Willis Towers Watson

The Winds of Change?

Energy Market Review Update November 2018

The Winds of Change?

Upstream stays basically flat while Downstream appears to harden – for the moment

Introduction - why change may be in the air

In 1960, Prime Minister Harold Macmillan heralded the beginning of the post-colonial era in British history by referring to the "Winds of Change" in an address given to the South African parliament. It has gone down in history as a speech which helped to usher in a new era in Britain's relationship with its African ex-colonies and is credited with marking a significant transition from the old British Empire to a modern Commonwealth.

Macmillan was an astute politician who could sense that change was in the air. And unlike some, he knew how to articulate it before the change was apparent to most.

Like Macmillan, it's our job as brokers to sense any "winds of change" in the Energy insurance markets before others do. On the face of it, it might be argued that life in the Energy insurance markets is carrying on in much the same way as it has done for many years. The glut of reinsurance market capital, referred to so often in our publications as the principal driver of soft market conditions, shows precious little signs of future deployment elsewhere. As a result, reinsurance prices have remained relatively low by historical standards, allowing direct insurers to compete more aggressively, thereby aggravating the softening market conditions that we have experienced for the last ten years or so.

But as we have argued for some time now, logic dictates that this continual market softening has to break down eventually; at some stage, premium income levels become so low that it is just not worth underwriting a given portfolio any more. In the past, we have been unable to say exactly when that point would be reached; only that further softening was showing that it had not been reached yet.

Is now the time? To answer that, let's have a look at some external factors which are influencing conditions in both markets.

Underlying underwriter pressures

The Lloyd's PMD initiative

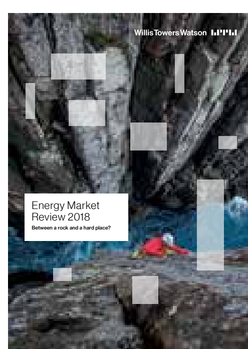
Figure 1 – 2017 catastrophes – the impact on Lloyd's

Lloyd's aggregated results				
£m	**Dec 2015**	**Dec 2016**	**Dec 2017**	**Change from 2016**
Gross written premium	26,690	29,862	33,591	6% growth + 6% FX
Net earned premium	20,565	22,660	24,498	+8%
Net incurred claims	(10,262)	(12,987)	(18,250)	+41%
Operating expenses[1]	(8,256)	(9,205)	9,669)	+5%
Underwriting result	**2,047**	**468**	**(3,421)**	-
Net investment income[2]	402	1,345	1,800	+34%
Foreign exchange gains/(losses)	(70)	578	(62)	-
Other expenses	(257)	(284)	(318)	+12%
Profit/(loss) before tax	**2,122**	**2,107**	**(2,001)**	-
Combined ratio	**90.0%**	**97.9%**	**114.0%**	-

Combined ratio increase to 114% driven by major claims and declining prices

Source: Lloyd's market results, 31 December 2017

[1] Technical account
[2] Return on syndicates' assets, notional investment return on members' funds at Lloyd's and return on central assets



This update should be treated as a supplement to the Willis Towers Watson Energy Market Review, which is published in April each year. Where information has been obtained from external sources, this is indicated at the end of each item.

This update is published for the benefit of clients and prospective clients of Willis Towers Watson. It is intended to highlight general issues relating to the subject matter which may be of interest and does not necessarily deal with every important subject nor cover every aspect of the subjects contained herein. If you intend to take any action or make any decision on the basis of the content of this bulletin, you should first seek specific professional advice and verify its content.

Let's start with Lloyd's; while of course Lloyd's is by no means the only market underwriting Energy around the world, it is perhaps a useful place to start in developing an overall picture of these markets.

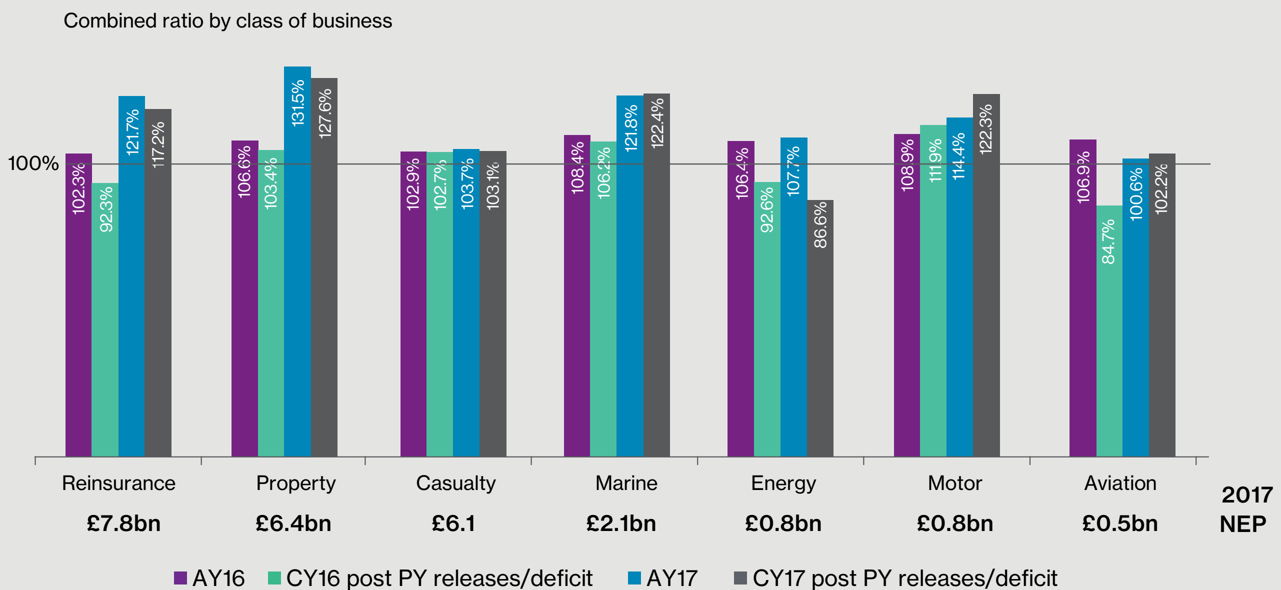
As some readers may know, the Lloyd's Performance Management Directive (PMD), under the leadership of John Hancock, has begun a process that is designed to bring significantly more rigour to the examination of individual syndicate business plans, following the overall underwriting loss made by the Corporation in 2017 (see chart on the previous page).

