



A NEW APPROACH TO PREDICTIVE MODELING OF EXECUTIVE RISK IN THE ENERGY SECTOR

Introduction

Beecher Carlson recently completed an exhaustive study of securities class action losses in the energy industry, using our unique approach to analyses-based risk transfer, known as Multivariate Algorithm for Risk Analysis (*MARA*). In the report, the potential challenges to the energy sector are delineated as they relate to Directors and Officers Liability, which in turn makes possible the formulation of appropriate preventative measures. Based upon our findings, we have been able to determine general predictors of class action (both in terms of likelihood and severity), as well as to identify a sub-set of general drivers that are especially important to energy firms.

Looking Back: A Decade of Securities Class Action Energy Losses

Risk is an inescapable consequence of conducting business. Whether it is strategic, compliance-related, financial or operational, risk can have a profound impact on organizations, not the least of which is the cost of mitigating, insuring against or otherwise minimizing the potential impact of risk on a firm's ability to generate revenue and ultimately, value for its shareholders as well as its employees.

According to a recent RIMS survey, the aggregate cost of risk to American businesses has nearly tripled over the past five years. This trend is at least partially attributable to the risk-management related expenditures associated with the September 11, 2001 terrorist attacks. However, the past decade also witnessed a string of corporate governance and business conduct related scandals, which gave rise to many of the more than 2,400 individual securities class action suits filed since the passage of the Private Securities Litigation Reform Act (PSLRA) of 1995.



Predictive Modeling can help risk managers at energy sector companies 'drill down' to identify D&O exposures.

In the energy sector (including energy exploration, production and transmission/distribution firms), companies have been faced with a steady flow of class action filings, a trend which has continued in spite of the enactment of the PSLRA. Although the

frequency of such class action filings has diminished since its peak in 2002, it is clear that continued exposure to shareholder litigation remains a fact of life for publicly traded energy companies.

On a more positive note, dismissal of securities class action lawsuits became more commonplace over the past decade, a development that may be credited to the PSLRA's passage. The PSLRA enhanced the docket control afforded to judges in such cases, while introducing a heightened pleading standard by mandating that complaints "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The result is that the pre-Act dismissal rate of 13% has more than doubled to 30%. It will be interesting to see if such relief is temporary, as the plaintiffs' bar begins to craft pleadings more likely to withstand the initial motion to dismiss.

The bar's adaptability and perseverance have been particularly evident in the virtual explosion in the magnitude of loss severity in the energy sector. Two of the ten largest securities class action settlements over the past decade have involved energy firms, and of the 24 settlements exceeding \$100 million, energy companies accounted for seven. Even excluding the not yet fully settled Enron case, the energy industry as a whole has incurred well in excess of \$2.5 billion of securities class action related liabilities, mostly in the last three years. In this respect, the trend in the energy sector mirrors other industries, as seven of the ten largest securities class action settlements of all time were recorded within the past two years.

At the same time, there are a number of notable differences between energy and other sectors. Perhaps the starkest contrast can be found in the large disparity between the two key aspects of risk: the *frequency* of securities class action suits and their *severity*. In terms of the former, energy firms compare quite favorably to other industries, accounting on average for about 3% of all securities class action filings (80 for energy and 2,419 overall) and settlements (24 for energy and 735 overall), while representing roughly 9% of the entire publicly traded universe of firms. The comparison is considerably less favorable in the context of severity, where the energy sector accounted for a whopping 43% of the aggregate losses suffered by publicly traded companies (through 2005).

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Not surprisingly, the mean losses in the energy sector are also considerably above the overall average, which is a direct result of the large dollar value settlements previously mentioned. Even excluding Enron, the severity of securities class action losses has risen sharply, and inasmuch as a single case (*i.e.*, Enron) can be considered an aberration, seven individual settlements exceeding \$100 million (out of the industry total of 24) cannot—and should not—be thought of as outliers. In other words, when nearly one-third of all securities class action outcomes in a given industry fall under the umbrella of "mega settlements", there are important risk mitigation lessons to be learned.

Looking to the Future: Emerging Trends & Associated Risks

The energy industry is currently facing the most significant array of opportunities and threats since the energy crisis of the 1970's. The already strong worldwide demand for energy is accelerating, while the instability of key oil producing regions of the world is increasing supply-side driven price volatility. The growing demand is driven on the one hand by steady consumption and continued dependence of the "developed" economies upon fossil fuels, and on the other hand by the brisk economic expansion of the more populous "developing" economies, particularly China and India. According to a 2005 ExxonMobil study, by 2020 global energy consumption will increase by approximately 40% from today's level. At the same time, supply-side uncertainties are growing, "fueled" by the continuing socio-political unrest and instability of major oil producing regions, resulting in record-setting wholesale energy prices.

