

RICE GLOBAL FORUM

THE CURRENT STATE OF OWNER – CONTRACTOR RELATIONSHIPS

(any hope for improvement ?)

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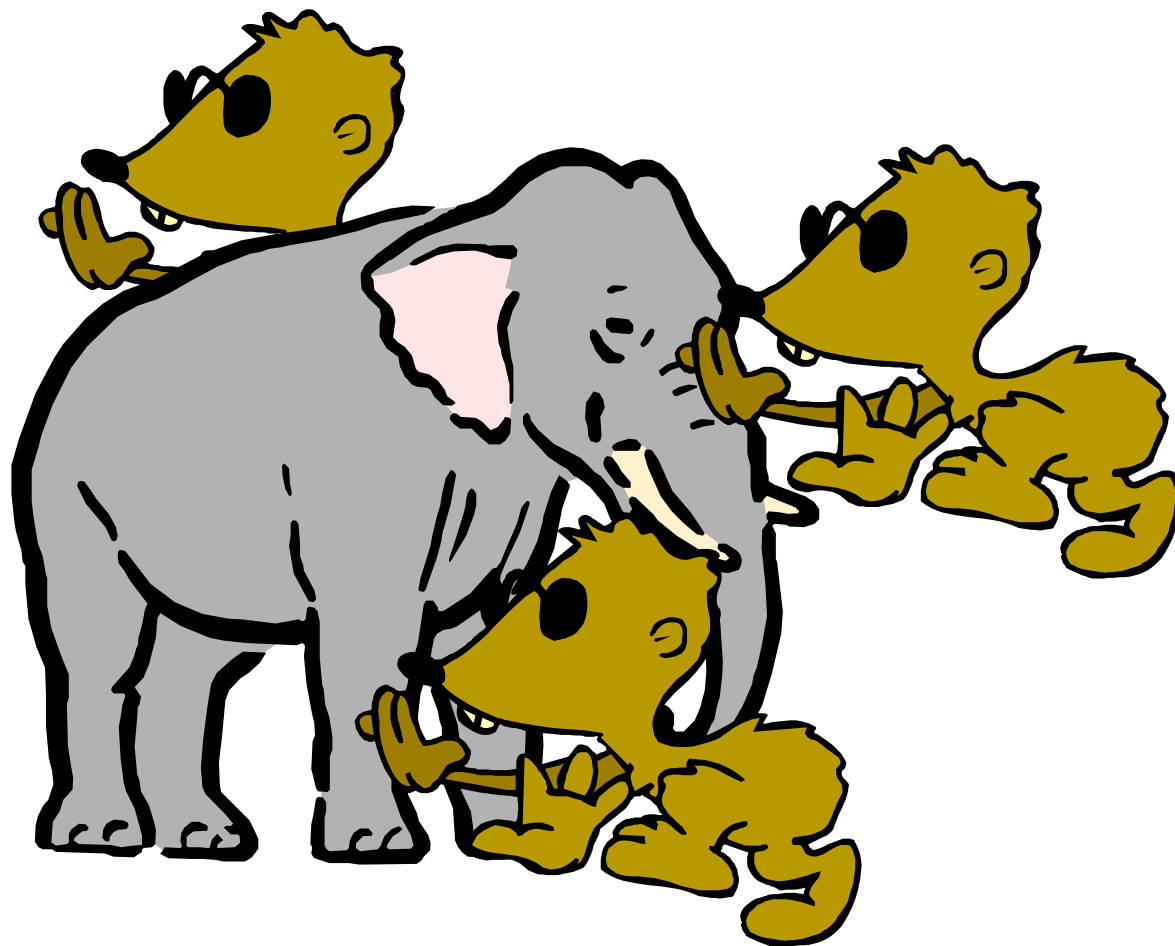


Eni's Way

Purpose of my talk

- to review the reasons behind the deteriorating Owner–Contractor relationships
- to set out what the Owner companies are doing to try to remedy the problems of our E&C suppliers

