Global Upstream

Increased activity levels are bolstering the premium pool

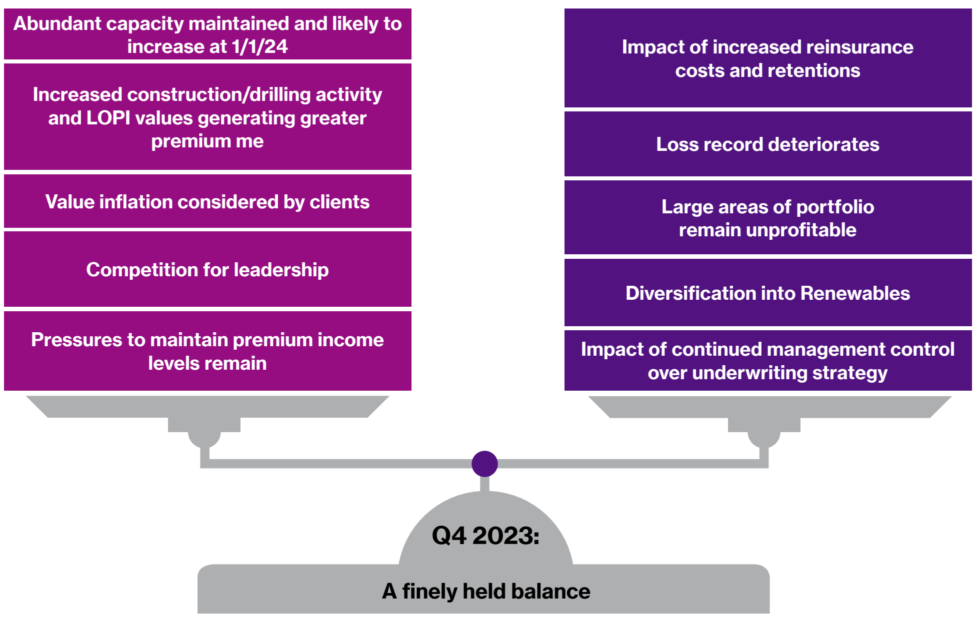
The premium base has increased due to the influx of constructions this year compared to the previous four or five years. This is due to a more stable oil price at US$80-90 levels, compared to the COVID-19 level of US$30-35. During the preceding low oil price environment, many projects were delayed but we have seen project activity restart over the last year, as governments are increasingly focussing on domestic energy security. Countries such as Norway offered meaningful tax incentives to new oil and gas projects, which have encouraged operators to dust off many temporarily shelved projects. The focus on energy security has also resulted in a temporary relaxation of local ESG requirements which had started to impact projects and insurance markets are supporting these placements.

In years to come these projects will likely cause a bump in upstream construction losses at a point in time when future ESG restrictions, both at governmental and insurer level, may result in considerably less incoming construction premium to balance these losses.

In the U.S., onshore we continue to see steady drilling as majors and large independents are sticking to their commitments of operating within cash flow, repurchasing shares and distributing cash back to their investor base. Their growth is steady, generally limited to about 5%, while the smaller public and private companies continue to increase their activity in light of the higher oil pricing. We have seen recent announcements in the U.S. of upstream consolidation and suspect there will be more to come in 2024 as buyers look to replace and supplement their drilling inventory.

Figure 1:

A fine balance — the Upstream underwriting environment, November 2023



A market in a finely balanced equilibrium waiting for what 2024 will hold.

Source: WTW

Offshore U.S. activity remains bifurcated, with significant drilling and completion operations in the deepwater Gulf of Mexico and a lesser volume of activity on the Gulf of Mexico shelf. There are generally fewer and smaller construction projects in the U.S. Gulf of Mexico at this time as operators focus on hub and spoke asset strategies by using tie backs to existing facilities as their preferred development concept.

There are other regions such as the UK North Sea, where project and drilling activity has significantly slowed as a result of the government windfall tax. Smaller independent companies are especially seeing their bottom line hit by this and are holding back from drilling wells, uncertain whether they will get a good return on their investment.

