

## MARSH INSIGHTS: ENERGY MARKET MONITOR

October 2014

### THE REALITY OF CAPACITY OVER-SUPPLY FINALLY SINKS IN

The last three years have remained remarkably stable for the energy market. Considering the over-supply of capacity during this time, underwriters demonstrated very strong discipline. This resulted in very good overall results for energy, supported, in particular, by exceptional results from upstream business.

We anticipated a degree of “tapering” of market prices at the beginning of 2014. Capacity was increasing by up to 10% at the time, and we expected that this would put pressure on prices which would gain in momentum throughout the year. Despite these forecasts, the pace at which prices reduced took everyone by surprise.

#### SO, WHAT CHANGED?

Recent changes in the investment environment have led new streams of capital providers to the insurance (and, in particular, the reinsurance) market. The length of time that this capital will be available remains unclear, but it is having a significant impact on the market today.

#### SO HOW DOES THIS AFFECT THE ENERGY INSURANCE MARKET?

In simple terms, these new investors are taking business away from traditional reinsurance companies which, in turn, have to respond by competing on price and expanding into other areas, such as energy. Treaty capacity is therefore getting more competitive for energy insurers and reinsurers, which are being pressured by management to grow. These tough growth targets sit uneasily alongside the increase in capacity and subsequent premium reductions.



## UPSTREAM

### CAPACITY

The brokers' addition of new downgrade clauses to client contracts enables security to be replaced with a pro-rata return of premium should a market's security rating fall below a certain level. Historically, it was almost impossible to remove troubled companies midterm. This has resulted in the rapid decline of troubled companies following a downgrade. Recent examples demonstrate that when insurers go into run-off, it has little, if any, impact on the market due to the abundance of capacity.

### RATES

Offshore underwriters are not only facing double-digit reductions in rates, but also huge pressure on their market shares.

Underwriters may be reducing rates, but what they are not doing is reducing deductibles or changing coverage parameters. In the past, underwriters have riskily reduced rates, terms, and deductibles. There are savings to be made in the market today and the downturn in the market cycle should last into the foreseeable future.

### LOSSES

In the last 18 months, the offshore market has not suffered any major losses, resulting in this sector continuing to make a profit.

### LOOKING FORWARD

Should the offshore market loss record continue in the same fashion it has been for the last couple of years, rates can only go down. The current run of very low frequency losses has been unprecedented in modern times and we feel that two individual losses, each in excess of US\$1 billion, is the only way that rates will start to increase. Undoubtedly, there will be a bottom to the rates currently enjoyed by the market but, with the current trend of losses, it is nowhere in sight.

## UPSTREAM CONSTRUCTION

### CAPACITY

The number of new offshore construction projects continues to fall. The resulting reduction in premium income is exacerbated further by a decline in rates due to overcapacity and high captive participation.

Against this background, the market remains soft and a continued downward trend is evident on the projects that do come to market. The limits of commercial market capacity are rarely being tested and project insurances are being completed at highly competitive rates.

### RATES

Underwriters that hold out for rating levels close to what they regard as the "technical rate" for the risk are finding that the placings are being completed without them as their competitors prioritize premium income over rating adequacy.

While rates have fallen to their lowest level since the late 1990s, deductible levels have held reasonably firm, thus continuing to eliminate attritional claims that have severely eroded profitability in the past.

### LOSSES

A very large offshore construction claim is currently in the market which, despite causing a little understandable consternation, has yet to have an impact. Otherwise, the recent incidence of construction losses lies within normal parameters.

### LOOKING FORWARD

There are many new, large-scale projects scheduled that are likely to reduce the downward pressure on premiums. However, should US regulators permit the large-scale exportation of shale gas, thus depressing commodity prices, this could affect the commercial viability of these projects and may, in turn, result in delays to final investment decisions.

Should captives pull back from this class, deciding not to chase the commercial market downwards for such long-term risks, the withdrawal of this capacity would also reduce the downward pressure. At present, however, there is no sign that they are considering this.

Marsh believes that the current trends look set to continue unless a market-changing loss or series of large losses occur.

## DOWNSTREAM

### CAPACITY

Downstream energy property capacity remains robust at around US\$4 billion to US\$4.50 billion for international non US risk and approximately US\$2.5 billion for US risks. Generally, capacity has remained stable throughout 2014 with only a few new entrants but we have seen markets willing to utilize their maximum capacity more frequently. There has been no significant withdrawal of capacity.

### RATES

Renewals have shown continuing and consistent rate reductions, typically of around 10% to 15%. Reductions of around 20% have been achieved for preferred risks (that is risks with good engineering, profitable loss records, limited or no natural catastrophe exposure, and a capacity requirement that does not stretch the market).

Deductible levels, however, remain unchanged – again demonstrating a strong discipline by underwriters to maintain a profitable book.

Despite the increased availability of capacity and reduction in rating levels, natural catastrophe exposure is still being monitored closely.

Contingent business interruption remains an area of focus for most underwriters. The downstream energy property market has been controlling these exposures since 2001 through the comprehensive use of sub-limits.

### LOSSES

Despite a recent spate of losses, the market continues to soften. This is being exacerbated by the predicted benign hurricane season in the Gulf of Mexico.

### LOOKING FORWARD

Absent of any market-changing events, Marsh believes significant rate reductions in the range of 10% to 20% will be standard on a widespread basis for preferred risks, particularly when considering the additional pressure for some markets to reach end-of-year income budgets.

## CASUALTY

### CAPACITY

Lloyd's syndicates, eager to broaden their product base, are offering new casualty capacity after being encouraged by the history of good results. This is also being mirrored by London company markets. The growth of the regional bases of major companies, particularly in Asia and Dubai, has slowed the flow of business into London and Europe. These conditions are starting to create a more competitive environment.