The problem of the blind men and the elephant

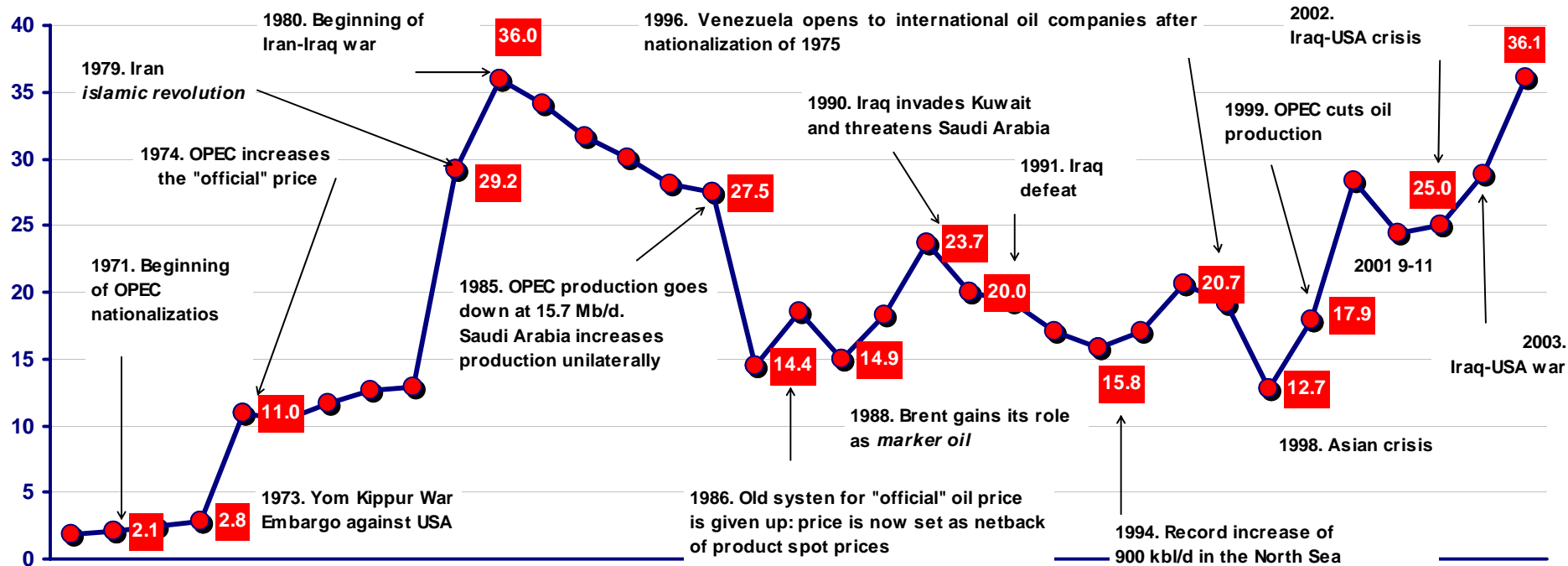


Better communication is needed

- each of the three blind men “see” the elephant differently, and there is no possibility of communication until each blind man feels the parts that the others have felt
- owners and E&C contractors also need to feel all the parts in order to communicate and see reality fully

Oil price: main events 1970 - 2003

\$/barrel (then current)