Imbalance in underwriting portfolios: A problem for next year

The uptick in construction activity means that most insurers have already made their 2023 budgets, resulting in less management pressure to write business towards the end of the year and likely some reticence by the market to being overly competitive to win business. Some insurers are likely to close their book to further construction business for Q4, having exceeded income targets.

However, the large amount of new construction business could well imbalance portfolios with many markets now writing a book that is more heavily weighted towards construction income than in previous years. This will cause a knock-on problem next year if fewer projects come in as insurers will need to replace this non-recurring income — a difficult position for markets to maintain. Looking back to the last time drilling and construction activity fell away, we saw insurers seeking to increase their lines on operating programmes to make up the shortfall in income, and if history repeats itself, this could result in a significant softening of operating rates as competition for these programmes increases.

> **Project activity restarted over the last year, as governments are increasingly focusing on domestic energy security and this uptick in construction activity has bolstered the insurance premium pool.**

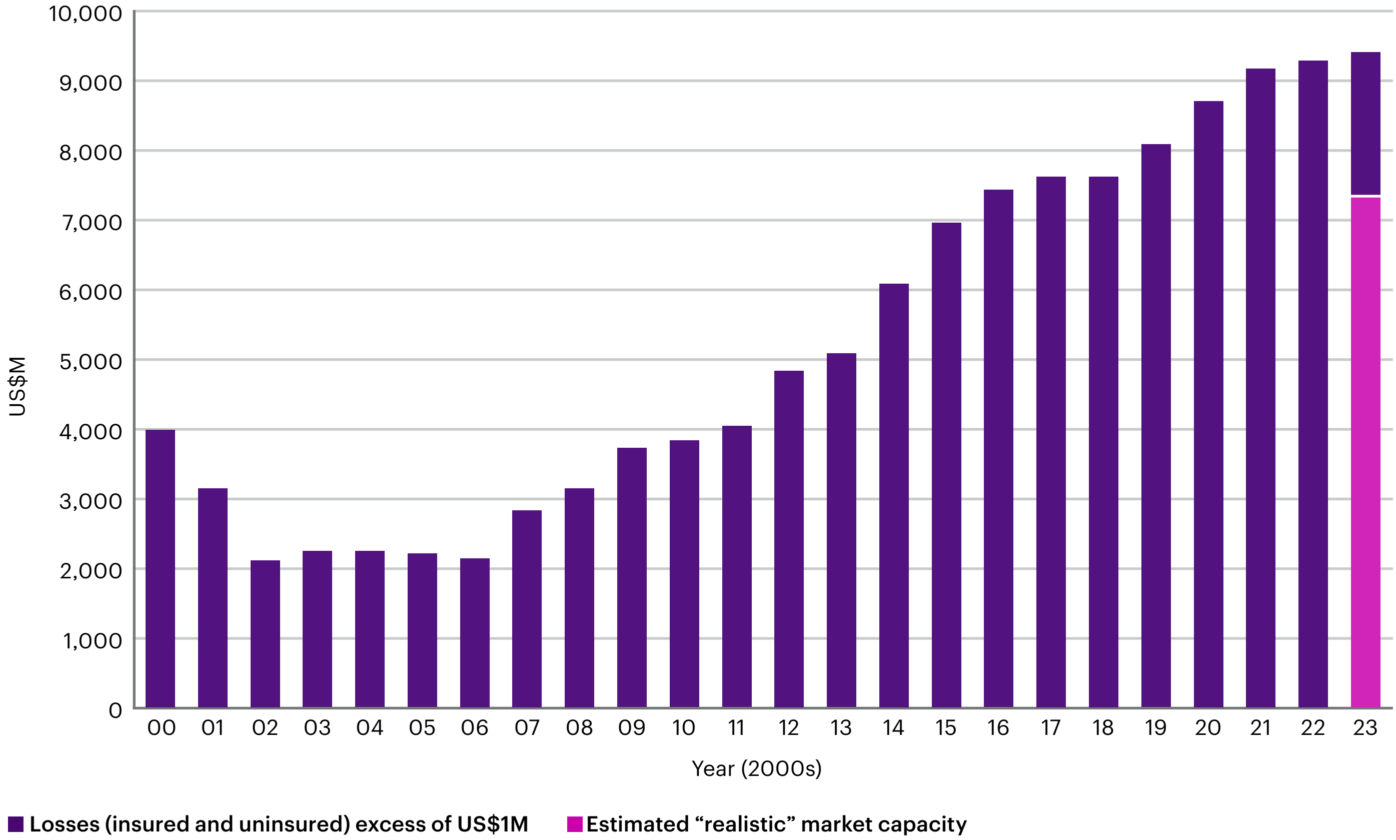
Capacity: Some things don't change

Plenty of capacity continues to be available for most good risks that markets want to write and capacity has in fact gone up slightly during the year. A few insurers have increased their lines, particularly for large North Sea clash assets and we are expecting further increases from existing players at 1st January 2024.

Gulf of Mexico Named Windstorm coverage has seen significant reductions in capacity over the past two years, but similar limits have generally been able to be purchased through increased take up from other incumbent insurers. Going forward we expect Gulf of Mexico Named Windstorm capacity to remain constrained alongside U.S. Business Interruption and/or Loss of Production capacity.

Figure 2:

Upstream Operating insurer capacities 2000-2023 (excluding Gulf of Mexico Windstorm)



Both theoretical and realistic capacity levels have increased in recent years — thwarting the efforts of insurers to accelerate the hardening process

Source: WTW

Chinese market

