>CAUSE</th>
<th>REGION</th>
<th>PD USD</th>
<th>BI USD</th>
<th>TOTAL USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refinery</td>
<td>Fire no explosion</td>
<td>Latin America</td>
<td>225,000,000</td>
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<td>220,000,000</td>
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<tr>
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<td>25,000,000</td>
<td>189,000,000</td>
<td>214,000,000</td>
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<td>Pipeline</td>
<td>Subsidence/landslide</td>
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<td>10,000,000</td>
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<tr>
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<td>Petrochemical</td>
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<td>40,000,000</td>
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<td>Petrochemical</td>
<td>Fire no explosion</td>
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<td>Petrochemical</td>
<td>Mechanical failure</td>
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<tr>
<td>Tank farm/terminal</td>
<td>Lightning + fire</td>
<td>Africa</td>
<td>50,000,000</td>
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<td>50,000,000</td>
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</tbody>
</table>

**Total** 3,545,747,392

Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

### Downstream losses in excess of USD50 million, 2014

2014 produced only the fourth Downstream loss excess of USD1 billion ever recorded – but other than two major incidents, the overall loss record remained relatively modest.

<table>
<thead>
<tr>
<th>TYPE</th>
<th>CAUSE</th>
<th>REGION</th>
<th>PD USD</th>
<th>BI USD</th>
<th>TOTAL USD</th>
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</thead>
<tbody>
<tr>
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<td>Tank farm/terminal</td>
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<td>Fire no explosion</td>
<td>Asia</td>
<td>40,000,000</td>
<td>120,000,000</td>
<td>160,000,000</td>
</tr>
<tr>
<td>Petrochemical</td>
<td>Mechanical failure</td>
<td>North America</td>
<td>25,000,000</td>
<td>85,000,000</td>
<td>110,000,000</td>
</tr>
<tr>
<td>Refinery</td>
<td>Faulty workmanship/operating error</td>
<td>Europe</td>
<td>41,065,180</td>
<td>65,155,500</td>
<td>106,220,680</td>
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<tr>
<td>Refinery</td>
<td>Fire no explosion</td>
<td>Asia</td>
<td>100,000,000</td>
<td></td>
<td>100,000,000</td>
</tr>
<tr>
<td>Chemical</td>
<td>Faulty workmanship/operating error</td>
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<td>72,360,540</td>
<td>94,694,040</td>
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<tr>
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<td>Refinery</td>
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<td>Refinery</td>
<td>Mechanical failure</td>
<td>Europe</td>
<td>775,000</td>
<td>50,475,000</td>
<td>51,250,000</td>
</tr>
</tbody>
</table>

**Total** 2,674,579,720

Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

*VCE = Vapour Cloud Explosion*
Profitability

**Downstream Losses v Premiums 2000 – 2014 (adjusted for inflation)**

The 2014 loss record is comparable to previous years, but is not sufficiently alarming to act as a brake on any softening process.

![Graph showing Downstream Losses v Premiums 2000 – 2014 (adjusted for inflation)](image)

**Source:** Willis/Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

This chart plots all Downstream Energy losses recorded by our Database this century, plotted against our own estimates of Global Downstream premium income. The inherent volatility of this class is evident not only from the hurricane affected years of 2005 and 2008 but also in the increase in overall losses recorded since 2010 (even taking inflation into account).

**Loss record since 2010 still poor by historical standards**

If Downstream insurers had hoped that 2011, which included losses emanating from the Tohuku earthquake among other catastrophes, would eventually prove to be a “one off” in terms of overall loss quantum, it can now be seen that they were misguided; while 2012 showed a marginal improvement the total for 2013 is not much less than that of 2011 and again while 2014 is an improvement over the three preceding years, our Database still recorded an extra USD1 billion over and above the figure for 2009 and an extra USD500 million on top of the figure for 2010.

Of course, this chart remains a somewhat rudimentary tool in terms of discerning overall profitability, and it must be borne in mind that a significant percentage of these losses may have been absorbed by self-insured retentions, captive insurance companies and Oil Insurance Limited.

**Lloyd’s figures point to overall portfolio profitability**

What other tools are available to us to determine downstream market profitability? The Lloyd's audit code figures for Downstream Property are set out in the chart below. Although Lloyd’s comprises only a minor part of the overall Downstream market, and in general terms does not see as much of the quota share portfolio as its composite market counterparts, we can still get some sort of impression as to where the portfolio is heading.
Lloyd’s Downstream Property Incurred Ratios, 1993 – 2014 (as at Q4 2014)

The recent Downstream record at Lloyd’s continues to suggest overall portfolio profitability.

This chart shows a slightly more positive outlook for Downstream insurers compared to the statistics from the previous chart. It is generally accepted that an Incurred Ratio (premiums received compared to paid and outstanding claims) of 80% or below is usually sufficient to maintain profitability in any given class. On this basis, it appears to be the case that Downstream insurers, in Lloyd’s at any rate, have made money in every year since hurricane Ike in 2008 apart from 2010, when most of the policies covering the Japan earthquake of 2011 incepted.

Differing portfolio perspectives

There is perhaps one further consideration to take into account in determining overall 2014 profitability – how this sector is viewed within the management of the insurer in question. For example:

— Some insurers prefer to look at their Property and Casualty (P&C) portfolio on a general basis, in which case given that many composite insurers continue to report a healthy combined ratio for this sector the portfolio can be regarded as generally a profitable one.
— Some prefer to see Downstream paired with Power and Utilities (especially as in many companies the same underwriting team is responsible for both portfolios); given the relative lack of profitability in the Power sector which we refer to later in this Review, in these companies this portfolio will therefore be seen in a more negative light.
— Some prefer to link their Downstream portfolio with their Upstream book, in which case because of the excellent Upstream results the portfolio can be viewed in a much more positive light.

Profitable or not, insurers will have to compete more in 2015

What can we conclude from these different approaches? In overall terms, it is certainly unclear as to whether this portfolio is making much of a return for most of the market. There can be no doubt that the loss record has not been nearly as favourable as Upstream, and premium levels have remained relatively flat. Certainly as we reported last year any attempt to force prices upwards has been resisted, and while there have been a few examples of withdrawal from the market, as yet we continue to see no signs of any wholesale market withdrawal – if fact, quite the opposite as our capacity data suggests.

Indeed, the elementary laws of supply and demand suggest that, regardless of current profitability levels, Downstream insurers will have to compete more vigorously this year given the rise in capacity. But even if they compete, will there continue to be sufficient demand for their products?
Reduced demand and cheaper oil prices will drive premium out of the market

The capacity increases referred to earlier would usually on their own lead to a softening market, even if demand for Downstream market products continued to remain robust. However, this fresh capacity injection has come at a time when:

— Many insurers’ premium income targets have been increased, in an attempt to ensure a reasonable Return on Equity for the capital that has been invested, but at the same time.
— Decreased risk management budgets (see our leading Special Feature) as well as the adoption of more sophisticated Risk Engineering tools, maybe forcing Risk Managers to reconsider the necessity of purchasing as much risk transfer as possible.

Oil price fall not as critical as for Upstream – but still significant

Although the collapse in oil prices is not affecting the Downstream sector as much as its Upstream counterpart, the pressure on risk management budgets in this sector is likely to be just as intense. To begin with, the major integrated oil companies that have both Upstream and Downstream operations will be feeling the impact of the low oil price in any event, and so pressure will be applied to these Risk Managers to make as much savings as possible across the board, while even companies that are only involved in Downstream operations are going to be declaring reduced Business Interruption values. And although margins have been temporarily high in some quarters due to cheaper feedstock prices, at some stage these margins will surely come under threat as the effect of lower oil prices finds its way through to produce lower refined product as well as feedstock prices.

