OTC 2004

BUSINESS RELATIONS BETWEEN THE OPERATORS AND THE SERVICE INDUSTRY: **WHO ASSUMES THE FINANCIAL RISK OF A PROJECT?**

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WHO ASSUMES THE FINANCIAL RISK OF A PROJECT?

- **Short Answer:** **The owner assumes the financial risk of its project**

- **The Reality:** **While most oil companies are enjoying record profits, many oil service companies are incurring heavy losses on projects**

An unhappy and unhealthy situation for everybody
- **The E&C industry is in turmoil**
- **Nevertheless, finding and development costs are rising**

I. THE E&C INDUSTRY IS IN TURMOIL

II. THE OIL COMPANIES ARE UNHAPPY TOO

III. THE WAY FORWARD

I. THE E&C INDUSTRY IS IN TURMOIL

GROWING IMBALANCE BETWEEN OIL AND E&C COMPANIES (1)

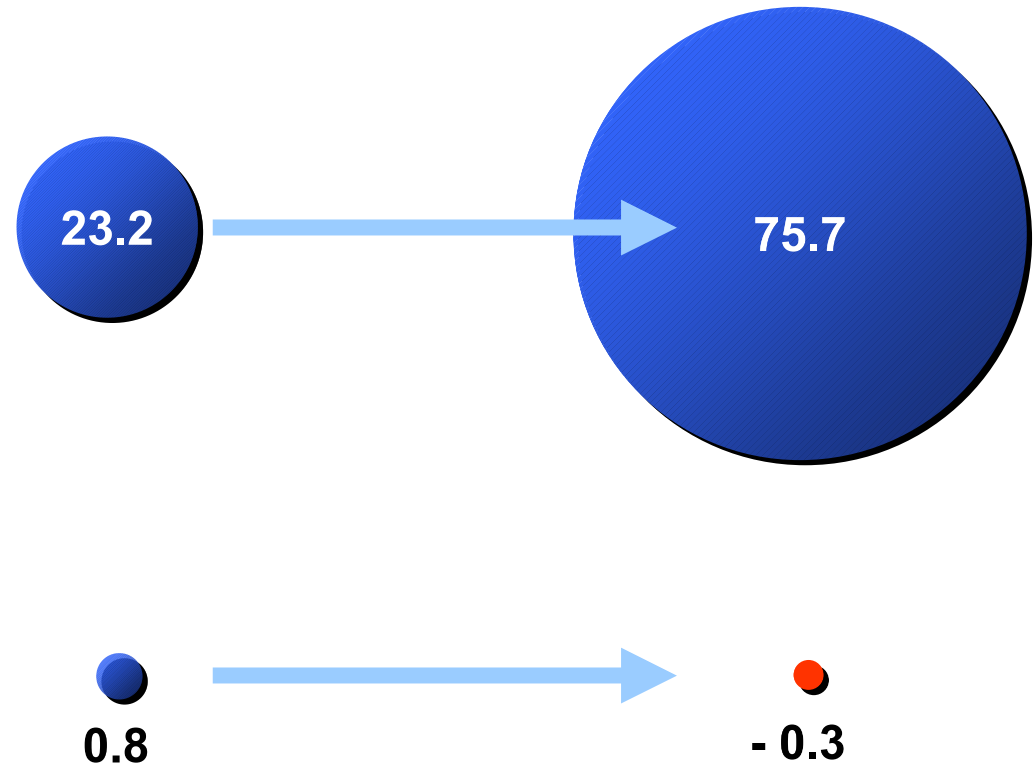
NET EARNINGS

USD in Billions

1994 **2003**

A) 10 largest oil companies

B) 10 largest E&C companies



Source: Bloomberg

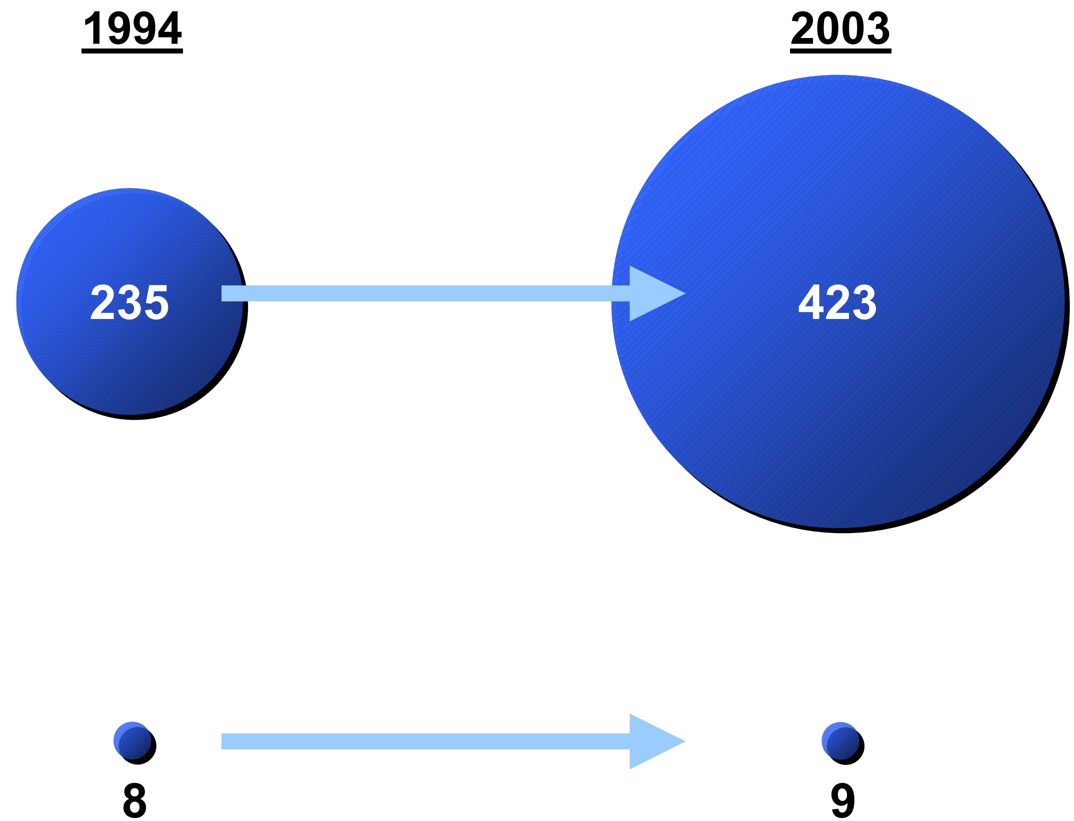
GROWING IMBALANCE BETWEEN OIL AND E&C COMPANIES (2)