Interestingly, we have seen a retrenchment in the Chinese market, which had in the past been a key enabler of competitive pricing for those placements with a Chinese interest. However, over the course of 2023, Chinese insurers have scaled back on the international business they write. This is a result of some significant non-domestic losses now coming through into their book from accounts where they wrote disproportionately large lines. Many Chinese insurers are now taking a stricter view on what qualifies for a "Chinese interest" on international business and are focussing more on technical underwriting to ensure that they are partnering with the right insureds.

For domestic Chinese clients, local markets continue to have meaningful appetite to support with large lines but appetite is more measured on construction where they are a scaling back on line sizes.

Figure 3:

2023 loss record appears more favourable...but there is more to come

Upstream losses excess of US$10 million, 2023 (to date)

Type	Cause	Region	PD US$	OEE US$	BI US$	Total US$
Platform	Unknown	Asia Pacific	0	54,890,000	0	54,890,000
Platform	Unknown	Asia Pacific	0	31,000,000	0	31,000,000
Well	Mechanical failure	North America	0	22,600,000	0	22,600,000
MOPU	Unknown	Europe	0	0	21,390,000	21,390,000
Well	Unknown	Asia Pacific	18,800,000	0	0	18,800,000
Well	Fire no explosion	North America	0	12,500,000	0	12,500,000
Platform	Anchor/jacking/trawl	Middle East	0	10,000,000	0	10,000,000

No losses above US$100 million have been recorded so far, but we expect several large losses to be added to the database following reserving later in the year

Source: WTW Energy Loss Database as of October 3rd, 2023 (figures include both insured and uninsured losses)

Losses: Was 2023 really as good as it looks?

Our WTW Energy Loss Database only tracks losses once they have been reserved and currently shows a total of US$225 million losses for 2023. However, we know of further, not yet recorded losses including a significant platform fire in Latin America likely to add US$600 — 750 million, two further Gulf of Mexico blowouts at around US$200 million each, a US$200m construction incident and another loss at circa US$250 million.

2022 was profitable for most underwriters with no significant loss activity, apart from a large construction loss which impacted some portfolios (as foreseen in the April update) and a major midstream BI loss in Europe. Insurers who avoided large lines on these losses generally fared well in 2022. Most upstream underwriters still sit on profitable portfolios and management are likely to want them to maintain or increase this further next year, adding to competitive pressures.

