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Surviving the storm: Optimum risk management strategies for a volatile world

WTW Energy Market Review — Executive Summary

April 2023

Energy Market Review 2023: Executive Summary

Introduction: A renewed focus on maintaining energy supply

Since our last EMR Update in November 2022, the energy insurance markets have experienced a very turbulent reinsurance treaty renewal season, a continuing fallout from the Russia-Ukraine conflict, more inflationary pressures around the world and yet more volatility in the prices of oil and gas. The energy industry focus seems to have shifted from the long-term acceleration of the energy transition towards a more short-term goal of maintaining energy supply.

Our Review contains an analysis of global energy activity in 2023 and where we can expect the industry's direction of travel to develop as the year professes. This analysis suggests that energy activity in both the upstream and downstream arenas is likely to increase in the immediate future – good news for the industry and maybe good news for insurers as well, as it brings with it the prospect of welcome additional premium income.

Our leading external article author, Michael Blakemore, an independent business consultant with over 25 years' experience, suggests that following the oil price crash in 2015 and eight years of underinvestment, it seems that the supply overhang that has weighed so heavily on markets has gone. In the intervening time, major oil companies have refocused their efforts, away from maintaining declining oilfields and growing new production, and towards energy transition initiatives. The events of 2022 have reminded investors and operators that their core oil and gas business is still the engine of medium-term profitability.

Michael Blakemore also suggests that one feature of the market has been the poor rewards that the oil majors have reaped from moving away from their core oil and gas business to embrace the energy transition; he points out that BP and Shell have trailed ExxonMobil and Chevron in terms of price-to-earnings ratios in recent years. This has mirrored the general discount of UK markets when compared to the US, but this trend has been more persistent than in the past and did not recover during 2022 when the equity UK market was one of the bright spots and closed the gap in its international rivals.

The most problematic issues for companies are the uncertainties around emerging technologies and the expected pace at which they will be implemented. In Michael Blakemore's view, it's clear that many of the technologies expected to be the foundation of the energy transition are simply not ready, many proposed technologies have not been demonstrated at commercial scale, and a large proportion do not yet resemble industrial technologies at all. The result is that the job of scaling up and commercialising these technologies is, in many cases, in the hands of 'first timers'.

Security of supply will remain a top priority for governments. The US government is responding to higher prices and striding ahead in all areas of energy production - if international governments follow suit, then both operators and contractors are set to benefit.

Four important risk management issues

Optimising risk: Strategies for a looming recession

Energy company CFOs and Treasurers are happy enough to limit the spend on premiums as a recession looms, but in the event of a loss the focus is always on the cover provided and seldom on the premium paid. In addition, communicating this to a senior audience that is unfamiliar with insurance at renewal time (especially when there hasn't been a large loss) can also pose problems.

- What is needed is an approach that allows insurance managers to fully understand what the key drivers of risk are, how they may be mitigated, and how different strategies balance the need for protection against losses at an affordable cost.
- By combining their company's own data with industry data, detailed and up-to-date knowledge of the available risk transfer markets and modern analytics, risk intermediaries can quickly develop a better understanding of the company's risk exposures and their variability under different economic scenarios.
- This process can enable energy companies to better understand their risks and their associated volatility, explain the benefits of insurance easily and clearly to senior management and highlight the key differences in risk and cost between their various insurance programme options.

Reviewing insured values: How to maximize returns on capital

- Supply chain disruption is inflating insured values and lengthening restoration periods, due to specialized equipment requiring lead times often exceeding a year. It's also significantly increasing the cost of materials and labour, thereby driving up the values that energy companies should report at renewal.
- Avoiding overstated values means energy companies won't pay increased insurance premiums and deploy business resources inefficiently. On the flipside, if an energy company reports understated values, it could encounter significant issues following a loss, resulting in uncovered losses for amounts exceeding stated limits.
- Historically, many energy companies may not have spent significant time and resources on the valuation process, perhaps only inputting the basic information into an insurer's statement of values worksheets at renewal. However, the current economic conditions mean that it is crucial a more comprehensive analysis of values is performed.
- The process of generating accurate insured values can lead energy companies into exploring their broader vulnerabilities and where resources can be deployed most efficiently.
- Accurately reflecting insured values and seeking broader optimization opportunities is not always straightforward. Energy companies may need to call on experts to ensure that the pre-loss valuation process is a fully comprehensive, accurate, and reliable assessment of loss exposures and values.

