

Insurance costs rising for the drilling industry

"THIS IS NOT a good time to be in the insurance service business," said **James R Pierce**, Managing Director of **Aon Risk Services Natural Resources Group**.

Nor is it a good time to be scouting for insurance if you're a drilling contractor.

Speaking at IADC's annual meeting, Mr Pierce said there probably wasn't anyone in the room who hasn't felt the pain of significantly higher insurance costs that in many cases are coupled with rising deductibles and increased costs for standard coverage, if they are included in the policy at all.

John Lloyd, a partner with **Jardine Lloyd Thompson** in London, said that during his 30 years in the business he has never seen a market like that of the past 12 months. "The 12 months that followed September 11, 2001, have been the most volatile ever in the world's insurance markets," Mr Lloyd said.

"However, for drilling contractors the insurance market had actually been moving in an unfavorable direction since the beginning of that year."

RISING COSTS

There are several reasons for increased insurance costs for the energy industry in general and the drilling industry in particular. One event, of course, is the attack on the World Trade Center. Also, capital that was previously available to the insurance industry has shifted to other less volatile, more secure businesses in the insurance sector. Capital providers for the insurance industry today can recognize insufficient returns within a year when previously it would take several years. Additionally, while drilling industry insurance costs have remained relatively stable with low deductibles the past 10 years, the number of claims has risen and along with them the claim cost has also increased.

"The energy business is one of the volatile exposures," Mr Pierce said, "and the mobile rig industry is perceived as being one of the worst classes in the energy business"

Consequently, there has been a flight of capital from that business sector as insurance companies seek to diversify

and reduce or eliminate volatility in more secure lines of business.

Insurance companies ran their business on the premise that it would be fine to take in \$1 of premium for \$1 of loss because the company intended to make 10-15% investment returns with that premium dollar. The problem is that no one has had investment returns for the past couple of years, Mr Pierce said, and in fact, portfolios have had negative returns.

Companies providing capital to the insurance industry are much more sophisticated investors than before, Mr Pierce noted, and they have very high

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expectations on returns on capital.

"The capital bearers will demand returns, will not accept losses to their portfolios, and are moving from volatile issues," he said. "That means they are going to sustain a profit margin from an underwriting standpoint, which means higher insurance costs."

And all of this was occurring before September 11, 2001. Putting that one event into perspective, the industry had over \$30 billion in losses over the last 10 years, which "has crippled the insurance industry," Mr Pierce said.

"The latest numbers show just over \$40 billion in losses (from September 11)," Mr Pierce said. "A \$40 billion event sends shock waves throughout the insurance community. It was a death blow to some and a near crippling event for many."

No sector remained untouched by September 11, 2001, and the impact was

immediate in all sectors, Mr Pierce said, including the contract drilling industry.

MORE CLAIMS

"Over the last six years, operators of mobile rigs claimed an average of over \$250 million every year from the insurance market," Mr Lloyd said. Even if the Petrobras claim for one of its floating production systems was excluded, he said, the annual average is more than \$160 million annually.

Mr Lloyd said an increase in activity will be accompanied by more accidents and thus more claims. He also said that high demand has brought less experienced personnel into the industry causing an increase in accidents.

"Declining reserves are driving E&P into deeper and less hospitable waters. The emergence of 3D and 4D seismic data technology has allowed previously overlooked reserves to be exploited but has also led to more exposure to high pressure zones."

"At a more general level," he added, "inflation has been at work so that even a minor accident results in a seven-figure claim."

Mr Lloyd noted that on the basis of experience with his clients, which includes four of the top 10 contractors representing about 50% of the total fleet value, that at the peak of the soft market in 2000 the contract drilling industry was paying less than \$100 million premium into the market.

"Claims in that year totaled nearly \$284 million," he said.

WHAT TO EXPECT

So what is happening in the insurance market specific to drilling contractors?

Capacity. There is less insurance capacity for drilling contractors today, particularly for international contractors, according to Mr Lloyd. Losses began driving some players out of the market, reducing competition that resulted in lower pricing. During the same time, the insurance industry was facing a bear equity market and declining investment returns, which magnified the insurance industry's losses.

There are significantly fewer energy insurers. "Prior to 2001 the insurance market was concentrated in the US, London, France and Norway," Mr Lloyd explained. "Today, there is no market in France and Norway while the US is severely diminished."