SHAREHOLDERS' EQUITY

USD in Billions

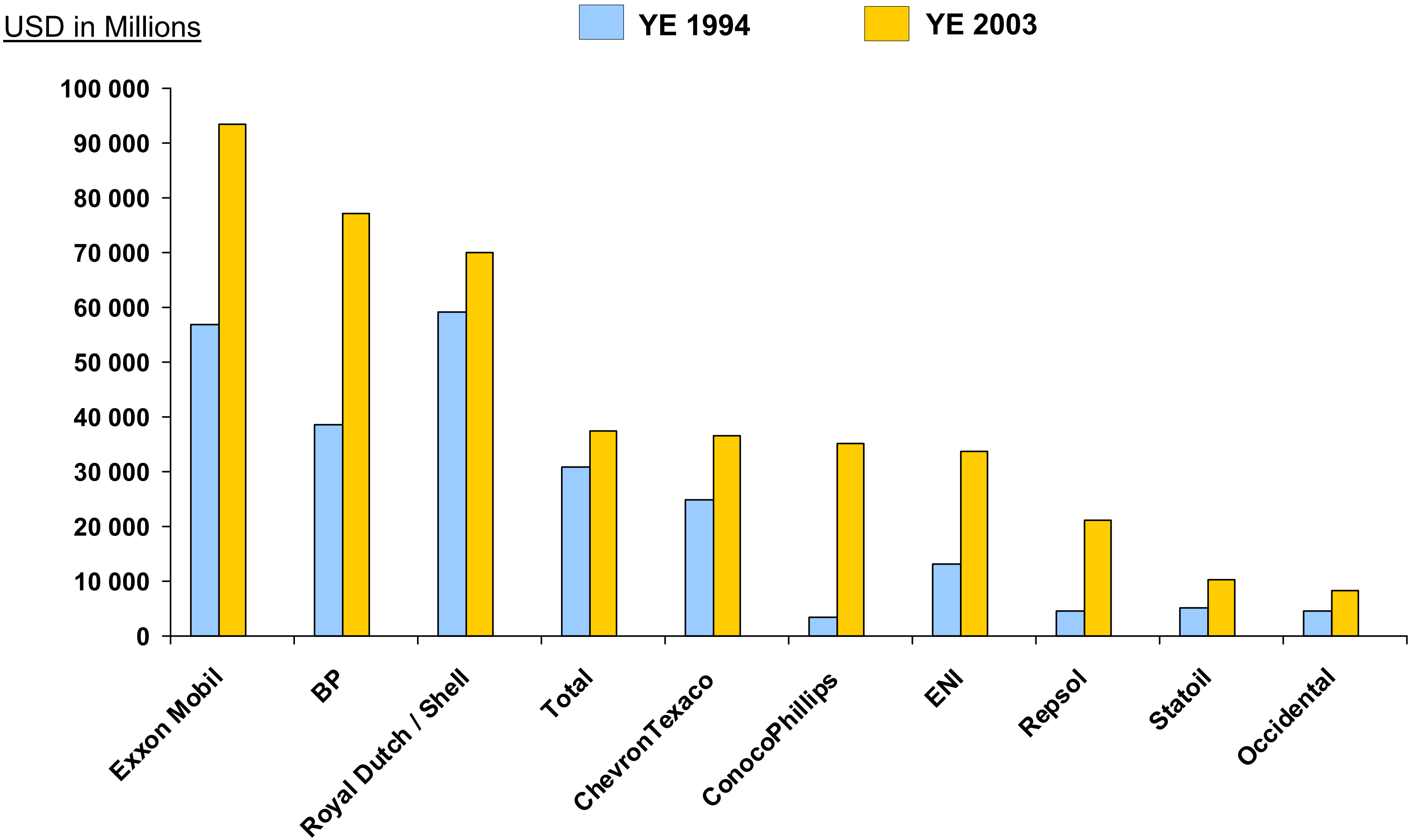
A) 10 largest oil companies

B) 10 largest E&C companies

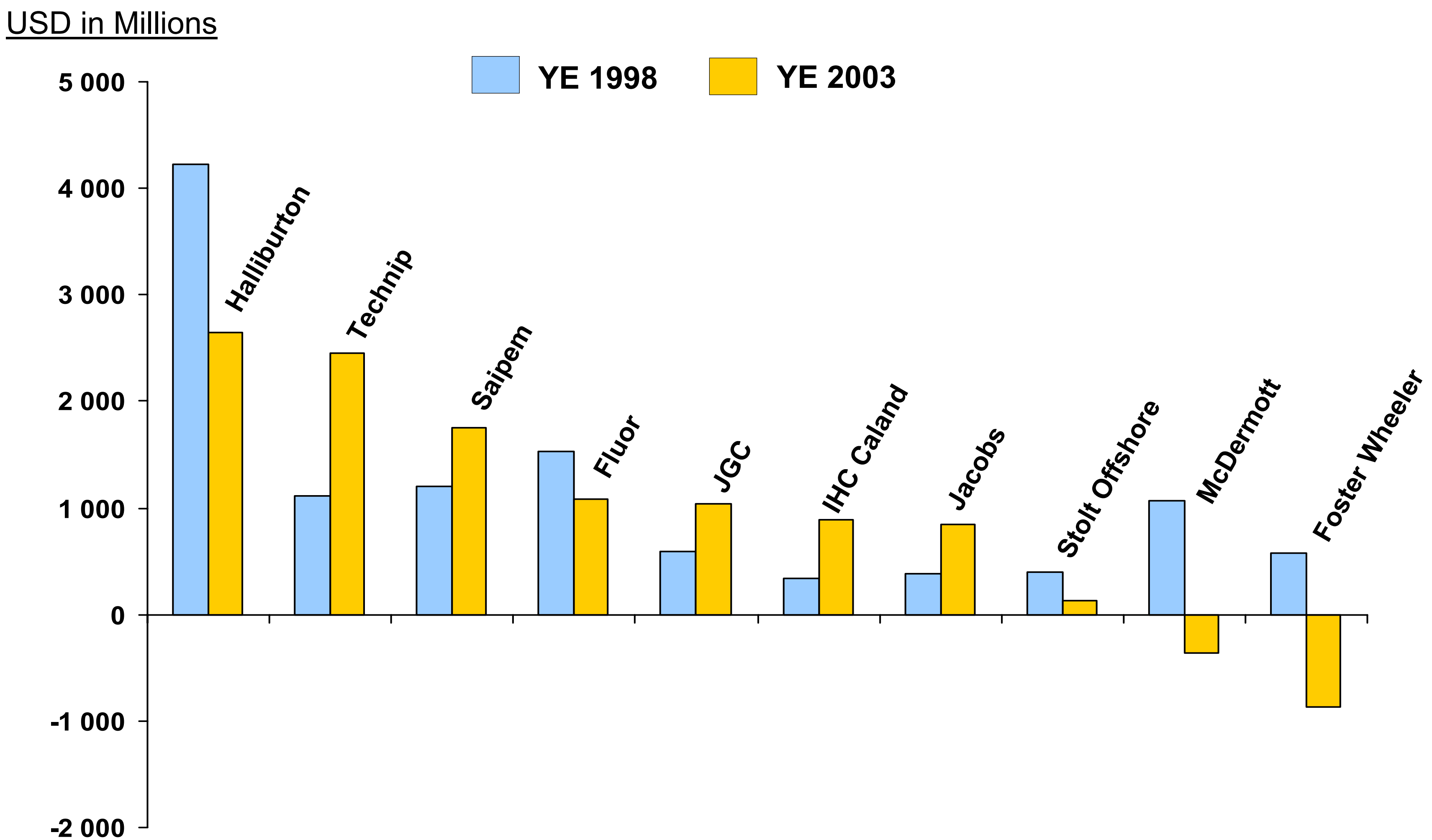


Source: Bloomberg

SHAREHOLDERS' EQUITY: MAIN OIL COMPANIES



SHAREHOLDERS' EQUITY: MAIN E&C COMPANIES



Technip 1998 includes Coflexip
Saipem 1998 includes Bouygues OS
Source: Bloomberg

SIZE OF PROJECTS:

GROWING FASTER THAN E&C COMPANIES' SIZE

At Technip, the 5 largest contracts in backlog (Group share) amounted to:

- **10 years ago : € 1.6 Billion**
- **5 years ago : € 2.1 Billion**
- **Today : € 2.9 Billion**

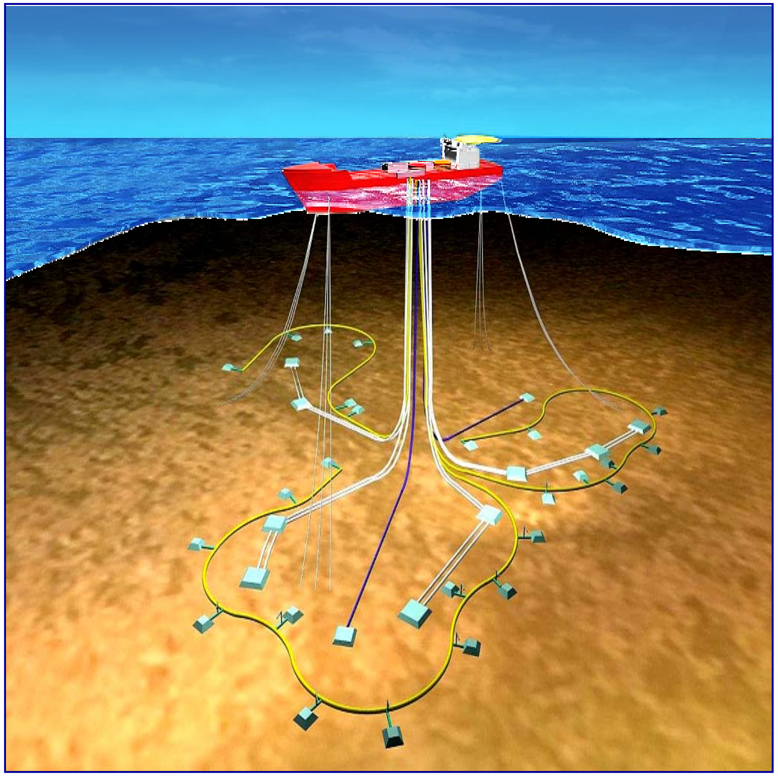
➔ **Average size of the 5 largest contracts is now close to €600m (~$700m) per contract: equivalent to about 1/3 of the Group's equity**