Managing supply chain risk: increasingly an issue for energy risk managers

Urgent action is needed to guarantee affordable supplies today and power the transition to clean energy tomorrow. But the supply chains that underpin these objectives are struggling to meet demand. Project times are lengthening and costs spiralling, as companies compete to get the raw materials and equipment they need on time, putting future plans at risk. To find out how the sector is navigating this challenging landscape, WTW commissioned our 2023 Energy Supply Chain Risk Report. Key findings included:

- 83% of respondents cited a lack of insurance solutions to be among the greatest challenges in addressing their supply chain risks.
- 67% of businesses said that losses related to the supply chain had been higher or much higher than expected over the last two years.
- 39% named shortage of raw materials are among the biggest supply chain factors expected to impact their businesses over the next two years, topping the list of concerns.

Many companies are heavily reliant on single-source contractors, suppliers and logistics providers, who themselves face problems sourcing raw materials and finding the experienced staff needed to service projects.

Diagnostic tools, such as WTW's Supply Chain Risk Diagnostic, enable companies to map the location of all the links and assets in the chain and assess how they connect and interact with each other. This transparency can give organizations a panoramic overview of dependencies and risk factors to enable better decision making. Our advice to energy companies is sixfold:

1. Make resilience a boardroom priority
2. Reduce reliance on single suppliers and locations
3. Develop closer working relationships with suppliers
4. Reconsider just-in-time models
5. Aim for end-to-end visibility and transparency
6. Use scenario planning and simulation modelling, such as digital twinning, to quantify the impacts and mitigate the effects of risks

Building competence barriers: Why they matter

- Competence is more than training and qualifications. Competence is really about the ability to undertake responsibilities and to perform activities to a recognised standard on a regular basis and is actually a combination of practical and thinking skills, experience and knowledge.
- Inadequate competence management has contributed to disasters such as ESSO Longford, Flixborough, Piper Alpha, Texas City and Buncefield.
- A well-developed Competency Management System, once implemented, includes the full cycle of assessment, gap analysis and planning, learning and development and finally, reassessment.
- A systems integration model can help avoid such failures in this digital era. All personnel working on a site should therefore have a Secure Digital Identity. It is possible to have digital Control of Work processes where data in the system can be used to instantly authorise or prevent a task being carried out and the use of mobile wireless devices is used to facilitate tasks safely in the field. Accessing the Employee Management and Planning Module could deliver several "barriers".
- If a competency framework and records are linked to other electronic systems, such as e-PTW and energy isolations, then a system can be put in place that could strengthen the competency "barrier", making it highly effective.

The Energy insurance markets in 2023

Global Upstream

The balance of power in the Upstream insurance market has changed again - this time, once more in favour of the insurer. Negative factors from a buyer perspective include:

- The impact of the January 1 reinsurance market season: This has had had a marked effect on pricing, retentions levels and coverage.
- The deterioration of the loss record at a time of declining premium income: Our database now shows several 2021 losses which had not been advised to the database this time last year, with 2022 looking to follow the same trend. Furthermore, overall sector global premium income estimates have actually decreased for 2022.
- Large areas of the portfolio remain unprofitable: These include Onshore Contractors, Subsea Construction and Midstream.
- The market leadership options remain basically restricted: The withdrawal of the MRS Syndicate last year has only served to restrict the choices of leader even further.
- Concerns over accuracy of values remain: Arbitrarily reducing or maintaining existing values in this economic climate is likely to be counterproductive in two ways; first, it may mean a higher rating increase than normal and second, should a loss materialise, it is equally likely that insurers will apply average (if such a provision exists), meaning that the buyer may not receive a full indemnity from the market.
- The Impact of continued management control over underwriting strategy: It seems to increasingly be the case that underwriters do not have the same flexibility and ability to make individual underwriting decisions that many in the market have become accustomed to.