One example from our own experience illustrates the issue of how much cover currently being purchased in the market may not be so in the future. In recent weeks we have seen one major energy company halve its programme limits from USD3 billion to USD1.5 billion, on the basis that while the official Estimated Maximum Loss of USD3 billion remains as valid as it has ever been from an engineering perspective, the likelihood of a loss exceeding USD1.5 billion has been considered remote enough to be able to be self-insured. As a result, this particular client has made some significant premium savings, while several insurers who have perhaps banked on income from this buyer year on year, have been discarded from the programme. Indeed, such is the capacity offered by the major composite insurance companies who prefer to participate in the main part of a company’s risk programme (i.e. the first USD1 billion or USD1.5 billion) that a major buyer’s broker only has to look to maybe five or six insurers to ensure the completion of the programme.

Downstream losses in excess of USD1 billion, 1973-2015

There have only ever been four Downstream losses ever recorded by our database in excess of USD one billion – even the largest was only USD2 billion. It’s perhaps no wonder that some buyers are restricting their programme limits to USD1.5 billion, reducing the premium available to the market.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>TYPE</th>
<th>SUB CATEGORY</th>
<th>CAUSE</th>
<th>REGION</th>
<th>TOTAL ACTUAL USD</th>
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<tbody>
<tr>
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<td>Fire + explosion/VCE</td>
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<td>2005</td>
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<td>2014</td>
<td>Refinery</td>
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<td>Eurasia</td>
<td>1,020,510,000</td>
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<td>2011</td>
<td>Oil Sands</td>
<td>Upgrader</td>
<td>Fire no explosion</td>
<td>North America</td>
<td>1,000,000,000</td>
</tr>
</tbody>
</table>

Source: Willis Energy Loss Database as at March 9, 2015 (figures include both insured and uninsured losses)

Pressure mounts on Excess markets

We anticipate that this is a trend which will continue during 2015, as Risk Managers focus on their exposure up to USD1 – 1.5 billion, ensuring that adequate cover is in place for all but the most remote risks and demonstrating savings by self-insuring in excess of a figure which they believe is unlikely ever to be threatened. And in the absence of a truly catastrophic loss to prove otherwise, who is to say that this does not represent a sound strategy – especially when buyers can generate additional competition for the USD1 – 1.5 billion stretch of their exposure by so doing.

But in the meantime this leaves large sections of the Downstream market, especially those with underwriting capacities below USD100 million who find it hard to compete with the major composites in terms of capacity, in a potentially precarious position.
While previously they could rely on a steady diet of excess layers of major programmes to produce sufficient income to make their portfolios worthwhile, if our earlier example starts to become the rule rather than the exception, they may well find themselves squeezed out of a significant proportion of their overall portfolio, forcing them to compete more aggressively for smaller and less profitable business.

Of course they would like to compete with the major composites for a share of the most sought after programmes, but with considerably less capacity they will be hard pressed to persuade major buyers and their brokers to include them on these programmes — unless they begin to offer even more competitive terms and undercut their larger leaders. Even then, without major composite market support it would take a brave broker to back a smaller lead and feel confident of completing the programme. Instead, we are seeing some smaller insurers start to show more interest in business from some third world countries where the standards of engineering are lower than average.

**Regional competition continues to increase**

In the meantime we can report that the competition between global insurers and their regional market competitors has increased even further since last year. Unlike the Upstream market, there is now significant capacity in at least five different cities across the globe – Houston, Miami, London, Dubai and Singapore – to absorb the first USD1 billion of a local Downstream programme. Given our earlier reflections on the potential for further reduced limits, it almost seems that the Downstream market is on its way to becoming more regionalised, especially in countries such as China and Korea where insurers are becoming particularly competitive. Should a more regional marketplace materialise, it may be that the only other way in which some of the smaller London insurers can stay in the game is to start to offer attractive facultative reinsurance to the major leaders – thereby fuelling the softening process still further.

**The outlook for 2015**

*Global Downstream capacity versus rating levels, 1993 – 2015 (excluding Gulf of Mexico windstorm)*

> Average rates may be at their lowest levels for 22 years, but the relentless increase in capacity is continuing to force them even lower.

![Graph showing Global Downstream capacity versus rating levels from 1993 to 2015](image)

*Source: Willis*
Our chart on the previous page shows the relationship between available capacity and estimated Downstream average rating levels over a 22 year period. The supply and demand correlation is remarkably consistent during this period, with the exception of the unusual period between 2002 and 2004 in the immediate aftermath of the capacity crisis prompted by September 11. What the chart also shows is how, as capacity has increased to record levels during the last few years, rating levels have continued to be held at the bottom of their historical range — and therefore at levels whereby the profitability of the portfolio is always going to be called into question eventually, once we have a year where catastrophe losses re-emerge as they did last in 2011.

Can anything stop the softening process?
All the signs in 2015 point to a further softening of the market, and perhaps the only way that there could be any sort of a market upturn would be if:

— The market experienced a series of catastrophic losses in 2015, including a sizeable Gulf of Mexico windstorm — even then, with the restricted aggregate limits imposed in the aftermath of hurricane Ike this may not impact the market as much as it would have done in the past.

— The market experiences a plethora of losses in the USD100 — 500 million range, high enough to be significant but not high enough to be covered by their excess of loss reinsurance treaties – this dynamic has already accounted for one major Downstream player in 2014. And with Risk Management budgets been reduced, we believe that more losses within this range might materialise in the future.

— A significant proportion of the following market become starved of premium income due to the serious reductions in programme limits and any increased use of captive insurance companies referred to earlier, necessitating their withdrawal from this sector.

So with even further softening of rating levels evident in the first few months of 2015, how will the Downstream market leaders respond? Some of the more obvious measures may not help them:

— For example, they could simply write for premium and try to undercut the opposition, but of course simple logic suggests that if every leader adopts this approach then the market will simply be back to square one with the available premium pool reduced still further (see our leading Special Feature).

— In order to generate more premium income, they could lower existing retention levels, but we see no enthusiasm for this from buyers who generally are as keen as the insurers are to avoid dollar swapping at a meaningless level.

More realistically, other alternatives might include:

— **Increasing sub-limits.** We are beginning to see a relaxation of some sub-limits, particularly for Contingent Business Interruption and some natural catastrophe risk. However, this is more than offset in cases where overall programme limits are being significantly reduced.

— **Developing package solutions.** In particular, we foresee the increasing inclusion of Terrorism within Property programmes at heavily discounted terms, while for the major composite market, the opportunity to offer a “one stop shop solution” along the lines discussed in our Special Feature is if anything greater now than at any time during this particular market cycle.

— **Offer a seamless construction through operating product.** Finally the potential continues to exist for major composite insurers to offer a seamless product that covers not only all construction activity for a particular project but also the operating life of the project for its first 12, 24 or even 36 months. Such a product may well be welcomed by buyers as so often in the past disputes have arisen regarding losses sustained just before or just after the handover period. These market conditions may encourage some Property underwriters to reach out to their Construction counterparts to develop a seamless solution, which in turn may guarantee more of their overall market share in both disciplines.

