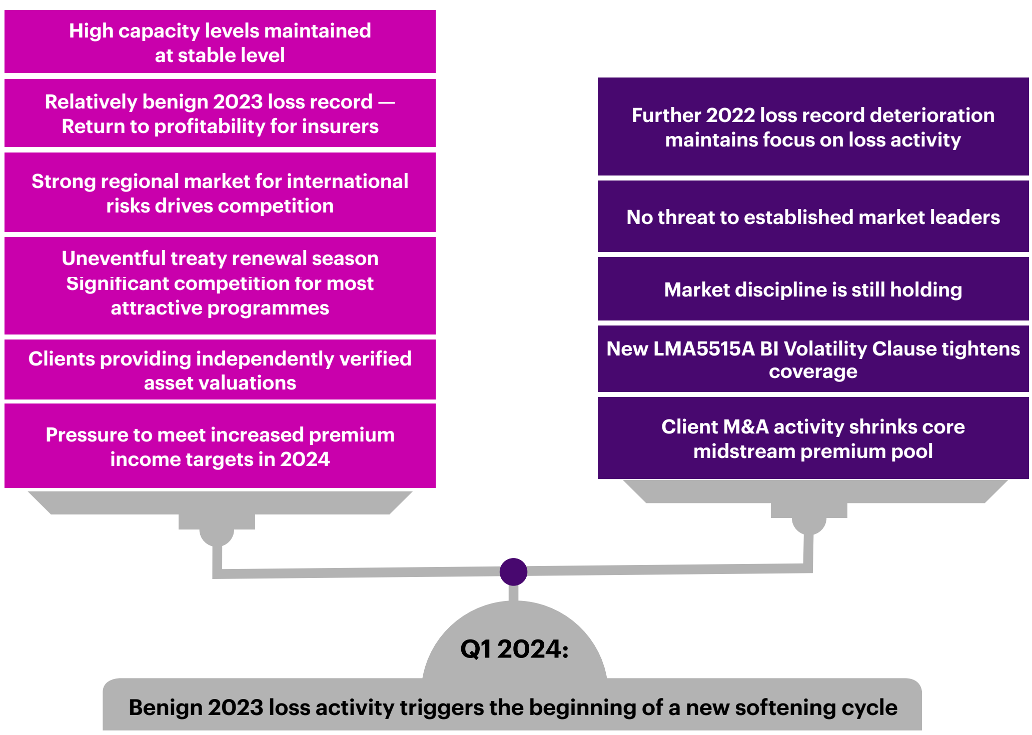
Downstream energy: Light at the end of the tunnel

The last couple of years have been tumultuous for downstream energy clients, however diligent clients who focus on risk quality and accurately assess their asset valuations and business interruption calculations can look forward to a calmer approach to this year's renewals. Whilst insurer discipline remains strong, and the market is highly verticalized, we will discuss below how clients can make savings by smartly controlling their placement structure and using their own retention appetite rather than relying on pure capacity supply pressure.

Figure 1:

The downstream underwriting environment, Q1 2024



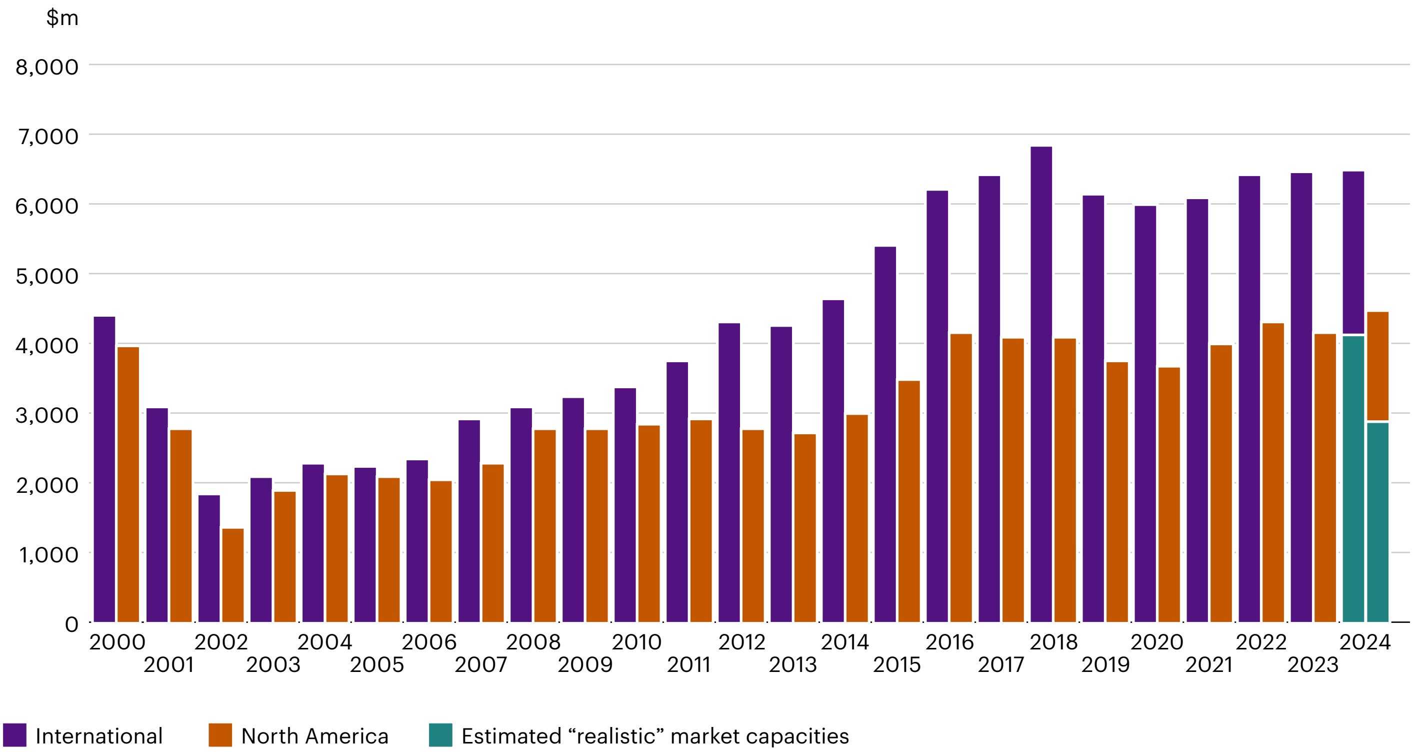
Rate softening will initially focus on the best risks, but how soon will it apply to all?

Source: WTW

Figure 2:

Increased deployed capacity

Global downstream insurer capacities, 2000-2024 (excluding Gulf of Mexico Windstorm)



Capacity remains stable, dampening the hardening market dynamic

Source: WTW

Reinsurance treaty renewals: Nothing to write home about

This year's reinsurance treaty renewals can be summarily described as organised compared to the chaos of last year, where most markets had to accept both large rate rises and increased retention, and prolonged negotiations ensued. Most treaties were renewed well in advance and direct markets knew their treaty position early in the lead up to 1st January which gave them the certainty to be able to commit promptly to direct placements.

Most insurers saw their treaties renewing at flat rates or small single-digit increases, driving improved loss performance in the downstream energy space. Despite this, treater reinsurers continue to be affected by multiple non-energy nat cat events which would have been factored into their renewals, especially on whole account reinsurance treaties. As a result, nat cat continues to be a big driver of treaty pricing, and the amount of nat cat limit purchased will directly affect the renewal terms.

Reinsurers did not seek to impose any new terms or coverage restrictions at 1st January.

Capacity is stabilising

Overall, downstream energy market capacities have remained stable both in theoretical and realistic terms with line size growth from some carriers offsetting a reduction in working capacity being utilised by others.

Midstream and LNG risks attract the most capacity as they are within appetite for most of the market due to the benign nature of these risks and increased competition driven by larger captive involvement.

Overall, this continued stability of capacity is good news for buyers as there is still plenty of capacity for most risks, and we continue to see the best placements being significantly oversubscribed.

Figure 3:

2023 loss record deteriorated but the year remains profitable

Downstream losses excess of $20 million, 2023

Type	Cause	Country	PD $	BI $	Total $
Refinery	Fire + explosion/VCE	North America	35,000,000	862,296,000	897,296,000
Petrochemical	Fire + explosion/VCE	North America	275,000,000	275,000,000	550,000,000
Refinery	Fire no explosion	Europe	63,600,000	309,000,000	372,600,000
Petrochemical	Fire no explosion	Europe	54,000,000	254,000,000	308,000,000
Chemical	Unknown	Middle East	20,000,000	150,000,000	170,000,000
Petrochemical	Fire no explosion	Middle East	55,000,000	95,000,000	150,000,000
Refinery	Fire no explosion	Europe	5,200,000	100,000,000	105,200,000
Refinery	Fire no explosion	Europe	25,000,000	66,000,000	91,000,000
Refinery	Impact	Australasia	4,550,000	68,640,000	73,190,000
Pipeline	Fire + explosion/VCE	North America	39,200,000	15,000,000	54,200,000
Chemical	Fire + explosion/VCE	North America	11,500,000	26,000,000	37,500,000
Chemical	Collapse	Australasia	10,000,000	24,600,000	34,600,000
Renewables	Explosion no fire	North America	17,800,000	16,250,000	34,050,000
Refinery	Lightning + fire	North America	27,600,000	4,200,000	31,800,000
Refinery	Impact	North America	15,000,000	12,000,000	27,000,000
Chemical	Mechanical failure	North America	10,000,000	16,500,000	26,500,000
Refinery	Fire no explosion	Europe	24,000,000	—	24,000,000
Gas plant	Mechanical failure	Middle East	20,000,000	3,000,000	23,000,000
Renewables	Fire no explosion	North America	20,000,000	—	20,000,000

Continued profitability despite some major losses, but attrition is creeping up.

Source: WTW Energy Loss Database as of February 23rd, 2024 (figures include both insured and uninsured losses)

Claims: A profitable year at last

2023 can be described as a fairly benign year by downstream energy standards with a total of $3.27 billion of insured and uninsured claims so far recorded within our Energy Loss Database. Whilst this is still a substantial amount, when mapped against the total market premium of circa $4.5 billion, it reveals a profitable year for insurers.

Figure 4:

2022 loss record shows continued deterioration

Downstream losses excess of $75 million, 2022

Type	Cause	Country	PD $	BI $	Total $
Gas plant	Fire + explosion/VCE	North America	225,000,000	1,231,200,000	1,456,200,000
Gas plant	Fire + explosion/VCE	North America	456,750,000	890,250,000	1,347,000,000
Refinery	Mechanical failure	Europe	40,000,000	639,800,000	679,800,000
Refinery	Fire + explosion/VCE	North America	75,000,000	495,500,000	570,500,000
Refinery	Fire + explosion/VCE	Europe	123,000,000	440,000,000	563,000,000
Petrochemical	Mechanical failure	Middle East	10,000,000	360,000,000	370,000,000
Gas plant	Fire no explosion	Middle East	13,600,000	228,440,000	242,040,000
Gas plant	Fire + explosion/VCE	North America	160,000,000	45,000,000	205,000,000
Tank farm/terminal	Unknown	Latin America	100,000,000	72,000,000	172,000,000
Refinery	Fire + explosion/VCE	Asia Pacific	28,000,000	122,500,000	150,500,000
Tank farm/terminal	Lightning + fire	Latin America	138,000,000	—	138,000,000
Chemical	Mechanical failure	North America	50,000,000	78,558,800	128,558,800
Gas plant	Heavy weather	North America	8,438,835	118,000,000	126,438,835
Pipeline	Impact	Asia Pacific	2,000,000	109,000,000	111,000,000
Chemical	Unknown	North America	3,100,000	103,500,000	106,600,000
Chemical	Contamination	North America	8,300,000	95,700,000	104,000,000
Petrochemical	Mechanical failure	Asia Pacific	59,500,000	43,800,000	103,300,000
Refinery	Fire no explosion	Europe	4,238,000	90,000,000	94,238,000
Pipeline	Ruptured pipeline	North America	11,000,000	80,000,000	91,000,000

