"The International Situation and Its Effect On Boiler Projects From a Suppliers Perspective"

The International Committee will present occasional articles for the Boiler Blast on international issues. This is the first of that new series.

At the ABMA Annual Meeting in January, 2009 Dan Baublis of CH2M Hill made an excellent presentation on international issues titled "The Impact of Recent Events: An EPC Perspective". This short article will summarize the high points of that presentation with some amplification and interpretation by the author.

GENERAL SITUATION

Key influences on international markets are:

1. Financial uncertainty and global recession
2. Money for new projects – how to get it?
3. There is still a demand but often power projects and water projects go together.
4. In the Middle East formerly giant projects are becoming more modest in size.
5. Global warming issues are slowing some projects.
6. Fuel supply security and price uncertainty are a concern.

Economic activity fell off a cliff in September and October 2008 and there is continuing deterioration. This is generally described as the worst recession since at least WWII. It affects major economies such as the US, Japan and Europe. This is the first contraction in Europe since the Euro zone was set up. Japan's economy is contracting. Emerging markets are also down. Global growth in the last year was maybe 0.5%. Markets that historically sell to The United States such as Asia are hurting.

Key indicators show that 2009 will be a down year but in 2010 there will be some improvement. One key indicator is that in general recessions last 18-24 months and with this recession having begun in December 2007 there is every reason to believe that we will be beginning to look better at this time next year. The reason for this approximate term to a recession is that it usually takes about that long to run through the inventories of goods that have been built up so that new orders can start to flow to meet demand.

The impact of the recession affects different parts of the world in differing ways. Brazil, for instance, is doing well because it has already restructured its banking and other financial institutions and it has a smart regulatory system. There is no recession currently in Australia with their more regulated banking system.

In general all the periods of uncertainty and recession that we have seen previously (at least five major downturns in the latter half of the twentieth century) have been followed by periods of growth. This too shall pass.

What is different this time? The first answer is the global response that is unprecedented. There are bailouts in the US, Europe and Asia. Interest rates have been reset to practically zero. In the US there is a major stimulus package being prepared (at least150 billion for renewable energy included) and continued demand, even urgency, about addressing environmental issues, principally global warming. Environmental issues are of concern everywhere now.
In addition, there is still market demand to for infrastructure enhancements, and replacement of outdated capacity. The investment risk is considered relatively low for power projects. However, the perception is that it will be a 'buyers market' in 2009 and 2010.

The energy outlook appears very strong for the future. It is estimated that approximately 26 trillion dollars will be invested in new energy infrastructure in the next 23 years with half of that being in transmission and distribution. However part of the current delay is that owners and lenders have seen the pause in the sharp run-up in commodity prices (i.e. steel, for example) and are anticipating that prices will begin to fall. Under the guise of waiting for environmental permitting projects are being delayed while owners are waiting for project pricing to start to begin to fall. This has not happened yet but when it happens it will stimulate the world economy. The same is true for lead times. There is no great relief yet in schedules because it takes awhile for the impact of the downturn to work its way through the system. There will be about a six month lag before prices start to turn down and schedules to start to improve.

Owners expect this improvement to happen but no one anticipates that prices will return to previous levels. This price readjustment will not be the same as what happened with oil and gas recently. They were being threatened with regulation because of serious disparity between prices at the wellhead and in the market. In addition the price reductions will be tempered because it is hard to swallow reducing prices for anyone until forced by the market in order to reduce inventory.

Another influence is that because investments in power have a high yield of permanent jobs so it is anticipated that the money for power projects in the stimulus package will have a beneficial effect on moving projects forward but may work against price decreases.

PROJECT DRIVERS

Who's got the money? The Middle East is sitting on significant reserves that have been built up over the past few years. Other key sources of capital include China, global investment funds and some sources within the United States. It is important to understand that The Middle East is going green and going to nuclear power. There are up to ten nuclear plants being planned for the United Arab Emirates (UAE). Egypt is also building a new nuclear reactor. In addition, they are also becoming bargain hunters and more careful investors.

Environmental issues are driving projects around the world. The focus is on improving efficiency and the use of alternate energy. This provides independence from imported fuel, some protection against energy price volatility and improvement in trade balances. For the oil rich countries they now consider their oil as a hard asset and they want to develop alternate sources of energy so they can sell their oil. This also works to improve their environmental quality.

There is a continued linkage of biomass as a fuel and separately developed bio fuels. Brazil, for instance, now gets 85% of its liquid fuel for transportation from homegrown biomass. They co-locate bio-fuel plants and biomass power facilities. There is some indication that this will be a breakout year for solar thermal facilities. Approximately 1200 mW of solar power generation is being planned for the south western US with at least four times that around the world. Significant geo thermal expansion is also planned in places like Iceland and in the ring of fire around the Pacific. Many of these projects will also require boilers. In effect oil is declining as a percentage of the total world mix of energy production although it is still growing in absolute terms.

PROJECT STRUCTURE IN THE NEAR FUTURE

The 'Golden Rule' ("Those who have the gold make the rules") applies now. There is limited funding for projects while the need remains strong. Those who fund projects want reduced prices and reduced risk. As a result contracts will now be written with reduced margins for contractors, reduced escalation clauses and reduced contingencies. There will be more fixed price contracts and further demands for labor concessions. This is also true in The United States where we have a continuing shortage of skilled labor in part because our unions are not as militant as they are around the world. The bottom line is that someone will set the new price at a level where buyers will get back in.

Another way of saying the same thing is that suppliers are no longer in the drivers seat and contractors will have to assume more risk in the future. Buyers will gravitate toward having single point responsibility for their projects. This will lead to more consortium agreements with joint and several liability, more liquidated damages with higher caps and less favorable payment terms. There are already more RFQs being issued with tougher contract provisions written in. These include the requirement for open book contracts.

The key relationship in a project will be that between the EPC contractor and his key suppliers. These relationships will determine project success or failure. EPCs will rely more and more on key suppliers with whom they can share the risk being pushed on them by the customers. Both risks and incentives will have to flow down through the contract structure in order to insure mutual success.

FINAL THOUGHTS

Global prospects remain strong in the energy industry. The trick is to get through 2009. Over the next couple of years there will be fewer business prospects and more competitors. Geotherman and solar facilities may help increase demand for boilers. However, there will be more off shore competition in international markets. This will be coupled with more onerous contract requirements that address investment criteria for mitigating risk. EPC companies and their key suppliers need to cooperate to execute business. Developers will be faced with requirements for more equity participation (up to 50%) before a project can be funded. On occasion they will look for equity participation by contractors.

There are some open political questions that will affect energy projects worldwide. Most solar companies obtain technology from Israel. Venezuela is beginning to become more open even

while it remains risky politically. The same can be said for Nigeria and, to some extent, Indonesia. The approach has to be based on a case-by-case analysis.

US companies can still compete. In general the international community wants to do business with us. We stand up very well against our competition around the world. Even though the dollar is a little stronger recently our prices are still holding pretty well. Countries have a “country personality” in the perception of the world community and contractors from the US are still looked on very well. Another way to say this is that it is perceived that The United States is a good country to buy from based on ability to perform, quality and price.