As discussed in our leading Special Feature earlier in this Review, the options open to the buyer are either to stick with their existing risk transfer partners through this period of the market cycle or to follow the market and select the most competitive option. In this market, we believe that generally it will pay buyers to stick with their leaders, on the basis that as they come under more pressure from some of the disenfranchised former excess layer insurers (often those with less capacity than the major composite insurers) they generally have the financial muscle and spread of business to be able to afford to respond and match any bids to undercut them.

In the meantime, the overall sentiment within the market is one of apprehension – apprehension on premium income levels, on regional competition, on placement signings and, more than any of these factors, on buyer appetite for their products.
A challenging year...

2014 was a challenging year for insurance companies operating in the Power sector. Like other Natural Resources sectors, this market is oversubscribed with capacity, which naturally increases competition and therefore creates the conditions for a continued softening of the marketplace. Furthermore, the volume of losses that the sector has experienced presents further challenges for the underwriting community.

Power losses and incidents, 2014

Both the frequency and severity of 2014’s Power losses have reduced in 2014 compared to past years – but not by much.

The Power industry has suffered both the occasional ‘mega’ loss (defined as a loss that exceeds USD100 million) and more significantly the attritional losses that ultimately decide insurers’ underwriting results through their high frequency. Losses in the global power market in 2014 amounted to roughly USD2.2 billion, compared with global premiums of approximately USD2.5 billion, which continues the pattern of the previous five years in this sector. These losses have arisen from a broad range of incidents, but principally fall under the Machinery Breakdown heading and are often associated with gas turbine technology.
Power losses in 2014 have arisen from a broad range of incidents, often arising from the use of gas turbine technology.

2014/15 market developments

Although the market is still experiencing over-capacity, there have been some significant capacity withdrawals from the sector. XL and Infrassure were the two main capacity withdrawals in 2014; both these two large carriers provided capacity on a Quota Share basis, with XL in particular acting as a leader on some accounts. Infrassure ceased carrying out insurance activity and went into run-off, while XL took the decision to pull out of the open market Onshore Energy sector entirely, while continuing writing other insurance lines.

These withdrawals have had a minimal effect on the continuing downward trend of rates, which has been boosted by the new capacity entering the sector:

- The Hardy syndicate, who were principally an excess capacity provider in the sector, changed their underwriting approach to start underwriting business on a ‘ground up’ basis, in the form of primary and Quota Share limits. This has been facilitated by acquiring the underwriting team from Mitsui.
- ARK syndicate are showing a greater appetite to underwrite excess of loss in the sector, having acquired three underwriters from Hardy.
- Pioneer are new to the market, offering principally primary capacity.
- Mitsui have employed a new team both from underwriting and broking backgrounds, underwriting at a primary level.
- Aviva have entered the conventional power market and will be writing Quota Share. Previously their involvement in this sector has been limited to renewables
- Priority Underwriting Limited (PUL) is a Managing General Agent which will underwrite on a primary basis.

In addition to the technical markets that have traditionally underwritten Power risks, the over-subscription of capacity in the sector is also the result of general property insurers becoming increasingly active in the sector. Likewise, greater international market capabilities and a broader approach to risks written (including Power) are increasing the amounts of theoretically
available capacity. This appetite for Power business on the part of general Property markets and international carriers adds further competition to the technical London markets, which may no longer be relied upon to lead such risks.

Another factor behind the over-supply of available capacity is the relative shortage of major catastrophe events since 2011, which has exerted downward pressure on the market as a whole, including the Power market. As we state elsewhere in this Review, increased investment in the insurance industry as a more attractive option for investors than certain other financial markets adds further downward pressure.

**Market differentiation efforts begin as softening takes hold**

It appears that insurers with long term ambitions in growing their premium from the Power sector will have to look at ways of differentiating themselves from the competition. Some of the differentiation measures seen to date have been:

— **The ability to lead.** Although the market is saturated, it is important to note that the ability to lead a major Power programme is still limited to a number of carriers. There are only five or six principal traditional lead markets, with the rest of the market taking their position from these credible leaders. We have seen these leaders try and partner with the broker early and obtain a competitive position to ensure they obtain an acceptable share of a placement.

— **Working with brokers to target new opportunities.** Underwriters have contacted us directly to work hand in hand in targeting new business. Brokers that have target territories and accounts which align with insurers’ ambitions may partner with an insurer in respect of both technical services and lead terms – while keeping in mind at all times their obligation to obtain the best terms for their clients. Insurers are aware that a traditional “subscription market” approach leaves them vulnerable to competition and that developing a stronger relationship with the buyer strengthens their position. The cycle of business coming into the London market is diminishing as a result of competition from local markets, increasing the need for London insurers to differentiate themselves.

There is a clear change in underwriting philosophies from a number of insurers, whilst others are sticking to their ‘tried and tested’ approaches. Those underwriters who are willing to adapt to the prevailing market conditions are approaching risks with an open view as to the price reductions they should offer at renewal. Their attitude is generally characterised by one or more of the following behaviours:

— For long term clients with a good market relationships, up-to-date underwriting information and a good loss history, they will support these programme with at least their existing line, unless the renewal rate and/or conditions are seen as too aggressive. In these circumstances they will often look to maintain their involvement on the account but with reduced capacity, rather than walking away.

— Some underwriters are offering increased shares on placements, in order to maintain their premium income in a falling market.

— Some are showing greater flexibility to write on a Quota Share, primary or excess basis, rather than rigidly sticking to their previous attachment points and limits.

— Some underwriters who in the past might have waited for a placement to take shape before offering follow capacity are now offering lead terms, in an attempt to mitigate signings.

The market is also showing increased flexibility with regard to clients’ coverage requirements. One innovation we have seen in the Power sector is the market being prepared to consider writing Business Interruption cover on a Fixed Indemnity basis, where the Insured sees this as being in his interests and is able to offer a sound rationale and business case.
Changes in market dynamics, 2015

Rating
— Rating levels have fallen, with the pace of price softening accelerating towards the last quarter of 2014. Typical rate reductions range between 5% and 20%, with risk quality and account history being key factors.
— Pricing has also been favourably affected by a reduction in the prevalence of differential pricing on syndicated placements, as a number of programme participants that had previously enjoyed more favourable prices have tended to fall into line with the leader’s terms.
— Where premiums have been previously loaded following a catastrophe event, these loadings are being reduced or eliminated in response to the benign global catastrophe activity of the past three years.
— In some cases regional markets are increasing the downward pressure with aggressive pricing behaviour.

Deductibles/retentions
— Notwithstanding the soft market conditions, the technical leaders continue to show discipline over deductibles, especially around turbines and Business Interruption.

Coverage
— There has been no significant change in the coverage generally available, but in some cases underwriters are agreeing higher sub-limits for certain policy extensions.
— The incidence of differential terms and conditions on syndicated placements, which had become commonplace on complex programmes with a large number of participating insurers, has reduced, as a result of the pressures created by market over-capacity.
— Some of the more technical underwriters are willing to entertain different approaches (e.g. surrounding business interruption indemnity) where the Insured can make a business case.

Capacity
— Capacity and appetite are strong, particular for the better quality risks.
— Some insurers are offering increased capacity compared to 2012 and 2013, and some whose business model has previously been to operate at an excess of loss basis are looking to get involved at the primary level, increasing competition in the area where the bulk of a programme premium lies.