### RATES

Over the last 10 years, casualty market pricing has remained relatively stable, with only a +/- 5% change over a 24-month period despite various influences of capacity or market share. While we are seeing opportunities to achieve some significant reductions, the long tail nature of some casualty claims may slow the competitive environment.

The US-domiciled risks still retain a profile of restricted competitive capacity, stringent policy drafting, and hard rates. The US rates are a counterpoint to the rest of the world, where the competitive environment prevails.

### LOSSES

Energy claims activity is dominated by the fallout from the two significant North American events. Both Deepwater Horizon and Lac Magantic (derailment of a runaway train carrying crude) are continuing to develop by exploiting the litigious environments where the cases are being heard. The result has been more expensive legal action and the broadening scope and number of potential litigants involved in the two incidents.

Aside from this, claims activity is light, ratifying the decision for additional capacity to enter the market creating a highly competitive environment.

### LOOKING FORWARD

Only risks with a heavy US profile or adverse claims activity are likely not to benefit from reduced premiums over the next year. The increased flow of business into London will generate more capacity on the very desirable "follow form" basis. Marsh believes that to achieve this, London and European underwriters will also offer better rates at higher layers on programs. Key indicators suggest that the likelihood of more significant reductions has increased.

# TERRORISM

The global political landscape remains uncertain. The threat of terrorism caused by religious and economic turmoil is still dominating countries such as Syria and Egypt.

The emergence of the Islamic State of Iraq and the Levant (ISIL) has put the terrorism market on high alert: Not just for the threat this group poses, but for the influence it is exerting on the impressionable and passionate youth.

## CAPACITY

Capacity is abundant and far-spread. Underwriters continue to pursue premiums to maintain their projected income targets, while still trying to maintain pricing diligence in difficult territories. Political violence capacity is still very constrained in high alert territories and, as always, there is a price for this capacity.

The demand for terrorism coverage in the Middle East has grown significantly in the past five years due to lenders' requirements and a change in the buying philosophy. As a result, the Dubai market is growing rapidly, with many Lloyd's markets opening franchises.

## RATES

The usual cycle of undercutting to maintain leadership and market share continues as does the hunger for new business to boost income. The softening market is encouraging underwriters to use facilities to guarantee their income and reduce the time required so that it can be spent on new endeavors and opportunities.

## LOSSES

Marsh is not aware of any significant energy terrorism claims this year. Additionally, we see little or no impact on the energy terrorism market resulting from any terrorism claims.

## LOOKING FORWARD

The global footprint of the terrorism market is growing rapidly, while risks are being placed quicker and pricing driven down further.

# MIDDLE EASTERN MARKET

## CAPACITY

The Middle East energy insurance market continues its remarkable growth. Lloyd's are in the advanced stages of finalizing their platform in Dubai, with other international reinsurers and new managing general agents (MGAs) believed to be following suit. During the last year, new upstream expertise in Dubai has resulted in an increasing number of leaders in this sector.

## RATES

This wealth of capacity, combined with the London market fight back, has delivered some very significant rate reductions. Premium rates for Gulf Cooperation Council (GCC) downstream energy clients are widely considered as being some of the most competitive of any in the market. Internationally, reductions in quarter two of 2014 were around 10% to 15%, but many clients in the region already enjoy rates firmly at the lowest end of the spectrum.

Achieving reductions of that magnitude, against a backdrop of mediocre underwriting results, has proved a real test for the market. Additional value was also provided as terms and conditions were enhanced in tandem with the reduced premium rates. The market's mantra that deductible reductions should be resisted predominantly stayed true.

## LOSSES

In the last year, there have been a number of losses worth US\$25 million or less, in addition to a handful of larger incidents. These have impacted the traditionally strong underwriting results in the region.

## LOOKING FORWARD

As 2014 progresses, the widely accepted view is that the downward trend will continue. As the year draws to an end, underwriters typically start looking at their individual budgets and many could well be faced with shortfalls. Attempts to maintain signed lines will add to the downward pressure caused by the general oversupply of capacity.

# ASIAN MARKET

## CAPACITY

The Asian insurance market remains most competitive for Asian-domiciled, onshore operational risks. Chinese, Japanese, and Korean domestic markets are becoming increasingly active and offer viable, secure alternatives for certain classes of risk.

The upstream market continues to soften in line with the global market. Feedback from the markets is that they are down on budget by circa 10%, although at the moment most are not generally thought to be under significant pressure from their management. Those reliant on offshore construction all risk (CAR) insurance will have a bigger deficit.

## RATES

Company markets have amended their rating models and risk appetites to become more relevant and aggressive in the current environment. Deductible levels and policy conditions have remained firm but rates have been plummeting, with competition over signed lines becoming a major issue.

## CONSTRUCTION

Construction insurance terms are just as competitive. New investments in upstream and downstream have been limited this year mainly for political reasons. Internal unrest, South China Sea border disputes, and election campaigns have delayed decisions and have driven insurance prices even lower for construction projects that have been authorized to proceed.

The London market remains the strongest driver for the upstream construction class of business in Asia and we would estimate that rates are generally 50% lower than they were 24 months ago. The onshore construction market continues to be extremely soft. Rates and deductibles are both reducing and markets have to quote aggressively just to ensure that they see the final terms.

## LOSSES

A number of sizeable industry losses in 2014, for example those in Thailand and India, have stabilized the downstream market. There is now less focus on top line growth and more on maintaining profitability.

## LOOKING FORWARD

To combat the effects of a softening market, some underwriters will look at alternative solutions (that is, reinsurance opportunities, wider coverage etc.) to grow or maintain their books. Underwriters are concerned about what will happen next year if the good loss record in the sector continues.

## This image shows a single sheet of white paper with horizontal blue ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.



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