

Energy Insurance market update

Q2/10

Capacity continues to be healthy in the energy insurance markets, but the two recent major losses are likely to lead to tougher negotiation positions from underwriters. Dialogue will be key to successful renewals.

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Introductory note from Bruce Jefferis, CEO of Aon Energy

Welcome to our first Aon Energy newsletter. The events of the past month highlight the importance of global communications on the complex risk issues that affect our lives in the energy sector. We hope that this newsletter is a step in the right direction to keep us all better informed.

Nassim Nicholas Taleb's book, *The Black Swan: the Impact of the Highly Improbable*, states that we all waste a lot of time managing for the predictable risks, but the only ones which really matter are the ones we cannot or at least do not imagine. And in just the past two months we have experienced two events near the border of our imagination.

Who could have predicted that one of the perils of scheduling our Middle East Energy Conference in Bahrain would be a volcano in Iceland? And, sadly, who would have imagined the scale of the disaster the industry is facing with the rig loss, blowout, and pollution from the well in the Gulf of Mexico. The record of forty years of nearly perfect drilling offshore the US since the Santa Barbara spill in 1969 has been deeply marred by the tragic loss that is still ongoing. I believe these events and others that we have not yet imagined will change the way we all view our exposure to risk in an ever complex world.

A year ago we launched Aon Energy as part of Aon's global strategy for all of our industry groups. We have always had successful worldwide energy operations, but had not pulled ourselves together into a truly global organization until last year. Our goal is to ensure that we share the best information, resources and practices for the benefit of all of our clients, regardless of location.

We also continue to build our network of industry professionals around the world adding substantial depth in London for global construction projects and risk engineering capabilities to support the massive energy projects around the world.

Each issue of this newsletter will look at market conditions, coverage issues, significant losses and risk management tools that we hope will help you.

To ensure we are doing that as efficiently as possible, we also want to hear from you. So in each issue we will include a link to a very short survey. Future editions will summarize the responses so you can see how your opinions compare to your peers and help us shape future newsletters.

I hope this newsletter is useful, and we look forward to your survey responses and any other input that you would like to provide. Until next time, let's hope we don't encounter any more black swans, but let's plan like we will.

MARKET REVIEW: THE SITUATION NOW

The second quarter of 2010 dawned with optimism for a better insurance buying environment, following some good Q1 renewals. Then on 20 April, the Deepwater Horizon suffered a blow out and subsequently sank. This was followed by the sinking of the Aban Pearl offshore Venezuela.

The consequences for the companies involved and their insurers are certainly significant, but also largely unknown at this point, apart from the rig losses themselves. The table on the right indicates the major categories of potential loss.

The loss also points to uncertainty for the energy market, and there is already evidence of a market reaction. Certainly the underwriters put the brakes on the material reductions we had expected

(continues overleaf)

Potential insurance exposures arising from the Deepwater Horizon incident

- Rig total loss
- Removal of wreck/debris (MMS decision pending)
- Well control/relief well/restoration
- Pollution clean up and third party liability
- Casualty operating partners liabilities
- Employee liabilities
- Contingent business interruption
- Contractors potential exposures
- Directors and officers liabilities



Market review (continued)

and achieved prior to these events. This is hardly surprising given the magnitude of the losses and the underwriters' need to assess their positions before moving forward again.

Of course we are all keenly focused on the direction and speed of any market movement. Our broking teams, particularly in London, Bermuda, Houston and Singapore, are keeping a close eye on developments of current market placements to allow us to distinguish renewal terms and associated risks for the benefit of our clients.

There is no panacea, but we believe in the effectiveness of an open, competitive market will help find optimum solutions for each client's unique needs. We do not believe punitive action by the insurance markets is appropriate and an across the board correction is not needed.

There are now far more questions than answers at a time when the majority of energy companies with Gulf of Mexico exposures are in the market for renewal. The only thing that we can say with certainty is that underwriters will have even greater focus on operational and deep water exposures.



DEEPWATER DEVELOPMENT PROJECTS: HOW THE MARKET SHOULD RESPOND

While the cause of the Deepwater Horizon rig and MS252 well losses may not be directly associated with water depth, it certainly complicates and raises the cost of the well control and redrill. Underwriters will weigh this risk against the loss history for deepwater projects, which has been relatively good.

The risks

Deep and ultra-deep (>1,500m) water developments are perceived by underwriters to push technological boundaries as well as the capabilities of the industry.

Water depth versus the technology, the difficulty and cost of carrying out repairs, well control and distant onshore tie backs all add to the challenges that underwriters face when setting premium. If there is anything positive to be gained by the ongoing well loss, it is in the exploration of new technology and processes to fight a lost well at great depth. Eventually as the facts become known, the industry will also learn additional steps to avoid the possibility of future deep water blow outs.