A bit of hystory

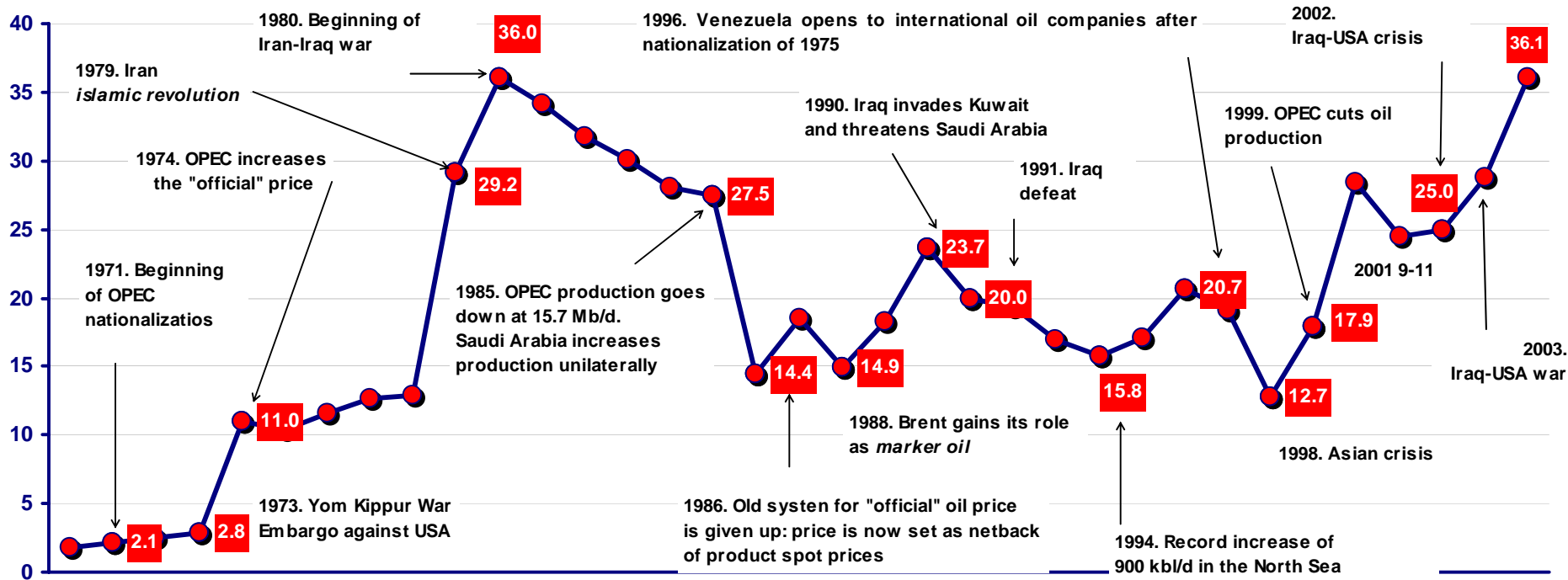
- **1985** – oil price goes down by 50%
- in the mid Eighties, oil companies adopted flat horizontal structures. They were lean and relied heavily on outsourcing
- **1997-1998** Asian crisis and very weak oil price are the reasons for capital spending at its lowest in ten years (very weak market for E&Cs)
- a wave of mergers and acquisitions in the oil industry changes the average size of owner companies

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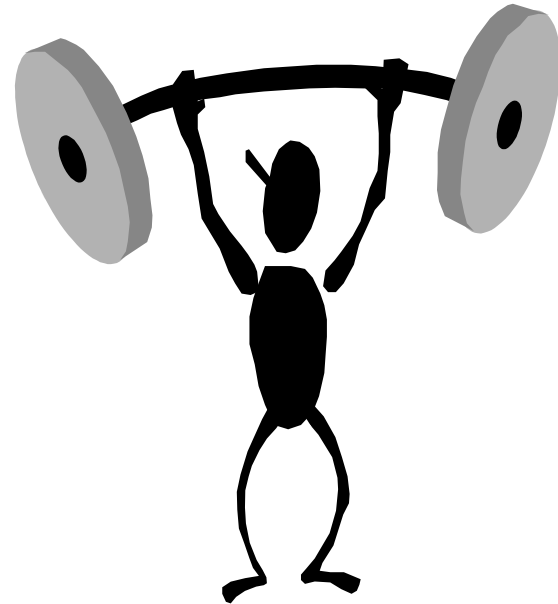
Industry consolidation and its impact on bargaining power

