LEGAL & FINANCE

FIVE TIPS EVERY RISK MANAGER IN THE ENERGY SECTOR SHOULD BE DOING TO ADDRESS FALLING OIL PRICES

By: John D. Collado, CEO, Southwest Regional CEO at USI Insurance Services.

If the sharp drop in oil prices persists, the slowdown in economic activity could spill beyond the reeling energy industry and possibly outside affected oil-producing states. Currently, oil and gas companies, as well as steelmakers, local banks, construction firms, and the real estate markets in such oil towns as West Virginia and other oil producing regions, are taking the direct brunt of falling oil prices.

The oil and gas companies and related support industries borrowed heavily on the assumption that oil would remain close to $100 per barrel – it is now more than 50% below that projection, wiping out billions of dollars in actual and projected value.

These falling oil prices have been placing greater pressure on risk management in the energy sector often requiring CFOs to justify current insurance program limits and premium spending. While much has been written about these potential market changes, there hasn't been many articles focused on solving the specific risk challenges the energy industry is facing.

The following are five recommendations that risk managers in the energy space can employ to address current financial concerns.

Contract Review – Risk managers working in oil and gas companies should ask their broker or insurance carrier to conduct a comprehensive evaluation of their contract including their vendor, and lease contracts. The review helps to determine if indemnification language and insurance limit or deductible requirements align with existing coverage, company's risk appetite and its financial capacity. Through this process companies are able to avoid uncovered claims for risks they are unknowingly taking on via contract language. For example, USI evaluated the insurance program of a global manufacturer of pipes and fittings for oil and gas companies and discovered why the company was having difficulty attracting vendors to sell their products – the existing contracts did not contain the additional insured vendor endorsement to protect vendors from product liability claims. The addition of this endorsement was negotiated, which ultimately eliminated and clarified liabilities and further helped the company increase sales by 20% or $16 million.

Classification Review – As risk profiles change along with business models, it is important to have the tools in place to review general liability classification codes to identify potential errors and reduce premium cost to reflect such changes. Properly classifying employees for worker's compensation, revenues for general liability, and vehicle types for auto liability has an immediate impact on what a company pays in premium for these standard coverages.

Exposure Review – Probabilistic models provide clients a clearer picture of potential risks and possible financial impact. By conducting a thorough review of insured values for properties, business, and general liability, a company can more accurately identify potential exposures and thereby mitigate risk and reduce cost.

Collateral Review – Reviewing collateral requirements and subsequent elimination of collateral can directly increase a company's lending capacity and help improve a strained balance sheet.

Loss Forecasting – By collecting and analyzing currently valued loss experience and historical exposure data, risk managers can determine the future ultimate cost of open claims and expected losses for the next three to five years. This process would allow an energy company to determine the most capital efficient deductible or retention structure for their insurance programs. As oil and gas companies experience revenue declines it is extremely important that they know the liabilities they may face in the future.

Risk Management – Companies restructuring or involved in M&A will want to have access to competitive markets for D&O, errors & omissions, credit insurance, environmental coverage, employment practices liability insurance and representations, and warranties insurance. Reducing exposure to loss directly translates to current or future liabilities, and it is critically important to minimize exposure to possible successor liabilities in M&A activity.

Goldman Sachs estimates that $2 trillion-worth of future investments in projects such as shale developments will be foregone as more companies announce plans to cancel or postpone drilling projects. Declining revenue, massive layoffs, consolidation and D&O litigation brought on by increase bankruptcy filings are all very real issues the oil and gas industry is facing. And, it is not only affecting the likes of Exxon and Caterpillar, both of which suffered sharp declines in fourth-quarter profits, but small and midsize firms are feeling the pinch even more. However, by integrating this five-step guideline into a company's strategy, risk managers can take important steps toward reducing risk, saving on premium spending and ensuring the efficient use of capital is made. Partnering with a savvy broker is critically important to ensure you are properly protected in the face of falling oil prices.

John D. Collado is Southwest Regional CEO at USI Insurance Services. John has more than 35 years of experience specializing in complex risk consulting across the energy and finance sectors and currently oversees operations and strategies across twelve Southwest offices and more than 500 professionals. The above recommendations are based off of a holistic, risk management approach known as USI ONE™ which uses proprietary analytics technology and local and national resources to solve business challenges. Email John at: John.Collado@usi.biz. For more information about USI or the USI ONE, visit www.usi.biz.