MEGA PROJECTS = HIGHER RISKS

In the SURF (Subsea Umbilicals Risers and Flowlines) business, as an example:

- In the nineties, a typical project (North Sea tie-back) would be:
  30 to 50 M€

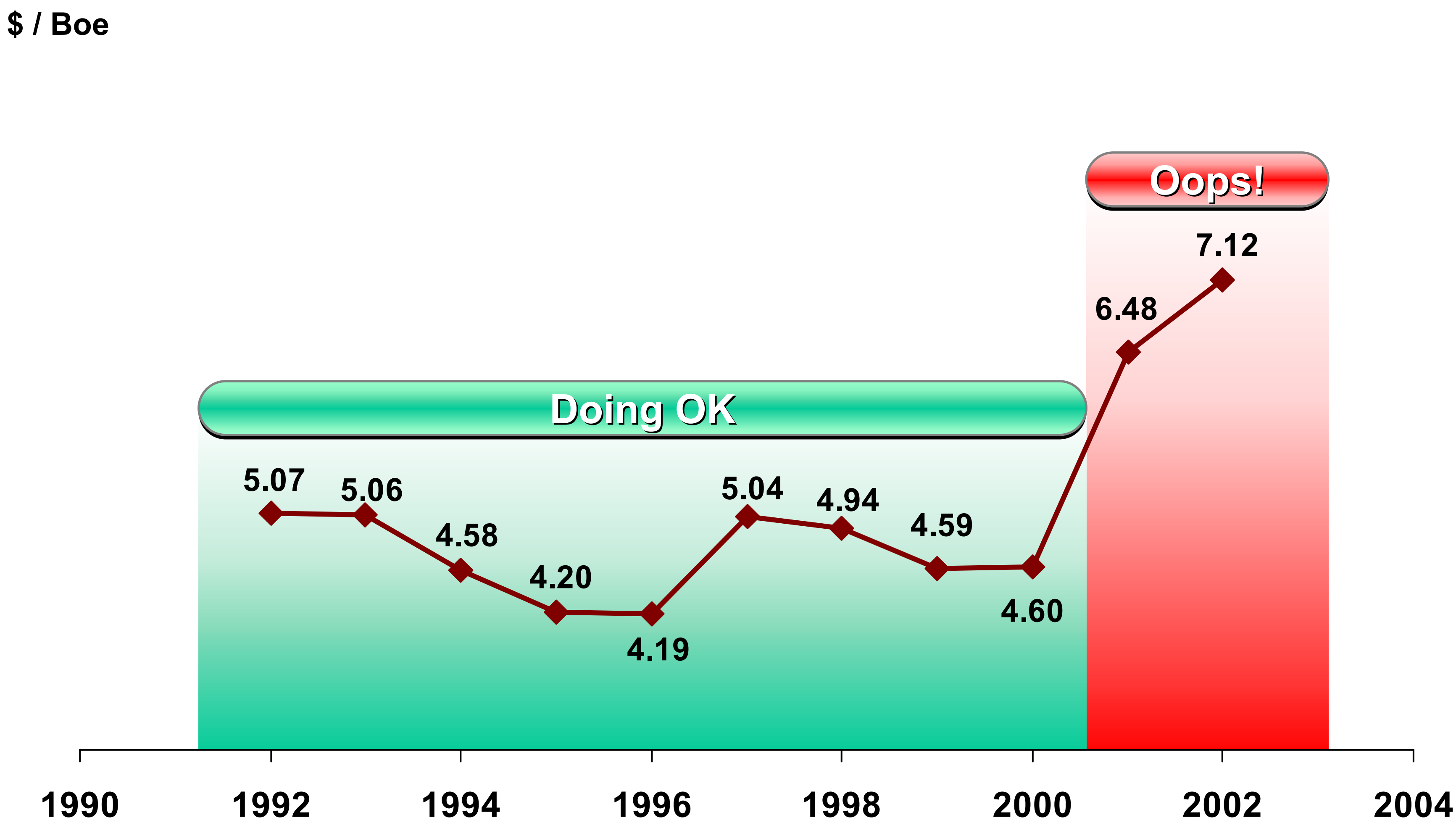
- Today, a typical SURF project (deepwater West Africa) is:
  500 to 800 M€



- Liability exposure equal to 15% of contract value was acceptable on small projects
- The same 15% exposure on a mega-project can kill an E&C co.