PETROLEUM INDUSTRY 1980



Top 5 Majors represent less than 14% of all hydrocarbon capital spending

PETROLEUM INDUSTRY 2004



Top 5 Super Majors represent over 33% of all hydrocarbon capital spending

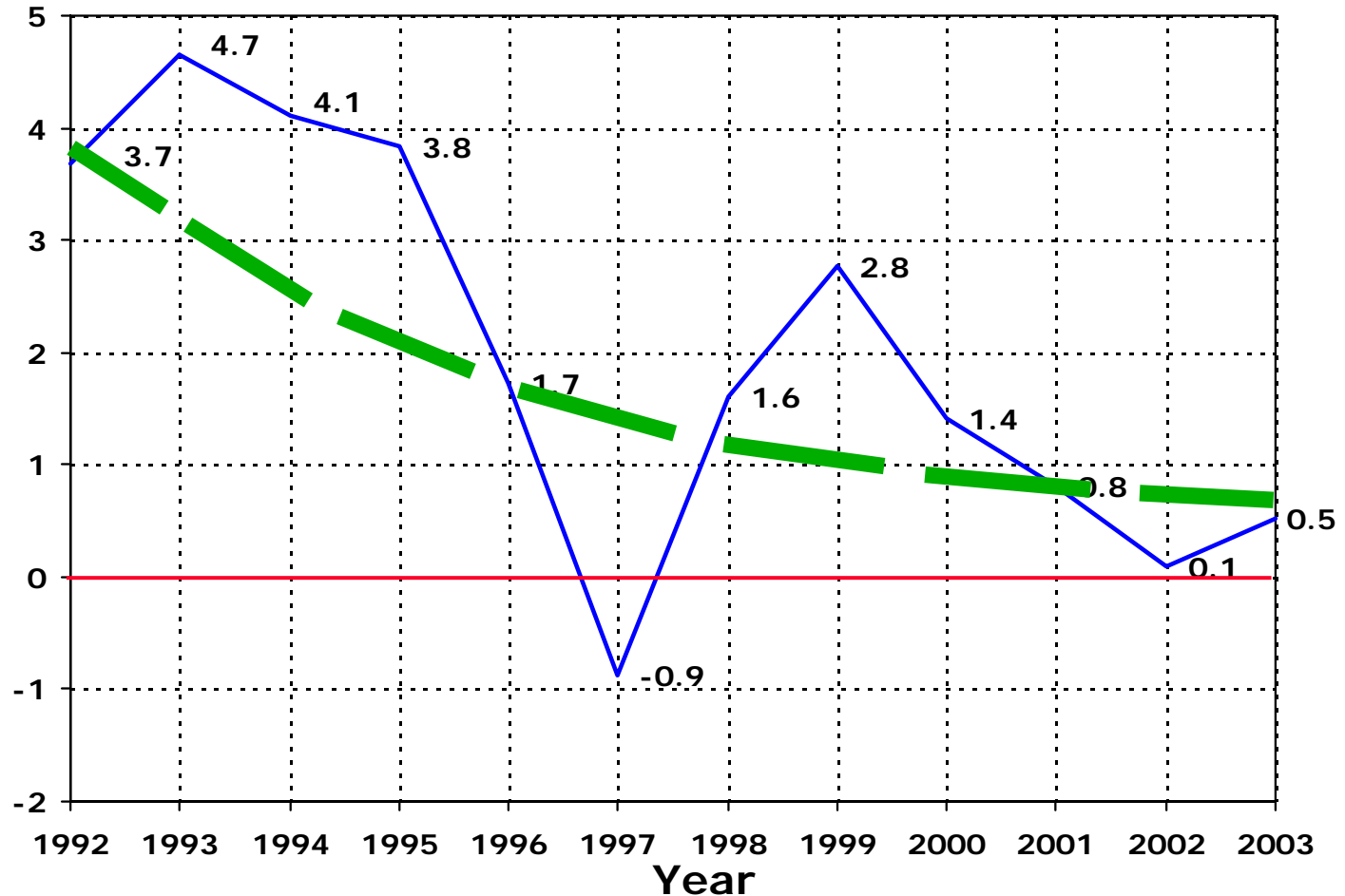
Owner - Contractor relationships: the key problem is structural

- structural changes created imbalances. Owners used their bargaining superiority to force down prices and introduce difficult contractual terms
- consequently, in recent years, many contractors have disappeared or are financially sick