A further $650 million deterioration compared to the autumn update

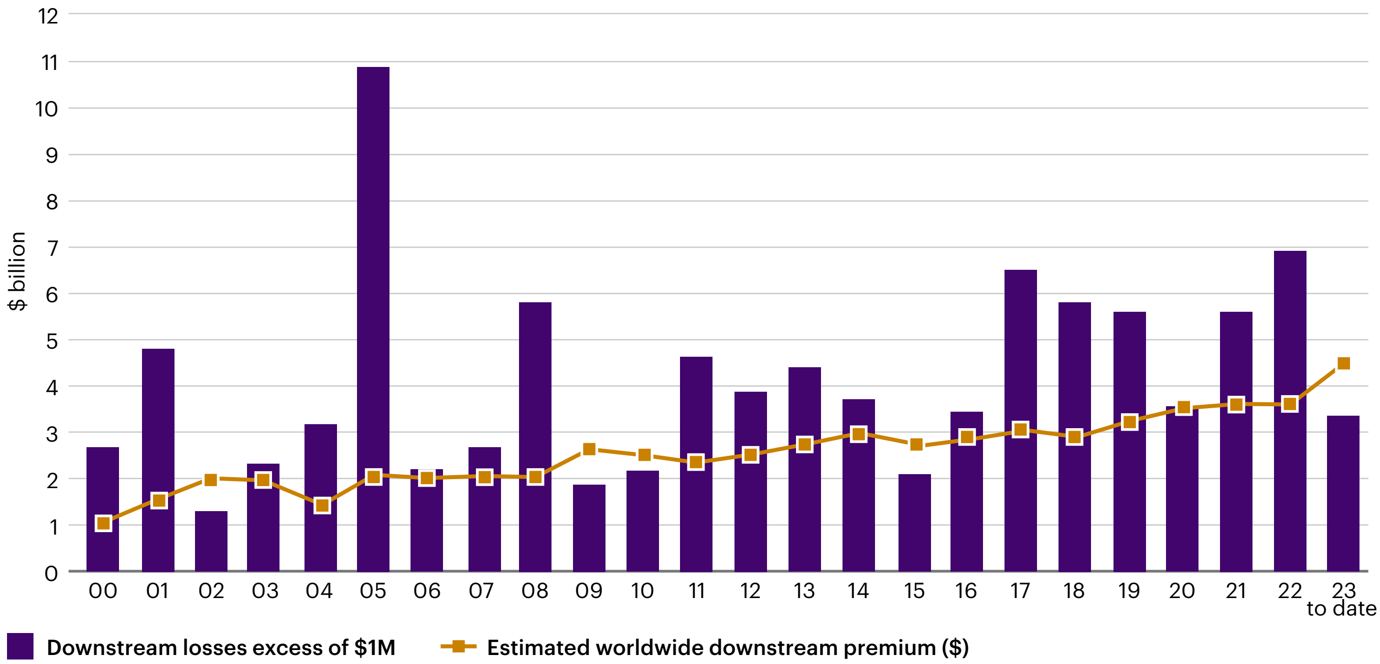
Source: WTW Energy Loss Database as of February 23rd, 2023 (figures include both insured and uninsured losses)

However, with increasing operating costs and the market still recovering from te substantial losses in 2021 and 2022 (some of which have deteriorated further), downstream insurers are not yet sharpening their pencils to aggressively attack rating levels again.

Figure 5:

Losses and premium income

WELD downstream losses 2000 — 2023 (excess of $1 million) versus estimated global downstream premium income



2023 provided insurers with a profitable year following the destructive loss activity of 2021 and 2022

Source: Willis Towers Watson/WTW Energy Loss Database as of February 23rd, 2024 (figures include both insured and uninsured losses)

With the increased reinsurance retentions imposed during the 2023 treaty renewals, we are also seeing direct insurers being hit more severely by smaller attritional losses, which are now fully borne by their bottom line rather than being passed on, at least in part, to treaty reinsurers.

Terms and conditions: A more considered approach to volatility

Insurers continue to focus on asset valuations both for PD and BI, and ensuring insured values are accurate is becoming increasingly important in a market environment where markets are no longer getting large rating increases that provide premium to pay for loss volatility. Thus, insurers are looking to tightly control claims recovery, predominantly due to the inclusion of BI volatility clauses as we have discussed in our most recent reviews. Whilst the leeway percentage in these volatility causes has progressively reduced as 2023 progressed, the downstream market has now taken a slightly different, more considered approach.

On 1st February 2024, the LMA released a new BI Volatility Clause LMA 5515A, which specifically addresses partial losses. This is particularly poignant, as in most loss scenarios, the client can maintain partial production. This was not previously properly considered within the market volatility clauses and the new clause is intended to provide greater clarity of loss recovery in event of a partial loss, effectively proportionally adjusting the recovery on a month-by-month basis to account for any partial production achieved by the client. We expect the LMA 5515A to be proposed on all or most BI placements going forward, however, we do envisage the market being more generous with percentage leeway in return for accepting new provisions, as there are possible scenarios where the clause could be more stringent than an average clause. Often, clients' businesses treat profit and costs in a different manner, for example, storage terminals may be treated as costs with profits attributed to refinery locations. As we know, BI losses are not always linearly proportional to production levels and multiple end products and margins to meet contractual requirements. We should not forget that the administration burden of BI declaration and adjustment is high, and there is uncertainty when a new clause is introduced. Insurers should carefully consider each individual insured and have confidence in their understanding of their business, ensuring that they remain focused on providing indemnity to clients applying the right rate to the right value.