II. THE OIL COMPANIES ARE UNHAPPY TOO

TRENDS IN FINDING & DEVELOPMENT COST PER BARREL



Source: ABN Amro

WHY ARE F&D COSTS RISING?

- More complex projects (deepwater, frontier areas)
- No new wave of major technological innovations (such as 3D seismic and horizontal drilling during the 90's)
- Ever-increasing local content requirements by host countries
- Higher euro impacting contractors' euro-based costs
- More recently, rising steel prices and freight costs

THE PARADOX

- In order to cut finding & development costs, oil companies are inclined to tighten terms and conditions on projects:
  - Lower margins for higher risks
  - Heavier liabilities (up to 100% of revenues !!)
  - Negative cash flows
  - Lower insurance coverage
- Paradoxically, such an approach is more likely to lead to higher costs on projects (+ a few casualties among the E&C companies)

The current relationship between the oil companies and their contractors is flawed by a few conceptual mistakes

A FEW CONCEPTUAL MISTAKES

MISTAKE #1: "ALWAYS LOW PRICES. ALWAYS."

- Trend of awarding contracts based on lowest offered price (even if it is obviously a dumping offer) and irrespective of:

  - ➔ Track record
  - ➔ Technological expertise
  - ➔ Project management capabilities

- In such cases, project execution is often very poor, with delays, cost overruns, claims and counterclaims.

  - ➔ Most of the time, at the end of the day, the 'lowest price' is not delivered

MISTAKE #2: LUMP-SUM CONTRACTING IN UNCHARTERED TERRITORIES

- **Can only lead to higher costs:**

  → **When risks are difficult or impossible to evaluate:**
  - E&C companies will raise contingencies - as much as competition will allow to cover these risks

  → **When the competition does not allow increased contingencies:**
  - experience has shown time and again that the "winning" contractor suffers a flow of **red** ink
  - triggering additional costs and delays for the client

A FEW CONCEPTUAL MISTAKES

MISTAKE #3: FAST TRACK PROJECTS FOR NEW TECHNOLOGIES

- A sure recipe for disaster
  - ➔ the necessary engineering and testing cannot be performed before the start-up of the project

- Fast-track should be limited
  - ➔ to projects for which scope of work and technologies are clearly defined and proven

MISTAKE #4: CHANGING THE RULES OF THE GAME DURING THE GAME

- Examples:
  - Organize bidding, then rebidding and even re-rebidding (as if the cost of bidding were not material for E&C companies)
  - Utilize mysterious criteria to weight the offers from competitors during the bidding process
  - During contract execution, change the scope of work first and negotiate variation orders second

→ **E&C companies need the rules of the game that are clear, stable and fair**

MISTAKE #5: ALLOCATE RISKS AND COSTS TO THE WRONG PARTY

In addition to their job (contractor), E&C companies are often requested to act as:

- A commercial bank (negative cash-flows on projects)
- An insurance company (providing insurance coverage for clients' risks)
- A Forex gambler (contract in $, costs in various currencies)

Given their size and financial strength, oil companies have cheaper access than E&C companies to funding, insurance and forex hedging

➔ **Transferring these risks / costs to the E&C companies does not make economic sense:**
IT CAN ONLY LEAD TO MORE EXPENSIVE PROJECTS

III. THE WAY FORWARD:
WHAT IS NEEDED TO RESTORE A MORE BALANCED RELATIONSHIP

THE WAY FORWARD: CONTRACTUAL TERMS (1)

- **Payment in multi-currencies in line with contractor’s cost structure**
- **Provide to contractor a neutral, if not positive, cash flow**
- **Late payments should incur financial costs**
- **Right of suspension / termination in case of non-payment**

THE WAY FORWARD: CONTRACTUAL TERMS (2)

- **Provide to contractor insurance coverage for major risks**
- **Compensate cost increases linked to major economic disruptions (steel prices…)**
- **Stop the extravaganza on liabilities: cap on liabilities per project should not exceed 1% of a world-class contractor equity**

THE WAY FORWARD: A NEW BEHAVIOR?

