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US ENERGY MARKET UPDATE REPORT

WINTER 2023/2024

Headlines:

- Natural disasters diminish capacity and propel insurance rate hikes across the energy sector. Wildfire risks loom large over the solar industry.
- Inflationary pressures on property damage losses have resulted in further increases in rates.
- Insurers expect energy sector clients to enhance risk mitigation measures.
- In addition to technological advances, regulatory policies are creating more confidence in the future of renewables.
- Underwriters are expanding their appetite and embracing the transition to cleaner sources.

OVERVIEW

Natural catastrophes remain a major threat

The renewable energy sector in the US is experiencing a tailwind in adoption with increased regulatory assistance as the country moves towards cleaner fuel sources. However, headwinds are also present. A significant concern revolves around the impact of natural catastrophes and major weather-related events on the US energy sector.

While the upsurge in the frequency of natural disasters has a direct and significant impact on the renewables sector, non-renewables are also affected due to the overall curtailment of insurance capacity and the raising of rates and premiums.[1] The trend remains pertinent to all renewables, although it appears to exert a more substantial influence on the solar sector due to the heightened damage impact in the event of a natural catastrophe.

Wildfire risk looms over solar

A particular challenge for the solar sector is the necessity for expansive land areas to accommodate solar panels and related infrastructure. In many cases, cost-effective land options for solar installations coincide with natural catastrophe-prone regions or less desirable locations where conventional development is less favored, often in rural and vegetated settings. These locations can face increased wildfire hazards, and the risks can be compounded by the fact that these installations are often unmanned. With a growing consensus that the **wildfire risk is spreading nationwide,** underwriters are rethinking how they approach coverage.

> "The impact of these natural disasters has contributed to the reduction of **available insurance capacity while simultaneously driving up insurance rates.** Influenced by this, we are observing an influx of new entrants into the market attracted by more favorable pricing and better terms and conditions.
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> Moreover, insurers are now looking for continuous enhancements in energy clients' risk management programs and ongoing mitigation strategies year after year. If clients are merely maintaining the status quo without noticeable risk mitigation improvement measures, this no longer aligns with insurers' expectations."
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> **Michael Hogue, Managing Director**

Premiums for energy clients continue to rise albeit at a slower pace

Property, general liability, and umbrella premiums for energy risks increased again in 2023, however, at a lower level compared to a year ago. Property rates for energy related risks without high hazard CAT exposure and with favorable loss history are presently seeing 5%–7% rises in rates compared to 10%–15% or more in 2022.

General liability rates for energy risks increases are more moderate and in some instances flat compared to 5%–10% increase in 2022. Umbrella rates have increased approximately 10%, also a smaller increase than those seen in recent years. Underwriters have a continued focus on risk quality and risk improvements, as well as reducing capacity as a tool to manage risk.

Navigating the impact of catastrophic losses

Traditional thermal and wind energy products in the US have demonstrated resilience during catastrophic storms. This is evident from severe 2023 storms in Florida, which left utilities relatively unscathed, highlighting the robust nature of these substantial industrial projects.

However, it is crucial to consider the full insurance landscape. Even where specific energy projects do not suffer losses due to a natural catastrophe, the insurance industry as a whole has to bear significant natural catastrophe losses. Therefore, if insurance companies face losses in personal lines or less robust and more exposed facilities, **they must recoup these losses through premium volume.** This situation has tangible effects on rates and capacity constraints.

CHANGING DYNAMICS AND NEW CHALLENGES

In the renewable energy sector, tax equity sponsors often **demand full replacement value in terms of coverage to address the risk of tax credit recapture if a damaged asset is not rebuilt to 100% value.** However, this demand clashes with the financial constraints of owners and operators, leading to a critical issue in the sector. **Accessing full coverage remains a challenge in the marketplace.**

Inflationary pressures affecting insurer capacity

In addition, property loss costs have witnessed **significant inflationary pressures,** resulting in property claims costing significantly more than five years ago. The shift from a soft market (one characterized by abundant capacity) to a hard market has led clients to more quota share structure with many underwriters sharing the risk versus single carrier programs due to reduced capacity and a more conservative underwriting appetite, **putting upward pressure on rates.**

Regulatory measures catching up with renewables

The **Inflation Reduction Act** provides long-term stability for the US renewables sector, creating more confidence in the future of clean energy. The act promises USD369 billion of federal incentives, loans, grants, and tax credits, and paves the way for private investment to play an even more significant role in funding new projects and companies. The benefits are already kicking in for wind and solar, setting the stage for emerging technologies, including battery storage, biofuels, hydrogen, and carbon capture.

