

Energy Insurance market update

Q3/10

The high level of losses has lead offshore insurance prices to harden significantly, although onshore has been relatively unscathed. Capacity means that prices could be stable for both sectors in the second half.

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Overview

A side effect of the Gulf of Mexico windstorms in 2005 and 2008 is that 70-80% of energy insurance programs are placed during the first half of the year.

As a result, Q3 and Q4 are comparatively fallow from an insurance placement perspective. This makes it a good opportunity to examine how the market has reacted to the high profile offshore losses of 2010.

Offshore energy

Offshore insurers' response has been to implement 20% increases on average to physical damage rates. The increases have been higher for offshore programs renewed with a loss.

Control of well has also come back under the spotlight, particularly for deep-water wells where rates increased. Underwriters are also now focused on liability where both rates and conditions have been significantly corrected.

There is debate about whether the Deepwater Horizon loss single-handedly turned the market. Our view is that the Montara, Deepwater and Aban Pearl losses within the space of nine months at a potential cost of around US\$3 billion all had an influence on ending the soft market conditions.

Which way for offshore?

It appears that the market pressed hard for price increases knowing that the window of opportunity for generating significant cash-flow would largely close at 1 July. In the absence of a further major loss, this could suggest an over-correction, with scope for softening during Q3 and Q4.

The 20% average premium increase during the first half of 2010 could mean that many underwriters have already achieved a high proportion of their premium budgets. That said, markets which declined renewals which did not meet their terms may also need to seek out new premium.

Looming over many insurers is the anticipation of a difficult 2010 treaty reinsurance renewal season with demands for higher premiums and retentions expected. This puts pressure on direct insurers to hold their line during the remaining months of 2010 and not to slide into softer terms.

Onshore energy

The low level of onshore losses and limited Gulf of Mexico storm season last year meant that underwriters entered 2010 with relatively good returns. The onshore market has also been relatively unaffected by offshore losses and has escaped the subsequent market hardening so far.

This benign environment has meant stable or rising capacity, particularly for non-catastrophic risks. This has created healthy competition between insurers.

Additionally, competition for market share and leadership position between traditional carriers and more recent market entrants has ensured that market rates continue to soften. Rate reductions are the norm as insurers struggle to meet income targets.

Hardening in places

This softening is not consistent across all areas of the onshore sector however.

There is significant focus on engineering risk quality and loss record. For programs deemed to have issues in this area there is evidence of a hardening of terms as major players seek to walk away.

Cat capacity also remains tight for Gulf of Mexico windstorm and South American earthquake perils, and there appears to be little price movement.

Equally, the softening in the US refinery market is generally less pronounced than in the international sphere, with insurers remaining firm after the losses of the past five years.

These factors aside, unless there is a major loss, we would expect the onshore sector to continue to soften into Q4 2010 and potentially into 2011. Some markets have even increased capacity from US\$50 million to \$100million and new markets are competing with established leaders for lead status and market share.

Capacity brings opportunity

Overall the energy insurance market still enjoys an excess of capacity.

(continues overleaf)



Overview (continued)

Additionally, the continuing growth of regional underwriting hubs in Norway, Singapore, Calgary, Houston and the Middle East indicates a hunger for premium and a desire to compete for the best risks in each part of the world.

The scene is set for an interesting struggle as insurers battle to keep rates high to pay claims, cover

increasing costs and meet the profit demands placed on them while buyers seek to exploit the robust capacity and regional hunger for business.

In this situation Aon's global network is exceptionally well positioned to explore and exploit the opportunities to deliver the best terms and products.

Aon Asia launches energy health-check

The major energy incidents have meant many oil, gas and mining companies are examining their insurance policies to ensure that there are no gaps between risk and cover. In response, Aon Risk Solutions' energy team in Asia has launched a health-check audit.

The health-check highlights gaps and overlaps in cover, ensuring that the perception of risk is closely aligned to actual risk exposure.

"Companies cannot deal with what they don't know, but ignorance of inherent risk is increasingly

unacceptable from a regulatory point of view," says Tony Meakin, Regional Director for Asia in the energy team. "The approach that we offer can be used to articulate to external stakeholders that a structured and auditable process has been undertaken, supporting good corporate governance and company statements. Showing this level of transparency helps in the event of an incident, and gives investors greater confidence."

For further details, please follow this link <http://insight.aon.com/?elqPURLPage=5609>.

Aon Asia's health-check helps ensure that energy clients' insurance programs are as efficient as possible

Aon Australia hosts risk finance conference

Aon's Advanced Risk Finance Conference will be held on 28 October in Melbourne. Now in its 6th year, the conference is focused on the risk financing from a financial, regulatory and insurance perspective.

Entitled The Next 10 Years and Beyond, the conference focuses on the key risk financing and management techniques that organizations may need to consider in the changing risk landscape.

