**Commodity Prices, Political Risk and Regulatory Changes Driving Demand for Risk Management in Energy Sector**

Commodity price risk, political interference along with regulatory/legislative changes are keeping risk managers in the energy sector awake at night, according to Aon’s Global Risk Management Survey. The report also indicates that this uncertainty and an increased focus from regulators are the most important external drivers to strengthen risk management within energy organisations going forward.

Peter Vermaak, Business Unit Head: Corporate at Aon South Africa says today's energy environment is impacted by a wide range of risks, and the ability to manage them effectively is critical to success. Those who have the tools and resources to make more informed risk decisions will produce better results for stakeholders.

**Environmental Regulatory Focus**

Regulatory focus in the mining industry is forcing the mid-tier mining sector to find innovative ways to economise and deal with operational constraints and project delays. The regulatory focus centres on health, safety and environmental issues, particularly the remediation of environmental damage.

“South African law requires mines to make financial provision for ongoing environmental rehabilitation and the environmental costs associated with mine closure - this is creating one of the biggest challenges facing mining companies today. The Mineral and Petroleum Resources Development Act (MPRDA) stipulates the requirements for making financial provision for the remediation of environmental damage. Closure costs for mine rehabilitation are based on the Department of Minerals and Energy’s prescribed master rates with the application of CPIX. This method of calculation can bring about shortcomings in the provision which will be for the account of the mining company even though the prescribed guarantee amount was provided. The use of an insurance based costing provision and annual policy review can ensure more accurate calculations that can reduce the risk of funding shortfalls,” explains Peter.

Provision for closure cost was initially made using four different methods as specified by the MPRDA:

* Cash deposit into an account specified by the Director General.
* An approved contribution to a trust fund as required in terms of the income Tax Act.
* A financial guarantee from a bank approved by the Director General.
* Any other method as determined by the Director General.

The methods most favoured by mid-tier mining companies were guarantees issued by either banks or insurance companies. “But during the first quarter of 2009, the DME suspended the practice in which mining companies obtained environmental rehabilitation guarantees from insurance companies. The reason provided for this is that insurance products expose the DME to guarantees not being honoured because the mining company did not comply with the policy conditions. This currently only leaves the first three options open to mining companies with the further exposure of inaccurate calculation of closure cost.”

Environmental insurance has had to evolve over the years largely in response to the key pollution exclusions from general liability programs which left companies and operators effectively uninsured for environmental risks. These exclusions were mirrored in the South African insurance industry and Europe. Generally the only cover obtainable has been sudden and accidental pollution arising from an indemnifiable event. Competent financial officers and risk managers would have provided for unforeseen events which fell outside of the available cover in the insurance market, but even so, providing adequately for an unquantifiable risk may prove a challenge.

“Regulation for mining concessions were only granted having provided Environmental Guarantees for restoration plan, abandonment and mine closure, which recently in itself is proving to be a challenge due to Regulators objections as discussed before. The recent regulatory activity in South Africa has increased exposure and strengthened implementation of actions that can be taken by the authorities.

“These international and South African trends have led to today’s active and growing environmental insurance market bringing relief for financial officers and risk managers. Environmental Insurance policies contain limitations on the maximum amount of a judgment payable under the insurance contract. Further, the cost of defence, supplementary payments, and punitive damages are covered,” explains Peter.

To summarise, environmental insurance programs provide the following main heads of cover and in all cases include gradual pollution:

* Third party property damage including claims for any consequential loss of value and business interruption;
* Third party bodily injury;
* Action by the authorities against the insured, including any clean up where required or directed;
* Cover in relation to insured loss and damage for directors, officers and employees.