In particular it is understood that business plans that anticipate any increases in premium throughput are being thoroughly analysed, and it is also understood that several syndicates have already had their initial business plans rejected by the PMD.

Although it is not our place to comment directly on this process, it seems quite clear that this development is likely to put a brake on individual syndicates' attempts to compete in the market by driving down prices in order to achieve increased premium income streams.

Unprofitability of other lines of business

Figure 2 – Lloyd's: poor underwriting results in other classes



Energy had a good underwriting result in 2017 – not so other classes of business at Lloyd's

Source: Lloyd's market results, 31 December 2017, NEP: net earned premium, AY accident year, CY: calendar year

As if this new degree of management scrutiny was not enough to change energy insurance market dynamics, individual underwriting teams are being forced onto the back foot by the results of other lines of business closely associated with their own portfolio (see chart above). For Upstream, such lines as Marine and Aviation have been reporting generally mixed results at best, leading to actual withdrawals from some sectors. And for Downstream, the scenario is even bleaker; it is understood that other Property lines such as Construction, Mining, Power and Renewable Energy have all been generally reporting negative underwriting results. Because Downstream is even more closely associated with these lines of business, as part of an overall Property portfolio, there is no question that their own account is definitely being viewed by the Lloyd's PMD through this overall Property prism. So even profitable lines such as Upstream Energy are being asked to make a contribution to holding the line and driving a turnaround in market conditions.

Insurance company management pressures

In a truly competitive market, it might be thought that if one sector was being forced to pull back from competing at full throttle then another sector would then be able to take full advantage. However, any notion that the company market might differentiate itself by continuing to offer increasingly competitive terms to buyers next year is almost certainly misplaced. If anything the major company market – including the likes of AIG, Swiss Re, Allianz, Munich and Chubb – have been hit more severely by last year's natural catastrophes and it is understood that their underwriters are under a similar pressure from senior management to scale back on premium income expansion and ensure that they "hold the line" on rating levels and other terms and conditions.

Result: a change of underwriting mood!

As a result, we are seeing a change of mood amongst underwriters in virtually every line of business and geography. In very general terms, no longer is their overriding requirement meeting ambitious premium income targets; instead, the focus has generally switched to underwriting profitability. From our conversations in the market it seems that some underwriters are not far away from seeing their own positions coming under threat if they continue to ignore the underwriting criteria laid out by their management.

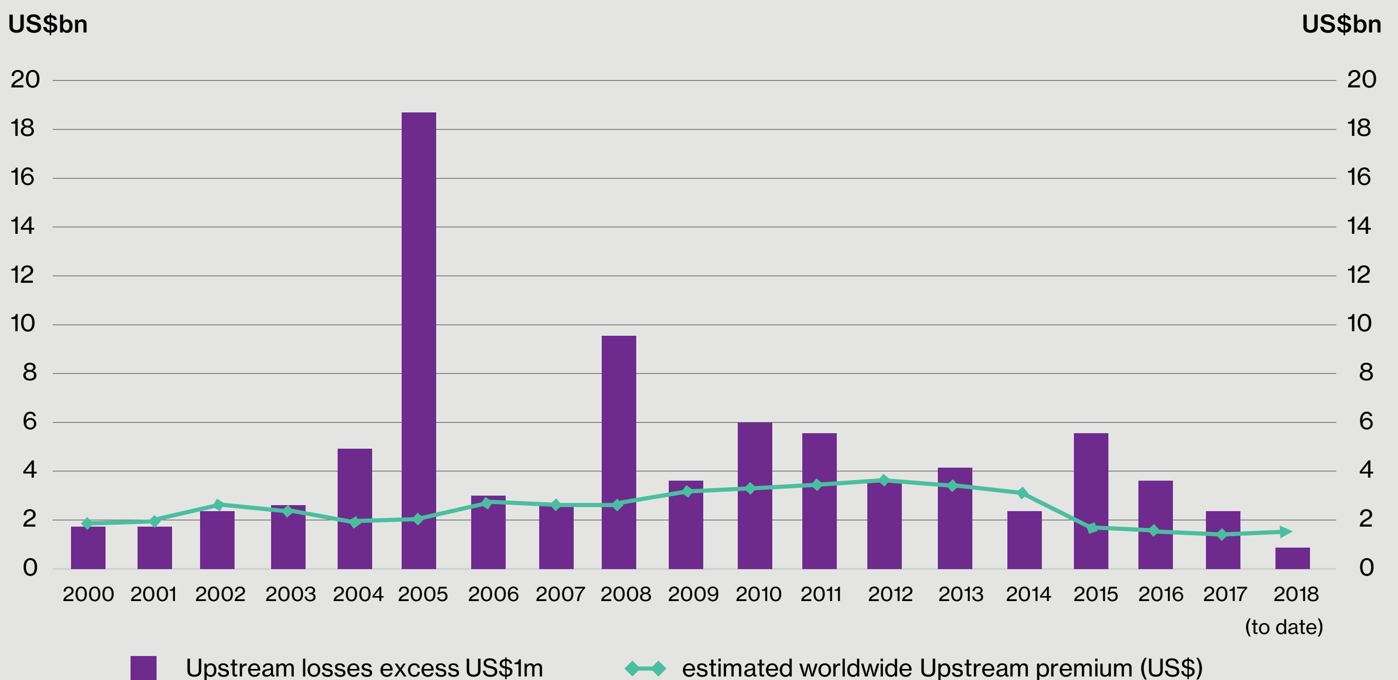
So although the overall theoretical capacity levels remain at record levels, brokers are finding it much more challenging to deliver the results that buyers have enjoyed now for so many years.