"Even in London both the number of underwriters and their capacity has declined materially," he added.

"I would say there are now as few as 20 active insurers and there is virtually no competition between the small number of recognized leaders, those companies that set the terms, conditions and pricing of the policies."

September 11th. There are two reasons why the September 11 attacks have affected the energy industry although the energy industry was not directly affected by the events of that day. First, according to Mr Lloyd, is that most insurance companies are diverse global businesses that underwrite business of all types. However, there will be very few insurers and reinsurers in the international market that are untouched by September 11th.

The second reason, he said, is less straightforward. Over the last 10 years the market has had a surplus of capacity but even prior to September 11, 2001, capital was beginning to leave the insurance market either as a result of underwriting losses or because of poor investment returns being offered.

September 11th, he said, with its tens of billions of dollars in losses, has brought supply and demand back into balance. There may even be a shortfall of capacity, Mr Lloyd said.

"That correction is the basis upon which insurers are increasing the price of their product."

It also means that insurers move their capital to sectors offering the best returns and least risk. The contract drilling business, Mr Lloyd said, has a long history of unprofitability for the insurance business and requires careful underwriting. As a result, he said, insurers withdrew their capacity from the sector to easier money to be made elsewhere.

Pricing. Less capacity translates into higher pricing. "I would say that insurers are trying to achieve a pricing cor-

rection of 2-3 times the soft market pricing levels," Mr Lloyd said.

He said that most contractors that have renewed their insurance programs during the past 12 months likely experienced an increase of that magnitude. Those contractors who are exiting long-term fixed price coverage should expect a similar increase.

However, Mr Lloyd said, those contractors who are on their second "hard" market renewal should experience smaller inflationary increases.

"It would probably be fair to say that the first round of hard market increases were a reflection of losses," he noted, "whereas the latest are simply being driven by the shortage of capacity."

Coverage. The amount of coverage also determines the insurer's performance. Insurers have "returned to technical underwriting", Mr Lloyd said, meaning they think more about the risks they are taking, the coverage they provide and the claims that could result rather than feeling obliged to offer the broadest possible policy in order to be competitive.

For example, Mr Lloyd noted, coverage for risks such as Contingent Extra Expense, Control of Well and Third Party Liabilities, which were previously standard components of most drilling contractors' insurance programs, are now only provided after much scrutiny of the risks involved. That also results in higher costs.

Deductibles/risk retention. Prior to the Pipe Alpha accident in 1987 the standard deductible on a drilling contractor's policy was \$100,000 for each loss. Following the Piper Alpha accident, the typical deductible rose to \$250,000. But subsequent to that increase deductible levels remained flat, Mr Lloyd said.

Until now.

"Programs that have renewed in the last 6-9 months have generally been subjected to a minimum deductible of \$1 million."

"However," he said, "a \$1 million deductible does little more than scratch the surface of most claims that reach the market and does not result in a meaningful sharing of loss with the insurer."

He said it is clear that drilling contractors could retain more risk because they have become billion dollar companies rather than million dollar companies, but the cheapness of transferring risk to insurers, until now, has not resulted in the need for risk retention, or self-insuring.

"By using the policy deductible to remove or substantially reduce the expected claims activity," Mr Lloyd said, "it is clear that substantial premium savings can be made."

Contractor's mutual concept. For some time, oil companies have operated a mutual insurer and it is enjoying record membership, according to Mr Lloyd. However, the concept has never been popular among drilling contractors.

The reason may be cultural, he says. Joint venturing and sharing risk has always been a feature of the oil industry but drilling contractors have always competed fiercely.

"As a result, I feel there is an aversion to joining together in order to share insurance risk and support each other's business."

That's understandable, he said, but he also feels the contract drilling industry is missing an opportunity. The insurance market is currently trying to recover the losses from the contract drilling business from all contractors, even if a particular policy has historically been profitable for insurers.

"To an extent," Mr Lloyd argues, "your fortunes in the insurance market are already linked. The formation of a mutual insurer would simply formalize this relationship and perhaps create a more stable market place for drilling contractors in the future."

He notes that the shipping industry, an equally competitive industry, has been successfully mutualizing its liability risks, known as Protection and Indemnity (P&I) for hundreds of years.

"The P&I clubs have proven, when managed professionally, that potential for supplementary calls for additional funds from members can be eliminated to the extent that coverage can be provided on a fixed cost basis." ■