- John Brown
- KTI
- Kvaerner
- Stone & Webster
- Foster Wheeler
- Comprimo
- Litwin
- Stolt
- Bouygues Offshore
- McDermott
- Raytheon Eng's & Constr's
- Humphreys & Glasgow
-

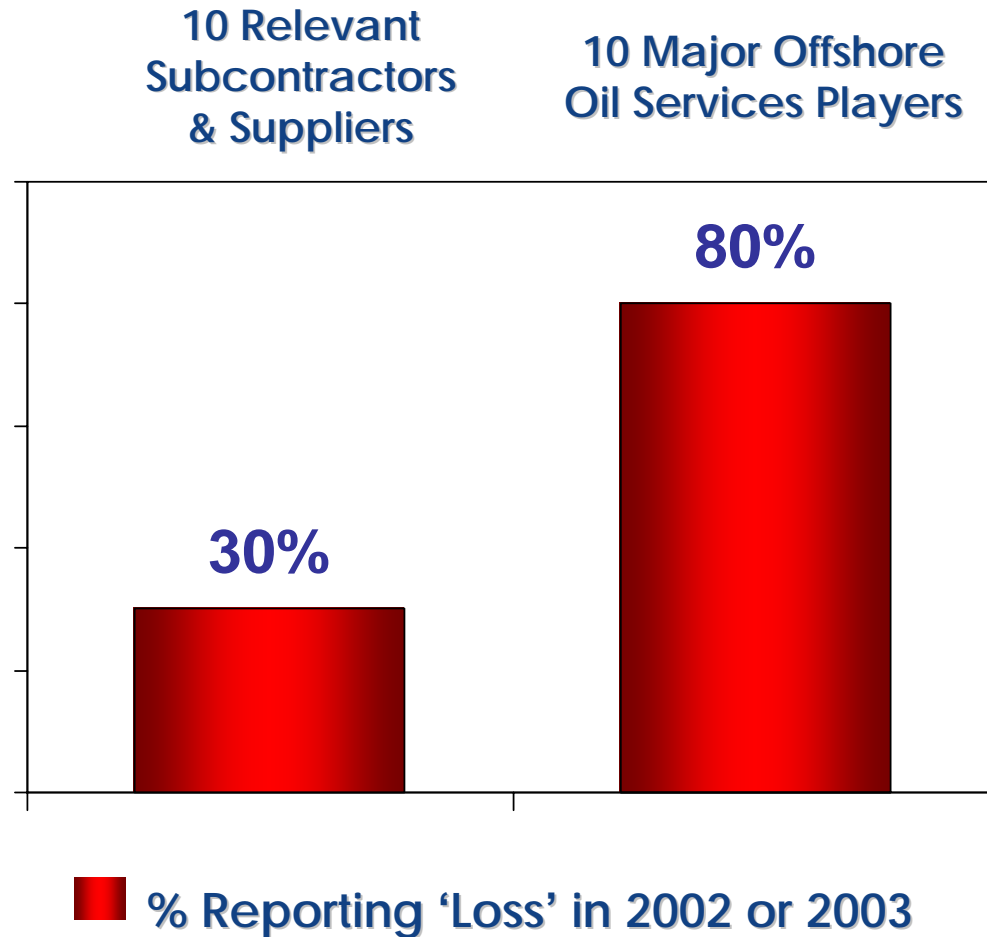
E&C Industry - onshore

Profit before Tax as a % of Sales



??

E&C Industry - Current Status Survey Offshore



Did the enhanced bargaining power of the petroleum companies impact contractors' results?

YES

Suppliers experienced over the last decades:

- falling operating margins
- falling profit margins
- falling returns on capital
- difficulty in recruiting young technical talent
- growing bankruptcies

Current status of relationships between owners and contractors is unsustainable in the long term

What if nothing is done?

- more bankruptcies among contractors
- problems of quality
- fewer qualified suppliers, hence ...
- ... lack of fair and healthy competition during bids
- increasing difficulty of attracting young talent and ...
- ... retaining first rate senior talent in the hydrocarbon industry

The Oil & Gas industry may face lack of qualified resources to carry out its challenging projects

What is the industry doing with regard to the owner-contractor relationship

- available research data were reviewed to ascertain the state of policy among the major petroleum companies (notably the survey by Transmar Consulting)
- a number of key issues were identified

KEY ISSUE #1: Are major oil companies conscious that there is a problem?

