

Middle East Oil and Energy Insurance: A Market in Turmoil



Mr Brad J Berg, Chief Underwriting Officer, Energy and Tech Lines, ACE Insurance, Bahrain, examines how recent developments bode troubling times ahead for oil & gas insurance.

With the rise in oil prices to US\$145 per barrel, energy insurance made headlines. Until the bubble burst, recently breaking below \$40, high energy prices were creating considerable challenges for the insurance market. Regional downstream capital costs have increased by 63% since 2000. Asset valuations for refineries increased as much as 19% in 2007. That meant for a major loss such as a vapour cloud explosion during construction testing or operations given a three year rebuild period, there could be a reinstatement 50% greater than the value of the plant at the time of the loss.

This construction boom was unparalleled from anything seen in the industry in recent times: human and equipment resources are not unlimited, and contractors were turning down business, picking and choosing the projects with the greatest profitability. This was driven to the point where, when requested to bid, a contractor was only willing to do so if the principal would pay for the cost of an engineer to put the quote together.

The oil and gas industry was facing high cost inflation in respect of both new facilities and de-bottlenecking projects. Coupled with longer lead times, this had the potential to produce significant upward pressure on estimated maximum losses (EMLs), from both a property

damage and business interruption perspective. Insurers had to operate under the premise that if valuations were neither realistic nor up to date (very much a perceived problem in the market), there was a strong likelihood that the calculated EML would not accurately reflect the cost of a major loss. This could result in two different scenarios:

- Where a loss limit is placed on a policy (the majority of accounts at present), this might result in a significant uninsured loss for the assured as the actual cost of a loss has the potential to exceed the loss limit (which is say EML plus 20%) by some margin.
- Where there is no loss limit on the policy (this is being offered on some policies now), this has the potential to result in an EML “bust” with the difference between the actual replacement cost and the calculated EML being taken net on to underwriter’s books. To minimise the risk of either scenario, it is important for both assureds and underwriters that a credible up-to-date valuation is made available, coupled with a realistic estimate of cost inflation and rebuild time post loss. This is the only way to gain a proper understanding of risk exposure and to assist in better decision making in the risk transfer process.



Pressure on Profitability

Now, we are experiencing an entirely reversed scenario. The oil price fluctuates greatly on a small imbalance between demand and supply as there are only limited storage facilities in the flow of delivery to the consumer. The world produces roughly 80 million barrels per day. We are seeing, for first time, a change in the global demand for oil, with a fall in demand of 200,000 barrels per day. This comes at a time when a major regional and global producer is coming back on line: Iraq, which has been down to 2-2.5 million barrels per day in recent years, increased to 3-3.5 million, with intentions to treble that in matter of years. With the global economic downturn and competition coming in from alternative energy sources, we can probably expect to see lower prices going forward in the short to medium term.

Historically, business interruption (BI) coverage has a loss experience that has taught underwriters there is rating inadequacy for refining and petrochemical risks. Also, there are other industrial occupancies. National oil companies, prevalent in this region, tend not to purchase BI as there is normally a broad spread of wells to diversify income risk while crude can be lifted at a later date. While oil companies allocate their available capital to exploration, finance for refining and petrochemical projects comes from the debt of lenders who generally require BI protection for their loans. As petrochemical products generally have a close correlation to crude prices, the values during the past upswing in crude prices have seen BI values as much as quadruple exposure at the peak of the boom.

All these have placed extreme pressure on capacity, exposures and profitability for insurers. In 2008, refining performed well outside the US, but domestically and in other occupancies, such as steel and mining, BI claims have been enormous. Whether insurers have properly reserved for these is in question. One saving grace insurers may have is the current recessionary economics we are experiencing. Basic raw materials, such as cement and steel, have dropped over 40% in a very short period of time. This will reduce rebuild costs and business interruption adjustments. We do not yet know what will happen to human resource and contracting companies, but we can assume they will become more competitive as many projects are being cancelled in the short term while contracts are being renegotiated to reflect current costs.

Inadequate Coverage

As both global and local competitors come into the market, correct technical rating is a concern at a time when

rates are just coming off their bottom. Since 2004, in MENA alone, there have been four major loss events of catastrophic proportion, mostly vapour cloud explosion. These losses total over US\$1 billion, not including \$250 million in under-insurance. For that period, the premium pool in MENA for onshore refining and petrochemical risks would hardly cover these losses besides attritional losses not considered.

A major reason for this, apart from pricing, is the inadequacy of deductibles in view of the large exposures faced by underwriters. The methodology for pricing energy risks used by many companies today originates from a technical rating handbook for refining and petrochemical risks created in the late 1950s. To rate a full conversion refinery, the minimum and standard deductible for the physical damage coverage is \$1 million. This is the same deductible commonly used today, approximately 50 years later. If one was to compare the global inflation in US dollar terms from 1960 to 2007, \$100 would now be worth \$692. Keeping in step with inflation, in today's equivalent terms and conditions would require an increase in the standard physical damage deductible to roughly \$7.5 million.

Shortage of Capital

Energy insurance is a highly volatile business line with severity losses. At the same time, given the current state of the global economy, it may be very difficult for treaty reinsurers to reload their capacity in the case of major loss events. With the demise of hedge funds that back the Bermudan companies, there is a scarcity of capital for treaty insurers. Even more so, this will produce a shortage of catastrophe capacity already hard hit by two hurricanes this year in the Gulf of Mexico. Within this region, according to Munich Re's Map of Natural Perils, Dubai is expected to change from Zone 0 to Zone II quake exposure. Many prudent insurers and reinsurers may choose to preserve their capital going forward and admitted insurers will be squeezed by reinsurance costs. Because of this scarcity of capital, rating saw no further decreases near the year's end and increases have firmly begun as the market hardens.

From the precipitous downturn in oil prices, refining and petrochemical assets are experiencing heavily deflated values and diminishing profits. Sums insured may decrease for both physical damage and business interruption coverage causing a decrease in premium volume. Conversely, ratings are on the rise and likely to increase substantially into the new year. So hold on to your hard hats and prepare for an unpredictably wild ride! ❏