ESG continues to loom large over the downstream market, however, there is not yet any consistency in approach between the different insurers. In fact, ESG appears to no longer be the focus it was a few years ago with the Russia-Ukraine conflict shifting focus towards energy security. We have observed some retrenchment from the markets who moved early on to declare their position with insurers re-evaluating whether their strict initial position was the right approach compared to a strategy of supporting clients through the transition. We are even seeing markets that declined business on ESG grounds just 2 years ago, and are now coming back to the same business. Whilst this by no means indicates that ESG considerations have been forgotten, it does show a shift in focus by the market and a return to the more holistic underwriting of the risk itself.

Market discipline is holding...for now

If all things come together and a client comes to the market with an international placement featuring good local market or captive participation, excellent engineering, up-to-date valuations, and a clean loss record, it is possible to obtain rate reductions in the current market.

As downstream energy continues to be a highly verticalized market, these reductions would likely be achieved through a combination of market rate reductions and the removal of the most expensive towers from the placement structure.

Local markets continue to aggressively pursue business in their region, be it the Middle East or Asia, and both markets offer robust pools of capacity totally in excess of $750 million in each region. In addition, the Middle Eastern market recently saw some movement of established underwriters to smaller insurers, which resulted in an increase in local capacity and risk appetite.

Placements that fully utilise the available local market capacity in both Dubai and Singapore are likely to see the best renewal outcomes as this will allow for the most competitive placement structures to be used. As a result of this substantial local market capacity, even some of the larger limits are oversubscribed and some of the core placements are coming to London with only small orders in the region of 20-30% left to fill. On the most desirable business, this is driving competition between London markets and the start of some bidding for share.

However, the same cannot be said for European or North and South American risks, which are not able to utilise the Middle Eastern and Asian markets because of licensing requirements or underwriting authority restrictions. These risks are heavily reliant on the cornerstone capacity provided in central Europe and London, and placements with limits exceeding $1.5 billion continue to be very challenging to place absent any meaningful captive participation.

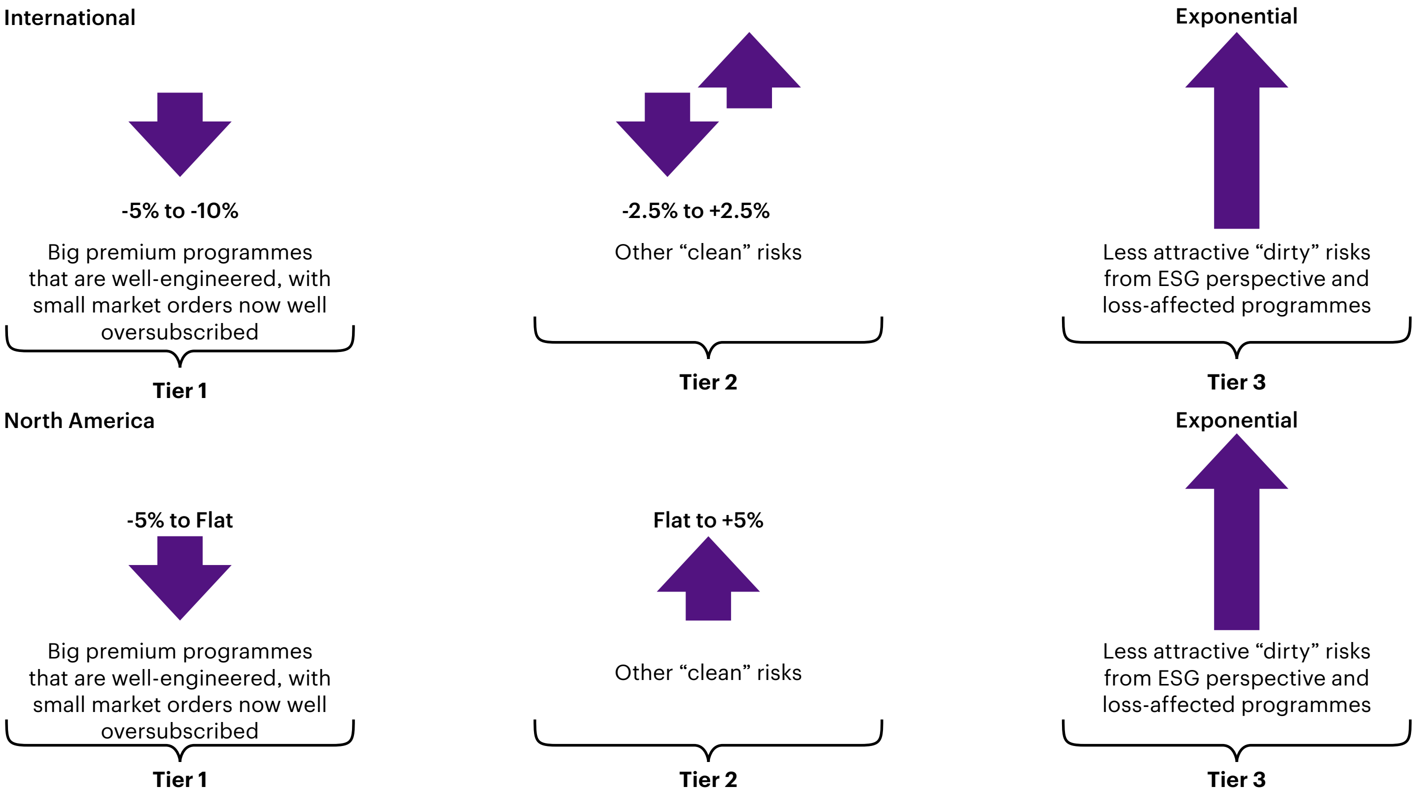
As a result, we are continuing to see a clear difference in downstream market's competitiveness for business where local markets can be used compared to placements relying solely on London and European capacity.

