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The hard road back to sustainability

Insurers need to consider their approach to the underwriting of energy risks as they await the anticipated upturn in the oil market over the next two years

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Well-documented difficulties in the oil and gas industry are reflected in the travails of the energy insurance market and have made both these tightly inter-connected sectors seem unsustainable under current conditions. With one or two blips, the oil price has been in continual free-fall for the past 18 months. It will surely experience a resurgence but a return to 2014 price levels is unlikely to occur in the near future. Casualties should be anticipated in both sectors before any upsurge, severely testing both energy insurers' and their backers' commitment to the market. An ability to adapt will be the key to their survival.

As can be seen in the global economic shocks we are now feeling, the world economy remains reliant on oil and insurance has proved to be essential to the functioning of the energy industry. Certain factors suggest an increase in cost per barrel will not be delayed past 2018 but the extent of the interim impact on the oil and gas industry and its participant companies is impossible to predict. Similarly, insurers' collective response to the current environment, as well as their plans for the longer term, will dictate the shape of the energy insurance market and its participants when a more sustainable environment is realised.

Getting to where we are was simple. High oil prices and innovations in shale gas prompted the launch of a number of start-ups, particularly in the US. Shale oil extraction costs on average $65 a barrel, but ranges from $20 to as much as $100 per barrel. Many new businesses, especially those at the higher end of the production-cost spectrum, are now under extreme pressure, and scrutinising every aspect of their balance sheets. A handful of bankruptcies have already happened in the shale gas market, with more likely.

Long-term solvency

Among conventional producers, Saudi Arabia's ultra-low extraction costs suggest at first glance it is best-placed among the big producers to weather the current oil price and potentially emerge with a stronger market share. Few economies however, are so reliant on a single commodity. Almost all Saudi investment and employment is tied to the cost per barrel. While it can probably rely on reserves until 2018, a persistently low oil price would test its long-term solvency.

The Venezuelan economy has been severely affected by the oil price. Both it and other higher-cost producers such as Nigeria, whose economies and political stability depend on oil revenues, will invariably be prompted to consider concessions in a drive to return to sustainability. As producing countries are increasingly adversely impacted, it seems inconceivable that international collaboration towards a more mutually beneficial cost per barrel will not arise. Its exact form remains to be seen but a disparate set of agreements between countries is a more likely first step than a return to a production cost agreed by the Organization of the Petroleum Exporting Countries.

Ultimately, oil prices are too low and must increase. While it could be argued that insurance rates in the energy market are also too low, a significant or even sector-wide increase seems less likely. How will the London market react before we see an upturn in the oil market?

Loss ratios

As a market, we have traditionally used loss ratios as our principal guiding factor. Analytical and actuarial capabilities have significantly improved energy insurers' risk selection but the information available to underwriters remains insufficient, particularly in today's conditions. A myriad of factors influence underwriters' views of clients and risks. Increased competition has made in-depth analysis of potential insureds' safety records, approaches, and backgrounds all the more important. Risk profiles are affected by a client's financial position and strategy, the contractors that they employ, and the third-party companies with which they do business. Other crucial factors add to the picture of an insured and its behaviour, such as the location of assets and local health and safety regulations. This type of information is increasingly vital in the current, competitive marketplace, where a significant decline in both drilling activity and new projects has steadily reduced the total amount of business. Although the outlook for an overall increased rating looks unlikely, perhaps the differential between clients with proven track records, running quality operations and being transparent with information and others will widen.

To survive requires us to become better underwriters, which in turn demands that we garner access to the information essential to making properly informed decisions. This needs the support of all parties, including carriers, brokers and insureds. That the oil price will increase at some stage seems likely and in turn, this will lead to stronger oil and energy insurance markets. The commitment of both oil producers and energy insurers to their markets is clear. Their ability to weather the current conditions however, may not rest within individual businesses but stem from the long-term outlook of their shareholders and management. Companies that can rely on supportive backers with a proven track record (Advent and its parent Fairfax Financial Holdings Limited being one example) and embrace underwriting based on in depth client and risk information, are more likely to be here when rising oil prices and insurance rates push our market back towards sustainability. ■

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