Environmental Guarantees for the restoration plan, abandonment and mine closure is based on expected clean-up costs to restore the environment following mining activities. Unfortunately cost overruns are very possible, for example ever changing environmental laws may place further responsibilities on the mining industry. The environmental insurance can be extended to cover remediation cost cap programmes which attaches above the expected clean-up costs. The mining industry is more susceptible to certain incidents’ which could pollute or impair, such as:-

* spills of gasoline, diesel, oil, lubricants, curing compounds and the like during mining operations and over time causing on and off-site soil and possible groundwater contamination;
* dust and air emissions gradually causing harm to human health or damage to the environment;
* allegations of contamination of the water supplies from operations and associated legal defence costs;
* off-site disposal of wastes and debris including tailings;
* discovery of unknown soil and/or ground water contamination.

“Worldwide, companies with similar operations are increasingly taking up the option to purchase a specific environmental program supplementing and complementing their ‘normal’ general liability insurance program, but for the mining sector this insurance is a must.”

**Increased Political Risk from State Intervention**

Oil multinationals are facing increased political and economic risks as governments readdress the balance of power by taking more control over their domestic product. Countries such as Venezuela and Uzbekistan for example pose a high risk for companies, with potential problems such as confiscation, sovereign non-payment and political interference. These political risks could threaten global oil supplies and push oil prices even further. In addition, an increasing number of power crises on a world-wide scale have elevated the principal fuels for power stations, namely coal and to a lesser extent uranium, to the status of strategic assets likely to incur forms of state intervention in private enterprise.

This also comes at a time when the main oil producing and refining region in Nigeria continues to suffer from high levels of political violence, kidnappings and general civil unrest, and tensions between the US and Iran are ongoing. These factors indicate potential for serious disruption to the operations of key oil producers as well as to established oil transportation routes which could well lead to further spikes in the price of oil.

“In South Africa, the government has injected billions of Rands into Eskom coffers, partly to maintain the utility credit rating, but also to fund its expansion drive and the increase in coal purchases that will be needed to cope with the increased electricity demand.

“Governments with state-owned oil companies have benefited and learnt from the technology, expertise and training from the oil multinationals that originally invested in exploration and production. Now, along with the increasing price of oil and by accruing tax and royalties, these governments have asserted themselves to bring the domestic product in their control through varying degrees of nationalisation. The drivers for state control vary from left wing politics, as evidenced in South American countries such as Venezuela, Ecuador and Bolivia, to capitalist economies,” says Peter.

With at least 80 per cent of world oil reserves in government hands, and three quarters of the 20 biggest oil companies owned by states, many of them struggling to meet the needs of their populations – multinationals are now dealing with nations with elevated levels of political and economic risk to meet increasing global demand.

A number of oil multinationals are facing serious challenges as governments take greater control over their resources. Not only are we seeing an increase in risk across a number of oil producing countries, but the supply situation could potentially worsen in some regions.

Commenting on the South Africa market, Aon’s Peter Vermaak says a particularly interesting angle is added in South Africa by the difference in the country’s cheap low quality coal, which has until now been the staple fuel for power stations, and high quality, high value export coal.

“With a number of previous prolonged periods of power interruption being partly blamed on poor quality coal supplies, pressure is bound to increase from Eskom on the coal producers to divert export products to the power stations. This has resulted in intense negotiations between Eskom and the suppliers, with Eskom’s projected price tag for burning higher quality coal already in the billions. As this in turn increases the price of electricity, how long before the government decides that coal is a strategic national asset as it relates to power generation, and increases its interference in the industry?

“It is crucial for energy companies to understand the nature and extent of these kinds of political threats to their operations and to take appropriate action to mitigate these risks. One way of doing this is by reviewing and strengthening concession contracts or production sharing agreements or through specialist insurance cover,” he concludes.

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**About Aon South Africa**

Aon  South  Africa  is  a  leading  provider  of  risk management services, insurance   and   reinsurance   brokerage,  human  capital  and  management consulting, and speciality insurance underwriting. The company employs more than 1500 professionals in its 17 offices in South Africa. Aon employs over 2000 people on the African continent. Aon South Africa’s head office is based in Sandton, Johannesburg.

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