This legislation also established the **Energy Infrastructure Reinvestment** program within the Department of Energy. It will provide loan guarantees to initiatives aimed at revitalizing, renewing, repurposing, or substituting energy infrastructure that has been rendered obsolete and support projects enabling currently operational energy infrastructure to curtail their greenhouse gas emissions.[2]

Current economic feasibility concerns for offshore wind

Although regulatory developments aim to further the cause of renewables, some hurdles remain. Offshore wind energy has enormous potential but has seen recent complications amid uncertain economic conditions. Winning bidders in this sector are now raising concerns over the financial viability of certain projects, citing challenges such as higher financing costs, inflation, and supply chain disruptions. In the near term, some projects are working through requests for renegotiation due to threats of cancellation. However, offshore wind energy projects on the East and West coasts remain a key part of longer-term US energy goals.

Supply chain hindrances for green hydrogen

The Inflation Reduction Act offers new incentives promoting low-carbon hydrogen and liquid fuels and other low greenhouse gas (GHG) emission technologies. The Investing in America agenda is pushing hydrogen hubs to kick-start a national network of clean hydrogen producers, consumers, and connective infrastructure while supporting the production, storage, delivery, and end-use of clean hydrogen. This adoption has brought a new set of obstacles, particularly in midstream infrastructure, where trucks are currently used for fuel transportation. A factor for long-term success is the installation of pipelines to transport this eco-friendly fuel.

"Gallagher is playing a key role in addressing climate-related risks. What's "insurable" is changing with expanding underwriting appetite and the creation of new risk-transfer products to support clean energy innovation. In addition to standard property and casualty coverages, we arrange specialty programs that facilitate project development including technology performance guarantees, tax credit insurance, and alternative risk transfer solutions."

Stefan Szulc, Executive Director

Oil and gas demand remains high as operators navigate the changing landscape

Oil and gas is well capitalized and the dominant source of energy, both domestically and worldwide; however, the mix of fuels used going forward is shifting to cleaner, lower-emission alternative products. Despite climate goals and an increasing push to phase out fossil fuels, oil and gas demand remains high and accordingly US production is not expected to fall in the near term. In fact, US oil production reached record levels in Q4 2023, eclipsing 13.3 million barrels per day, with current production volumes expected to be maintained, if not slightly increased, during the upcoming 12 month period.

During the post-COVID-19 period, major oil companies shifted focus from the growth strategies which characterized the shale boom to value harvesting strategies, which proved highly successful. The resultant balance sheet strength amongst the companies successfully navigating the prior 3 year period has seen M&A activity increase, as several large operators made multibillion-dollar transactions adding acreage positions and expanding reserves and production.

At the 28th United Nations Climate Change Conference (COP28), participants made a historic agreement to cut future CO^2 and methane emissions and contribute to a global transition effort away from fossil fuels by 2050. The outcome of COP28 appears to constitute an inflection point for the oil and gas industry. As much of the developed world appears united in the stated goal of "phasing down" the use of fossil fuels in coming years, increased regulatory headwinds are certain to challenge the oil and gas industry. While much of the near-term focus will likely surround coming regulations, we expect those same regulations to yield opportunities for companies to pioneer more environmentally friendly methods of operating. Some fossil fuel giants fear a scenario of "stranded assets" in which they have access to fossil fuel resources but can't burn or sell them, are investing in carbon removal technologies. As the road to a renewable dominated energy economy will surely be long, the oil and gas industry will remain a key pillar of the US and world economy.