Figure 4:

2022 loss record has deteriorated as expected

Upstream losses excess of US$20 million, 2022 (to date)

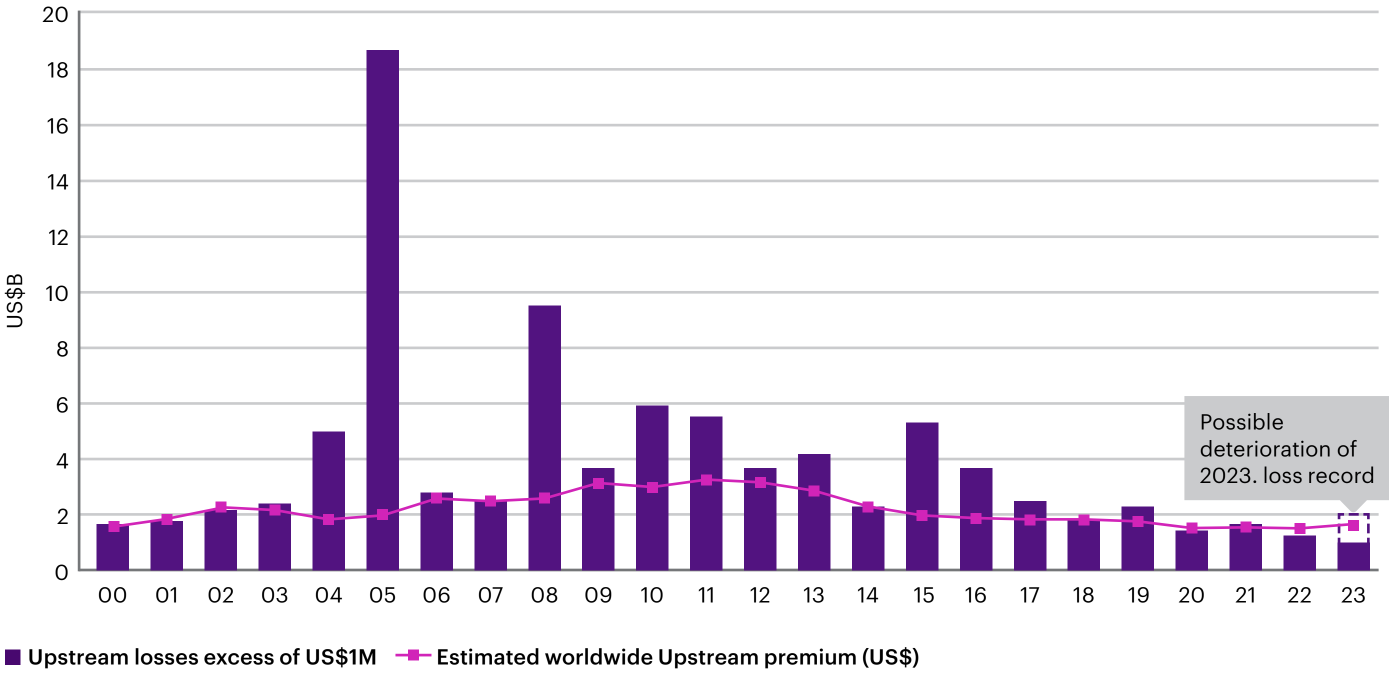
Type	Cause	Region	PD US$	OEE US$	BI US$	Total US$
Platform	Faulty work/op error	Europe	0	0	400,000,000	400,000,000
Rig	Mechanical failure	Latin America	0	92,000,000	0	92,000,000
SSCS	Corrosion	Europe	0	19,000,000	56,250,000	75,250,000
Well	Unknown	Africa	0	60,000,000	0	60,000,000
Well	Blowout no fire	North America	57,000,000	0	0	57,000,000
Plant	Fire no explosion	Middle East	0	45,000,000	0	45,000,000
Vessel	Mechanical failure	Europe	0	37,000,000	0	37,000,000
Platform	Mechanical failure	Europe	0	14,200,000	20,000,000	34,200,000
Well	Blowout no fire	Europe	21,300,000	0	10,600,000	31,900,000
Pipeline	Anchor/jacking/trawl	Asia Pacific	0	30,000,000	0	30,000,000
SSCS	Anchor/jacking/trawl	Africa	0	30,000,000	0	30,000,000
Well	Blowout no fire	Latin America	29,000,000	0	0	29,000,000
Platform	Unknown	Asia Pacific	0	27,000,000	0	27,000,000
Well	Blowout + fire	North America	20,000,000	6,000,000	0	26,000,000
MOPU	Impact	Asia Pacific	0	24,500,000	0	24,500,000
Rig	Fire no explosion	North America	0	20,100,000	0	20,100,000
MOPU	Faulty work/op error	Asia Pacific	0	20,000,000	0	20,000,000