The outlook for 2015
In our view, the Power market will continue the trend which has been seen since early 2014 of sustained softening. This is despite a backdrop of losses to the sector at similar levels to prior years at around USD2.2 billion. The abundance of capacity (likely to remain in the region of USD 2.5 billion) in the insurance market will continue to drive rates downwards in the absence of significant Natural Catastrophe losses.

Gap between Power and Property closing
The Power market, historically and currently, has lagged behind the wider property markets in terms of its rating movements, but during the January and February 2015 renewals we started to see evidence of the gap closing. With some caveats, clean business renewed with a rate reduction of circa 10% – 20% and accounts with active loss histories flat to +5%. There were obviously exceptions in both categories, particularly for accounts with high-profile or large losses. Underwriters will continue to try to resist significant rate reductions in 2015, but with Property insurers increasingly entertaining the sector and further competition from regional areas, this stance will become under pressure. We believe that markets will continue the trend for increasing lines on renewal business to maintain premium income.
The design of insurance placements in 2015 will continue the pattern forming latterly in 2014. For large programmes with no losses and limited catastrophe exposure the programme structure will most likely be of a proportional nature. However, accounts where there have been losses will most likely be structured non-proportionally in order to isolate the impact of any losses within the PML and drive pricing in the excess of loss markets.

**Good underwriting submissions still vital**
To enable Power underwriters to continue in the sector and justify their underwriting decisions, quality and up-to-date risk information will be paramount. It would be a mistake to conclude from the soft market conditions that this is no longer a requirement; underwriters in the Power sector want to see a demonstration of proactive risk management to avoid attritional losses, and are looking more than ever to participate on high-quality risks with the lowest chance of posting losses. The provision of clear, well presented risk submissions supplemented by risk engineering surveys will assist in generating the optimal result for the client.

**2015: a year of changing priorities**
As 2015 progresses, the changing priorities of the Power market will become evident. Few markets are writing for “top-line” premium income, and therefore the focus will be on profitability driven by risk selection. The role of the broker will therefore be to ensure that a specific client stands out from the crowd by promoting proactive risk management and asset maintenance through roadshows and submissions. The requirement for high quality and up to date information will be paramount for clients to differentiate themselves and achieve the best results from the insurance industry.

“The Power market, historically and currently, has lagged behind the wider property markets in terms of its rating movements, but during the January and February 2015 renewals we started to see evidence of the gap closing.”
Introduction – industry conditions remain tough

In line with global stagnation in the commodity markets, demand is still down and the tough economic environment continues for mining companies. Highly leveraged financial transactions made when commodity prices were high in 2007 and 2008 continue to weigh on many mining companies. Conditions are so dire that bankruptcies are starting to occur for the highly geared. Struggling mines are being put into care and maintenance, and many “juniors” are falling by the wayside. Capital is extremely tight, but for those with access to it the opportunities are considerable.

A rare piece of positive news for buyers...insurance costs are falling!

The interaction between surplus insurance capacity, lower insurable assets, lack of construction projects and a relatively benign claims picture are all contributing to the softness of the current market.

How to drive the best insurance deal is therefore vital in this environment, and not all miners will be treated the same way by the market.

Capacity increases

Capacity continues to expand and the current available property capacity is between USD1.2 — 1.5 billion (excluding FM Global) for aboveground exposures. Underground capacity is also expanding, but at a slower pace, with Underground Business Interruption capacity now at approximately USD300 — 350 million. Underground coal capacity is still typically no more than USD150 million. These are typical maximums and there are still some variations within regions.

Excess liability capacity is now in excess of USD1 billion, with underground mining capacity still significant at USD700 — 800 million. Capacity remains dependent on attachment point and specific account characteristics.

Losses: few headline events

There have been very few “headline” losses since Rio Tinto’s Bingham Canyon loss, and natural catastrophe events in particular are indisputably low (please see the table overleaf).

“The interaction between surplus insurance capacity, lower insurable assets, lack of construction projects and a relatively benign claims picture are all contributing to the softness of the current market.”
### Major Mining losses, 2013 – 2015

<table>
<thead>
<tr>
<th>DATE</th>
<th>TERRITORY</th>
<th>CAUSE</th>
<th>QUANTUM (USD NET)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1’13</td>
<td>USA</td>
<td>Pit Wall Failure</td>
<td>800,000,000</td>
</tr>
<tr>
<td>Q2’13</td>
<td>Canada</td>
<td>Machinery Breakdown</td>
<td>300,000,000</td>
</tr>
<tr>
<td>Q3’13</td>
<td>USA</td>
<td>Buried Longwall</td>
<td>180,000,000</td>
</tr>
<tr>
<td>Q1’14</td>
<td>South Africa</td>
<td>Earthquake &amp; Fire</td>
<td>200,000,000</td>
</tr>
<tr>
<td>Q1’14</td>
<td>Philippines</td>
<td>Machinery Breakdown to a SAG mill</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Q1’14</td>
<td>Australia</td>
<td>Fire in a benefaction plant</td>
<td>120,000,000</td>
</tr>
<tr>
<td>Q3’14</td>
<td>British Columbia</td>
<td>Tailings Failure</td>
<td>25,000,000</td>
</tr>
<tr>
<td>Q3’14</td>
<td>Asia</td>
<td>Fire - hot work failure</td>
<td>65,000,000</td>
</tr>
<tr>
<td>Q4’14</td>
<td>Australia</td>
<td>Flood - breach of sea wall</td>
<td>250,000,000</td>
</tr>
<tr>
<td>Q4’14</td>
<td>Papua New Guinea</td>
<td>Machinery Breakdown - belt failure</td>
<td>15,000,000</td>
</tr>
<tr>
<td>Q1’15</td>
<td>Australia</td>
<td>Leach Tank Collapse</td>
<td>90,000,000</td>
</tr>
<tr>
<td>Q1’15</td>
<td>New Caledonia</td>
<td>TBC</td>
<td>outstanding</td>
</tr>
<tr>
<td>Q1’15</td>
<td>Namibia</td>
<td>Machinery breakdown</td>
<td>outstanding</td>
</tr>
<tr>
<td>Q1’15</td>
<td>South Africa</td>
<td>Fire</td>
<td>outstanding</td>
</tr>
<tr>
<td>Q1’15</td>
<td>Zimbabwe</td>
<td>Underground Collapse</td>
<td>100,000,000</td>
</tr>
</tbody>
</table>

Source: Willis

**A profitable portfolio – so competition is intensifying**

Operational losses continue to erode underwriting profits, but not sufficiently to affect market dynamics. While it is always difficult to isolate and identify insurer profitability, it is widely accepted that the segment is profitable at the present time and has been for the last four underwriting years since the Queensland floods of 2010/2011. As illustrated in our table above, significant claims are occurring, but apart from Bingham Canyon (which is part of a very large insurance programme with substantial retentions) claims have not been of the magnitude of the Queensland floods.

While the Mining market has historically had periods of divergence away from a soft General Property market cycle, the relatively benign mining claims experience of recent years is minimising this effect. Furthermore Reinsurers, who themselves are under intense competition from alternative capital suppliers, are throwing additional capacity in to the Property market and the Mining sector is not immune from this positive trend.

**Lower values threaten premium income**

On-going cost cutting in the mining industry is flowing through to progressively lower insurable values. This phenomenon, combined with falling rates, is requiring insurers to write larger shares of programmes to maintain or grow their premium income. Furthermore, the absence of a strong construction “pipeline” is making insurers compete even more fiercely for operational programmes to compensate for a lack of construction premium.

