MARSH INSIGHTS: ENERGY MARKET MONITOR

March 2014

NOWHERE TO HIDE

A recent report on the reinsurance sector, published by Standard & Poor's, predicts global reinsurers are facing a potential credit rating downgrade as the industry has nowhere to hide from mounting competition.

The situation appears to be very similar for the specialist energy insurance market. In this edition of Marsh's *Energy Market Monitor*, we focus solely on the upstream and downstream operational markets, but similar comments would apply for the specialist construction liability or terrorism markets.

The first few months of 2014 have shown very strong risk appetite and capacity inflation from many corners of the energy market. New capital streams are, however, changing the dynamics of the market, making it, we believe, the most volatile it has been for a generation. Additional capacity created by an influx of capital from private equity and hedge funds could be potentially short-lived if expected returns on investment fail to materialize. Meanwhile, longer-term investments from pension funds could provide greater stability, although we are only just beginning to see this type of capacity impacting the market.

Reduced reinsurance costs, positive results last year (particularly in the upstream arena), and management focus on growth are all pointing to a downward trend in pricing across the key energy classes.

After three years of an overall "stable" marketplace, there is clearly renewed competition, and this must bode well for energy insurance buyers.

The market is buzzing with talk of "softening". Many are now predicting that the softening trend will only accelerate in the months leading up to the key renewal dates of June 1 and July 1.

JUST PUBLISHED

LATEST PUBLICATIONS ISSUED BY MARSH'S ENERGY PRACTICE

Marsh's Energy Practice has just published three new papers: *Benchmarking the Middle East Onshore Energy Industry*, *Advanced Cyber Attacks on Global Energy Facilities,* and the 23rd edition of Marsh's *The 100 Largest Losses*. Please visit **Marsh.com** for your copy of these new publications.

UPSTREAM

Losses and capacity drive the market. There were few losses in 2013 and, at year end, overall capacity had increased by close to US$1bn; creating approximately US$6bn of useable capacity. There are very few risks that need this level of capacity, and a lack of demand puts further downward pressure on pricing. These two factors are moving the market. If there continue to be few large losses, the situation can only improve for upstream energy insurance buyers.

The frequency of losses in 2013 was extraordinarily low. One potentially major loss (in excess of US$1bn) was a construction claim that dates back to 2006. This claim will be borne by the reinsurance market, who will be unhappy that a claim has manifested after all these years. Another is a business interruption claim in the North Sea which could total as much as US$350m. Otherwise, the upstream energy market is enjoying a very healthy loss record, which is resulting in a profitable book of business. However, the problem is that the rest of the underwriters' books are not performing as well.

The improving loss record is undoubtedly being helped by oil companies around the world who are being more careful with regard to the environment, their workforce, and their reputations as they look to expand their horizons in search of oil. For example, regulation surrounding deep water drilling is becoming increasingly onerous, and has had a positive impact on loss frequency as companies make sure they keep to a high standard of operational excellence.

As we have said in previous editions of this publication, underwriters are facing two major problems; rate reductions at what they would describe as an alarming pace (double digit reductions), and overcapacity leading to a decreasing percentage share on the various risks for many underwriters. Leaders are typically offered the placement of any line they would like; this does, however, need to be tempered on occasion as appetite is strong. The following markets then tend to attempt to attain as high a percentage share on the risk as possible.

For example, if an underwriter writes a US$100m account and rates go down by 15% and the signings reduce by 15%, this leads to a reduction of US$28m on their book. Naturally, this will cause serious concern to senior management. This situation will only get worse as the year goes on as the underwriters' management demands its staff keep to budgeted premium income targets. This, in itself, will result in underwriters themselves chasing the market down. The only thing that will slow this falling market is multiple large losses, which will lead to a removal in capacity as the insurance companies fail to provide the expected returns on equity.

This is nothing new; the only change would appear to be that the "insurance cycle" is shorter and sharper than previously because larger chunks of capacity are in fewer hands. The result will ultimately lead to a consolidation of insurance companies as equity returns dwindle and share prices reduce.

DOWNSTREAM

The downstream energy property insurance market is showing a definite accelerated softening trend as we move through the first quarter of 2014. During 2013, the market continued on a stable path for the first three quarters, with a slight upwards trending on a general account basis. However, as we approached year end, it became clear that the market was prepared to offer flat rates and perhaps even slight rate reductions on a global basis.

Reviewing the general results of the downstream energy property market in 2013 in isolation, this softening trend might appear quite surprising. Estimates of loss amounts incurred in 2013 vary enormously between US$2.5bn and US$3bn, depending on the losses and the loss amounts being included in the total. Bearing in mind that there is an approximate global premium estimate of US$2bn to US$2.25bn annually for this sector of the market, clearly the market is either slightly in deficit at the bottom end of this range or it was a very poor year at the top.

2013 DOWNSTREAM ENERGY LOSSES

NUMBER OF LOSSES (APPROX.)	200
LOSS ESTIMATE TO COMMERCIAL MARKET NET OF DEDUCTIBLES	Range US$2.5bn to US$3bn
LARGE INDIVIDUAL 2013 LOSSES	ESTIMATE (US$)
South American refinery	700m to 900m
USA petrochemical	500m
North American refinery	350m to 450m
US refinery	200m
Thailand incident	180m
UK refinery	160m
Middle East refinery	90m
UK refinery	60m
Brazil petrochemical	50m to 100m
TOTAL	2.35bn to 2.7bn

Source: Marsh Energy Loss Database.