- no major oil company appears to have a real appreciation of the nature of the problem
- there are only some individuals and groups within major oil companies who are concerned
- there are factions within the Majors who strongly resist the idea that any problem exists between contractors and owners
- no major oil company as yet has developed a comprehensive corporate policy to manage all aspects of the owner-contractor relationship

KEY ISSUE #2: Contractual Arrangements / 1

- shift towards harsher contractual terms ?
- all the Majors tend to insert clauses for high level of liquidated damages, completion guarantees, performance guarantees and even consequential damages/loss of profit in their project contracts. However, policy could be more *de facto* than *de jure*
- great ambiguity about the effectiveness of tough contractual clauses among most executives: many doubt their fairness, but are forced to use them

KEY ISSUE #2: Contractual Arrangements / 2

- One corrective move by the owners is the trend to develop standard framework-type contracts
 - ✓ Exxon Mobil with ABB Lummus Global, Cooper Cameron, and Aker Kvaerner
 - ✓ Marathon with Fluor for design engineering
 - ✓ BP with Cooper Cameron, Mustang Engineering, and Sumitomo
- such owners desire to assure themselves quality equipment and personnel at affordable prices
- while no set policy exists, there is definitely a tendency to develop a close relationship with a limited number of preferred large-size contractors

KEY ISSUE #3: Work Scope Allocation

Ideally, how should the work be divided between an owner and a contractor?

- for over a decade, the clear choice was for the owners to outsource a maximum amount of work keeping only core activities in-house
- the growing awareness of the increasing importance of the project definition phase and the deteriorating quality of work by contractors are inducing oil company managements to re-think outsourcing policy
- today, more and more oil companies are strengthening their in-house front-end engineering capabilities and their project management groups

KEY ISSUE #4: Attitude Toward Risk

- everyone (owners and contractors alike) agree with the general principle

risk should be allocated to the party who can better bear and mitigate it

- however, in recent years, owner companies have pushed more and more risk on the shoulders of contractors
- many oil company managers and executives could frankly admit that the current level of risk allocation between owners and contractors is unsustainable in the long term for the weakened E&C industry
- nonetheless there is no clear will for the owners to rectify the risk allocation unilaterally. They do what others (competitors) do and many are convinced that the worst are the NOCs of the host countries

KEY ISSUE #5: Asian Contractors

Can Asian contractors significantly take the place of Western contractors?

- after Chaebols collapsed Koreans are aligning their prices to Western levels
- Chinese contractors cannot handle sophisticated engineering and construction tasks
- Chinese domestic workload will fully occupy their engineering and construction companies

Therefore it is doubtful that Asia is a panacea for our problems

Recent study work by Transmar shows that the Asian contractors cannot fully replace Western contractors

SUMMING UP

- consciousness is starting to grow within owners that there are problems with owner-contractor relationships. Some owners designate key executives to monitor and tackle the problem
- owners are concerned with diminishing number of bidders for world-class projects and the weak financial situation of many contractors
- almost all Majors insert contracting terms tougher than in the past although unconvinced of their effectiveness. Increasing resistance from contractors after bad experiences
- contractors were unable as yet to react to new market conditions

SUMMING UP

- owners are increasingly meeting with key contractors to try and hammer out solutions
- some owners are reviewing work scope allocations while increasing the size of their upfront engineering staffs directly or through subsidiary companies
- owners are uncertain about the extent of technical help that Asian contractors can bring as Western contractors fail. Study results show it will be limited

SUMMING UP

- thus, the majors have not yet formulated comprehensive corporate policies to mitigate the crisis in owner-contractor relations. However, events are growing which will force them to act
- the E&C industry, in competition with more dynamic sectors, is experiencing increasing difficulties in attracting and retaining quality talent
- if this situation is not corrected the Oil & Gas industry will be facing lack of qualified resources to carry out its most challenging projects