Major loss now included and further deterioration on other incidents

Source: WTW Energy Loss Database as of October 3rd, 2023 (figures include both insured and uninsured losses)

Figure 5:

2023 loss record will deteriorate making it an unprofitable year

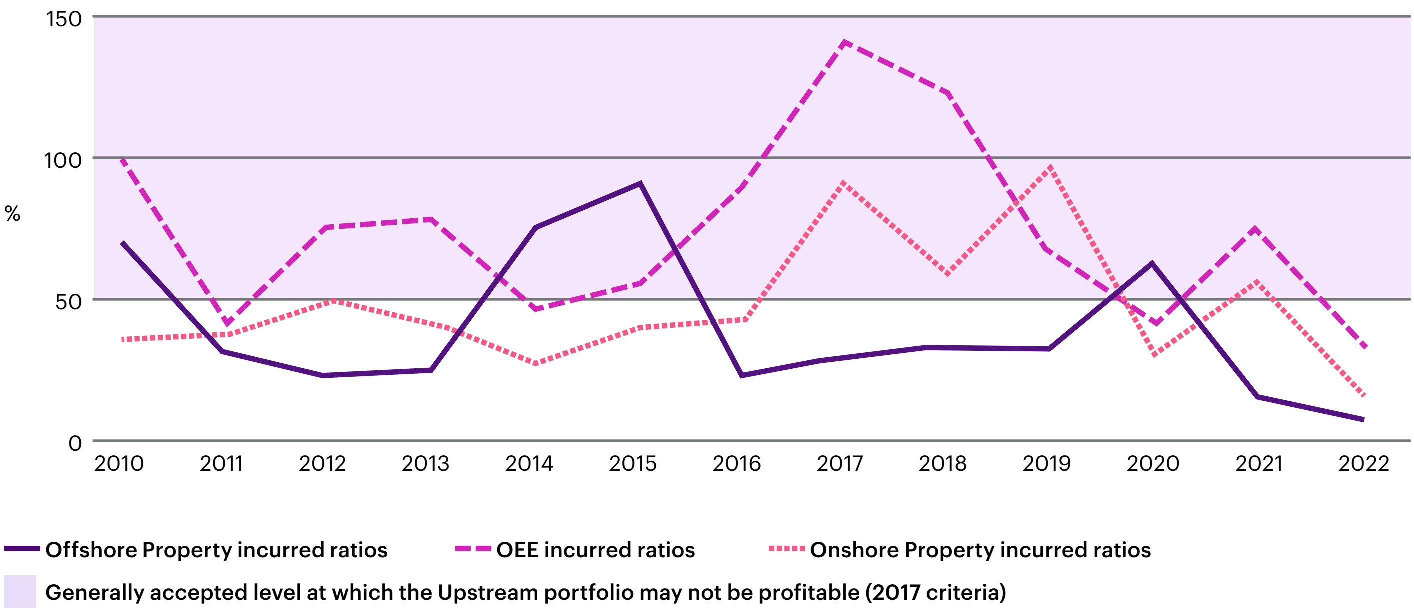


Greater incidence of large losses but also more attritional exposure in underwriting portfolios

Source: WTW/WTW Energy Loss Database as of October 16th, 2023 (figures include both insured and uninsured losses)

Figure 6:

Lloyd's Upstream portfolio profitable for all subsectors



Positive Lloyd's data for all upstream portfolio sectors but further deterioration still expected

Source: Lloyd's Market Association Quarterly Loss Report Q2 2023. "Offshore Property" — combination of ET/EC/EM/EN Audit Codes "OEE" — combination of EW, EY and EZ Audit Codes. "Onshore Property" — EF audit code.