How is this playing out in practice? Let's examine each of our market sectors in greater detail.

Upstream – a profitable book, but further significant rate reductions unlikely

A glance at our updated Upstream losses versus premiums chart from our April 2018 Review (below) shows a significantly improving loss picture during the last four years, with 2018 set to perhaps even eclipse 2017 in terms of a further reduced level of overall quantum and number of losses. As we intimated in April, some of the reason for this loss improvement must be put down to the reduced levels of E&P activity due to the lower oil prices of recent years; now that the oil price has recovered, and new E&P activity is anticipated, it will be interesting to see if this loss record can be maintained.

Figure 3 – WELD Upstream Energy losses 2000–2018 (excess of US$1m) versus estimated Upstream premium income



2017 was a relatively benign year for the Upstream insurance market - at this stage, 2018 looks likely to be just as profitable.

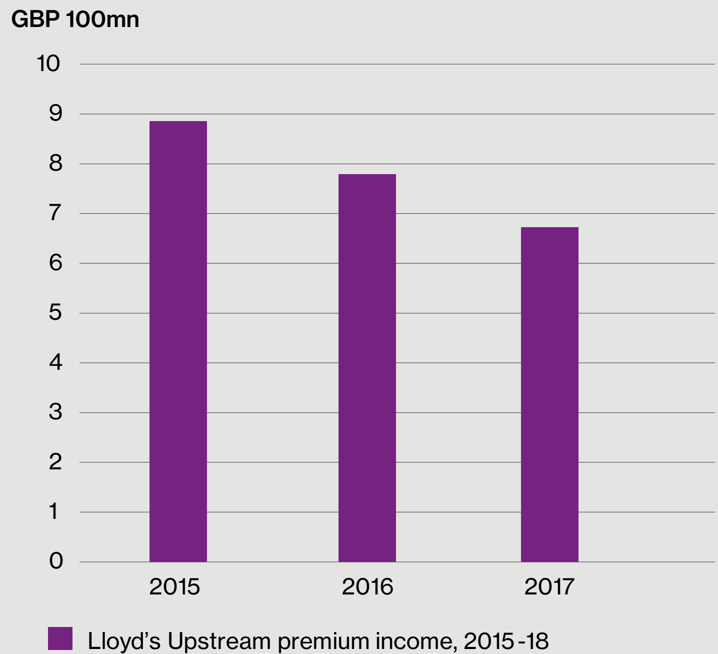
Source: WTW/WTW Energy Loss Database as of 2 November 2018 (figures include both insured and uninsured losses)

Minor market bifurcation

However, we do understand from the market that there has been an upswing in land rig and other smaller losses recently associated with the high volume E&P business emanating from North America. In contrast, other areas of the portfolio, particularly deep water projects in Europe, Brazil and Asia, have continued to be attractive to insurers. As a result, we are seeing a minor bifurcation in this market between two important areas of the portfolio; in general terms there has been a minor rating upswing for the North American volume business whereas the deeper water accounts have generally been renewed at the same terms as last year.

Be that as it may, although losses have decreased, so has the Upstream premium income pool, as the above chart shows. As a result, insurers are nervous that it would only take a modest upturn in claims for today's profitable portfolio to become unprofitable. It is for this reason that Upstream insurers are keen to stick to management instructions not to reduce rating levels any further.

Figure 4 – Lloyd's Upstream Energy premium income, 2015 - 17



Lloyd's Upstream income pool has continued to deteriorate in recent years – increasing insurer apprehension

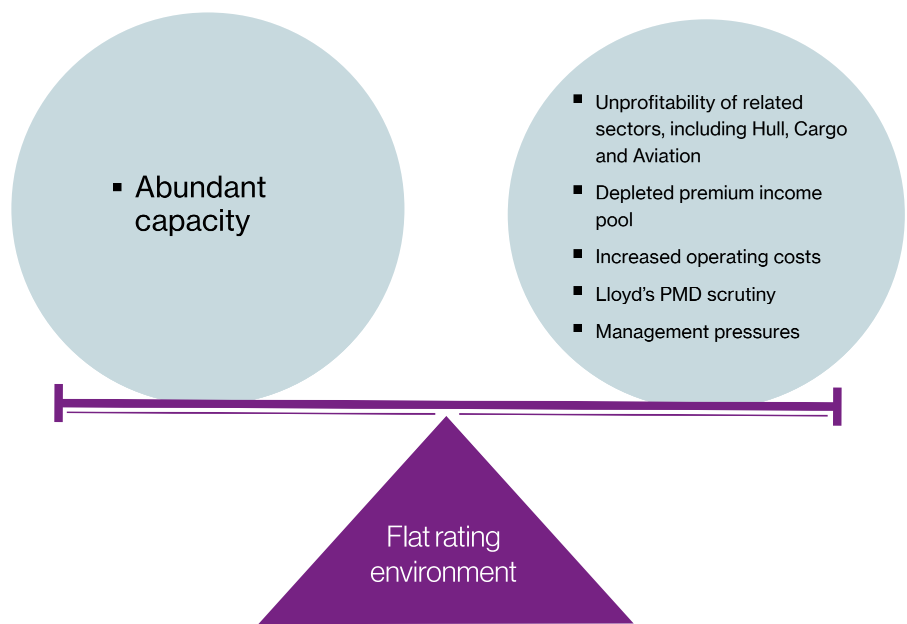
Source: Lloyd's (EZ, EY, EC, EM and EN audit codes combined)

