MARSH INSIGHTS:

ENERGY MATTERS
A SUMMARY OF OUR DECEMBER 2016 SEMINAR

Our most recent Energy Matters event in London took place on a gloomy December day, reflecting the environment the energy industry has been operating under over the past two years. Oil prices have slumped, reaching a peak low of just below US$30 per barrel at the start of 2016. Prices are forecasted to stay low for some time, with little expectation of a significant recovery in sight.

As prices stabilize, and buyer and seller value perceptions align, we are likely to see merger and acquisition (M&A) activity pick-up as opportunities, particularly in the upstream space, increase.

Keeping the challenges of the oil and gas sector in mind, the insurance industry, which is in a soft cycle, will need to make changes in order to remain profitable and relevant to clients.

This publication provides a summary of the discussions from the event in London, which covered the energy insurance industry, M&A activity in the upstream energy sector, and the challenges surrounding late-life assets. Our panel of speakers provided their insight on market trends and offered advice on risk management and risk transfer strategies that companies can adopt to help them survive this complex environment.

We would like thank our speakers and attendees for their participation in our December event. We look forward to continuing this thought-provoking dialogue with you over the course of 2017.

INSURANCE INDUSTRY MUST ADAPT TO THE SHIFTING OIL AND GAS ENVIRONMENT

The oil and gas industry has undergone a rapid period of change over the past two years, and the insurance industry must take a more innovative approach to meet its needs, according to Gordon Browne, UK head of energy and construction at AIG.

Since the end of 2014, the energy industry has undergone rapid change in order to adapt to the continuing low oil price environment, in which Brent Crude dropped below US$30 a barrel at the start of 2016. Oil and gas companies moved quickly to accommodate the change in commodity prices. As a result, Browne pointed out that we have seen a reduction of approximately 250,000 jobs in the industry globally and a greater top-down focus on costs.

In addition, M&A activity in the industry is beginning to pick up. We have seen a spate of major divestures, particularly in the North Sea.

"We are moving towards a sector where the landscape is going to be very different," said Browne. "But we have always expected the energy industry to survive, and ultimately, it is not the first time we've been through this."

The energy insurance market, particularly for upstream classes, has seen pricing under pressure, with premium rates staying low as capital and competition remain plentiful. However, this has left less premium to cover losses in a volatile market.

"This is due, in part, to the activities of our clients with regards to the low commodity price environment and minimal construction in the industry. The construction we are seeing is not that of mega-projects we may have seen in the past," added Browne.

One could draw parallels between the environment oil and gas companies have been operating within and that of the insurance industry. Like the energy sector, M&A activity has picked up considerably in the insurance industry over the past two years, driven by a low rating environment and the drive for top-line growth.

> "It is fairly evident that we have not done enough to be able to provide our clients with additional products and innovative solutions."

2015, for example, was one of the biggest years for insurance M&A. We saw a number of mega-deals such as the tie-up between Ace and Chubb and the acquisition of HCC by Tokio Marine. 2016 also saw several high value tie-ups, such as that between Sompo and Endurance and Liberty and Ironshore.

In addition, large losses have impacted the insurance market over the past couple of years, leading to claims overtaking income for this class of insurers.

Browne said that, as a result, the industry needs to change the way it is doing business: "It is fairly evident that we have not done enough to be able to provide our clients with additional products and innovative solutions." Ideas included:

- Being more client-centric by offering cover that is more holistic, traversing both first- and third-party risks and trying to fill existing gaps in coverage.
- Becoming more innovative through a greater utilization of technology. The oil and gas industry is increasingly using digital technology and drones to make its businesses efficient. The insurance industry would benefit from greater use of these types of technology.
- Add more value to services. Rather than focusing mainly on pricing and pure risk transfer, energy clients would benefit from having access to decision makers with the right expertise in their class of business.

"There are a lot of challenges in the insurance industry and a lot of pressure on us, but if we are going to survive, we need to make some difficult decisions and change the way that we are thinking about our market."

We need to make sure we are set up so that we can achieve profitability in today's environment, rather than waiting for the market to improve," Browne concluded.

DRIVERS TO M&A ACTIVITY EMERGING FOR INVESTORS IN ENERGY SECTOR

As the energy industry faces increasing pressure, M&A activity in the industry has recently started showing signs of picking up according to Martin Bennett, Managing Director, Marsh's Private Equity and M&A Practice.

