OFFSHORE ENERGY INSURANCE – WHERE NEXT?

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The Offshore Energy sector over recent years has provided underwriters with a rollercoaster ride of performance, with adjacent years of significant loss and profit. The market performance has demonstrated the volatility of a class that has to deal with a portfolio imbalanced by large values and a concentration of risk in areas of catastrophe activity. For this reason, the business model for Offshore Energy insurance, with its estimated worldwide premium base of $3bn, looks both fragile and under threat.

Since 2005, the market has witnessed significant loss-making years, in particular, 2005 and 2008, which were both affected by hurricane losses in the Gulf of Mexico. Furthermore, following the sinking of the *Deepwater Horizon* drilling unit and the subsequent blowout of the Macondo well in April 2010, it is anticipated that 2010 will now join this roll-call of significant loss years. It is accepted that these loss-making years have been punctuated by years of reasonable profit; however, 2006 has been the only star performer. Furthermore, the marginal profit made in 2009 was largely propped up by a very benign Gulf of Mexico windstorm season, which managed to just offset the losses elsewhere in the portfolio.

As a summary, it is estimated that global market incurred loss ratios (net of acquisition costs but before reinsurance) are as follows:

	Incurred Loss Ratio
2000–2009	101%
2005–2009	105%

Therefore it is evident that Offshore Energy underwriting since 2000 has been an exercise in capital destruction. To achieve an acceptable return in this class of business, there has to be a fundamental change in the underwriting dynamics.

It is possible that the market has resolved the issue of Gulf of Mexico hurricane insurance. The re-engineering of the account in 2009, with significant price and retention increases, coupled with coverage restriction, has created the theoretical (and hopefully to remain untested in 2010) position of account sustainability in the Gulf of Mexico. However, the problem now appears to lie elsewhere – that being in the balance of the portfolio. During 2009, the two largest insured risk losses since *Piper Alpha* in 1988 occurred: the Ekofisk collision ($1bn) and the *West Atlas*/Montara well ($0.75bn) blowout. This was compounded earlier this year with the *Deepwater Horizon*/Macondo well loss, with an insured loss forecast of between $1.5bn and $3.5bn.

It is expected that the reinsurance market, driven by these losses and the likely increase in retrocessional costs, will be uncompromising during the 2011 renewal negotiations, with significant increases in both pricing and retention levels. In some cases, it is anticipated that the double pressure of the increasing severe loss frequency, coupled with the demands of the reinsurance market, will force withdrawals from the class of Offshore Energy insurance. All this is against a 2010 hurricane forecast that is ‘above average’ and has already been heralded by the appearance of the first June hurricane since 1995, namely Hurricane Alex.

Taking all this into account, underwriters are facing a crossroads. Failure to act in a decisive and robust manner will drive away the capital providers. The Offshore Energy sector requires a significant increase in worldwide premium base to ensure that the increasing loss frequency and severity is managed, and that an appropriate and sustainable return on capital is delivered.

In the immediate aftermath of the *Deepwater Horizon*/Macondo well loss, it does appear that the market is grasping the severity of the situation. Rate increases are being applied across the portfolio, with areas of significant risk such as deepwater drilling attracting further rating loads. The timing of the loss, occurring before the busy mid-year renewal season, has ensured that a significant element of the 2010 portfolio has been impacted by these rates rises. It is imperative that this market momentum is maintained into 2011 and beyond. If the market hesitates in its resolve, it is quite possible that the bond between capital providers and underwriters will be broken for good.

Photo of Deepwater Horizon