A flat rating environment

So market conditions in Upstream can be summarised by this "see-saw" schematic. This is a balanced market where both softening and hardening factors are currently being cancelled out, resulting in a basically flat market environment, although brokers continue to search for optimum terms wherever available.

Of course, as ever in this market individual programmes can always buck the trend, and it is possible that for some programmes an element of rating reduction may still be possible, especially if existing programme structures are restructured. Equally, other programmes that don't offer a reasonable loss record may find this more difficult to achieve. Going into 2019, we expect similar levels of capacity to 2018 and for the current fragile stability to be maintained – for now.

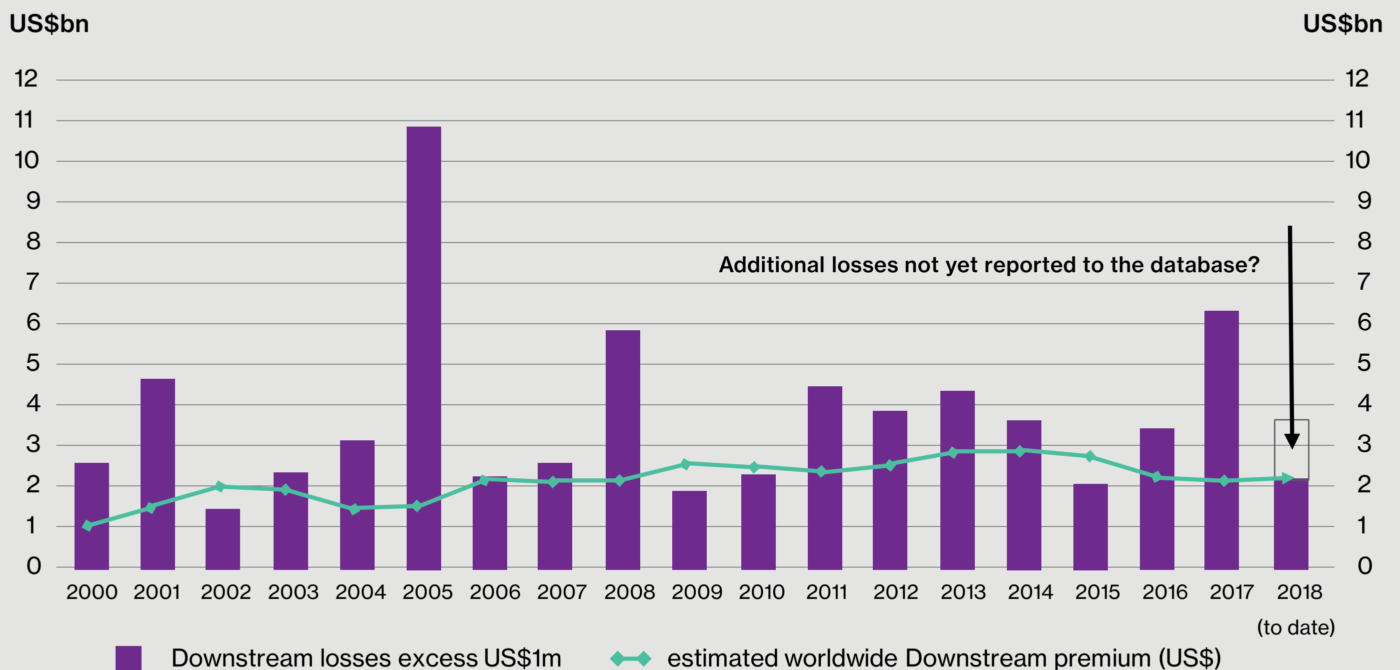
Figure 5 – A market in balance: Upstream



Downstream – a market turnaround is now a fact, not just an assertion

Downstream loss record continues to shock the market

Figure 6 – WELD Downstream losses 2000 – 2018 (excess of US$1m) versus estimated global Downstream premium income



The 2017 loss record was truly catastrophic for the Downstream energy market – 2018 may not be much better.

Source: Willis Towers Watson/WTW Energy Loss Database as of November 2 2018 (figures include both insured and uninsured losses)

One glance at our losses and premiums chart for Downstream shows just how different market conditions are for this sector compared to its Upstream counterpart. Indeed, 2017 has now overtaken 2008 (the year of Hurricane Ike) as the second worst underwriting year on record after 2005 (the year of Hurricanes Katrina, Rita and Wilma).

From the losses already recorded in our Database, together with market intelligence that we have discerned in recent weeks, it may be that 2018 won't be far behind 2017 when the final figures mature (see table overleaf).