The considerable stress experienced by the energy sector since oil and gas prices crashed in 2014 has had a knock on effect on the number of deals taking place. Data from Ernst & Young (EY) revealed that M&A activity in the oil and gas sector decreased by 40% in 2015, with 448 deals taking place as buyer and sellers had a mis-match on pricing expectations[1].

However, increased debt and significantly reduced profits are now driving a need for M&A activity. Buyers and sellers have been considering the advantages and disadvantages of different types of deals, including:

- Assets sale: Provides a relatively quick transaction process without the encumbrance of legacy and liability issues. However, transactional undertakings may still be transferred along with the assets.
- Minority equity sale: Provides an opportunity for new entry into the market for both strategic and financial investors. However, the assumption of legacy liabilities and the potential for incompatible risk tolerance and risk-bearing capabilities between the new investor and the seller can be a challenge.
- Company sales or a share sale of a business: If the deal is well-structured, it should provide a clean exit for the seller and a good opportunity for the buyer.

Asset sales will most commonly be used as a strategy by traditional energy firms to counter low fossil fuel prices. Minority equity sales follow in popularity and company sales account for the lowest percentage of deals likely to take place in the short term. This is according to a Mergermarket survey of 100 managing directors and partners from private equity firms, who have at least one investment in the oil and gas sector during Q1 2016.

OPPORTUNITIES EMERGING IN UPSTREAM ENERGY

"The biggest opportunities for buyers in today's market exist in the upstream space," Bennett said. This will likely remain a growing opportunity over the next 12 to 18 months, particularly where existing infrastructure, in mature fields, can be operated by new entrants at lower cost. Midstream companies have seen sustained M&A activity and investors see the predictability of returns from long-term contracted structures as attractive investment opportunities.

Meanwhile, the downstream market is currently not considered to offer attractive investment opportunities due to high costs for the modernization and maintenance of refineries, along with the volatility of product pricing and low margins in the market. Bennett said he expects to see the least M&A activity in this sector over the next few years.

Increased debt and significantly reduced profits are driving a need for M&A activity.

He highlighted that attractive prospects are also based on region, with more investors looking into North America, Europe, and Asian-Pacific markets over opportunities in Africa and the Middle East.

For buyers considering taking advantage of current opportunities in the oil and gas sector, Bennett warns that challenges can arise at every stage of the acquisition process. These must be addressed carefully and with due diligence if a transaction is to go smoothly.

1 EY. Global oil and gas transactions review 2015.

SELLERS NEED TO POSITION THEMSELVES FOR INCREASING DIVESTMENT OPPORTUNITIES

Companies need to take the proper preparation in order to achieve the best price, according to Suzanne Jones, UK Corporate M&A practice leader at Marsh.

"While acquisitions grab the headlines, it's just as important to focus on disposals, especially when it comes to adding value to your company," said Jones.

According to Jones, planning and preparation is key in achieving a successful divestment. "There are some very sophisticated buyers. To achieve the right prices, it's all about how you manage and present your own risks," she said.

To achieve the best price, planning and preparation should identify potential transaction issues. Avoiding surprises for purchasers will help sellers achieve a better price and increase the chance that the disposal will be successful. Jones suggested taking the following steps in order to achieve a good price for assets:

- Consider how historic liabilities will be dealt with.
- Anticipate your buyer's area of concern.
- Consider ways to limit your liability post-sale, while not reducing the amount of protection afforded to buyers.
- Be prepared for challenging due diligence enquiries.
- Ensure sale and purchase agreement is tightly drafted.

Particular, care should be taken when drafting initial seller-purchaser agreements, Jones warns.

"I've seen a huge number of seller-purchaser agreements where there is a misunderstanding of what the seller wants and what is drafted in the seller-purchaser agreement. That has ended up with the seller retaining liability where the intention was to transfer that liability to the buyer," said Jones.

"When providing risk and insurance information to potential buyers, it is important that there is enough information for the buyer to be able to put a value on the cost of insurance. If only limited information is provided, buyers may not be able to get comfortable with the possible risk exposure."

HAVING THE RIGHT COVER IN PLACE FOR TRANSACTIONS

Whether you are a buyer or a seller, insurance plays an important role in transferring the risk of known and unknown risks. Transactional risk insurance is available for both buyers and sellers to cover losses that are unknown and unforeseen and those which are quantifiable and known at the time of signing.

According to Bennett, these types of insurance "can provide great opportunities for both buyers and sellers by moving the risk into the insurance market, rather than maintaining it as part of the overall transaction structure."

"When providing information, it is important that there is enough information for the buyer to be able to put a value on the cost of insurance."