Although arguably benefiting from the surging demand and the corresponding price escalation (witness ExxonMobil surging past Wal-Mart to claim the crown of the world's largest company, as measured by revenue, in 2005), energy companies are also facing mounting public dissatisfaction and increasing regulatory and governmental scrutiny in the wake of record profits. In contrast, the investment community looks at energy companies in a far more rational, balanced and pragmatic fashion. In absolute terms as well as in relation to other opportunities, energy producers and distributors are now widely considered to be among the most

attractive investment options, as evidenced by considerable resource inflows from hedge funds and institutional investors (e.g., Berkshire Hathaway), as well as major investment banks (e.g., Goldman Sachs, Morgan Stanley). Of course, this also serves to heighten performance expectations while adding able and vigilant watchdogs.

Strong profitability and demand provide the necessary foundation to justify the funding of significant investments in new exploration and processing technologies. Promising developments, such as recent gains in superconductivity aimed at diminishing the energy loss inherent in the traditional transmission methods, the use of electromagnetic waves in oil exploration, and the deployment of microbial agents in oil recovery, are commonly viewed as key sources of a potentially significant competitive advantage, assuming the still significant technological and developmental challenges can be successfully mounted.

Of course, should these potential breakthroughs fail to deliver as expected, the costly pursuits of these advancements may raise questions about the use of investment funds in this fashion, potentially pitting the firm's management against the recourse-seeking investor community.

Another trend favoring the energy industry as a whole, but especially favorable to power generation companies, is deepening deregulation. Beginning with Energy Policy Act of 1992, which laid the groundwork for deregulation, and culminating with the passage of the Domenici-Barton Energy Policy Act of 2005, Congress effectively

repealed the Public Utility Holding Company Act of 1935, which had placed utilities in a rigid web of governmental regulations. This legislative action brought an end to the 70-year long era of “natural monopolies”, which made it possible for local energy producers to not only expand geographically, but also to pursue non-energy related business opportunities. Coupled with similar changes in the telecommunications industry and rapid advancements in digital technologies, the energy deregulation is thus opening up a number of previously “out of reach” opportunities, including bundling of consumer utilities and the development of energy portfolios as a product mix.

However, it’s axiomatic that greater opportunities usually carry higher risks. As internationally renowned economist and Nobel Prize winner Milton Friedman noted, “there is no free lunch.” The truth of this whimsically expressed albeit astute observation is reflected in the business outlook of the energy industry as a whole. As noted earlier, the forces of demand and supply are producing a very favorable business environment, but also one that will require careful navigation around many clearly visible and some harder to spot risks. As Mr. Friedman would have expected, virtually all of the otherwise exciting energy opportunities must be approached as risk-bearing endeavors.

What might be less obvious is that many of the risks associated with the now unfolding business environment are different from the “traditional” energy risks, which largely fall within the operational risk domain. In contrast to those “familiar” operational risks, the “newcomers” tend to be somewhat

harder to manage, not only because they are “new,” but also because they are less about the business of energy, such as exploration and production, and more about the conduct of business in general. We are witnessing broader changes in the business climate in which energy companies operate: shareholders and consumers are demanding greater levels of accountability from board members and executives (with the resulting transactional costs for instituting and communicating responsiveness to these concerns), emerging technologies vie for corporate investment dollars, and opportunities abound to bundle and cross-sell services to households and businesses in ways that would have been unimaginable prior to deregulation.

The common thread here is the increased likelihood of governmental and investor scrutiny, often precursors of securities class action suits. Faced with mounting public discontent, the various consumer and investor-driven regulatory agencies (such as the Securities and Exchange Commission, the Federal Trade Commission and state public service commissions) are more likely to conduct investigative probes of everything from corporate governance to executive compensation, even in some cases challenging the soundness of business judgment. Errors may be found which will necessitate restatements (which can greatly increase the likelihood of shareholder litigation). Even if no errors are found, the damage to a company’s reputation can be enormous. The market may lose confidence in a company’s stock, which in turn props the door open for new charges of deceptive or dishonest business practices.

Understanding the Drivers of Risk

The goal here is not to sound the alarm, but to raise the level of awareness with respect to the potential undesirable consequences of an otherwise bright business outlook. In keeping with the old saying that “luck favors the well-prepared,” the objective of the ensuing analysis is to call for comprehensive and vigilant risk mitigation practices. Fortunately, there are new analytical tools available to assist energy companies in identifying the factors, and combinations of factors, that help to mold their company’s risk profile. These drivers are increasingly being taken into account during the underwriting process. Understanding their nature will enable a company to take the actions necessary to better position itself in the market, and to be able to differentiate its own business practices from those of its competitors in a way that makes a difference to a company’s cost of transferring risk.

For a copy of the FULL report detailing the drivers of D&O risk in the energy sector, please contact Jeff Lattmann, Managing Director, at jlattmann@beechercarlson.com

Revolutionary

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