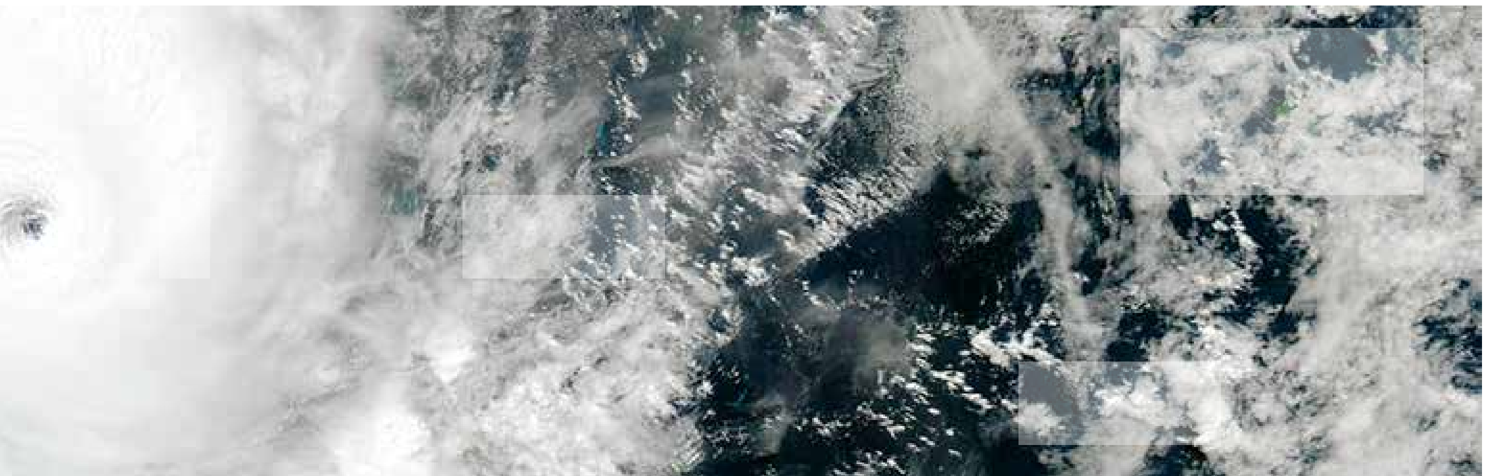


Figure 7 – Downstream losses excess of US$50 million to date, 2018

Type	Cause	Region	PD US$	BI US$	Total US$
Refinery	Fire + explosion/VCE	Europe	397,267,000	283,430,000	680,697,000
Refinery	Fire + explosion/VCE	North America	260,000,000	390,000,000	650,000,000
Chemical	Fire no explosion	Europe	42,500,000	112,500,000	155,000,000
Chemical	Explosion no fire	North America	20,000,000	94,500,000	114,500,000
Petrochemical	Mechanical failure	Latin America	5,500,000	92,000,000	97,500,000
Chemical	Ice/snow/freeze	North America	11,000,000	81,000,000	92,000,000
Refinery	Fire no explosion	North America	30,000,000	52,000,000	82,000,000
Oil Sands	Supply interruption	North America	75,182,000	0	75,182,000

From our market intelligence we are also aware of a handful of additional major losses not yet recorded by our database, totalling in the region of US$1.3 billion – even more may be to come.

Source: WTW Energy Loss Database as of November 2 2018 (figures include both insured and uninsured losses)

Although our Database has already recorded over US$2 billion of Downstream losses to date in 2018 (including 8 losses over US$50 million) we are aware of at least three other recent losses which have only recently been reported for which initial figures are not yet available. We understand from market sources that these losses the potential to amount to another US$1.3 billion, taking the overall total to almost US$4 billion, as referenced in our chart.

The market finally turns – for now

We are therefore seeing a modest but distinct turnaround in this market. This continual series of major losses has served to focus insurers' minds still further, not only as regards the future profitability of the portfolio but also in taking into account the overall picture as outlined earlier. Unlike the Upstream sector, they cannot point to a profitable portfolio; not only are any rating reductions out of the question for the time being, we are now seeing a market that is quietly insistent that they must see a rating increase on virtually every piece of business (again there are always exceptions to this general rule, particularly for programmes with little or no natural catastrophe or Business Interruption element).

Underwriters standing firm

Whereas in the past insurers that had been holding out for rate increases could be by-passed in favour of those leaders who were not on the existing programme (for whom a given programme might be considered new business), it seems that even this option may not produce the desired outcome from a buyer perspective. As 2018 draws to a close, it seems that virtually every insurer underwriting this class of business has been affected by the recent losses; it is therefore becoming increasingly challenging to identify any leaders that have the wherewithal and commercial desire to undercut existing placements and to differentiate themselves from their competitors.