**Cross class underwriting more popular as specialist Mining insurers often prove to be the most competitive**

The interaction between surplus capacity, lower insurable assets, lack of construction projects and a relatively benign claims picture is underpinning the softness on the current market. Looking at both new and existing business on a cross-class basis is therefore now the norm for many insurers who want to maximise their premium pool and secure favourable signings on their principal lines of business.
While insurers share a common dislike of the soft market, there are some discernible differences in approach. Mining specialists, with a single focus on the segment, seem more closely in tune with their clients. They acknowledge that the cost and revenue pressures faced by miners are every bit as brutal as those they face in the insurance market, and as such some see their discounting of terms as a genuine offer of assistance to clients in need.

**Regional variations**

— For South American business, the soft international markets have become relatively more competitive leading to greater orders and deal flow for the London market.
— The South African market is awash with surplus capacity largely underpinned by easier access to both treaty and facultative reinsurance capacity. Increased reinsurance spending is resulting in insurers setting higher gross written premium budgets.
— In the US there appears to be a significant variance in pricing as insurers favour those buyers with the strongest engineering profile.

**Key issues**

— Business Interruption, as always, remains the primary concern of insurers. Peak risks such as complex supply chain exposures, political risks, riots, strikes, civil commotion, cyber threats and actions by public and regulatory authorities and (most currently) tailings dams, remain at the forefront of insurers’ concerns.
— Declared values, alternative structures and valuation methods that track current market trends of mine closures and oversupplied equipment are being discussed on a more frequent basis.
— Cost cutting across the mining industry is causing insurers to question the levels of maintenance and risk reduction investment, particularly as existing plant and resources are being worked harder.
— On the positive side, waiting times for mobile plant and key machinery are lower and workforce turnover (for key employees) is reduced.

**Market movements**

— BHSI (Berkshire Hathaway) has set up in Australia and is expanding in the US
— Domestic Australian carriers such as Vero and CGU continue to expand their appetite for mining
— Infrassure ceased underwriting in 2015 and some underwriters have found new roles
— Swiss Re Corporate recently opened in South Africa

The outlook for 2015 - how to get the best out of your insurers

Barring a market moving event, probably of financial origin and of catastrophic proportions, we see the balance of 2015 playing out much the same as 2014, with carriers aggressively chasing business.

Nonetheless, in 2015 miners will face increased scrutiny from insurers over their ability to maintain risk management standards in a heavily cost constrained environment. There may be a perceptible “flight to quality” by insurers and terms available for risks considered to be top quartile will be treated more favourably than those deemed to have a mediocre risk profile. Those mining companies with a strong engineering focus, who can effectively address questions over peak exposures (particularly relating to Business Interruption) are more likely to obtain coverage enhancements, lower retentions and the full price benefits of competition.

The utilization of analytics to drive programme structures will continue to gain traction, providing an environment where miners can show off their individual company metrics in a more sophisticated negotiation strategy with their insurance partners. What was a market characterized by industry peer benchmarking will gradually become more individually focused. In particular, structured deals have become a strong feature of the South African and Australian markets.

While the global operating environment remains challenging for all miners, the insurance marketplace offers a safe haven in the storm. With creative thinking, strong relationships, well documented information and an innovative and aggressive broker strategy, miners should expect to achieve effective balance sheet protection at a reduced cost in 2015.
Introduction – a seventh year of continued softening
The Onshore Construction market, like most (if not all) classes of property insurance, remains a competitive environment for the seventh year running – in some respects, we are at an unprecedented low point. The market scramble for business, coupled with low oil prices, has meant a sizeable reduction on new builds within the Energy sector during the last 12 months. As a result of all of this, apart from projects being developed in India and China, there has been a noticeable slow-down in proposed investment in this sector in countries such as like Russia, Vietnam, Brazil and even the Middle East. Meanwhile, the Onshore Construction Markets playing in the other Natural Resources sectors are beginning to widen their product offering, both in terms of existing policy parameters and to a certain extent additional products.

Sanctions issues and oil price collapse reduce premium opportunities
A major change over the last 12 months has been the fallout over the alleged Russian involvement in Ukraine and the resulting sanctions applying to Russian individuals and companies. The London and European insurance markets have become important partners to these Russian Energy companies. So if we combine the significant effect that these sanctions are having with the resulting fall in oil prices, it seems clear that the lack of investment opportunities for Russian companies is resulting in reduced premium opportunities for these markets.

Brokers instigate the innovation process
Innovation is emerging more from competitive pressures than from the provision of creative new products. However, with the competitive market comes fresh impetus from the broking community to reach out for new innovation. Areas of focus include:

- Better Delay in Start Up covers
- Easier acceptance of wider cover such as Suppliers’ and Customers’ extensions
- A more liberal attitude towards projects that have reached Provisional Acceptance that consequently should be insured under an Operational policy
- As referenced elsewhere in this Review, there is now a more blurred line between Construction and Operational than ever before

Loss record makes little impact
There have been a number of Construction claims in the Natural Resources arena since we reported last year, including one notable Energy claim in Algeria. However, these losses have made no impact on the overall claims experience for the global Construction market.

Market movements
There has been quite a significant amount of market movement in the last 12 months, which includes the Torus team of four underwriters who have moved to Kiln/Tokio Marine, with their positions at Torus been taken by for individuals from Zurich. The Zurich space was subsequently filled by an underwriter from Swiss Re, a senior underwriter from HSB and the relocation of the Regional Underwriting Manager from Switzerland to London and some internal relocations creating the new Construction team. In addition, two underwriting operations within Munich Re (CIP and Reinsurance London Branch) have replaced their leading underwriters with underwriters from Zurich and Chubb respectively.

As in other insurance sectors, Infrassure has closed its doors for Construction underwriting, seeking dramatic exit strategies with brokers for projects written. A new entrant in the market – Allied World Assurance Company (AWAC) – has publicly opened its doors to Construction and
Energy underwriting (amongst other sectors), employing Alf Mueller from AIG and Ronan Beerli from Infrassure. These two people will soon be followed by an additional underwriter who has been employed by Kiln/Tokio Marine. Liberty saw one of its retiring underwriters being replaced by an underwriter from Talbot Syndicate and the recent merger of Catlin and XL has seen the departure of Paul Latimer in London to go to Travellers, although his business appetite and objectives are as yet unknown. Finally ACE saw the departure of its Power Underwriting Manager Ian Smith to join Hardie Syndicate, thereby boosting its capabilities up by 50%.

**Middle East tensions and Ebola affect construction industry**

As well as the lower oil prices project values seem to be escalating significantly; projects with values upwards of USD10 billion are no longer an eye-opener, with similar values being related to Advance Loss of Profits or Delay in Start Up. Furthermore, the Middle East and its on-going troubles have greatly impacted the growth of the oil, gas and petrochemical industries in countries such as Iraq, Libya, Algeria and Syria. Similar challenges are being faced in some of the heavy natural resourced countries in Africa. Here, energy projects in territories such as Nigeria and Equatorial Guinea and mining investments in territories that were affected by the Ebola outbreak caused a lack of insurance opportunities, and therefore a reduced premium flow to the London and international markets.