A segment is focused on economic insight into the future of energy and mining investment in Australia.

The conference will provide the latest thinking on global risk management and financing trends and provides the opportunity to explore what the risk financing climate might look like in 2020.

A range of international and local speakers will provide risk management and risk financing thought leadership, and delegates will have the opportunity to participate in the panel discussions.

For further details please contact Chris McMichael, chris.mcmichael@aon.com.au or Lisa Pugliese, lisa.pugliese@aon.com.au

Aon Australia's risk conference includes a strong energy focus

Aon Energy survey

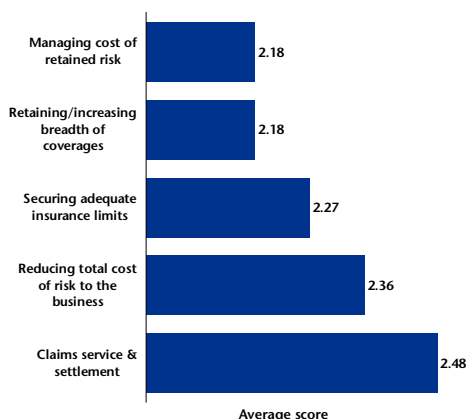
The results of the survey that we carried out with the first issue of this newsletter have confirmed that the main thing that the industry wants from its insurance brokers it to be able to trust them to manage the cost of risk efficiently.

Equally important is retaining or increasing breadth of coverage.

"The results of this brief survey confirm that what our clients want is to be able to work in partnership with their insurance brokers to look after the basics and have the flexibility to respond efficiently to changes in the industry," observes Paul O'Keefe, executive director with Aon Risk Solutions' energy team.

To participate in the current survey that accompanies this newsletter, please follow go to www.surveymonkey.com/s/aonenergyq32010.

In the next 12 months, which of your principal objectives are you concerned about achieving? (1: very concerned, 5: not at all concerned)



Aon's brief newsletter survey highlights that prudence and innovation are still high in the minds of energy organizations

Effective risk quantification helps reduce costs

Creating or enhancing value is a key objective for most organizations, particularly in the current economic climate. Risk management can play a key role in this by evaluating and measuring alternative approaches to risk to ensure that risk profiles are closely and efficiently aligned to risk tolerance. This requires understanding and balancing the various, often conflicting, goals of the risk management function. Broadly these include:

- Lowering the total cost of risk associated with a portfolio of exposures
- Raising the probability of achieving financial objectives within risk tolerance
- Exposure control and cost of catastrophic loss

Complicating matters for decision makers is the complex nature of operational and natural hazard risks faced by the energy industry. Do insurance markets account for specific operational and natural hazard risk profiles appropriately when developing coverage terms and pricing? How does commodity price impact overall exposure to risk events, and does this enter into the decision making process?

Answers to these questions are very important from a capital perspective. The transfer of too much risk increases costs and inefficiencies, while the transfer of too little risk increases volatility.

Determining the optimum balance is the challenge, and objective, quantifiable information is the solution. An integrated, analytical process linking financial analysis, actuarial analysis, and insurance market factors is a powerful approach to generating this essential information.

Understand

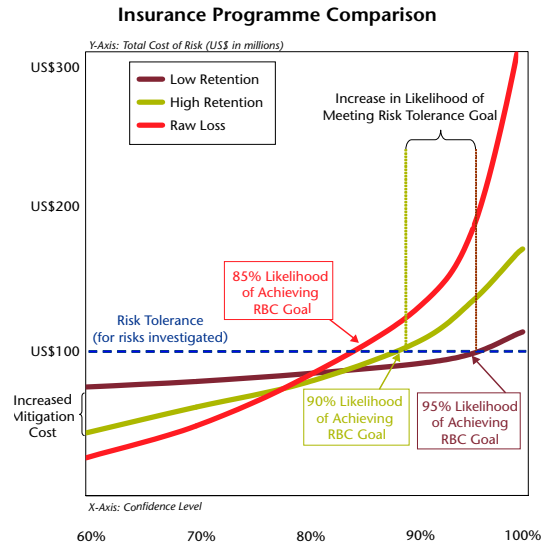
The first step to obtaining quantifiable information is to establish an organization's risk bearing capacity (RBC). When done correctly, this process establishes risk tolerance at both the enterprise and insurable risk level that are linked to corporate performance objectives and performance driver volatility such as commodity prices or interest rates.

The second step is to generate a thorough understanding of current exposures, individually and in portfolio via dynamic risk modelling. This goes beyond the traditional exercise of loss forecasts and focuses on the underlying risk profile by utilizing simulation techniques.

