MARSH JLT SPECIALTY

THOUGHT LEADERSHIP

Focus on: Onshore Energy Construction

From well pad to plastics with many deviations into civil engineering, power production and many other sub-classes in between, onshore construction is a well-established and specialist insurance market. In this article, we look at the recent market changes and what we may expect in the near future.

The Easy Bit

Once the oil or gas is out of the ground, significant infrastructure is required to treat, transport, process, refine and store either crude, interim or final products. That is where the onshore construction market operates. The roads, pipelines, power, water, accommodation for workers, even the jetty required for export or imports, the list goes on. It is often thought it is far simpler to build something you can see as opposed to drilling thousands of feet below the ground looking for oil or gas, or battling with hydrocarbons in a Force 8 gale right? Indeed it should be.

But of course, as with all things, we have need for progress. That arrives in the shape of building things faster and cheaper and the benefits of that are not just for respective company CEO's and shareholders, but to all of us in our daily lives. Better, cheaper products available to all. Progress is just one factor that changes risk. Along with economic, political, geographic and meteorological issues – every company's risk profile has changed over the last 20 years; the onshore construction market, and the insurance industry, may have miscalculated the risks.

Long-term Nature

The onshore construction market has been in a softening phase since circa 2006. After the tragic events of September 11, insurers saw rate rises, a narrowing of cover and general stability for four or five years. Thereafter, as buyers of insurance, we have seen 13 or 14 years of improving insurance terms and conditions. This article is not about which capacity has redacted its appetite for the onshore construction sector - we know significant capacity has left – but it is about the reasons for its departure and what might occur next.

The complex hydrocarbon projects we typically deal with take time; three to four years and longer is not uncommon. Insurance terms and conditions are set at the outset for the project term, to comply with buyer requirements, lender requirements, contractor requirements and more. Broadly speaking, insurance terms do not change much throughout the duration of a project, though insurers may have some reasonable flexibility to re-underwrite where a policy change is requested. Insurers have been shown their previous errors in the form of unprofitable books of business, they are now faced with a likelihood that they still have three or four years of their incorrect past rating to come to fruition. They are all mindful

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they have to act now. They are all well aware that the promises of change they make to their management, and reinsurers today, will be broken by the tail of the existing projects. In two or three years the insurers, internal conversations between manager and underwriter are likely to go:

Manager: *You said two years ago the market was changing, it would all be better in the future.....and still the losses arrive, and still we lose money.*

Underwriter: *Yes, but it takes time because of the tail, I promise what we have been doing will yield better results in the future.*

You can permutate the next sentence from the manager as you see fit. But, for those who doubt this as a likely conversation, we have seen it all before, circa 2004, well in to the stable market period, and before the underwriting changes enacted two years prior started to alter onshore construction results. We apologise that this is not what we wish to hear – whether we are a client, a broker or an insurer – but being prepared and advised correctly can help you through this.

I told you so…

So what, and where, did underwriters get things wrong? A few of the headline issues underwriters have discovered to their detriment:

1. The insufficient construction premiums of the many were not enough to pay the large losses of the few. That's an easy one, but of course the frequency of small losses also increased. There was always the fear in the latter stages of the softening market that there was nothing in reserve to pay for the overdue, expected big loss that would one day arrive. That day arrived, more than once.
2. Operating costs are too high, investment income too low, reinsurance costs have increased – insurers themselves are inefficient and need to reconsider their models.
3. Modularisation as a risk improvement – Once considered an improvement in risk control by onshore construction underwriters, and rewarded with premium discounts, modular fabrication was seen as a way of performing significant elements of a construction project in a clean, well-spaced and controlled environment. Construction could be started earlier removing on-site bottlenecks and time pressures. All seen as better than the risk factors experienced on the actual site where space/people/environmental logistics can add to the complexity and likelihood of a loss. Undiscovered, an error in a fabrication yard may be replicated many hundreds or thousands of times. When the loss is discovered, often on site, the repair costs may be exponentially expensive as local wage and/or access conditions may result in significantly higher costs than the original build.
4. Corrosion – Long seen as a problem, whether due to stress corrosion cracking or simple rust or oxidation, corrosion claims had become prevalent and expensive. Tighter exclusions are being sought by the market and a focus on paint and coatings is also high on the agenda.
5. Natural Catastrophe (CAT) – construction typically escapes large losses from high profile CAT events. When hurricanes hit or floods arrive, risk management plans perform adequately – and on the occasions they don't, the values exposed are generally low. This no longer seems to be the case. In addition, rising annual costs for CAT reinsurance cannot be passed onto the client (since the premium terms are set for the duration of the project).
6. Defects – Claims for defects and poor workmanship contribute significantly to the insurers' loss ratios, and they are consistent, expensive and not going away from the construction sector any time soon.