The benefits

While there are certainly risks to deepwater development, the asset values tend to be much larger than on inshore projects. This creates the opportunity for significantly more premium for underwriters. In a global insurance market that has been falling for some time in all other industry sectors, there should still be significant attraction to the large premium opportunities.

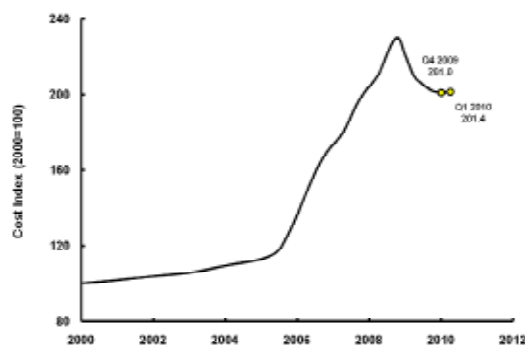
In years past, underwriters were of the view that deepwater construction all risk (CAR) policies were paying for research and development costs that should have been borne by the manufacturers and operators. However, with the imposition of higher deductibles and restrictions for faulty part coverage, this concern has been mitigated.

Complex repairs in deep water are a concern, but some have also been proven. For example a major crack in an operating pipeline in 1,300m of water with a diverless pipeline repair system was repaired effectively both in terms of cost and capability.

The cost of the high specification deepwater vessels cannot be ignored, but the energy market

IHS CERA UCCI

0.2% increase in first quarter 2010



CERA

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was caught off guard by the cost escalation which generated higher than anticipated losses (see graph above). CAPEX indices suggest that rates have peaked and this problem will not persist. Premiums have since been adjusted based on the peak rates, but repair rates are now at or below this level.

Historically, there have not been many claims that are the direct result of the works or asset being in deep water. Part of the reason for this may be that oil companies tend to deploy strong teams on deep water projects because of the high profile and value.

Equally, deeper water projects do not tend to involve new major technologies, they simply bring together a string of improvements to provide a robust solution. As a result, the component parts of a project tend to be tried and tested, even if they are brought together in an innovative way.

A partnership approach

Underwriters will always be concerned about supporting projects that test the limits of technology. By helping them understand the risk, Aon works with underwriters for a resolution rather than leaving them to measure premium on an uncertain basis.

This will save the industry money, extend cover and potentially avoid significant premium swings following a loss.

The Deepwater Horizon loss has put deep water developments under the spotlight. The sector's loss history suggests that the insurance markets should avoid a knee-jerk reaction.

IN THE VIEW OF THE PRACTITIONER

An interview
with Tom Bolt,
Director of
Performance at
Lloyd's.



As Performance Director, Tom Bolt is responsible for working with individual Lloyd's businesses to improve the commercial performance of the market. This includes monitoring each syndicate's performance against its business plan and ensuring that the underwriting guidelines are adhered to.

Tom kindly accepted the opportunity to discuss some of his views of current market trading and the challenges ahead.

What is your view on the role of a specialist insurance broker?

I am a big fan, as the specialist broker has the capacity to add a lot of value to the marketplace. There is the opportunity, but also the challenge, to prove your value and provide a broader offering than just price. Brokers are not known to be the best able to establish their value. When you look at a combined Aon Benfield and your modelling capabilities for example, the deeper analytics can better secure insurers' commitment and make a big difference to your clients.

What do you expect will be the market's biggest challenges in the coming period?

When I look at our published figures for our Upstream Energy business, our combined loss ratio for 15 years prior to 2009 was 111%. And the five years prior 2009 was 130%. Our business plans need to react to this. At Lloyd's we need to be sure that our rating assumptions respond to any changes in the landscape, that we differentiate risks and maintain more discipline. The upcoming Gulf of Mexico renewals will be a test for us and we shall see whether underwriters will 'walk the talk'. Capacity in the world has reloaded, and as a result more intelligent underwriting is needed by all, because any spiral of an ever reducing new benchmark price will end in tears.

Do you have any specific comments about Aon's Global Risk Insight Platform (GRIP)?

I don't have any specific opinion of the virtues of GRIP to our business, but I do hold a view that it will be the honesty and integrity of the tool that will be its hallmark. There must be visibility of the benefits, where they are coming from and going to, in using the system.