Figure 8 – A market no longer in balance: Downstream

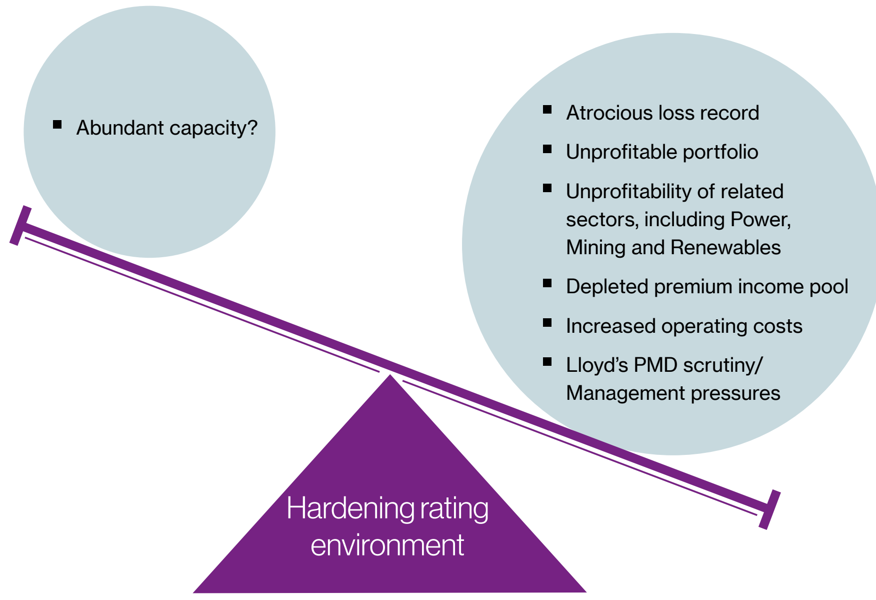
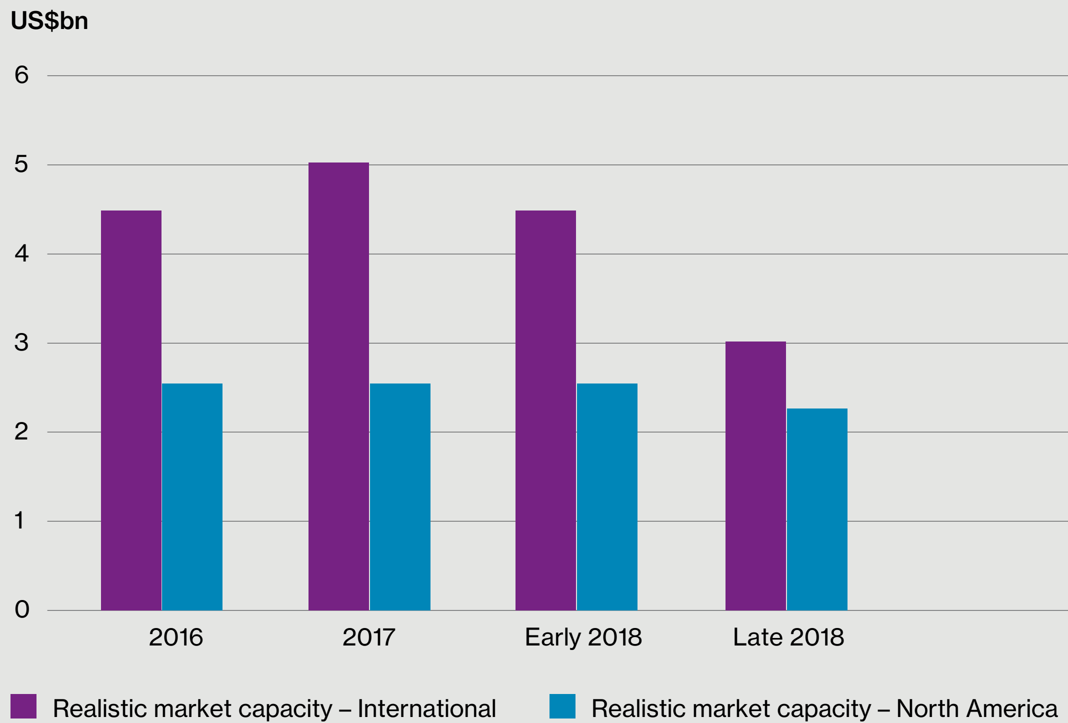


Figure 9 – Realistic maximum Downstream market capacity levels, 2016 -18



"In realistic terms, the level of capacity available to Downstream buyers has actually reduced further during 2018 – finally destroying the underlying softening dynamic"

Source: Willis Towers Watson

A hardening rating environment

As our "see-saw" schematic for Downstream (left) shows, this is now no longer a market in balance. The one factor that has kept this market relatively soft over the last few years – abundant capacity – has now been overwhelmed by a combination of the factors that we have discussed in this Update. As a result, prices in this market are only going in one direction, albeit that the rating increases being insisted upon are only modest by historical hard market standards.

Abundant capacity?

Moreover, in recent weeks even the very notion of "abundant capacity" has started to become somewhat obsolete. In our Energy Market Review we are careful to point out that the maximum theoretical capacities produced by the insurers themselves are never able to be accessed together in practice; instead we always suggest a maximum realistic level that can be obtained for a given programme. In April, we suggested that this level was at US$4.5 billion for International business and US$2.3 billion for North American business; today we would suggest that achieving even these limits is becoming increasingly challenging. So many major insurers are now scaling back on what they can potentially offer than we would suggest that these amounts should now be reduced to US$3 billion and US$2.25 billion respectively. So this is a realistic contraction in supply - the first for many years and probably the first for a number of market practitioners, including underwriters, brokers and risk managers.

Casualty market also affected

It is becoming clear that the "winds" that we have referenced are now rippling the previously calmer waters of the Casualty sector.