- **Contracting strategy:**
  - ➔ **Clarify and stabilize the rules**
  - ➔ **Limit EPIC contracts to well-defined scope and technologies**
  - ➔ **Allocate risks/costs to the right party**
- **Relationship:**
  - ➔ **Let business people run the show (rather than lawyers)**
  - ➔ **… and provide them some give-and-take authority**
  - ➔ **Forget short-termism and focus on long-term partnerships**

➔ **In their best interest, oil companies should try to re-establish an appropriate risk-reward balance for their contractors**

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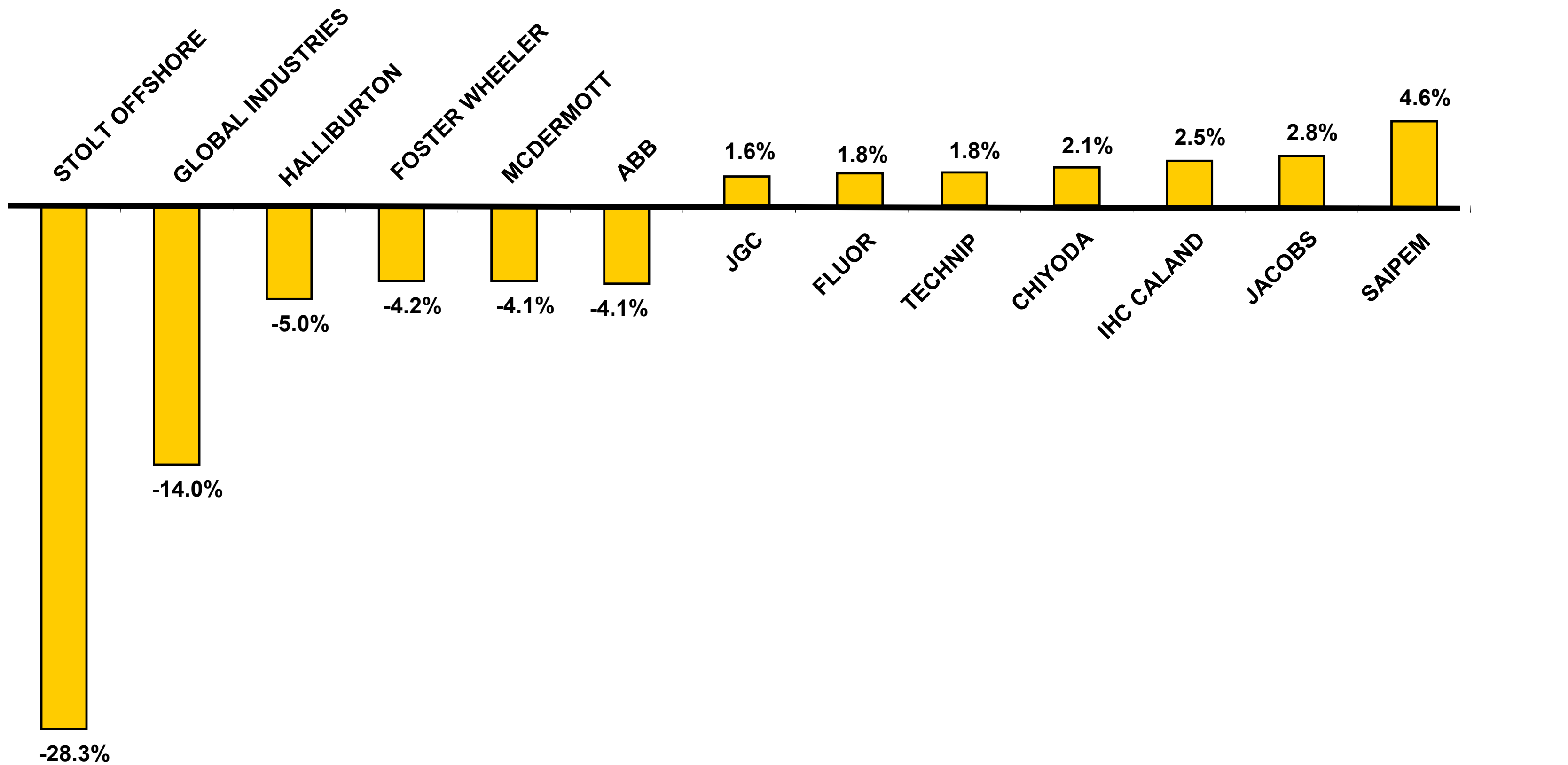
THE OVERALL FINANCIAL PERFORMANCE OF E&C COMPANIES

NET INCOME (US GAAP) / REVENUES IN 2003



Source: Bloomberg