

# Insight to Action

Liberty Mutual Insurance | Energy

## Energy Companies and Oil Price Volatility:

Identifying and Managing Risk in a New World



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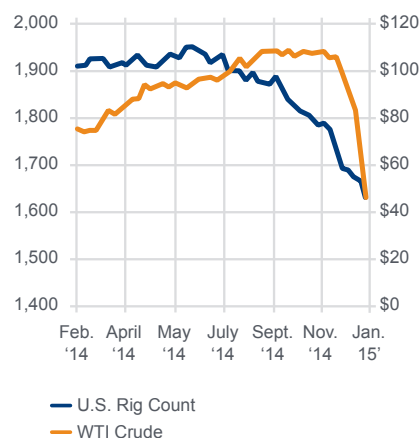
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### Areas affected by changing oil prices:

- Workforce
- Maintenance
- Contractual liability
- Mergers and acquisitions
- Risk financing

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### Volatility in the Energy Industry



Oil prices and producer contracts for rigs showed volatility and a precipitous drop in 2014 to 2015 — energy companies need to fine tune their risk management programs to protect against the risks of the new market.

The domestic oil market and volatility go hand in hand. Cycles of boom and bust — some lasting years, others decades — punctuate the history of domestic oil production as supply and demand respond to new technologies, evolving political landscapes, and other critical developments.

With each new cycle, upstream and midstream oil companies should partner with their insurance brokers and carriers to refine risk management programs so that they continue to protect their employees, the public, and, ultimately, their bottom lines.

Today, the domestic oil market is turning from boom to a new era of volatility. Horizontal drilling and hydraulic fracturing have dramatically increased domestic supply. This overproduction combined with lower global demand continues to put downward pressure on prices and revenues in the industry. As a result, from Houston boardrooms to field offices in the Bakken, many oil companies are working with their insurance partners to understand and adjust to the five leading risk management implications of this new market.

### Areas affected by oil price volatility

#### Workforce

As rig counts and revenues drop, companies are forced to downsize their workforce. Here are a few risk management solutions to help energy companies reduce the inevitable risks associated with downsizing.

**First**, if the company is able to select the employees it will keep — given applicable employment law and union contracts — factoring an employee's safety record into the hiring and retention process will help build a workforce committed to safety and one more likely to deliver financial benefits.

**Second**, it's important to consider how the oil company will retrain the remaining workforce. Having fewer employees will likely require retraining to meet new and broader job demands. Giving employees the knowledge needed for their success will directly impact the growth, safety, and profitability of the company.

**Third**, in the past, employers have noticed that imminent layoffs can give rise to a flood of workers compensation claims. Key activities to minimize this risk range from documenting all workplace injuries quickly to confirming during the exit interview that departing employees were not hurt on the job.

#### Maintenance

The new oil market will impact equipment maintenance, which clearly has risk management implications. Onshore oil extraction involves complex equipment and the consequences of equipment failure are high. Poor maintenance of a drilling rig or high pressure fracturing iron is potentially a severe hazard. As equipment is recalled from the field, careful steps must be taken to maintain and store it properly.

Production equipment in the field must also be carefully maintained. Equipment certification is an example of the challenge of proper maintenance in the new market. High pressure equipment — like the fracturing iron — requires certification to American Petroleum Institute Standards. Often, oil companies outsource recertification to a certified professional who understands the standards and proper testing techniques. Bringing equipment certification in-house may open the door to new exposures and potentially cost more in the long run. Maintenance must be a priority as the company reorganizes to compete — even survive — in the new market.

## Five Leading Areas of Impact

<b>Workforce</b>	<ul style="list-style-type: none"><li>■ Factor an employee's safety record into the hiring process</li><li>■ Retrain employees to meet new and broader job demands</li><li>■ Document workplace injuries and conduct exit interviews</li></ul>
<b>Maintenance</b>	<ul style="list-style-type: none"><li>■ Take careful steps to properly maintain and store recalled equipment</li><li>■ Outsource recertification of field equipment to a certified professional</li></ul>
<b>Contractual Liability</b>	<ul style="list-style-type: none"><li>■ Understand if renegotiated contracts shift liability from operator to contractor</li><li>■ Be aware of the liability you're assuming in renegotiated contracts</li><li>■ Adjust risk management programs in light of new exposures</li></ul>
<b>Mergers and Acquisitions</b>	<ul style="list-style-type: none"><li>■ Understand legacy liabilities and lawsuits</li><li>■ Analyze why companies are selling their assets</li><li>■ Learn their ownership structure including hidden investors</li></ul>
<b>Risk Financing</b>	<ul style="list-style-type: none"><li>■ Conduct analysis comparing cost savings against the risk of greater exposure</li><li>■ Consider new financing structures including lower deductibles or guaranteed cost programs</li><li>■ Lower excess limits or eliminate certain coverages</li></ul>

### Contractual Liability

As oil prices fluctuate, renegotiating contracts between oil field service providers, operators, and supporting contractors can help reduce costs, but also result in shifting liability. All parties involved should understand how renegotiated contracts can unexpectedly shift liability. Typically, oil field managing service agreements include “knock-for-knock” provisions that specify each party assumes risk for the equipment and personnel it brings to the site, and indemnifies the other parties from such liability.

In a similar way, contractors in higher-demand specialties — such as horizontal drilling and hydraulic fracturing — historically have been able to include more favorable wording in contracts, placing exposure to subsurface damages and pollution with well operators. As fewer wells are drilled and completed, well operators may push contractors to assume more liability through new or renegotiated contracts. Contractors should be fully aware of the liability they assume in such contracts, and adjust their risk management program in light of these new exposures.

### Mergers and Acquisitions (M&A)

Any downturn in the oil industry sparks a wave of M&A. Midstream assets, such as pipelines, have become a target of recent acquisitions. Proper due diligence is critical for successful M&A, particularly since many pipelines are older and prone to leaks, which may go undetected for long periods. Buyers must understand any legacy liabilities — such as slowly emerging environmental damages — and lawsuits. In addition, it is prudent to analyze why the company is selling the asset and learn the ownership structure, including potential hidden investors.

### Risk Financing

Many in the oil industry — from shale drillers to large servicing companies — borrowed extensively to capitalize on the boom. In fact, the boom was largely driven by expensive technology that allowed horizontal drilling and hydraulic fracturing. Highly advanced — and costly — drilling rigs made extraction possible from formerly played-out fields and uneconomic geographies.

Overleveraged companies may face a challenge securing collateral for certain risk transfer program structures. As buyers, brokers, and insurers partner to fine tune risk management programs in light of the new market, they should consider other potential structures.

Lowering deductibles or shifting to a guaranteed cost program may reduce collateral requirements and eliminate cost uncertainty. Similarly, a company may seek to lower excess limits or eliminate certain coverages, given the new economic realities. Both of these strategies may be effective options, but only after detailed analysis that compares any cost savings against the risk of greater exposures.

Oil companies face a new market ripe with opportunities and exposures. In successfully navigating this new reality, they should partner with their insurance brokers and carriers to help fine tune their risk management program to effectively protect the company.

For more information, please contact your Liberty Mutual territory manager, account executive, or underwriter today.

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## Liberty Mutual Insurance

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