However, despite the overall 2013 loss picture, the market softening accelerated as we approached January 1, 2014, and indeed Marsh saw this trend develop further and more consistently as we moved into the early part of the year. We have already seen multiple cases of double-digit rate reductions within Marsh.

The reasons behind this change are probably a combination of the following factors:

- Continued and unchanged high levels of capacity in the market – approximately US$3.5bn to US$4bn for non-US risks, and US$2.5bn for US risks.
- Robust financial results in 2013 from the insurance and reinsurance companies as a whole, i.e. not energy-specific.

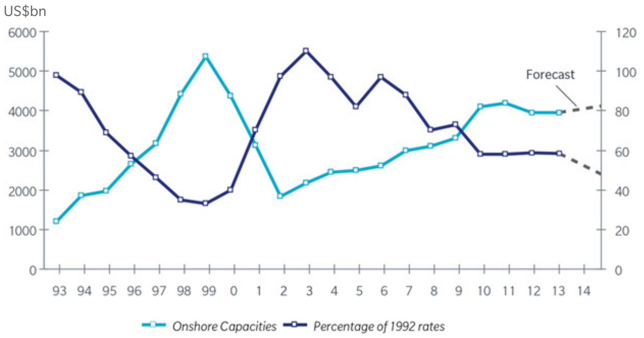
2013 FULL YEAR RESULTS

SAMPLE OF MAJOR COMPANIES	NET PROFIT (US$)
Munich Re	4.29bn
Swiss Re	4.4bn
AIG	9.1bn
Allianz	13.13bn
Zurich	4.7bn
ACE	998m
Axis	684m

- Markets, in general, are being mandated by their management to grow their books, and several markets have aggressive income budgets that need to be delivered.
- Markets that do not have aggressive income targets are now also resigned to the change in market dynamic and acknowledge the need to follow the market downwards for all but the most capacity-driven risks.
- Many markets are in a bullish mood and are using more of their available capacity, which is creating increased competition.

- Regional competition from local insurers continues to have an influence – for some markets this can result in further internal competition.
- Competition from the general industrial property insurers is a factor on many risks.
- Significantly cheaper reinsurance costs – both treaty and facultative.
- Major losses that hit the market in 2013 have not been evenly spread across all insurers, resulting in some markets actually experiencing a relatively positive year in 2013 and competing more aggressively for share.
- Some increase in appetite from some of the smaller capacity markets, with limited new entrants.

During the first quarter of 2014, Marsh has seen the rating levels on an average basis across the world reduce in the range of 5% to 15%. Of course, there are many variations to this trend for specific risk reasons; however, on certain risks we have already seen rate reductions in the region of 25% to 30% from those markets anxious not to lose their position on desirable programs.



OTHER FACTORS

- Natural catastrophe (NATCAT) exposure continues to be closely monitored by the market. However, due to the lack of natural catastrophes impacting the energy market, particularly the lack of natural catastrophes in the Gulf of Mexico, we are seeing a softening trend for NATCAT rates in 2014.

  This softening trend has also been driven by the availability of more competitive treaty reinsurance capacity as a result of large rate reductions on treaties during the major January 1, 2014, renewal season.

- Program retentions/deductibles remain stable currently. In general, current "standard" deductible levels have served the market well to reduce frequency losses, so there is no sustained pressure for increased levels. At the same time, trying to reduce retentions is often penalized heavily by the market, which makes it an unattractive option for the majority of clients.

  The other side to this is that the softening market is proving to be a time for some clients to consider higher retentions if they are comfortable with the additional exposure. This is on the basis that significant additional rate reductions can now be leveraged from the market in recognition of higher retentions. The increased retention gives the market a reason to grant an even more aggressive reduction in rates.

- Contingent business interruption exposure continues to be reviewed closely, with increasing amounts of information required for unusually high limits of liability.
- Verticalization remains an active part of the market. However, our sense is that as market rates ease and many accounts become significantly over placed, the amount of accounts being verticalized will diminish as markets realize they will lose their order if they do not follow the lead terms.

  Now is the time for clients to seek to consolidate terms behind a single competitive lead. This can result in very attractive overall composite price reductions as the most expensive capacity is leveraged to fall into line.

CONCLUSION

In conclusion, the downstream energy property market is now softening after a period of stability. The softening trend is accelerating significantly as we progress through the first quarter as discipline in the market reduces.

The big question is: Where will the market be at the end of 2014?

Our feeling is that, absent of any market changing events, significant rate reductions in the range of 20% will be standard on a widespread basis for preferred risks.

NOTES

ABOUT MARSH

Marsh is a global leader in insurance broking and risk management. We help clients succeed by defining, designing, and delivering innovative industry-specific solutions that help them effectively manage risk. We have approximately 27,000 colleagues working together to serve clients in more than 100 countries. Marsh is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), a global professional services firm offering clients advice and solutions in the areas of risk, strategy, and human capital. With more than 54,000 employees worldwide and approximately $12 billion in annual revenue, Marsh & McLennan Companies is also the parent company of Guy Carpenter, a global leader in providing risk and reinsurance intermediary services; Mercer, a global leader in talent, health, retirement, and investment consulting; and Oliver Wyman, a global leader in management consulting. Follow Marsh on Twitter @Marsh_Inc.

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