Energy Companies: Factors to Consider when Buying Catastrophe Insurance Coverage

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Natural catastrophes pose especially daunting risk management challenges to energy companies. Energy companies frequently are complex enterprises that often have high concentrations of property values in catastrophe prone regions. They tend to be interconnected with other companies in the energy sector with similar catastrophe exposures so that a single event can cause havoc throughout the supply chain. Some types of energy companies are vulnerable to liability suits following a natural catastrophe.

Although a few large companies substantially self-insure at least some portions of their catastrophe exposures, insurance is a critical component of the overall catastrophe risk management program for the vast majority of energy companies. In addition to insurance of physical property, various types of time element coverages such as business interruption, contingent business interruption and extra expense coverages are essential to most firms. Some companies, especially those that produce, refine, store or transport crude oil and refined petroleum products, may need environmental liability coverage that responds to a release caused by a hurricane or earthquake.

The following questions will help assure that energy companies have purchased enough of the correct coverages in a well structured insurance program to meet their catastrophe insurance needs.

Has all physical property been fully accounted for and correctly valued?

It may be trivial to note that companies need to identify property in order to insure it, but accounting for assets has proved to be a challenge for many energy companies. M&As, for example, often result in property being left off schedules. Valuations can shift quickly in some sectors of the energy industry, so the value of assets should be reassessed on a regular basis. Even if a company self-insures, the rigor of process in identifying and valuing assets is a highly beneficial risk management exercise.

Have all catastrophe exposures been identified and quantified, and the appropriate insurance coverages purchased?

Some energy companies may be principally exposed to, for example, windstorm, but also may have earthquake and flood exposures that need to be addressed. Flood and earthquake coverage typically are purchased in addition to standard property coverage. Regardless of the peril, almost all energy companies need to purchase a package of time element coverages, which likely will include business interruption, contingent business interruption and extra expense protection.

Are retentions or deductibles appropriate to the company's financial strength, liquidity and risk appetite?

Some companies are satisfied with setting deductibles and retentions using heuristics such as retaining losses equal to a one-in-four-year storm, but others may wish to decide how much risk to retain based on modeling the impact of various catastrophe scenarios on the company's balance sheet and income statement. Computerized catastrophe models may be helpful in testing retentions and deductibles.

In addition to deciding how much risk they wish to retain, energy companies need to consider the premium surcharge or savings associated with either decreasing or increasing retained losses.

Have business interruption values been fully and correctly quantified?

An energy company usually needs to consider a wide array of variables to be certain that the calculated business interruption (BI) value is the best estimate of the company's future earnings. A critical factor in establishing adequate BI values is a realistic assessment of how revenues and expenses will change over the coming year. This can be highly variable and contingent upon difficult-to-forecast factors in some segments of the energy industry, especially those with revenues dependent upon constantly shifting energy-related commodity prices. The period of time it would take for the business to recover after a major loss event is also an important consideration in setting BI values. In the aftermath of a large natural catastrophe such as an earthquake or hurricane, limitations on labor, materials and infrastructure services can slow the recovery process.

Have supply chain vulnerabilities to catastrophes been identified, quantified and addressed?

Suppliers, service providers and customers in catastrophe exposed regions can lead to significant supply chain risk management challenges and contingent business interruption exposures for energy companies. In some sectors of the energy industry, large segments of the supply chain may be concentrated in the same catastrophe exposed area, with a single event potentially causing major disruptions up and down the chain. Supply chain vulnerabilities need to be identified and appropriate contingent business interruption insurance purchased. All "dependent property" should be identified and listed in the policy to facilitate claims settlements and maximize recoveries.

Are appropriate and adequate liability coverages in place to respond to any third party liability claims that may follow in the wake of a major natural catastrophe?

Some segments of the energy industry are vulnerable to lawsuits following a natural disaster. A number of oil companies, for example, were sued following Hurricane Katrina, with Murphy Oil paying $330 million to settle a suit over a spill from an oil storage tank at the company's Meraux refinery near New Orleans. Liability insurance should be considered part of the overall catastrophe insurance program.

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