Newton's third law of motion – the one about equal and opposite reactions

Elements of the changes may be labelled outrageous, and unfair, but if the market does not adapt, it will not survive creating a bigger problem. New capacity will come in right? Eventually yes. But, while the returns on insurers, capital are good in short tail markets, a loss making longer tail market looks less attractive – so onshore construction is forced to adjust prices, and reduce cover and policy limits. The requirement is for construction insurers to demonstrate a continued improvement in their portfolio performance, and risk selection. The question is for how long, and how much improvement is required?

There has been a lot emanating from onshore construction insurers which causes concern, including:

- COVID-19 exclusions.
- Cyber exclusions.
- Price rises.
- Deductible increases.
- Curtailed sub-limits.
- New corrosion exclusions.
- Reluctance to offer LEG3 coverage (in accordance with London Engineering Group definition).

- Reluctance to offer delay in start-up (DSU) or advanced loss of profits (ALOP) cover.
- Refusal of, or resistance to, period extensions.
- Fewer insurers willing to offer lead terms.

But these issues can be managed so that a project remains bankable, and can proceed with adequate risk transfer in place. Relationships do count, as does a sensible and fair approach to a request for cover.

So what do companies need to do to smooth the process and gain coverage?

- **The smart buyer today will identify what is most important to them** – Is it cost certainty over the entire duration of the project, is it low deductibles, is it the broadest cover or a particular extension of cover you just cannot do without? Prioritise those needs. Then list the wants. You may not get all of the desired, but with a good strategy and the right risk controls in place, you can achieve the 'must haves'.
- **Plan properly** – Approach the market in good time and at good times. A quotation offered the week after a hurricane or big market loss is not going to be viewed in the best light. Sometimes it cannot be avoided of course, but if insurers already had the project in mind before hand, or if you still have many months to go until likely final investment decision or notice to proceed, there is time for the 'unequal reaction' to subdue. You need to make time your ally, not your enemy.
- **Take a sensible approach to the hurdles** – Using an example – you need LEG3 cover. Insurers may try not to offer it. So if it is a priority, the carrot needs to be fatter and the stick shorter if you wish to grab insurers, attention. Maybe full value limits will not exist for LEG3 coverage (we estimate currently there may be circa. USD 750 million of useable probable maximum loss (PML) capacity available for onshore energy projects with LEG3 – as opposed to circa USD2 billion of useable PML capacity with LEG2). Work out what you actually need, the deductible you can really bear and what the contractor, manufacturer or supplier can accept as a contractual obligation either by guarantee or warranty. Be mindful that to tempt insurers to come to the table, the premium loading over LEG2 has increased.

So what is a buyer of onshore construction insurance likely to experience?

- **Price increases** –Whether as increased original premium, or a more significant percentage of pro-rata on extensions, on average prices are increasing and the trend is unlikely to slow until insurer profitability improves.
- **Quotes open for only short periods** –Consider the timing of the works packages and whether 'early work' can be used to bind insurers to a price for the full works package. Are you able to purchase a 'futures option', giving you the right to purchase an insurance programme at a specific set of terms within a set period of time?
- **Automatic extension provisions** –Insurers accept that a project may be delayed; however, when an extension is needed (or when a significant change in risk has occurred) insurers have the ability to adjust policy terms and conditions to reflect current market conditions. If whole term certainty of price is a driving factor for you, insurers will consider that, but it is akin to them offering a lump sum turnkey approach, so you can be expected to be charged for that margin.
- **Lower sub-limits and higher deductibles** – Work with your broker and risk engineers to fully evaluate your requirements. Insurers will curtail offered capacity if their exposure is too great on just one aspect of cover. Think about restructuring your programme and/or reviewing the value of sub-limits.
- **Focus on new technologies or processes** – Continue to ensure you provide comprehensive details, data, and the validation of any new or scaled up processes to demonstrate to insurers you have fully considered all the issues that could arise.
- **Longer response time**s – We have mentioned already that time can be your ally or enemy. Those insurers left trading are now seeing more business and cannot always cope with the volume, especially as additional peer reviews and referrals are included in the process. A period of up to six months should be considered as prudent, and allows for insurer presentations and roadshows. Less is of course achievable, but make time your ally. See the below comments regarding period extensions and bear in mind that operational insurers may have similar issues, so approaches to transfer construction projects to operating programmes will also take longer.
- **Replacement of existing panel of insurers** – For projects placed some years ago, it is possible that an insurer used then is now in run-off, or their security has been downgraded. Run-off does not necessarily mean bad, but run-off markets will not be looking to extend policies, even if obligated to do so. If replacement of an existing carrier is required, allow sufficient time, and provide the relevant information for a new insurer to fully consider offering terms.
- **CAT** –We plot values exposed during each season, and use that to guide the pricing and exposure to insurers. Under current market conditions, it may be worth considering smaller limits in the policy in the early years, and stepping them over time as values increase. Another option to consider is purchasing CAT annually rather than for term of the project, though consideration should be given to the risk of price