Other major factors to impact the market include:

- Technology upgrades
- The lack of catastrophe losses
- The dominance of Chinese Contractors and Chinese funding
- The absence of captives for contractors and most owners involved in the Natural Resource sector
- Rapidly expanding regional markets in Singapore, Dubai, Hong Kong in addition to the traditional market of London
- The emergence of regional markets in Miami and Australia, which are teetering on the brink of becoming more greatly established

**Improving technology less of a concern**

The issue of improving technology to gain more efficiency, both from a power perspective and processing units for the oil, gas and petrochemical industries, has become less of a concern. Turbine manufacturers have not seen the great strides in progress that have been seen over the past 10 years in other sectors, although unproven/prototypical installations are still treated with extreme caution – these allow insurers (at least to a certain extent) to maintain the consistent level of deductibles that have been applied over the last five years.

**Maintenance of market share a key driver**

The main priorities for insurers specialising in the Onshore Construction market are to ensure that they achieve a fair share of the premium volume on offer, to maintain their position in the minds of the brokers, to see all new risks and to hope that the rates, deductibles and scope of cover are maintained to as near to the 2014 (or even 2015) level as possible. Another priority is the quality of information and the importance paid by the carriers to a clear and concise explanation of the risk. As ever, this should be accompanied by as much additional information as possible, including risk engineering reports, quality controls, site conditions and, in areas of high natural catastrophes risk, the modelling and construction methods that are being adopted to combat these exposures.

**More overt marketing and acceptance of lower deductibles**

From a market perspective, the prevailing conditions are showing an interesting change of attitude by insurers towards enticing business, by using their sizeable capacity increases and a more flexible attitude towards cover. However, one of the most noticeable changes over the last 12 months has been the reduction in deductibles and the seeming acceptance by insurers that lower deductibles can be regarded as normal. The seven major reinsurance markets still dominate the sector, namely Munich Re, Swiss Re, Allianz, SCOR, AIG, ACE and Zurich. However, the “balance of power” that has been evident for the last five years with other markets such as CV Starr, the Construction Consortium at Lloyd’s, XL and Liberty continues to prevail.
Mergers and acquisitions open the door to new product development

Like other industry sectors, the mergers and acquisitions that have recently taken place, including XL and Catlin, Kiln and Tokio Marine and the impending purchase of RSA Asia operations by AWAC, create the opportunity for additional capacity and even additional lead markets for certain risks. One significant example of this positive approach from international markets has been the emergence of major refining and petrochemical projects in territories such as India. In one such example, the market faced the challenge of being requested to include Advance Consequential Loss cover to an existing Property Damage policy at a critical stage of the construction, with a complex structure of multi-completion dates, interdependency and an extremely large insurable indemnity. The market responded with a solution filled with capacity, creativity and appetite. This is not only a sign of a competitive market needing to respond but a market wanting to provide a response and a solution.

Softening process includes both rating and deductible reductions

Over the last 12 months a noticeable reduction in both rating and deductibles has occurred, which on average has consisted of a 30% reduction in rates and a 20% reduction in deductibles. The London Engineering Group continues to dominate innovative covers, but not at the expense of heavy reduction in rates or deductibles. The global capacity for Natural Resource projects stands at approximately USD4 billion on a Probable Maximum Loss basis, although it has to be recognised that this anticipates a project attracting all the available capacity and therefore the terms and conditions are at acceptable levels for all Construction & Engineering underwriters to participate. There have been some noticeable absentees, particularly Berkshire Hathaway who have reduced their appetite levels for single projects, preferring to put their capacity behind reinsurance treaties of regional underwriting markets, particularly Asia.

The outlook for 2015 - are new products on the horizon?

Going forward into 2015 and beyond, there seems to be no sign of any hardening and more importantly little sign of the downward trend for terms and conditions. Natural catastrophes will continue to occur whether earthquakes, hurricanes or flooding (as occurred in Thailand) but construction projects very rarely suffer from these events and therefore they have no impact in the conditions that might apply in project insurance. Technological losses or high value losses incurred in some of the mega-projects are likely to be easily absorbed without conditions being affected, and so therefore we see little change over the next 18 months to global terms and conditions. The natural resource sector remains highly skilled, with quality contractors and supply chain processes; this will only continue to produce competitive levels of terms and conditions and widening of cover.

New products, such as Liquidated Damages, Performance Warranties, Supply Chain Warranties and combined insurance programmes involving Marine and Construction or Construction and Operational risk are likely to be an realistic proposition from the international markets in the future.
“The formation of IS has had significant impact across the Middle East and North Africa. The emergence of an alliance with Boko Haram significantly increases the possibility for cross border attacks in Northern Africa and widens the scope for coordinated attacks in multiple regions.”
TERRORISM & POLITICAL VIOLENCE

Introduction
2014 has seen the continued development of capability and scope of global terrorist activity. The focus is with the activities of Islamic State Militants, but they are far from the only threat:

— Extremist terrorist activity has become increasingly widespread, sophisticated and co-ordinated.
— Terror groups have the strategy, the capability and the funds to launch sizeable attacks, with US/Western companies remaining the key targets.
— “Lone Wolf” attacks on soft targets continue to increase in scope and frequency.
— Iraq, Syria, Libya, Russia and Colombia are all key areas where attacks have been most prolific, coupled with the high profile incidents in Paris and Nigeria.
— Violence continues in Africa. In West Africa, Al Qaeda inspired groups, MEND, Islamic State Militants and their allies Boko Harem; in East Africa, predominately Al Shabaab. Further attacks against Western, Government and Strategic interests should be anticipated in both regions.
— The Terrorism & Political Violence markets in London, Singapore and Dubai, in spite of significant losses, have remained competitive, with rate reductions for most risks – this is expected to continue through 2015.

IS behind the increase in global terrorism activity
2014 saw increased levels of terrorism and political violence and significant new threats emerge. Chief among this is the formation of the Islamic State movement within Iraq, Syria and newly Libya and as many readers will know, this movement is well funded, organised and ruthless. The civil war within Ukraine escalated with alarming rapidity and caught western countries by surprise. The emergence of these two separate situations clearly underlines the expanding threat is no longer just traditional Terrorism market risk but also the wider perils of Political Violence.

The formation of IS has had significant impact across the Middle East and North Africa. The emergence of an alliance with Boko Haram significantly increases the possibility for cross border attacks in Northern Africa and widens the scope for coordinated attacks in multiple regions. IS are ideologically driven to expand their territory and, with the slowing of progress within Iraq and Syria, North Africa offers them new avenues to continue their territorial expansion.

Focus will continue to be on energy infrastructure
IS considers energy infrastructure critical to their operation, as oil and gas production is one of their main methods of generating finance alongside kidnappings and ransoms. The income generated has helped propel them to their position as the pre-eminent Islamic extremist group; oil and gas production in Syria and Northern Iraq therefore remains under considerable threat and it will be interesting to see if this strategy is repeated in Libya.

Energy and mining companies remain at an increased threat level due to their propensity to work in hostile environments and the high value of their product. Moreover, due to the international nature of many energy and mining operations there is often a nationalist sentiment against their operations locally which can easily be exploited by extremist groups.
Tensions in Former Soviet Union

The civil war in Ukraine was widely unexpected. The involvement of Russia and the annexation of Crimea have increased the tensions between Russia and the West. The use of sanctions to financially inflict damage upon Russia has had a mixed result and further divided the two spheres of influence. Former Soviet countries, Lithuania, Latvia and Estonia especially, are subject to increased tensions within their populations as Russia exerts its influence.