Parametric and captives: A shifting landscape with alternative solutions

Parametric and alternative risks associated with captives have gained traction and now have a growing presence within the US. Insurance underwriters have embraced the new shift and broadened their appetite to capitalize on it. We explore all coverage options to address complex insurance challenges, including alternative capital solutions. Neglecting these nontraditional emerging products means running the risk of not considering the potential best option for clients in this evolving landscape.

D&O SEES INCREASED COMPETITION AS PREMIUMS FALL

The third quarter of 2023 has seen the Directors & Officers liability insurance market remain highly competitive, with the influx of significant new capacity in recent years continuing to exert downward pressure on D&O premiums. The primary D&O market exhibited greater stability compared to the hyper-competitive excess D&O market.

Greater scrutiny for companies with high leverage

For publicly traded companies, renewals varied from remaining flat for smaller premium renewals to experiencing a substantial 20% reduction in premiums, on average, for larger renewals. Notably, recent IPOs and SPACs/de-SPACs witnessed premium slashes well exceeding 20% in most instances. D&O underwriters are now focusing on cash flow and assessing exposure to potential interest rate changes. There is also greater scrutiny of companies with high leverage regarding debt refinancing.

"In the case of large private companies with revenues exceeding USD1 billion, the private company D&O market has posed challenges. However, there was greater competition for this segment. Renewals for such large private companies have remained relatively stable, but those with significant premiums have experienced double-digit decreases through comprehensive marketing of the renewal.

Smaller D&O renewals have remained stable, although competition has heightened as carriers that previously targeted larger premium renewals have expanded their willingness to underwrite smaller premium renewals."

John Ergastolo, Area Executive Vice President, Executive and Financial Risk

Gallagher market data for Q3 in the energy sector shows a median premium reduction of 11% for public companies and generally flat for private companies. The overall trend for D&O premiums should continue its current downward path for the foreseeable future, and we expect 2024 to be another competitive year for the D&O market.

INSURERS PREPARE FOR POTENTIAL SHIFTS AS REGULATORY CHANGES LOOM OVER CYBER

In cyber insurance, many sectors are experiencing a period of stabilization after enduring three years of a hardened market. This shift has brought about changes in underwriting strategies, particularly in sectors vulnerable to advanced persistent threats (APTs) orchestrated by nation-states. Among those, the energy sector stands out as a primary target for such advanced attacks, resulting in heightened scrutiny from insurance providers.

While some sectors are witnessing a trend of rate decreases, the energy sector, although commonly facing reductions, is often confronted with small-to-moderate rate increases. This dynamic reflects the unique challenges and risks associated with the energy industry, necessitating a balanced approach in determining insurance premiums.

"The energy sector sits on the precipice of potential regulatory changes that could significantly impact its cyber insurance landscape. The US National Cybersecurity Strategy is paving the way for minimum cybersecurity standard requirements, urging industries, including energy, to adhere strictly to established frameworks such as the NIST's Cybersecurity Framework and CISA's Cybersecurity Performance Goals.

Additionally, there is a possibility of even more robust frameworks being mandated by its Sector Risk Management Agency, which is the Department of Energy. This regulatory landscape may reshape how insurers assess risk in the energy sector, perhaps leading to a reevaluation of underwriting practices and ensuring that policies align with evolving cybersecurity standards. This would help to safeguard the sector against cyberthreats and vulnerabilities."

Joey Sylvester, Area Senior Vice President

ENVIRONMENTAL PRESSURES ON BUSINESSES AND INSURERS

Environmental awareness and expectations are likely to exert significant pressure on businesses to adopt eco-friendly practices, driven by client demands and the insurance sector, with insurers taking precautionary measures to avoid endorsing actions that could harm the planet.

A tougher regulatory stance is forming towards non-renewables

Governmental authorities, climatologists, and advocacy groups are actively working to introduce more stringent regulations and barriers for traditional energy sources, particularly fossil fuels. These developments in the market have ensured that environmental considerations are now of paramount importance within the oil and gas sector.

