UNIQUE PERSPECTIVES

LIBERTY SPECIALTY MARKETS: DOWNSTREAM ENERGY

HAS DOWNSTREAM ENERGY REACHED A TIPPING POINT?

Paul Sankey, Liberty Specialty Market's Global Head of Oil & Gas, says the downstream energy market needs to do some serious thinking about its profitability in the light of a run of major losses.

Paul Sankey
Global Head of Oil & Gas, Liberty Specialty Markets

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The downstream energy market is experiencing unprecedented levels of operational loss. 2017 is expected to be the worst year on record for operational losses since the turn of the century. And to add salt to the wounds, another recent period of major loss activity added to the market's growing woes in 2018. So far, losses for 2017 and 2018 are estimated at $5 billion and over $3 billion respectively. These figures are set against a global premium income for the downstream energy market currently believed to be in the region of $1.8 billion.

Recent loss activity includes significant refinery events in the USA, Germany and Canada plus a fire at a major petrochemical facility in Saudi Arabia. All these losses included significant business interruption impacts resulting from extensive property damage. While it is too early to give precise estimates of the magnitude of these four losses, it is evident that two of them will be in the region of $1 billion and the remaining two could be in the region of $500 million each.

Worryingly, 2018 was the first year since the turn of the century in which four distinct and unrelated operational events have produced combined losses of roughly $3 billion. This figure means the market is loss-making even before smaller attritional events are taken into consideration.

Status quo no longer

So, the question demands to be asked: what exactly is happening? At a fundamental level, in order to estimate loss frequency and magnitude for each occupancy within the industry, the market relies on a relatively predictable frequency of large and attritional events combined with the usual modelling techniques for estimating natural catastrophe exposures. This allows pricing models to be set which can build in expenses and acquisition costs to produce a margin to give an adequate return on capital.

However, the experience of the last two years suggests that this may no longer be a reliable approach. The question on the lips of everyone in the business is: does this constitute a new trend or is it merely a statistical blip that will sort itself out over the long-term? At the moment, it is doubtful anyone can genuinely answer this question.

In terms of where we go from here, it is clear the market needs to marshal all of its technical experience and knowledge to address this problem. This is the only way in which the market can continue to support the downstream energy business in the long term. We need to understand the underlying root causes of each of these events individually, although history suggests that most of their causes – poor attention to maintenance and inspection, inadequate operator training, poor isolation practices, corrosion of ageing equipment, historical design issues and fundamental failings in process safety management – will have been experienced before by the industry.

If this does turn out to be the case, we will need to dig deeper to examine the sector's underlying trends in order to better explain the reasons behind recent increased frequency of major events. External issues may need much more detailed further analysis. Do we need a better understanding of the effects of merger and acquisition activity on the safety culture of an organisation? What is the impact of governmental and regulatory involvement such as issuing permits and licences following a major event? What is the impact of operational pressures to optimise margins in periods of strong profitability? And how do changes in workforce demographics such as the loss of experienced personnel due to early retirement, affect the memory of an organisation and its ability to learn lessons based on historical claims?

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New thinking needed

One example of the potential pressures produced by improved refining margins could be the predicted impact of the new International Maritime Organisation fuel specifications on global refining margins over the next 2–3 years. Most analysts suggest a significant up-swing in refining margins is likely, particularly for highly complex refineries capable of handling sour crudes and converting these into the low sulphur fuels required by the new regulations. This 'window of opportunity' may be short-lived but the potential pressures on refinery managers can only be negative in terms of insurance loss frequency and magnitude due to significantly increased business interruption values.

It is highly doubtful any single factor will be the underlying cause of the recent increase in loss activity and magnitude. However, it is likely that a combination of these has contributed significantly to the loss figures experienced by the market over the last two years and may well continue to do so for the foreseeable future.

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As a market providing security and stability for our customers in the downstream energy business, our message has to be simple and clear. We believe the market landscape has changed due to a fundamental shift in loss activity in the business. We cannot go on assuming things will revert to normal and loss activity will somehow magically come back in line with the market premium income. We need to dig deeper, question everything we do and produce new approaches to risk analysis and technical pricing that can ensure the stability and strength of the downstream energy market for many years to come.

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