However, there are still several positive factors in play which may lead to an easing of the softening dynamic later in the year:

- Abundant capacity has been maintained: Capacity levels at a continuing record high, with just over US$7 billion of "realistic" market capacity still available for the most attractive programmes. There is still a marked underwriter appetite for those offshore programmes featuring significant premium income, spread of risk and clean loss records.
- High oil prices are likely to lead to increased construction/drilling activity and LOPI values: The Russia-Ukraine conflict has led to higher fossil fuel prices and consequently further increases in Loss of Production Income (LOPI) values and additional premium generation as a result of increased drilling and exploration activity.
- The growth of the facultative reinsurance market: The purchase of more facultative reinsurance may enable direct insurers to offer more competitive terms in the future.
- Pressures to maintain premium income levels will remain: Insurers will still need to secure sufficient premium income to pay for their reinsurance costs, not only in terms of their treaties but also in terms of any facultative reinsurance purchases.

Average rating increases (as at April 4 2023) can be summarised as follows:

- Major E&P programmes: +5%
- Offshore contractors: +5% to +7.5%
- Small to medium E&P programmes: +7.5% to +12.5%
- Midstream: +15% to +20%
- Offshore Construction (Platforms): +15% to +25%
- Onshore Contractors: +20% to +30%
- Offshore Construction (subsea): +30% to +50%
- Loss-affected business: exponential

Buyers are encouraged to start the renewal process early, develop and communicate effective underwriting submissions to the market, answer the questions posed by the JNRC ESG questionnaire as comprehensively as possible, obtain more than one indication to support any "leader-only" terms, and finally ensure that insurers have every possible ammunition to convince their senior management that preferential terms should be offered.

Global Downstream

This has been one of the toughest reinsurance renewal seasons on record, so there has been a re-hardening of this market for all but the most sought-after business.

Negative factors that have affected this market include:

- The effect of January 1 reinsurance renewal season: It was not simply the range of rate increases by reinsurers which caused some consternation in the Downstream market, but also the scale of the retention increases – for some, up to double the same figure for the previous year. We have also seen reinsurers imposing more restrictive conditions on their treaty policy wordings.
- Recent major losses have wiped out recent profitability: The overall Downstream loss total in our database now stands at nearly US$7 billion, a record for this century with the exception of 2005, Three discernible trends can be borne out from these figures - the continuing increases in the overall share of the loss total taken by BI losses, a notable increase in the portion of the overall loss total taken by mechanical failure losses and a continuing increase in the share of the loss total pertaining to the North American region. As a result, Lloyd's most recent Onshore Energy figures suggest that this portfolio probably remains in unprofitable territory.
- There is no threat to the established market leaders: We are seeing a retrenchment in almost every area of the Downstream portfolio, with insurers preferring to focus on negotiating increased line sizes for preferred business rather than to compete directly against the incumbent market.
- Concerns remain over impact of inflation on declared values: There is now a real danger that the market may over-react to submissions that repeat existing value schedules by not only charging a disproportionate rating increase but also apply average in the event of a loss, thereby reducing the overall claim figure. Insurers are now focusing on this issue intently and are unlikely to hesitate to apply punitive rate increases where they believe that values have not been updated.
- Increased senior management scrutiny has led to less harmonization of placements: Instead, individual underwriters are more concerned about "stepping out of line" and failing to adhere to management directives. As a result, brokers have found it particularly challenging to persuade underwriters to follow the terms and conditions of the market leaders.