“Lone Wolf” attacks increasing

“Lone Wolf” (individuals acting outside of established terrorism networks) attacks increased in both frequency and complexity. The Charlie Hebdo attack in Paris and hostage incident in Sydney both underline the fact that the developed western countries are not immune to these incidents. Security services often struggle to detect and prevent these attacks, while overseas extremist groups continue to exhort their follower/supporters to carry out further attacks. As western fighters return from the conflicts in Syria, Libya and Iraq, there is a likelihood that these style of attacks will increase.

12 month attack round-up

— January 7-12, 2015 saw the Charlie Hebdo attacks in Paris, France which sparked international outrage. These attacks highlight the increased threat from small embedded cells of extremists.

— Boko Haram have increased the severity of their insurgency in North East Nigeria throughout 2014. Notable attacks have included the abduction of 276 schoolgirls from Chibok in April 2014 and the massacre at Baga on January 3, 2015. Given Nigeria’s emergence as the largest economy in Africa, the economic implication of an active insurgency are profound. Presidential elections have had to be postponed which increases political uncertainty.

— Ukraine has been one of the continuous stories of 2014. Unrest initially surfaced towards the end of 2013 against the government’s pro-Russian stance, which quickly developed into widespread civil unrest. Russia took the unexpected move of annexing Crimea on February 27/28, 2014; trouble then spread towards the eastern Donbas region as separatists declared independent “Peoples Republics” in Luhansk and Donetsk. The Ukrainian government launched an offensive against the rebels, and the region slid into civil war. On July 17, 2014, Malaysian Airline flight MH17 was shot down over rebel held territory. Rebels, widely believed to be supported by Russia, made gains across the Donbas region. By February 12, 2015 when the final Minsk agreement came into effect, the rebels controlled a region from Luhansk to Novoazovsk.

— 2014 has been a year of significant development in Colombia. Peace negotiations have made progress between the government and FARC, but ELN, the country’s second largest rebel group continues to be excluded from the talks. Attacks have continued as both groups exert pressure on the government to strengthen their negotiating position. Energy infrastructure remains the prime target, with pipelines suffering numerous attacks.

— On March 1, 2014, the Kunming Railway Station in China was attacked which was widely attributed to Xinjiang militants. It left 29 civilians and 4 perpetrators dead, with 140 other injured. China continues to deal with internal dissatisfaction and separatist movements, which can often flare into violent confrontation.
Market developments – new entrants increase competition

The Terrorism and Political Violence market continues to evolve. With the softening of Terrorism rates in the traditional markets of North America and Europe, insurers are prepared to consider more delicate geographies as they look to maintain premium income. There are also new entrants to the market this year, increasing capacity and competition. In combination, this should lead to clients benefiting from softening rates and increased capacity for difficult coverages. The limits available are growing for all perils.

Lloyd’s Dubai has now opened and is trading. A number of Lloyd’s syndicates not previously in the region have started writing Terrorism and Political Violence, which will increase the competition for Middle East business between local markets and London. This follows a similar pattern to the establishment of Lloyd’s Singapore, where there was significant competition for Asian business between London and the Singapore market. This has brought benefits to the insured, as local markets pushed rates downwards.

What natural resources companies should do next

It is of paramount importance that natural resources companies are aware of the risk they face and manage it appropriately. Oil and gas companies benefit from OIL, which provides limited coverage, and buyers need to make sure that the coverage offered is appropriate for the risk they are facing. The commercial market is able to provide capacity in excess of OIL and on a Difference in Conditions/Difference in Limits basis.

Extensions such as Denial of Access coverage should be considered, especially in areas where “Lone Wolf” attacks are the prevailing threat. These are most likely to lead to business shutdown due to acts of authority as opposed to conventional property damage.

The world continues to be a difficult place to conduct business, with political violence in all its guises a real and present risk; companies need to make sure that this risk is clearly identified and evaluated. Risk mitigation needs to be considered, of which insurance can form a crucial part. The Political Violence market continues to evolve and bespoke offerings are able to be crafted as never before. 2015 will continue to create challenges but with active risk management there are always solutions to these challenges.
LIABILITIES

International Onshore

Some of the trends emerging in the Onshore International Liability market are more akin to the world of Cosmology than Casualty. In the ever expanding Liability universe, Global Onshore International Liability capacity currently stands at an all-time high of USD2.8 billion (see chart below). While realistic market capacity available per risk is usually estimated at 50% of maximum published capacity, this is more than adequate for most buyers and represents a doubling of available Liability market capacity over the past 10 years.

International Onshore Liability capacities, 1994 – 2015

International Onshore Liability market capacity continues to increase beyond what has been available in the past.

Source: Willis

“Big Bang” or “Big Crunch”?

While some of this year’s capacity increase has resulted from increased line sizes by existing markets, a particular feature of the past 18 months has been the explosion of new capacity entering the market. This has primarily been at the expense of some major carriers who have lost talented staff to the new start-ups. This “Big Bang” phenomenon has not only increased the market capacity but also the marketing options open to buyers, examples of which include including Ascot, Acappella, Apollo, Dale, Hardy, MCI and Navigators.

By contrast, we are also seeing a consolidation trend with major mergers occurring between XL/Catlin and Partner Re/Axis in the past few months alone. This has been driven by a desire to achieve economies of scale, improve distribution channels and increased market influence in order to improve profitability, which has been increasingly squeezed by low investment income and depressed rates. The big question is whether these consolidations will result in any contraction of Onshore International Liability market capacity. While we expect the intention is not to reduce the combined portfolio, it is inevitable that some loss of capacity may occur and “one plus one” may ultimately equal “less than two”.

Source: Willis
The most interesting question is how these conflicting trends will resolve themselves in the future: will the increasing number of new smaller players be sucked into the black hole of further consolidations? This remains to be seen and depends on the future profitability of the market. Certainly we see the emergence of new carriers as a positive development for buyers who value the specialist knowledge, diversity and additional choice that this genesis of new capacity has provided.

“The Parallel Universe of Market Pricing”

Unsurprisingly this continued growth in capacity, coupled with a relatively benign loss environment, has resulted in downward pressure on rates. However, there is a distinction in the pricing dynamic, depending upon the nature of the risk.

— For “non-complex” Energy risks (i.e. those in single territories with no US or offshore exposures, no pipelines and no fracking activities) there is ample capacity and strong competition, particularly for those buyers purchasing more modest limits, which in turn has led to some meaningful rate reductions.

— For larger buyers with complex exposures, which feature a wide geographical spread, US and/or marine/offshore exposures, available capacity is more restricted, particularly as these buyers also tend to require higher limits and more sophisticated coverage. Whilst competition exists it is less intense than for the smaller non-complex programme and downwards rating pressure for these risks is more measured.

“When is a Market a Soft Market?” — coverage and risk profile

As the old adage goes, a market is only truly soft when insurers are prepared to concede willingly on coverage and risk quality as well as price, and in early 2015 this is not currently the case. While insurers are prepared to negotiate on price they continue to maintain strong underwriting discipline, both in terms of coverage and quality of information. It is true to say that in an effort to maintain profitability, markets are placing an even greater emphasis on risk selection. Clients that provide comprehensive information and demonstrate strong risk management procedures will be able to differentiate themselves and achieve more preferential terms than their peers.