Inflation: An inconsistent picture

The upstream market is still somewhat behind its downstream and power counterparts in reacting quickly enough to the increase in global inflation and supply chain timeframes. Whilst other markets are tightening conditions and adjusting rates accordingly, most upstream underwriters are purely asking whether clients have considered inflationary factors with only a few applying related restrictions or rating loads. This may be because many clients voluntarily revise their values in line with inflation, particularly on the contractor book where we routinely see increases of 15-20% in insured values. However, few valuations are independently verified, and the market does not tend to request this.

In regions such as the North Sea, we are not seeing the same increase in asset values because of older infrastructure, which is unlikely to be replaced like for like, especially in view of the regions' ambitious net zero targets and the complications this may bring on the sanctioning of replacement infrastructure. If clients insure lower values for these assets, it is important that they sufficiently cover any partial losses such as the replacement costs on compressors.

We are also seeing a wide variance in the asset values submitted by different joint venture partners for the same assets based on their internal view of Estimated Maximum Loss scenarios and the likely rebuild scenario and field/asset life expectancy. If markets believe a client has undervalued assets, they may apply higher rate rise at renewal to reflect this perceived underinsurance.

Whilst we expected more focus from the market on deductible levels and waiting period adequacy in the inflationary environment, this has not materialised.

Reinsurance market impact has not been fully passed on to direct clients

At the time of our Energy Market Review in April, insurers were reeling from quite severe treaty renewals and the market was talking up the conditions and the amount of money that they were going to have to spend on increased reinsurance.

As Q1 progressed, we saw a divergence in how different markets reacted. The insurers with a multi-class reinsurance program that covered downstream and upstream were probably hit the hardest. Also hard hit were those markets with a whole account program that included aviation, due to the Ukraine crisis and political violence losses. However, those insurers that had energy specific treaties were treated more leniently except for on Gulf of Mexico Windstorm. Gulf of Mexico Windstorm coverage was the hardest hit area of the1st January treaty renewals, with increases in treaty costs passed onto direct clients.

Overall, reinsurance treaty renewals were not as bad as many markets expected from a cost increase point of view, but many had to accept significantly increased retentions.

Due to the timing of these reinsurance treaty renewals, many of the large 1st January renewing accounts were quoted and placed before treaties were finalised and so missed out on any adjustments made in view of treaty increases. It may only be at the end of 2023, when underwriters see their full year numbers including increased retention levels, that the direct market will fully react to the impact the 1st January 2023 treaty renewals. This may result in some very different rating conditions in 2024.

2024 treaty renewal discussions are just commencing but we do not expect upstream energy portfolios to be treated differentially at this renewal. In fact, reinsurers may feel that they have adequately addressed concerns with the upstream portfolio through last year's adjustment in retention levels, which results in more attritional losses remaining with direct insurers.

Facultative reinsurance

In the April Energy Market Review, we said that facultative reinsurance might fill the gap of the increased reinsurance retention, but this has not transpired as the reinsurance cost uplift in premium has not been passed on to direct clients. Insurers have not been able to achieve a significant uptick in rates which would have generated the money for them to buy facultative reinsurance to compensate for the increased treaty retention levels.

Conversely, appetite for purchasing facultative reinsurance has actually slowed down and more deals are now being done on the renewables book where the market is significantly growing.

Offshore renewables firmly established in the upstream portfolio

During 2023 we have seen more upstream insurers diversifying into offshore renewables to support their clients through the energy transition and take advantage of the premium volume generated by the sector. For most markets offshore renewables sits within the upstream reinsurance treaty, so they are able to write these exposures within existing treaty structures.

Upstream underwriters are keen to write operational risks, but most risks are placed on a project basis with the construction policy including a number of years of operating exposure post completion. If the upstream market is serious about broadening out into these risks, they will need to move away from focussing solely on operational risks and get comfortable with writing these construction projects with operational bolt-ons with 4 or 5 year policy periods.

This diversification into renewables allows insurers to remain firmer on rating expectations going forward as they will have the benefit of the renewables premium to offset any business they lose due to inadequate rating or risk selection.