However, despite these challenging market dynamics, there are now some signs that insurers will not have everything entirely their own way in the months ahead:

- Current capacity levels have been maintained: Capacity levels for Downstream have remain remarkably consistent over the last five years or so. As a result, premium income targets are likely to be maintained – or even increased. This in turn is likely to ensure that there will remain a healthy appetite within the market for the most well-regarded business at least.
- A "new normal" for refinery and other plant volatility has emerged: If oil & gas prices continue to stabilise at the current lower level, then refinery and other plant utilisation rates will also begin to follow suit, which may in turn lead to a return to more normal levels of loss frequency and severity. This in turn should encourage insurers to offer more preferential terms in exchange for increased premium income.
- Excellent overall insurer results: although as we have seen the Downstream sector itself is very unlikely to produce an overall profit for 2022, the same cannot be said for the insurers who make up the market in more general terms. We have seen Combined Ratios well beneath 100% reported from a number of key (re) insurers in recent weeks, which should help prompt more aggressive premium income strategies.
- Some attractive programmes are still over-placed: Premium attracts capacity and the market continues to differentiate strongly in favour of the best business. From our own review of our current programmes, we can see that there is already some underwriting "slack" that can be taken up by brokers without materially affecting these programmes' current terms.
- The Everen limit increase may add to competitive pressures: Commercial market insurers may face an interesting dilemma should Everen members elect to retain more of their risk within the mutual than they do at present, as a result of the recent increase in Everen limits to US$450 million. At the very least, it represents an alternative that may well secure increased leverage to limit the extent of insurers' drive towards increased rating levels.

- Pressure to meet premium targets later in the year: Increased reinsurance costs have to be paid for somehow, and while insurers will be hoping this can be achieved simply by applying rate rises on their existing portfolio, history would suggest that their appetite for premium income tends to increase as the year progresses and when income targets still need to be met.

Current average rating increases can be summarised as follows:

- Large premium programmes that are well-engineered and well over-subscribed – International 5% to flat, North America +5% to +10%
- Other “clean” risks - International flat to +10%, North America +10% to +15%
- Loss-affected business: exponential

History suggests that the current hardening dynamic cannot be sustained indefinitely; although insurers can point to increased reinsurance costs, heavier claims records and an unprofitable year to justify increasing rating levels, there may come a time when capacity providers require a better return, while buyers may decide that there are now other ways to manage their risk than the simple purchase of insurance.

International Liability

The changing trend towards insurance market profitability is an encouraging development, broadly echoed across other Liability markets internationally, and is a result of tighter underwriting controls, greater risk selection and several years of compound rate increases.

After three consecutive years of decline, total Liability capacity continues to gently nudge back upwards, to US$3.10 billion of theoretical capacity and US$900 million of actual working capacity.

Broadly speaking, the Energy Liability market consists of four different interlocking market sectors:

- General Liability insurers (able to write Primarily Downstream Energy), now offering mid-single digit percentage rating increases
- Specialist Energy Liability insurers (able to write Upstream, Downstream, Onshore, Offshore), now offering mid-high single digit percentage rating increases
- •Marine/Upstream Liability insurers, writing Marine and Upstream exposures, now offering double digit percentage rating increases
- Bermuda/Dublin Occurrence Reported Excess insurers, now offering double digit percentage rating increases

This disparity in renewal experience across the fur Liability sectors means that buyers will have varying renewal experiences, dependent upon their risk profile, coverage requirements and market segments that they need to access.