Impact of the Inflation Reduction Act and Bipartisan Infrastructure Law

In August 2023, the Office of Policy in the US Department of Energy issued a report that explores the effects of the Inflation Reduction Act and the Bipartisan Infrastructure Law on the US energy landscape and emissions reduction efforts. The report highlights the potential impact of specific provisions aimed at stimulating domestic clean energy supply chains. It projects that these facilities will produce significant changes, including the potential deployment of around 250 GW of new wind power, up to 475 GW of new solar energy capacity, and the production of approximately 14 million new light-duty electric vehicles between 2022 and 2030.[3]

The report also notes that the US power sector could be the primary driver of emission reductions up to 2030, primarily due to the significant expansion of clean energy sources. The influx of tax incentives and substantial investments in infrastructure projects are expected to usher in numerous opportunities for modernizing and enhancing the reliability and resilience of energy systems across the US.

> "The SEC is set to release proposed rules for greenhouse gas emission accounting and disclosure by April 2024. A major issue that stands out is the disclosure of Scope 3 emissions, which are indirect emissions in a company's value chain. It is expected that the SEC's rules will align with international standards like the International Sustainability Standards Board (ISSB) and the Task Force on Climate-Related Financial Disclosures (TCFD).
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> However, there is uncertainty over factors such as the required independent assurance and adaptation timelines. Many companies are now gearing up to align with the ISSB and the Global Reporting Initiative (GRI), improving data capture systems for smoother reporting."
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> **Lisanne Sison, Managing Director**

Economic viability driving renewables in the US

The industry is experiencing an increased demand for green and renewable energy options, which has drawn new market participants and insurers prepared to take on the risks associated with renewable energy.

> "Several factors are driving the growth of greener energy options. ESG considerations and the Inflation Reduction Act are shaping the industry's macro trends with a significant array of incentives to promote investment in renewable energy projects.
>
> The primary impetus for businesses to develop in this area is the increasing economic viability of renewable energy technologies. It is essential to recognize that without the long-term financial feasibility of these projects, incentives alone would not suffice to stimulate their construction."
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> **Michael Hogue, Managing Director**

WHAT TO EXPECT AS THE INTERNET OF THINGS (IOT) AND AUTOMATION EVOLVE

The energy sector in the US is currently witnessing a shift towards **proactive loss control strategies,** especially within the oil and gas industries. Insured entities are increasingly embracing various technological measures to preemptively mitigate potential losses, such as adopting IoT, a network of "smart" devices that collect and share data, and automation on drilling rig floors where significant innovation is underway.

These advancements aim to enhance safety standards for personnel and assets, and represent a substantial leap forward in risk management. Still, it is crucial to acknowledge the challenges accompanying the integration of IoT solutions. Implementing such technologies brings a range of issues, including cybersecurity concerns that necessitate careful consideration.

CONCLUSION

Overall, the US energy market is undergoing significant transformations driven by various factors, such as natural disasters and wildfires, which have reduced insurance capacity and increased rates, attracting new entrants seeking more favorable pricing.

Meanwhile, underwriting practices may be reevaluated as the energy sector also faces potential regulatory changes, especially in cybersecurity, to align with evolving standards. Insurers are also demanding continuous improvements in clients' risk management and mitigation strategies.

The growth of greener energy options has gained traction with the increased significance of ESG considerations and incentives such as the Inflation Reduction Act. While the economic viability of renewable energy projects is the key driver, underwriters are adapting to the changing landscape and venturing into the renewable space to maintain market share. The industry is now poised for further evolution, balancing economic feasibility, regulatory compliance, and risk management strategies.

Gallagher is perfectly placed to share the knowledge gained through our extensive expertise in the US and global energy sectors. Our strategic prowess is instrumental in meeting customized needs and working closely with insurance partners and risk managers to achieve collective goals.

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Citations

[1] "Billion-Dollar Weather And Climate Disasters," National Centers for Environmental Information, November 2023.
[2] "Building A Clean Energy Economy Guidebook," Clean Energy Innovation and Implementation, January 2023.
[3] "Investing In American Energy," U.S. Department of Energy Office of Policy, August 2023.