Can Energy Firms Break the Historical Nexus Between Oil Price Falls and Large Losses?

Historical loss trends reveal a potential correlation between significant oil price falls and increased energy losses: Energy companies must exercise caution when implementing cost-cutting measures, designed to counteract/offset the effects of low oil prices, to ensure history doesn't repeat itself.

LESS REVENUE MEANS LESS INVESTMENT

Over the past 20 months, oil prices have fallen by around 70%. Historically, in the upstream market, periods of significant pricing falls have been met by:

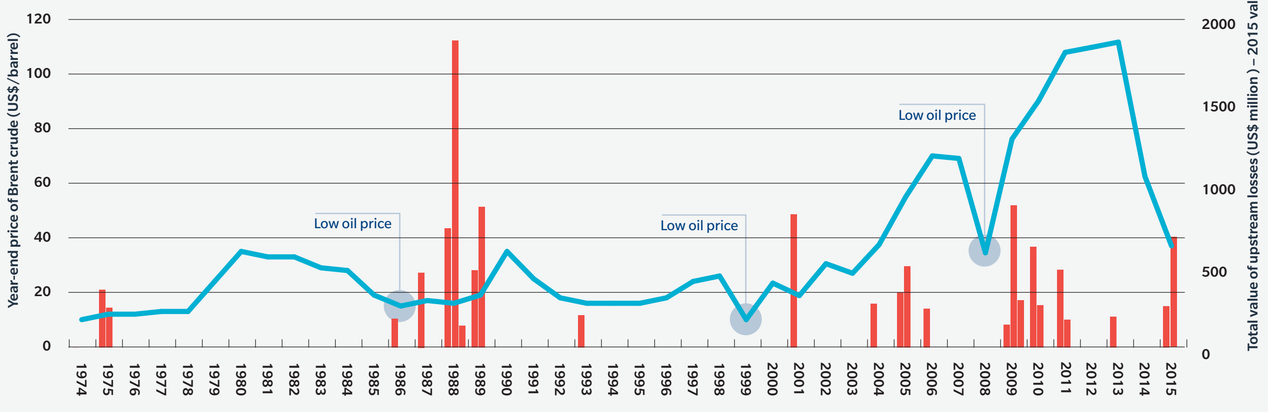
- New projects being shelved or canceled.
- Increase in redundancies and hiring freezes.
- Cuts in infrastructure and maintenance spending.
- Less investment in health and safety measures and employee training.

Cost-cutting decisions such as these by the industry appear to have led to increased losses in the past according to Marsh research (see Figure 1).

"Cost-cutting decisions ... by the industry appear to have led to increased losses in the past."

FIGURE 1 CRUDE OIL PRICE VERSUS UPSTREAM LOSSES BY YEAR – 1974-2015

Source: Marsh Research



SPOTLIGHT

THE FALL IN OIL PRICES HAS REDUCED COMPANIES' ABILITY TO WITHSTAND VOLATILITY

With less revenue and more strain on budgets, companies could find themselves challenged to face future volatility should it arise, which could be driven by reduced demand and supply issues, such as:

- A slowdown in growth in previously high-growth countries, such as China.
- The proliferation of societal challenges in countries whose economies are supported by the oil and gas industry.
- A drive towards greener energy production, compounded by the COP 21 agreement.
- Improved technology reducing consumption patterns.
- The further lifting of sanctions on Iran increasing the flow of cheap "easy oil" into the global market.

Similar reductions occurred between 1980 and 1986 when Brent crude oil price fell from US$35 to US$15 per barrel, in the late 1990s when the price fell below US$10 per barrel, and in 2008 when the price fell from over US$100 to US$32 per barrel. A period of increased frequency or larger losses has typically followed soon after.

Already, companies have been canceling projects and making staffing reductions. It is estimated that projects worth up to US$380 billion have been shelved[1], according to consultancy group Wood Mackenzie. Meanwhile, a recent survey in the *Chemical Engineer* revealed that the majority of respondents had seen redundancies within their companies.[2] Additionally, 36% had seen training budgets cut and 45% reported hiring freezes.

While project cancellations and redundancies are easy to quantify due to publicly available information, cuts in maintenance, health and safety measures, and employee training are far more difficult to assess. With a prolonged period of low oil prices expected, however, the question now is when oil and gas companies begin spending less on maintenance and health and safety.