The key market drivers that buyers need to overcome are:

- Increased reinsurance treaty costs
- Economic inflation
- Social inflation
- Adverse prior loss development/Insufficient reserving

Restraining factors acting as a “brake to mitigate these pressures are:

- Increases in capacity
- Greater market choice/competition

However, the welcome arrival of some new capacity has increased competition and choice in the market. Other current market developments include:

- The leveraging effect of inflation: for major/catastrophe risks the dynamic of loss cost inflation can impact differently across a given Liability programme
- The recent measured expansion in capacity and insurer choice has enabled buyers to build-back their overall programme limits to amounts approaching their previous levels
- The ever-increasing focus on ESG considerations poses both challenges and opportunities for Liability insurers and their customers. Capacity for thermal coal and oil sands operations is increasingly constrained, as markets respond to pressure from activist investors to decarbonise their portfolios and some buyers have elected to withdraw from or severely limit their capabilities in respect of Oil & Gas business.

The big question is the pricing trajectory for the remainder of the year. Much will depend upon the remaining 2023 reinsurance treaty renewal seasons — which will dictate market sentiment — as well as the supply of Liability capacity and the rate at which premium income limits are used up.

US Casualty

The initial feedback from insurers regarding January 1 reinsurance renewals has not been positive. As a result, many insurers are expecting increases in reinsurance retentions across their respective product silos as well as potentially substantial premium increases. While we do not expect "trickle down" costs to have a large impact on clean North American Energy buyers, we do expect rates to continue to trend in a positive direction for many accounts in the first half of 2023.

Both Primary and Excess Liability market capacity remains stable and many insurers have aggressive new business goals for the 2023 fiscal year, As a result, Auto Liability rating increases remain in the mid-to-high single-digits, while Workers Compensation rates remain flat to slightly down and General Liability for most segments remains in the single digit range. We expect Excess liability pricing to continue in the same manner as during 2022, with most buyers experiencing single digit rate increases.

Key developments by segment include:

- Upstream: The Offshore market has been especially challenging from a Primary Liability and Lead Umbrella standpoint, as one of the larger participants in this space is undergoing changes in both limit availability and necessary pricing. In contrast, despite the challenges faced by the offshore operator segment, the Onshore market has ample capacity and so buyers have a multitude of potential options for General Liability and Lead Umbrella policies. Overall capacity in the US has been reduced by nearly US$80-100 million in 2023; however, buyers are still able to procure ample overall Excess Liability limits.
- Oilfield Services: Capacity remains at extremely high levels, despite a continued uptick in the severity of "action-over" employee injury claims and as large Auto Liability judgements continue to trend in an alarming direction in the US. As there is ample capacity remaining in the space, many insurers are aggressively targeting profitable programs during marketing exercises.
- Midstream & Downstream: These segments have both experienced a few severe losses in the last 12 months; however, despite this capacity remains stable for Downstream and has increased for Midstream companies during the last 12 months, with risk-transfer attachment levels remaining consistent year-on-year. There has also been a slight uptick in capacity for middle-market Midstream business via the US market in the Excess & Surplus (E&S) space.

Current market concerns include:

- Claims trends: The perceived anti-corporate sentiment of juries over the last few years remains a prevalent concern for insurers and the normalization of larger awards and settlements bears monitoring.
- Continued underwriting focus on fleet safety programs: As a result of the increase in Auto Liability settlements, insurers are paying closer attention to buyers' fleet safety programs. It is strongly recommended that buyers provide details of their auto safety programs in submissions and renewal presentations to differentiate themselves from their peer companies.
- Focus on ESG: Insurers are increasingly requesting detailed information concerning insureds' ESG initiatives and policies.
- Cyber: Due to headlines of a breach in the Midstream sector, insurers are also paying closer attention to buyers' cyber practices and procedures. We recommend that buyers, especially from the Midstream and Downstream sectors, educate their insurers and their management about the protocols and measures that have been put into place to protect their SCADA systems
- PFAS: PFAS exclusions have become more prevalent in the London Excess Liability market and now becoming more common on both US and Bermuda policies.
- Climate change: Insurers within the Bermuda market and London have begun to insist on Climate Change exclusions being imposed on new business as well as on renewal business if the buyer has been named in a lawsuit.
- Inflation: We expect insurers will remain focused on three key areas of inflation: claim cost inflation, wage inflation and interest rates.

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