Tom Bolt, Director of
Performance at Lloyd's

Our data mining project is similar. In the past, being a member of Lloyd's was like being a member of an old library. If you were lucky enough to find your library card and you were able to find the location of the book you were looking for, you could be sure that when you opened it up, the pages would all be in the wrong order! Like Aon, we have a tremendous amount of useful data, we just have to find it and consolidate it into something useful. While we obviously must respect data sharing restrictions, this project, started by my predecessor Rolf Tolle, is beginning to bear fruit.

What do you think about the long term sustainability of the inherently volatile energy market?

They say it is hard for bookmakers to do business with each other! This is the real challenge in energy. You see, the interesting thing about your customer base is that it thinks in terms of probability, just like we do. An oil field development is a probabilistic exercise, the finance directors are constantly asking themselves 'what are the odds?' and they also deal with constant volatility. The buyer thus doesn't hold a long term view and if an insurer has the same attitude then deals will only be done on the basis of one believing they have more opportunity over and above the other. It is not easy to engender long term harmonious placements, a dog can love a fish, but where do they make a home?

AON'S GLOBAL RISK INSIGHT PLATFORM

Aon's Global Risk Insight Platform (GRIP) tracks the global insurance market every day, in real time. It means that we can tell you what other businesses in your sector and region are paying.

This fact-based understanding of your risks relative to your peers allows us to design and negotiate the most competitive combination of premium, cover and service in the market.

To arrange a demonstration of GRIP, please contact paul.o'keefe@aon.co.uk.





Aon's 10th Middle East Energy Insurance Conference
Economic recovery and continued expansion

ENERGY INDUSTRY AT PIVOTAL POINT

The global financial crisis made the operating environment for the energy industry and its insurers, intermediaries and regulators extremely challenging. Demand is finally starting to recover, and previously stalled projects are now getting off the ground.

The insurance industry has the opportunity to play a key role in building the future energy landscape by facilitating project development and giving investors the confidence to play their part.

With this in mind, Aon's 10th Middle East Energy Insurance Conference, rescheduled from April following the disruption to airspace caused by the Icelandic volcano, is being held between 11 and 13 October. The conference, being held in Bahrain, will gather leading industry figures including His Excellency Rasheed M Al Maraj, Governor of the Central Bank of Bahrain, and senior representatives from major insurance and industry organisations including Ace, the Abu Dhabi National Insurance Company, Allianz, Chartis, Validus Group and Zurich Insurance Company.

His Excellency Rasheed M Al Maraj commented, "The insurance sector is becoming an increasingly important part of Bahrain's financial system. Firms are attracted by our comprehensive and transparent regulatory framework and use their presence as a

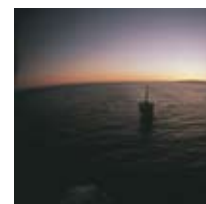
hub from which to tap the opportunities of the wider Middle East. There is enormous potential for the energy insurance industry to offer specialist services and risk mitigation throughout the GCC and MENA region."

Magne Seljeflot, Chairman, Aon Energy London, commented: "The energy industry remains on the cusp of recovery and we are starting to see some exciting new projects get back off the ground after several years of mothballing. Working on making risks attractive to insurers is going to be key in making sure these and future projects are viable. At the same time, climate change, pricing and future energy policies are still very serious causes of debate and we hope to provide a valuable forum for companies, the insurance markets and regulators to get together and learn from one another."

If you would like to book a place at the conference, please contact emma.sewell@aon.co.uk. Please also contact us if you were booked for the original dates and would still like to attend.

Aon Energy is also holding an Energy Training Seminar in London, 13-17 September 2010. For further details, please visit www.AonEnergyTrainingSeminar.com.

Economic recovery and future of energy industry to be debated at Aon's 10th Middle East Energy Insurance Conference in Bahrain between 11 and 13 October.



AON ENERGY ON THE MOVE

Liu relocates to London

James Liu has transferred to our London office to help Chinese clients with their significant outward investment programmes. He previously headed Aon's energy and construction team in China. His replacement in Beijing will be announced shortly.

HRC Expanding the Network

Hydrocarbon Risk Consultants (HRC), part of Aon's engineering team, has hired Singapore-based Paul Clarke to head its engineering function in Asia.

Clarke brings extensive engineering underwriting experience and was most recently at Zurich in London. He will manage Aon's engineering group across Asia and brings specific energy experience to the team.

O'Neill and Bush join Broking Team

Peter O'Neill has joined Aon in London. Joining from Marsh, he brings significant experience that will bolster Aon's support for downstream clients. He is joined by Varian Bush, formerly of HSBC.

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While we try to comment on issues we know to be fact, we are fully aware that in gathering the information contained from various sources there is always the possibility of inaccuracy.

We can therefore only claim that the information in this newsletter is correct to the best of our knowledge at the time of publication.

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