DECOMMISSIONING COSTS PRESENT AN INCREASING RISK

With the number of late-life assets entering the decommissioning phase expected to increase in the coming years, companies are not always planning effectively for the costs involved, says Amy Barnes, global energy and power chief client officer for Marsh.

According to Barnes, decommissioning is relatively immature, typically suffering from significant cost overruns and little understanding and quantification of risks. The industry, and operators especially, therefore have a significant challenge ahead of them.

Recent findings from Marsh's sister company, Oliver Wyman, have shown that organizations engaged in the decommissioning of assets on the UK continental shelf are overrunning considerably on costs[1].

"When we look at the typical decommissioning cost, what we found is that people aren't planning for cost overruns," Barnes said, pointing out that experience in the North Sea has shown that decommissioning risks typically run at about 40% over budget.

"If decommissioning costs are understated, we have a real concern that there is going to be an adjustment of enterprise value at some point in the near future for companies with major decommissioning liabilities," she said.

In order to put more consideration into their approach to decommissioning, operators will need to think about how they manage late-life assets and the associated challenges. These can be complex, including financial, environmental, and technological.

1 Oliver Wyman. Defusing the Decommissioning Time Bomb.

Historically, insurance has played a relatively small part in the various issues and challenges associated with decommissioning and late-life assets. Barnes said that it would take stakeholders coming together to address decommissioning issues holistically.

She pointed out that one could view the issues around the decommissioning risk transfer market in a similar way to how pensions have been viewed. Both are long-term obligations with a degree of uncertainty. Rather than concern over the trend of longer life expectancy (as with pensions), it is the possibility of early death of assets that is creating aversion from decommissioning risk transfer.

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However, there are risk financing and transfer solutions that operators can consider at different phases of the decommissioning process. License holders can consider captive utilization in order to transfer some of the risks. If it is a transferred asset, operators can consider paying premium up front as part of the transaction or securitizing production for future obligations.

For operating late-life assets, risk transfer consideration should be given to basis of valuation, basis of recovery, impact of stranded assets, and dependant infrastructure. Once the asset is being decommissioned, operators can consider policies such as de-construction all risks (DAR), decommissioning liability, and post-closure liabilities, which are available for up to 20 years.

While some financial solutions are available, it remains challenging for operators to have holistic cover in place to address the full range of liabilities and exposures associated with decommissioning and late-life assets.

"It's a very complex problem and while we may not have all of the answers, we have some that can help at various times during the lifecycle," Barnes concluded.

EXPOSURES ARE INCREASING

Growing regulatory burdens, the increasing size of structures, and a greater number of structures entering decommissioning are increasing the exposures for energy companies, according to Nabil Khawaja, managing director and offshore construction team leader for Marsh.

Khawaja highlighted the growing exposures that are associated with decommissioning. This is, in part, due to increasing regulatory scrutiny around these issues, including legislation such as:

- The International Maritime Organization (IMO) guidelines, which require the complete removal of decommissioned structures under 4,000 tonnes in water with a depth of less than100 meters.
- OSPAR – Decision 98/3, prohibiting the dumping at sea, and the leaving wholly or partly in place of disused offshore installations.
- UK Petroleum Act 1998, applied by the Department for Business, Energy & Industrial Strategy (BEIS), and similar to the OSPAR rules.

As such, decommissioning represents an increasing financial burden, particularly in the North Sea and the Gulf of Mexico. Activity is set to increase over the next 10 years, particularly in the North Sea, with close to 100 platforms slated for removal and nearly 800 pipelines, totaling about 7,000 kilometers. With an increasing number of decommissioning projects taking place, companies need to be mindful of the possible liabilities and exposures at each stage of the process.

The exposures at each stage of decommissioning include:

1. Removal: During this stage, risk exposures may include structure collapse, items coming loose from the main structure, damage to existing structures, or possible pollution. These will depend on the method of removal that is used.
2. Transportation: This stage carries the risk of breakup or loss of structure, possible pollution or contamination, or third-party damage.
3. Unloading: Risks at this stage are similar to those encountered during the transportation stage.
4. Onshore dismantling/breakup: Pollution/contamination: Risks at this stage are expected to pass from the operator to the breakup or disposal contractor, or to a new owner if items are sold for reuse. However, contingent operator liability may remain.
5. Disposal: Risks at this stage are similar to those encountered during onshore dismantling or breakup.

Liability covers are available in the market to protect against many of the exposures operators and owners may face throughout the lifecycle of decommissioning. In addition, operators undertake proper planning as assets reach the end of their life cycle to avoid unexpected losses.

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