New Times, New Thinking for Project Owners

Kathleen Bury and **Wissam Batran** from the Business Advisory team at Contax Partners explore the implications of a more conservative era of project ownership, including risk sharing mechanisms and incentive schemes

Between 2004 and 2008, the energy project Capex market was in a boom cycle with overambitious spending and the awarding of projects that resulted in a severe resource crunch and greater than ever cost escalations. The market was clearly a seller's market with some top tier EPC contractors being selective and turning down project work whilst the majority took the opposite road and overloaded themselves. This resulted in numerous project schedule and budget overruns as contractors were unable to cope with the project workload burden. Over the past year, however, we have seen the pendulum swing back towards the buyer. This is primarily as a result of decreasing contractor backlog and the postponement of many energy projects as project owners look to take advantage of the reduced input costs. Nevertheless, despite this shift, project owners are still faced with the challenge of how to identify, attract and secure the 'best fit' contractors for their project at the right price.

Although some signs of global economic stabilisation have begun to emerge, there remains a great deal of uncertainty in the market with many companies financially strained and thus more risk averse. In today's market, contractors are more robustly assessing their opportunities against stricter criteria and are asking themselves key questions before bidding for a project, for instance:


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- **Project owner risk**: Is this project owner reliable and committed to the project? Do they pay their bills on time? What are the project owner's capabilities in managing the project?
- **Project cost risk:** How are project costs evolving? How can we accurately forecast certain costs for projects due for award next year? Will the project owner be willing to share some of the risk with the contractors? If so, how?
- **Execution Capability:** Do I have the true capability to execute this project profitability?
- **Bidding costs:** What is the estimated bidding cost? Are we really able to afford this bid cost given the other bids that we are putting together?
- **Competition:** Who else is bidding on this project? What are my chances of winning?

Realising the need to adapt to this changing contracting landscape and attract competent and quality contractors to their projects in a competitive bid environment, many GCC energy sector project owners have taken initial steps to share some of the project cost risk elements with their

$146bn

Estimated budget for new refining projects across the MENA region

Source: Organisation of Arab Petroleum Exporting Countires


Qatargas has offered to reimburse contractors for bidding costs to increase competitiveness on projects.

contractors and adopt incentive schemes. This does not mean moving away from the traditional lump sum turnkey (LSTK) form of contract, but rather the addition of some risk-sharing clauses and relaxation of some terms and conditions which were a significant burden for contractors. A few projects in 2009 saw project owners take initiatives to attract contractors and ease their risk burden; on the recently awarded Plateau Maintenance Project, Qatargas offered to reimburse contractors for their associated bidding costs to increase the competitiveness of the project. Some project owners in Abu Dhabi and Saudi Arabia also took steps to reduce the risk premium levels that contractors include within their bid prices, by offering advanced payments, relaxing some of the terms and conditions and indemnifying the contractor of certain obligations. These steps enabled the project owners to decrease the EPC bid costs by 15-20%, a key economic target for any project.

Certain project owners have also taken the step towards holding direct negotiations with trusted EPC contractors with which they have worked with in the past. This strategy generally helps to reduce the time and cost associated with tendering a project on a competitive basis, which can considerably extend a project timeline and cost several millions of dollars. However, on the flipside, it can also exclude potential new competitive players from the race. These risk sharing mechanisms and incentive schemes, tailored to each owner's risk appetite, have in some respects signalled the development of a more balanced relationship between project owners and contractors, enhancing trust between the different parties. While this new balance can reduce risk premiums and increase project attractiveness to contractors, it also means that the project owner is taking on more risk; a behaviour which many contractors have been looking forward to seeing project owners develop. However, there are a number of other steps that project owners can and are taking to ensure that they identify, attract and secure the right contractors for their project:

1. Understand the trends in the market around key areas such as input costs, labour availability, the likely project awards and the 'sweet spot' for award - See Graph 1.

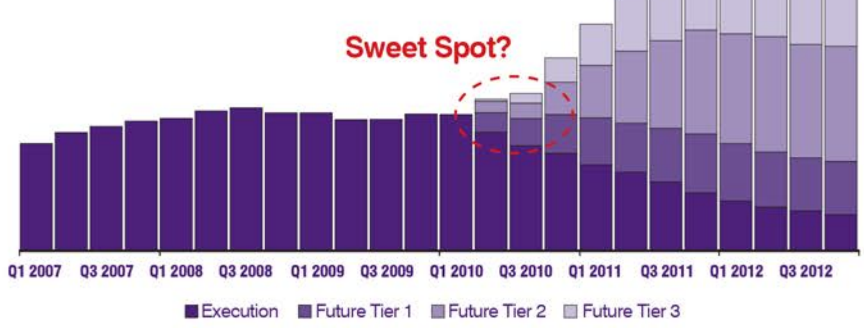
2. Robust benchmarking assessment of EPC contractors during PQ and bidding stages to identify and rank existing and new contractors against key attributes around competency, financial health and capacity.

3. Further analysis of the project execution risks that are better managed by project owners vs. the contractor.

In conclusion, project owners are beginning to adapt to the changing project and contracting landscape in the GCC, by adopting 'new times, new thinking' contracting strategies that are more closely tailored to the nature of the project, to the contractor's cash flow requirement and to their risk appetite. Doing so will contribute to helping them secure the contractors best fit for the job at the right price. However, they will also be required to plan early mitigation strategies for some of the risks associated with this new strategy. PME

Graph 1

Total GCC EPC Workload: Q1 2007 - Q4 2012



To further discuss how the Contax Partners Business Advisory team can help you plan for and execute your projects successfully, please contact Ann-Marie Carbery Antoun at AnnMarie.Carbery@contaxpartners.com. We look forward to speaking with you.