Based on past experience (see Figure 1), when this pullback in funding occurs, if it hasn't already, we would expect to see an increase in losses soon after.

LOW OIL PRICES: THE NEW NORMAL?

Signs in the market point to oil and gas prices remaining low for an extended period of time. Analysts at Goldman Sachs have predicted recovery being delayed, with prices staying lower for longer than seen in the past.[3] As a result of this new environment, we are likely to see:

- New projects becoming smaller, cheaper, and quicker. Multibillion-dollar projects are likely to decrease, with more projects falling in the US$50 million to US$100 million cost range becoming more common.
- Exploration drilling projects in new regions such as the Arctic will largely be put on hold, as the cost of extraction versus the market price of oil render this commercially unviable.
- Merger and acquisition activity will likely increase as the number of attractively priced energy assets increase. Although we have yet to see a rise in acquisitions, a high number of deals carried out during past periods of low prices suggest we could anticipate an increase if the low-pricing environment continues.

All of this is happening at a time where the risk environment is high due to the slowdown of high-growth economies, a greater drive towards greener energy production, improved technology reducing consumption, and the prospect of cheap, "easy oil" into the global marketplace.

This has the potential to change the face of the oil and gas industry over the course of the next decade, partly driven by a decrease in risk appetite and tolerance in the market.

INSURANCE MARKET REMAINS UNMOVED

One might expect that, as volatility increases and insurance rates continue to fall, companies would be looking to take additional risk off their balance sheets. However, companies are yet to take advantage of lower prices in a benign insurance market to push for increased protection in uncertain times. With the cost of insurance capital at historic lows, the opportunity clearly exists for companies to access cheap sources of capital from the insurance markets, reduce overall insurance premium costs, purchase insurance in areas that were previously omitted due to cost, and renegotiate coverage terms.

However, buyers continue to purchase largely "traditional" policies, in an attempt to take advantage of the cost savings available from the current soft insurance market, rather than expand the protection they have in place and/or take advantage of new and innovative coverage options. Now would appear the time to transfer risk off their balance sheets before volatility increases.

CONCLUSION

Due to the low price environment, energy companies are shelving and canceling new projects and reducing staff numbers. It may only be a matter of time before companies also reduce spending on maintenance, health and safety measures, and employee training. If this is the case, then, based on past experience, such cuts in spending will lead to an uptick in losses.

If economic predictions come to fruition, it could be some time before we see a let up in low pricing, with oil and gas companies set to face increasing challenges over the next decade. On top of a decreased ability to withstand volatility, new risks are emerging from technological and socioeconomic developments.

Amid this difficult environment, oil and gas companies are welcoming the soft insurance market as one of many means of reducing expenditure. Organizations that take a more forward-looking approach, re-evaluate their risk appetite and tolerance, and use the energy insurance market to transfer greater amounts of risk off their balance sheets will likely be in a stronger position over the longer term.

The next challenge is for the commercial insurance market to respond to the changing demand of energy companies and offer lower retentions, higher limits, and/or increased coverage, in such a way that recognizes the continuing cost pressures faced by the energy industry.

SPOTLIGHT

NEW TYPES OF COVERAGE

There is an opportunity for insurers to be more innovative in the products they are offering in order to generate more interest from energy companies. For example:

- **Cyber**
  The remote use of SCADA (supervisory control and data acquisition) systems in the oil and gas sectors exposes facilities to attack, which is generating increasing concern around cyber risk. However, few policies are offering coverage for cyber risks or the possibility for resulting physical damage.
- **Loss of revenue**
  Policies covering loss of revenue are complex; insurers could develop simplified products to aid insurance buyers for whom this is becoming a growing concern.
- **Other types of cover**
  In addition, some other types of insurance have seen a small amount of increased interest, including:
  - Credit risk, as clients look to protect receivables.
  - Directors and officers (D&O) liability insurance due to fears of litigation and claims from shareholders as profits collapse.
  - Warranty and indemnity policies in association with acquisitions, as assets become more attractively priced.
  - More flexible policies that respond to losses in a more timely manner.

[1] Wood Mackenzie "Deferred upstream projects tally reaches 68", available at http://www.woodmac.com/media-centre/12530462, accessed 26 February 2016

[2] "News in Numbers" *The Chemical Engineer, February 2016* pp.4-5

[3] Goldman Sachs "New Oil Order". http://www.goldmansachs.com/our-thinking/pages/the-new-oil-order/, accessed 26 February 2016

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