However, we have seen this story before when markets moved to diversify into the midstream book a few years ago, but losses soon came to haunt them and capacity retrenched once again from the sector. So, it remains to be seen whether upstream markets have greater longevity in writing renewables risks.

Leadership and markets

We are finding that markets with a less diversified book, which do not write renewables or downstream are more dependent on the large premium volume upstream accounts and simply cannot afford to walk away from these large accounts even if rating levels do not meet their expectations.

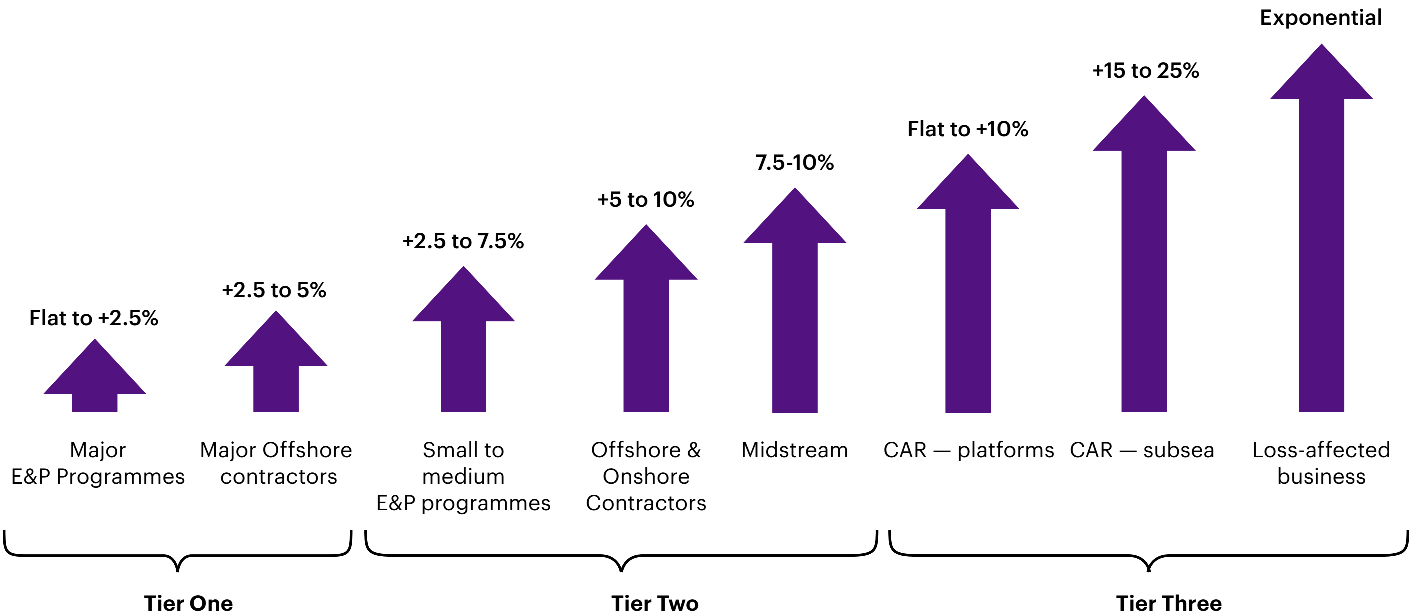
Conversely for some of the traditional leaders, who are writing multi-class in natural resources, upstream is the sector not delivering the desired returns on capital. Whilst the loss ratios over the last few years have been favourable, it is evident that it will not take many losses to push the portfolio into unprofitable territory. These diversified markets are getting far better rates on line on power and downstream and as a result are not aggressively quoting to grow their upstream position. Despite this, we are seeing these markets continue to honour long-standing client relationships and quote competitively to maintain their leadership position on existing good quality business.

There are still markets that are hungry for premium, particularly those that do not have a strong position on the Tier one business and those that are looking to grow their portfolios. Some markets have significant growth targets for 2023 and others are trying to offset the losses paid over the last two years.