On the surface, there is little initial evidence of this:

- Total global Casualty capacity remains at approximately US$3.3 bn, with an estimated realistic capacity of US$1.65 bn.
- Loss results for Casualty as an overall class has been relatively benign (ref; Lloyds combined loss ratios of 102.9% – 103.7% for 2016 and 2017 respectively)

However, looking more deeply it is clear that there are a number of factors that are changing market behaviours and sentiment:

- Loss ratios are starting to deteriorate in specific geographical areas and industry segments (for example US Casualty) and in certain Natural Resources sectors such as pipelines, refineries, wildfires and tailings dams.
- The drive by certain larger insurers to remediate their books, together with the impact of the Lloyd's "10th Decile" performance improvement drive, has also had a tangible impact on Casualty underwriter sentiment.
- Some major carriers are limiting their primary capacity and/or pulling out of certain specific classes, for example midstream/pipelines.

The net result is that the Natural Resources Casualty market has not only certainly bottomed-out - there is now a discernible pressure to achieve a modest level of rate increases.

Casualty underwriters have also become much more discerning. Accounts are now benchmarked against their peers and are also considered in the context of their own historic performance. Underwriters are walking away from or repricing accounts that are considered distressed or under-priced. On the positive side, those clients that can demonstrate good risk management and help the broker to articulate their message to the market and can clearly evidence no change in exposure base are receiving more favourable treatment.

In short, whilst we would not yet contend that this is a truly hard Casualty market (more of a gently hardening one), in order to obtain the best outcome it is essential for client and broker to behave as if it is. A robust and coherent market strategy, early engagement with insurers and comprehensive, credible underwriting information will undoubtedly yield the best results.

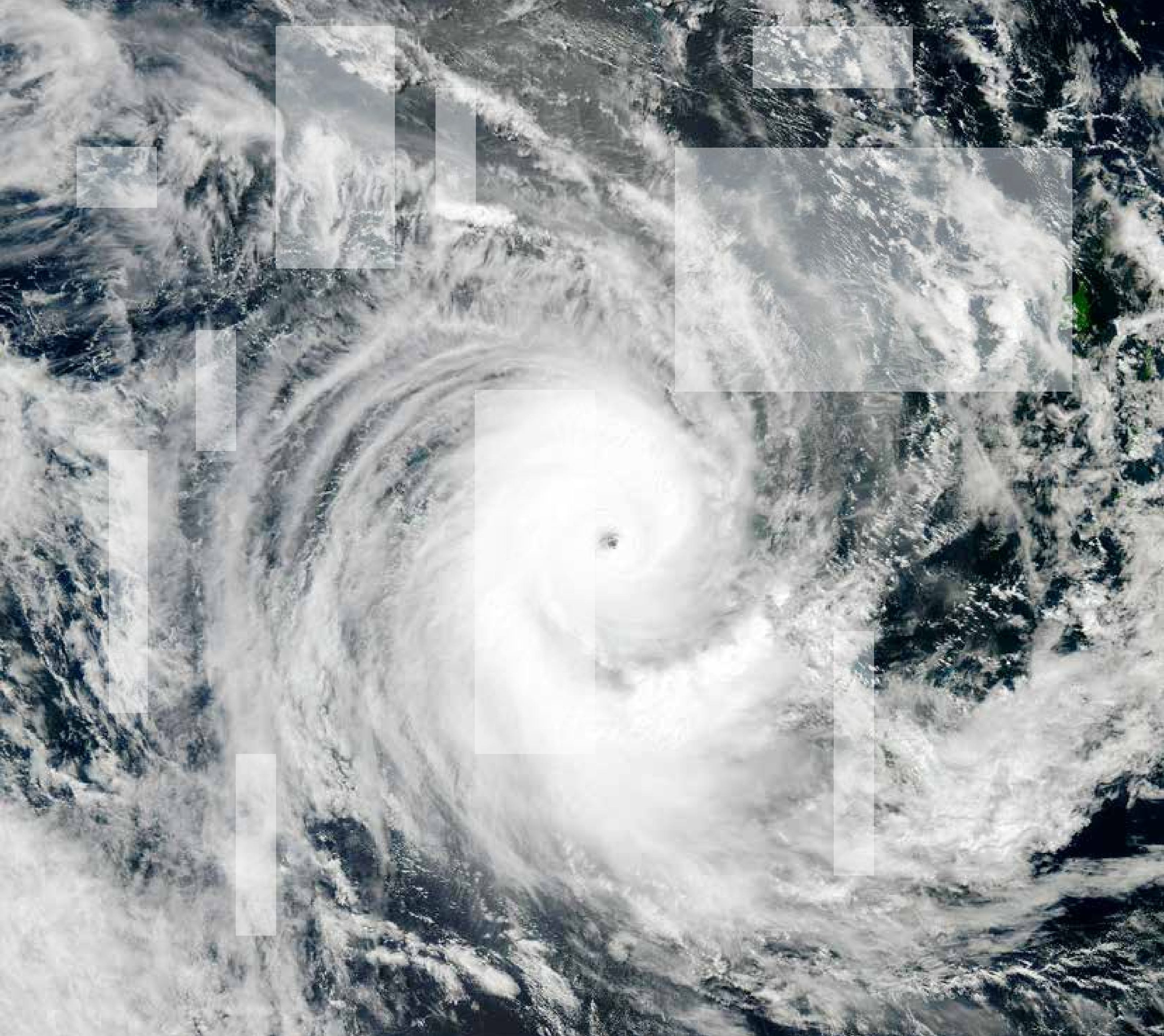
Conclusion: uncharted waters?