volatility this may introduce. Parametric programmes may also be available and, depending on whether or not there are additional assets in the vicinity, the pricing may be applied across construction and operational assets.

- **Exclusions** –Engage your project team with your broker and risk engineers to consider the impact of exclusions, including cyber, COVID, corrosion, paint and coatings, as well as challenges to LEG3. Work with insurers, own engineers. Good insurers would prefer to work with you, and to get fully comfortable with the measures you are taking to fully understand risk, as opposed to applying blanket exclusions.

- **Further capacity reductions** –This may just mean existing insurers look to offer lower capacity per risk than previously, or there may be further withdrawals of insurers from the market. Consider your strategy when placing project coverage.

Be prepared, allow sufficient time, and seek advice from experts and you will be best placed to navigate the challenges of a changing market landscape.

TIPS FOR DEALING WITH POLICY EXTENSIONS:

Fundamental to negotiating the best outcome on any contract change are time and information. The time required to negotiate any contract change has dramatically increased over recent months, meaning early engagement with insurers is essential. Being prepared with a comprehensive explanation of the project status is the best way to approach underwriters - gaps in information often result in higher premium levels.

Bear in mind that onshore construction insurers may not wish to extend the construction policy, and onshore operational insurers may not be able to accept an incomplete plant in to an operational policy.

Your Marsh JLT Specialty team will engage you early in the lead-up to the expiry of your policy, and will look to provide both construction and operational insurers with detailed, current project information.

While each client, and project, is unique, we have summarised below the information generally required for a construction period extension:

Key reasons for the delay:

- Effects of COVID-19 shutdown or delay.
- Changes in the original scope of work or material change in risk (variation orders, etc.).
- Current status of the project/works currently completed.
- Detailed description and value of remaining works, have any testing periods been exhausted?
- Detailed timeline and Gantt bar chart for the remaining works.
- A realistic anticipated project completion date. Avoid extending the policy for very short periods at a time if, in reality, the project will not be completed; DSU can complicate this.
- Confirmation of no known or reported losses, or up to date details and status of known losses/incidents.
- Details of any proportion of the project which may have been handed over or put into commercial operation.
- Confirmation of policy sums insured/contract value to ensure that they are still current.
- Copy of the latest progress report or, if available, a copy of the latest risk management report undertaken by the lead insurer or Marsh JLT Specialty Risk Engineer.
- Status of loss prevention recommendations highlighted in previous risk engineering reports. If not implemented yet, an update on the proposed plan.

If DSU/ALOP cover is purchased, has a physical damage claim caused or contributed to the delay? If so:

A. You should be aware that by extending the policy you may be removing the opportunity to make a DSU claim until the newly declared completion date(s) is reached. Indemnity will start from the newly declared completion date(s)!

B. If you have a situation where one or more claims could have contributed to the delay, then discuss in good time with your broker – if it is ‘late in the day’,

it’s more challenging to resolve. Does the DSU section require reinstatement?

C. Consider carefully the information you need to provide if you have multiple completion dates.

INTRODUCING MARSH JLT SPECIALTY

We are specialists who are committed to delivering consulting, placement, account management and claims solutions to clients who require specialist advice and support. We consider problems from every angle and challenge the status quo with entrepreneurial ideas and solutions.

Our Marsh JLT Specialty global team is united by a determination to bring the most experienced and relevant specialist resources to our clients, regardless of where in the world they are located. This approach means our local specialists work seamlessly with global experts, together creating and delivering tailor-made risk and insurance solutions which address each client's unique challenges.

Our service offering is enhanced with insight-driven advice supported by tailored data, analytic and consultancy capabilities to support clients in making important decisions about their complex risks.

Exceptional service combined with transparency, integrity, and accessibility underpins our partnerships with clients.

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