Despite this, we anticipate that 2024 will bring some harmonisation in programmes with renewal terms for the bulk of the Downstream portfolio ranging between small reductions and small rises.

Of course, every risk is different, and the observations we have made below will be subject to deviation dependent on limits, territory, clauses, and deductibles.

Figure 6:

Current downstream market rating movements, April 2024



With loss activity understandably still a key focus, it will be those accounts that have suffered recent losses, which will continue to see the brunt of the rate increases.

However, despite the market starting to soften once again, market discipline persists, and markets not yet starting to compete so aggressively that they undercut each other. Whilst 2023 looks to be a profitable year for most and some carriers have ambitious growth targets for 2024, insurers do not yet have carte blanche from senior management to provide significant rate reductions and grow the book at all costs.

For now, at least, markets will continue to fight for flat renewals, with insurers not wanting to be seen as the ones setting the market on a downward trajectory. However, this market discipline will unlikely last for long and reductions are already going through the books albeit on a case-by-case basis. While some of the early placements in the spring season will require some complex rearranging of towers to achieve the above reductions, as the year progresses, we expect that markets will come to terms with the new reality of the market.

And if 2024 proves to be another good year, we will likely see markets start competing for share which could send the Downstream market once again into meaningful softening. However, based on current sentiment, we are more likely to see a persistent but steady decline in rates than the freefall of recent years as underwriters do not want to return to rates falling off the cliff again only to spend several subsequent years working hard to recover to a reasonable base rating level.

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What will the future bring?

As we look further into the future of the downstream market, we see a trend of client merger and acquisition activity, particularly in the U.S. midstream market. This is a concerning trend for insurers as in any combination of two large clients, in insurance terms, one plus one rarely equals two. Such erosion of the Downstream premium pool, especially when relating to some of the market's preferred business, will of course be of concern.

Similarly, the trend of increased self-insurance, either via increased risk retentions or through larger captive participations, also continues, and this will further chip away at the reducing premium pool.

If the overall premium base reduces, insurers can mitigate the effect either by maintaining rating discipline and pushing for rating increases (which they are unlikely to achieve if the current oversupply of capacity persists) or by searching out new sources of income. To this end, many downstream markets are keeping an eye on developments in hydrogen space, as clients are considering retrofitting hydrogen capacity to their existing installations. Hydrogen is viewed as a key future revenue driver by many markets; however, the technology is still reasonably nascent in its development, and it is too soon for hydrogen to be a relevant revenue stream in the market.

Michael Buckle is London Head of Downstream, Natural Resources Global Line of Business, WTW.
michael.buckle@wtwco.com

Kieran McVeigh is GB Head of Downstream Broking, Natural Resources Global Line of Business, WTW.
kieran.mcveigh@wtwco.com