

Putting energy back into the market

In the first of our three roundtables for HMIS 2015 we ask leading members of the market for their views on the state of the sector and whether there remains room for manoeuvre

ON THE PANEL

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Brent Oil commodity price - US\$100 per barrel HMIS 2014 v US\$50 per barrel 2015 what are the future implications to the insurance industry?

RP: Who would have thought that we would be pondering this question 12 months ago? It has certainly been an interesting and challenging year. The Global E&P insurance market premium pool appears to have 'almost' halved, due to the reduction in commodity prices, coupled with unprecedented surplus capacity within our industry. The decrease in premium base is due to a vast array of industry changes: less drilling, a huge change within the offshore construction industry, with many multi-billion dollar projects cancelled or postponed and, as mentioned, reduced premium rating which has compounded over the past 3 years.

Further issues are the financial implications

which have affected Oil and Gas operators and contractors within the industry. Stock prices have 'tumbled' and revenues are greatly reduced. Mergers and Acquisitions is a trend we have been observing for the past two years and has continued into 2015.

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Therefore where we have 'marched' with the success of the oil and gas industry, if we are not careful insurers could also 'fall' by it. Underwriters will need to revisit the E&P results of the late 90's to see how painful this could become.

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LC: The severe drop in oil and gas prices has resulted in a dramatic drop in activity, particularly in Europe and North America but with activity less impacted in other regions. The immediate impact has been the delay or cancellation of projects, stacked and scrapped rigs and equipment, slashed drilling budgets, reduced business interruption figures, large swathes of layoffs, and increased merger and acquisition activity. The issue for the insurance market is that this dynamic in the underlying oil and gas industry has come at a time when the insurance industry itself is experiencing the weakest rating environment in several decades; this has caused even

further rating pressure as the markets compete for a much reduced premium base.

Sustained reduced commodity price levels will probably only have a short term impact on the insurance market, primarily affecting 2015 and 2016, but may require underwriters to significantly modify their cost bases depending on how deep the reduction in premium base is (currently estimated to be 50% to 65% of 2014). In the medium term, clients adjust their cost base to accommodate a new commodity price level and activity resumes, and sustained depressed commodity pricing will allow new entrants to the oil and gas sector relatively cheaply.

Au: Among other factors, a low interest rate environment, a shift in investor profile and benign loss activity has led to an oversupply in capital in the energy insurance market. These factors have led to an extremely aggressive pricing environment for

energy risks by insurers.

Coupled with these factors, low oil commodity prices have reduced the financial viability for such energy risks and has led to a slow down in capital projects and drilling activity. These

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factors further weaken demand for insurance capital, reducing premiums available to the market and thereby driving even softer market conditions.

Continued downward shifts in oil commodity pricing will doubtless further slow activity in the energy industry, the resulting lack of opportunity may hasten a retreat of investors from the insurance arena, thereby stabilizing prices.

While an upwards shift in commodity price theoretically creates more demand for energy insurance products and will stimulate investment in to the oil and gas sector, unless this materially changes the vertical values at risk, this won't result in in an upwards shift in prices for energy insurance.

If investors in the energy insurance arena are looking at an uptick in commodity prices to provide a rise in pricing, they may be disappointed. It may be that further addressing their own cost structures and a greater discipline regarding technical risk differentiation may assist investors in achieving what they are looking for.

Investors in the energy insurance sector should brace themselves for continued low pricing environment, irrespective of extraneous factors. They should use this time to seek ways by which the product they provide can be further enhanced and drive additional value for their clients through fundamental changes in policy forms and conditions.

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KJ: In the short term, a low oil price leads to less development and hence a smaller premium base. When this is combined with a very soft energy insurance market, the picture is not encouraging. Added to this is a general view that claims are pursued more doggedly when earnings are under pressure.

However, the picture is not quite as simple as this and some of the other factors that immediately occur to me are;

• Regional variations; for example, production/ development has not reduced in some areas, such as the Middle East. • Downstream operations benefit from a lower feedstock price and hence a higher margin; although, one should remember that B.I. is more commonly purchased in the downstream market and hence there is a potential for larger claims

• You mention oil and gas; remember that the gas price does not move in unison with the oil price and the gas market saw falls a long time prior to the oil price. The gas industry has nevertheless weathered this storm.

• Operators and contractors ultimately adjust to a new pricing environment.

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Providing there is no further



When and what do you believe will drive operators to increase drilling activity again?

LC: Providing there is no further deterioration in the commodity price, the adjustment of the cost base will allow for the resumption of drilling activity. Many industry experts expect this to be late in 2016.

RW: The simple answer to this is if the profit margin increases, then so will drilling activity. Obviously the commodity price falling has cut profit margins significantly, which in turn has led to reduced activity. We hear talks of cancelled or renegotiated drilling contracts in order to cut costs for the operators in line with the price of a barrel of oil. You only have to look at the number of drilling rigs out of action as evidence of this.