Aon appoints head of energy China

Steven Chang has taken the newly created role of national head of Aon Risk Solutions' energy team in China. He joins from GM at China Resources, a large state owned enterprise (SOE) where he was a deputy. Prior to this Chang worked for Marsh Energy in Beijing and for four years in Calgary.

Tony Meakin, regional head of the energy team says "We are tremendously excited that Steven has joined Aon as head of the energy team in China. He adds a new dimension to our customer solutions in China and his unique background crossing the divide



The third step is evaluating the effectiveness of alternative insurance structures in terms of the three risk management goals. This should utilize insurance structures and pricing available to the organization.

Ultimately the process is concluded with the placement of the best combination of program structures in the underwriting markets.

Benefit

Following this approach, organizations can most efficiently deploy capital for risk by:

- Relating information on enterprise performance volatility to risk management
- Identifying the value of different approaches to risk financing
- Integrating with insurance purchasing processes to deliver superior results
- Lowering total cost of risk over the long-term

Aon's Risk Financing Decision Platform provides both the information necessary to make informed, objective decisions and the decision support critical to corporate disclosure and governance requirements. Aon clients using the approach have enjoyed a 5% reduction in their average total cost of risk without introducing material volatility.

If you would like further information or would like a demonstration of the Risk Financing Decision Platform, please contact mike.giacobbe@aon.com

Making sure that an organization's risk framework is as efficient as possible is can deliver significant savings

Aon continues to support the growth of the Chinese energy sector

between SOE and international energy broker, allows Aon to meet the changing needs of the Chinese energy sector."

As a result of the move, James Liu has relocated to the Aon energy team in London. He will focus on providing joined up support to Chinese overseas direct investment, which is growing exponentially. Liu, who has been part of the Aon team for over ten years, is a graduate of the leading Chinese oil university and has worked in industry in Middle East, North Sea and China.



Iraq prepares for gas auction by Dr Jennifer Coolidge, CMX Caspian and Gulf Consultants



Dr Jennifer Coolidge, Executive Director at CMX Caspian and Gulf Consultants, is an expert on energy policy in the Middle East. Here she provides her thoughts on current developments in the Iraqi energy sector.

The Iraqi government in Baghdad has so far focused on oil production despite significant gas reserves, which are currently flared but could be used for much needed domestic electrification. Before gas exports are politically defensible, the country must address its internal electrification requirements.

Reserve estimates vary among Iraqi official statistics, International Energy Association, the US Energy Information Administration, BP Statistical Review, and foreign operators. The US Department of Energy estimates that Iraq possesses 3.1 trillion cubic meters (tcm) of gas, of which 71% (2.2 tcm) is associated, 20% (620 bcm) is non-associated and 9% dome gas. The vast majority, 2.1 tcm, of gas is located in the south of Iraq, and is generally associated gas, although 1 tcm is predominantly non-associated gas in the northern, Kurdish controlled, territory. Iraq's total gas reserves could be as high as 7.8-8.5 tcm.

The auction of three of Iraq's major gas fields, Akkas, Mansuriyya and Siba, is scheduled for October 1, 2010. Baghdad however intends to buy only 50% of volumes produced at the three fields, a policy which has become a point of concern for potential bidders.

Production plateaus for the fields have been extended to 13 years with cost recovery and remuneration coming into effect at 25% of targeted plateau output. The Iraqi government's attempt to force Pearl Petroleum (operator of the northern

Khor Mor and Chemchemical fields in northern Iraq) to supply the domestic market at subsidized prices, rather than allowing its gas to be exported, is a major sticking point and a deterrent to investors.

Once Iraqi domestic gas needs are catered for, export options are currently hampered by the internal stand-off between Baghdad and the Kurdish Regional Government (KRG) over revenue sharing.

The dispute will not be solved until a coalition government is successfully formed.

The lack of a regional gas grid among Gulf States prohibits flexible export to the Gulf. Iraq's best option for a dedicated gas export pipeline is currently to Dubai. The UAE is currently a net importer of 9.7 bcm/year, and while Abu Dhabi exports LNG, Dubai imports LNG. Observers have stated that 15 bcm/year could be available from Akkas and Nasiriyya in the near term, with an additional 10 bcm/year available from Mansuriyya and other fields in the medium term.

Iraq faces numerous obstacles to the development of its hydrocarbon sector, not least of which are continued sectarian violence. Flare-ups may increase in the near term with the recent withdrawal of US combat troops. Even optimistically it will be another 4-8 years before Iraq becomes a significant global gas supplier. In order to become a front-runner in gas production and export, the development of a cohesive national gas strategy will be crucial.

Dr Coolidge will be speaking at Aon's 10th Middle East Energy Insurance Conference which is being held between 11-13 October in Bahrain. To book a place at the conference, please contact emma.sewell@aon.co.uk

Political stumbling blocks are slowing efforts to help Iraq take advantage of its abundant energy reserves

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