As the January 1 renewal season come further into focus, our advice to buyers is clear:

- **Prepare for your renewal earlier than usual.** In the more challenging market conditions it is inevitably going to take longer to negotiate optimum terms and conditions.
- **Ensure that your underwriting submission is as professional as possible.** In this market climate, every last detail may be critical in mitigating against the general market upswing. Up the specification on your underwriting submission, don't let the clock run down and make sure to get your broking strategy in place with the right priced leadership.
- **Ensure that your broker builds your programme from a secure base.** It is now more important than ever to ensure that leading markets that can offer the most competitive terms are accessed first so that your programme is built around solid foundations.
- **Expect a more challenging endorsement process during the programme year.** Programme amendments may take more time to process, and some changes may result in Additional Premiums where not required in the past. There may be less consensus from following insurers rather than the "full follow" mentality that we have experienced in the past.
- **Assume that future claims negotiations may be more challenging.** In this market environment, "grey" claims areas may be challenged, and consensus on settlement may be more difficult to build.
- **Some regional markets (mostly Downstream) can and do continue to buck the trend.** It is therefore important that all options are fully explored and vital that your broker has the right local resources to exploit potential opportunities.

We have seen that underwriters in both markets are now under significant pressure following directives from Lloyd's and other managers. So far, this pressure has escaped the majority of the Upstream market; here we have seen that conditions remain calm. However, should a major Upstream loss materialise in the next few months, all that could change.

Meanwhile, Downstream insurers are able, at present, to offer a relatively united front in insisting on change. When we publish our next Energy Market Review in April 2019, we will be in a better position to determine whether the current "winds of change" herald a long term change in market dynamics, or whether the potential capacity available to these markets will ensure fresh competition to the existing players will emerge next year. For now at least, change is in the air – and buyers better prepare for it.



Editor: Robin Somerville

© Copyright 2018 Willis Towers Watson.

All rights reserved: No part of this document may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, whether electronic, mechanical, photocopying, recording, or otherwise, without the written permission of Willis Limited.

Some information contained in this document may be compiled from third party sources we consider to be reliable. However, we do not guarantee and are not responsible for the accuracy of such. Willis Limited accepts no responsibility for the content or quality of any third party websites or publications to which we refer.

This publication and all of the information material, data and contents contained herein are for general informational purposes only, are not presented for purposes of reliance, and do not constitute risk management advice, legal advice, tax advice, investment advice or any other form of professional advice. This document is for general discussion and/or guidance only, is not intended to be relied upon, and action based on or in connection with anything contained herein should not be taken without first obtaining specific advice from a suitably qualified professional.

Beijing
18th Floor, West Tower,
Twin Towers
B-12 Jian Guo Men Wai
Avenue
East Chang'an Street
Chaoyang District
Beijing, PRC 100022
Tel: +86 21 3887 9988

Bogota
Av Calle 26 No. 59-41 6
Floor Bogota
Colombia
Tel: +57 1 606 7575

Buenos Aires
San Martin 344 Piso 16
Buenos Aires 1004
Argentina
Tel: +54 11 4324 1191

Calgary
First Canadian Centre
Suite 2200,
350-7th Avenue SW,
Calgary, AB T2P 3N9
Tel: +1 403 263 6117

Dubai
Office GV04/L02/210,
Level 2,
Gate Village Building 4,
Dubai International Financial
Centre, Dubai, 507018,
United Arab Emirates

Houston
920 Memorial City Way
Suite 500
Houston, TX 77024
Tel: +1 713 961 3800

Johannesburg
Illovo Edge, 1 Harries Road
Illovo, Johannesburg 2196
South Africa
Tel: +27 11 535 5400

Lima
Willis Corredores de
Seguros SA
Piso 6 - Oficina 604
Avenida de la Floresta 497
Lima 41, Peru
Tel: +51 1 700 0200

London
The Willis Building
51 Lime Street
London, EC3M 7DQ
United Kingdom
Tel: +44 (0)20 3124 6000

Miami
1450 Brickell Avenue
Suite 1600 Floor 16
Miami, Florida 33131
United States
Tel: +1 305-421-6227

Mexico
Av. Santa Fe No. 495
Pisos 9 y 10, Col. Cruz Manca
Del. Cuajimalpa de Morelos
CDMX, Mexico, C.P. 05349
Tel: +52 55 91 77 30 00

Moscow
ul. Ostozhenka, 28
Moscow
Russia 119034
Tel: +7 495 956 3435

New York
Brookfield Place
200 Liberty Street 7th Floor
New York, NY 10281
212.915.8265 office
Tel: +212 915 8265

Oslo
Drammensveien 147 A
Postboks 344 Skøyen
0213 Oslo
Norway
Tel: +47 23 29 60 00

Perth
Level 4
88 William Street
Perth
WA 6000 Australia
Tel +61 8 9214 7400

Rio de Janeiro
Edifício
"Palácio Austregéliso
de Athayde"
Av. Presidente Wilson
231 Rooms 603 and 604
Rio de Janeiro
Brazill
Tel: +55 11 2161 6005

Santiago
Ave. Apoquindo 3846 Piso 12
Comuna Las Condes,
Santiago
Chile
Tel: +56 22 386 4000

Singapore
6 Battery Road #06-01/02
Singapore 049909
Tel: +65 6 591 8000

Follow us on our website at: http://www.willis.com/naturalresources
and on LinkedIn at: https://www.linkedin.com/company/natural-resources-industry-group

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 40,000 employees serving more than 140 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

Willis Limited, Registered number: 181116 England and Wales.
Registered address: 51 Lime Street, London, EC3M 7DQ.
A Lloyd's Broker. Authorised and regulated by the Financial Conduct Authority
for its general insurance mediation activities only.

Copyright © 2018 Willis Towers Watson. All rights reserved.

FPS153/WTW38558/11/2018

willistowerswatson.com

Willis Towers Watson