Some operators have deemed it prudent to put their drilling on hold and will wait for the commodity price to stabilise before re-entering. There is also a necessary relationship to keep up with their contractors; do they cancel/amend contracts and risk a backlash if the oil price is to rejuvenate or placate a long term relationship? 'What?' will drive up drilling activity is easier

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answered than 'when?' will it increase? With the Iranian sanctions, proposed EPA rules adding costs to the onshore shale market, as well as the back log of oil and weakening Chinese economy, it looks like the oil price isn't moving 'north' anytime soon. How the GoM operators will deal with it is another story altogether.

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KJ: The temptation is to simply answer this with; a higher oil price, which means that the supply/demand balance needs to be corrected. However, the reality is probably slightly more complex. Firstly, there needs to be a return of confidence. Large energy projects or investments in equipment such as rigs, are planned years ahead of

when the associated income will arise. This suggests that stability may ultimately be more important than a full return to the \$100 + per barrel that we saw up to one year ago. Organisations will ultimately adapt to the 'new normal' if they have visibility and some certainty on what the future holds.

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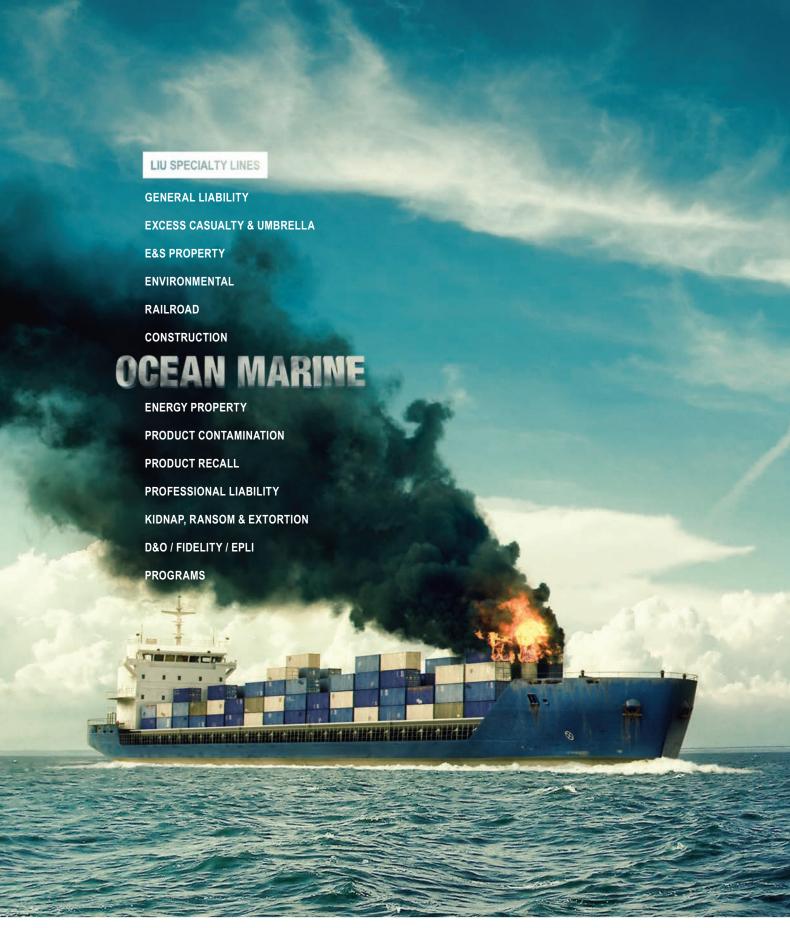
AG: Reserves replacement ratios and the generation of free cash flow are important measures by which many publicly traded operators are judged. In order to be successful in these areas of measurement it is critical that pperators find new reserves. While the low commodity prices may create acquisition opportunities as an option to grow reserves, frequently exploration is where operators seek to generate significant value. In the absence of a sustained increase in commodity prices there are catalysts that will bring operators back to drilling:

- There has been consolidation in the oil field services and contractor market. While costs of such services are already extremely low, there will be synergy in such transactions that further reduce costs of exploration to operators.
- There will be a continued improvement in technology and efficiency in drilling techniques that will further lend cost efficiencies. This will be particularly relevant in the highly challenging deep water or harsh environments where drilling costs have hitherto been prohibitive.

• Various petro-economies are running significant fiscal deficits at the current commodity prices. While conventional wisdom may suggest that those governments hold back reserves and produce such in times of higher commodity prices, some of these governments will seek to generate as much revenue as possible today, ignoring the consequences for tomorrow. This may stimulate some more beneficial arrangements and activity with operators to explore and produce.

One thing is for certain, the oil price commodity market is extremely volatile and is impacted by myriad global economic and political factors. Oil and gas investments are generally long lead. Prediction of commodity prices in the long term is fraught with challenge. Oil and gas operators are adept at navigating such challenges and have done so for decades now. While commodity prices may remain low well into 2016, there is no doubt that the operators will find ways to start drilling again very soon. meer

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