Energy — specific Liability issues

There are a number of specific issues that are of concern to the Energy Liability insurance community in 2015:

— **Refinery utilisation rates** — one function of the low oil price has been has been the improvement in refinery margins, which has in turn led to increased refinery utilisation rates. Refinery margins in Europe are reported to be almost three times higher in the first quarter of 2015 compared with the same period last year (USD4.25 a barrel currently versus USD1.50 a barrel in the first quarter of 2014). As a result, refineries have been run at close to 100% capacity with maintenance delayed and repair or upgrading work postponed. In addition, stocks of hydrocarbons in storage have significantly increased. All of this potentially increases the liability exposure and insurers are monitoring the position to ensure there is no significant risk deterioration.

— **Rail transport** — following a spate of rail accidents involving the transport of hydrocarbons over the past two years, most notably the 2013 rail disaster at Lac-Mégantic, Canada, there has been concern over the contingent liabilities arising from rail transportation. Buyers are increasingly aware that, even though they may have no responsibility for owning or operating rail systems, they face a potential vicarious liability as owners of the hydrocarbons being transported. This has led to buyers and insurers alike looking more deeply into the extent of exposures in order to quantify the risk, and ensure that sufficient indemnity is in place.

— **Pipelines** — pipelines have always been an area of focus by insurers, as they can be a major cause of the small erosional/working claims (through regular leaks and spills) as well as many of the largest catastrophic claims such as P.G and E (California, September 2010) and Enbridge (Michigan, USA July 2010). In general, Liability markets will continue to provide the full market standard Sudden and Accidental Pollution coverage for pipeline risks, subject
to satisfactory loss record and risk management data (SCADA, pigging and maintenance schedules, details on length, depth and water crossings etc). It should be noted that there is a reluctance among some carriers to provide primary pollution cover in some of the more challenging Latin American territories where loss records have been poor. Again, quality of information and demonstrable risk management practices remain key to the achieving the best result for our clients.

— Adequacy of Limit — the million dollar liability question asked by risk managers is: “what is the appropriate limit to buy?” Liability has always been seen as something of a “dark art” compared to Property, where sophisticated tools (e.g. ExTool) can be applied to ascertain EMLs and provide statistical guidance on appropriate limits.

Brokers providing more sophisticated advice as demand for higher limits increases
With increased focus on analytics, and enhanced survey capabilities combined with loss and benchmarking data, the more sophisticated brokers are now able to provide more informed advice to clients. Notwithstanding shrinking oil prices, it is certainly true that increased utilisation rates, more onerous environmental requirements, the gradual improvement of many economies and the continued spread of litigation and increase in average awards have all combined to increase liability exposures and increase demand for higher liability limits.

“To Boldly Go?”
So what of the future? With no sign of liability supply/capacity waning, in order to create a wider premium pool will insurers evolve their products to encompass the new and emerging exposures?

Cyber Liability is an increasing concern to buyers and our 2014 Energy Market Review has examined the exposures particularly pertinent to the energy industry, where cyber-attacks could lead not just to data loss issues but to real catastrophic physical and financial liability losses.

A number of brokers and insurers have already developed wordings to address Cyber exposures — usually as a separate stand-alone product. However, it is generally accepted that there is insufficient capacity in the market to cover a major loss, so this is an obvious area where existing and alternative capital could be harnessed to drive a more significant and buyer-friendly solution.

We have mentioned that environmental exposures continue to evolve with the emergence of new legislation and the development (at least until the drop in oil price) of new frontier drilling particularly in the Arctic. Progress has been made in broadening certain pollution covers to encompass some of these wider exposures.

In summary, it is clear that the Onshore International Liability market continues to evolve, with some potential conflicting trends emerging along the way. Capacity remains abundant; and for the informed and well prepared buyer it is a positive time to purchase and potentially expand their existing Liability covers.

Marine Liabilities
Marine Liability capacity, which for some years has been in excess of what has been required by buyers, has increased somewhat in 2015 and this has naturally created favourable renewal positions for buyers. The premium dynamic signals the opportunity to negotiate coverage extensions and renewals where insurers wish to compete will see some reductions of rates and premiums. Singular losses have continued to hit the market, but there have been no recent catastrophic losses. During 2015, without a major event to impact the market, we expect to see renewals resulting in maybe double digit reductions. Retention levels are flat, with some buyers happy to pay more premium for a reduced retention.
North America Onshore

Still no real leadership competition

The US/North American Excess Liability market has enjoyed a respite from large losses, which has been almost as dramatic as its International counterpart, and yet we note that several of our market discussion points remain from our 2014 Review. The Energy marketplace is still devoid of the robust leadership competition that would push the market, not only on pricing but also on conditions. Liability insurers that may entertain leading programs include AIG and Zurich, while for smaller to medium size accounts interest has been shown by Swiss Re and ACE USA.

Realistic capacity still flat

We expect that the capacity in 2015 will remain essentially at the levels it has for the past several years, up slightly in 2015 to approximately USD1.1 billion to USD1.3 billion. Bermuda represents about half of the excess capacity, North American and London/Europe predominantly making up the remainder, with opportunistic plays from the Middle East and the Asia Pacific regions. Despite this theoretical increase, realistic capacity remains flat at approximately USD750 — 800 million, driven by reasonable pricing, compatible forms, and buyers’ budgetary restraints. To maintain pricing integrity some buyers have had to accept a larger retention on some part of their Liability programs, and in 2015 we see the best opportunity in years to shore up missing capacity.

Reluctance to pay back previous premium increases

Whereas Onshore Property and Upstream buyers are continuing to enjoy a strong renewal experience starting in late 2014 and now into moving into 2015, North American Excess Liability buyers in general are noting that the market is reluctant to give back increases negotiated over the past four years. Given the expectations that the market should be turning, buyers are also looking at reduced exposures, given the current price of oil and dropping payrolls, headcount and activity. We expect renewal results to be driven by reductions in those exposures rather than insurers clamouring for market share, although we do expect some increase in competition in this market. We certainly detect continued concerns from the market about the risks that feature prominently in several areas of the industry, notably rail exposure to crude and other shipped products as well as pipelines. The market continues to demand more underwriting information when considering these risks, although perhaps this is not so much the case in respect of fracking operations.

Overall profitability maintained

Insurer profitability over the last several years in this class has been good, assisted not only by the underwriting discipline seen during this period, but also (and perhaps more significantly) by the lack of a large number of substantial losses. However, the industry has not been without its losses, notably in the areas of crude by rail derailment losses and chemical products.

Buyers will benefit by packaging with Property market

Those buyers in the industry who have the opening to package Excess Liability with Property and Control of Well coverages will benefit from the reductions those segments are offering. It is important to note that the package market has less appetite for exposures that include those that are predominantly onshore, especially for refining and petrochemical risks, and this is likely to be reflected in the policy wording, which in all likelihood will be reduced to a Claims Made form from an Occurrence form.

Land transportation continues to be an issue

Lead Excess and Umbrella Liability markets have seen a marked increase in automobile loss activity over the past five years, reflecting a similar increase in industrial trucking use following the growth in onshore exploration and production in North America. Lawsuits brought against energy insureds for automobile events are being characterised by wildly increased Ad Damna and surprising jury verdicts. While we note elsewhere that Automobile Liability facultative reinsurance is becoming more competitive, the Energy sector continues to attract disciplined scrutiny. Excess Liability underwriters are pushing for higher attachment points for the auto exposure (including non-owned) and we note increased interest from some underwriters to provide “auto buffers”. These can assist in developing a premium benefit by reducing the limit of the primary carrier layer and then filling in with other markets, thereby establishing a higher attachment point for the excess layer.
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