> **"There are still markets that are hungry for premium, particularly those that do not have a strong position on the Tier one business and those that are looking to grow their portfolios."**

Figure 7:

Three-tier market differentials, November 2023



The range of rating increases across the three tiers is narrowing

Source: WTW

Pricing: Have we reached the top of the market?

At the beginning of the year, insurers stated that they needed a 10% overall increase in premium levels across their book in order to stand still and pay their reinsurance costs. However, with much of the 1st January business missing these rate increases and renewing at a much lower level, many insurers would have been significantly below this target. We have not seen any particular evidence that other parts of the book and accounts renewing later in the year are meaningfully hardening to meet this overall rating expectation.

As the year progressed, the market moved to a position of flat renewals to minor rate increases of circa 2.5%, particularly for the most sought-after and sizeable business. Third party liability sections are still seeing larger increases of 5-10% but the premium for this coverage is usually minor compared to the overall placement and does not significantly shift overall rate change. The less desirable business such as construction, onshore contractors and standalone control well accounts are still seeing more significant upward rate movement.

Gulf of Mexico Named Windstorm was generally flat for deepwater in 2023 while shelf wind saw double digit increases.

Growth

For clients that can evidence significant growth, markets have been more commercial than in the past. They offer attractive growth credits for acquisitions as increased premium generated from this growth give them more flexibility on rate.

Order

Markets are proving to be significantly more competitive on placements with small commercial marketed orders, either because large swathes of the risk are retained in local markets such as China, or because there is meaningful self-insured participation. Such accounts face stiffer competition from insurers who all want to write a share of the small commercial order, where only a few markets can participate. Into 2024, these accounts will continue to see the best terms. Larger orders, which require more subscribing markets to complete, will be harder to place at the most competitive terms. The size of the commercial market order alone can be sufficient to move an account from Tier one to Tier two.

Competitive Pressures

In the current market environment, it is important for brokers to test the pricing provided by incumbent leaders to ensure that clients' terms remain competitive. Regular benchmark quoting and programme structure reviews should form part of account renewal strategies, even for clients with long standing market relationships. For programmes that do not have large capacity requirements, this market evaluation exercise may well yield favourable terms and give the broker greater negotiation leverage with existing insurers.

The outlook for 2024: A buoyant market ahead

The latter months of the year, ahead of the treaty renewals, have often been the softer part of the year. But with many markets having achieved their budget, we may see some reticence to be competitive during Q4, especially for less desirable parts of the book such as construction.

The market is more selective on construction business than we have seen for a long time. If markets are now presented with a pure subsea project where they have no existing relationship with the operator, they are more likely to decline. We anticipate that this enhanced risk selection will continue into next year.

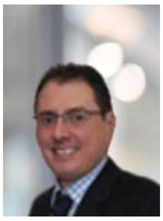
For operational business, with potential capacity increases at 1st January 2024 for several insurers, we may see a further drive for market share as insurers are seeking to fully utilise their new increased capacity and this could further soften pricing levels.

Significant additional portfolio losses and increased reinsurance retention levels in 2023 will mean that insurers will carefully evaluate the requirements for a profitable book of upstream business going forward. They may find it nonetheless difficult to achieve the required rate increases. If markets cannot achieve the rate movements needed, they may instead explore more cost-effective ways to write the business.

This could see a rise in the use of managing general agents (MGAs), which insurers can use to enter new markets or segments in a more economical way, without incurring the costs of setting up a business line or regional office. We have seen a number of specialist MGAs set up to address this need, be it regional, sectoral or broader with a technology flavour. In addition, we may also see increased participation in and / or establishment of "Follow-Only" insurers to provide markets with a cost-effective way to increase market share.

Whilst the specific use of MGAs can be highly effective, caution should be exercised as these arrangements often do not provide clients with the same level of longevity as direct underwriter relationships.

As we move to the end of year renewal season, clients should be encouraged by the buoyant market in the upstream sector. Although there is much variation in approach depending on the sub-sector, insurers are taking account of client differentiation, whether in size, nature of activities, location, loss record or longevity of their market relationships. This highlights the importance of engaging early with insurers and your broker to ensure that the placement can be presented in the best possible light.



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