

Contracting/commercial strategy for the 21st century

As a 30-year veteran of the offshore and construction industries, I read with interest the recent article by K.E. Arnold (*Beyond the Horizon*, May 2003).

I detect a cycle in the manner the contracting players are developing their strategies, and a feeling of déjà vu prevails.

During the early 1980s most clients in the UK North Sea carried out developments by way of a management contract (on a reimbursable/plus fee basis), engineering contracts (usually let on the same basis) with a series of fabrication contracts for modules, jackets, helidecks, pipelines, installation, and tie-ins (predominantly let on a lump-sum basis) with certification, hook-up and accommodation contracts (let mainly on a reimbursable basis).

During the late '80s and the '90s, major contractors pursued a strategy of vertical integration, purchasing fabrication yards, specialist engineering firms, and major suppliers, forging links with installers and pipelay companies.

Simultaneously they promoted a "one stop" shop approach to better coordinate and integrate problems and transfer project risk to one main contractor.

Clients bought into this, and consequently, small players disappeared or were swallowed up.

Now the tide has turned. Major contractors are selling off or closing yards and subletting more complex elements of the design. This trend is partially driven by project location, the local content requirement in all tenders, and improvement of standards in emerging nations.

While the overall number of projects diminishes, those that remain are much larger and often include complex technical, logistical, and political challenges. As a result, increased contractor risk is spread over a smaller number of larger projects.

To address this imbalance, alliances and partnering were tested with limited success. Purely incentivized contracts worked reasonably. The major problem was that, unlike other industries, there is no real financial inducement to the contractor beyond the construction and commissioning phase; thus opex suffers for lower capex.

Currently, major construction companies refuse to bid lump sum EPC/EPIC work.

This stance is driven by a number of factors, such as:

- Larger contracts with more risk
- Problematic geographic and political locations
- Tighter insurance market (CAR/BAR/PI)
- Greater transfer of risk to the contractor
- Longer design life requirements
- Functional specifications.

Contractors now offer to carry out engineering and management of procurement and construction (EPCm) contracts on a reimbursable basis. How they can convince clients that they can manage these risks efficiently when they were previously unable to manage them for themselves remains a mystery. Clients' only other choice is to directly hire contract personnel.

Apparently, contractors failed to realize that clients would require

similar obligations/liabilities under EPCm contracts as they did for EPCs and EPICs.

If the contract is to be reimbursable, no opportunity exists for contractors to include contingencies for such risks as reworks, warranty, insurance deductibles, and so on. The margins on a significantly reduced turnover fail to encourage such risk taking.

Many court cases have been reported in which the management contractor has fared badly. With a reimbursable contract, contractors remain potentially liable, and such liability is not restricted to that of a body-shop contractor.

Surprisingly, clients now approach contractors to ascertain suggestions on the type of contract to let.

This opens up a set of common, but divergent problems including:

- Risk control
- Price control (cost - client capex/opex and contractor turnover/profit)
- Availability of construction and operation contractors
- Ability to carry out difficult to insure work (UK scaffolding companies finding it difficult to obtain employers liability coverage).

Can both parties mutually satisfy their requirements? I believe a contractual and commercially viable accommodation can be reached.

With a contract let on cost-plus-target basis (target bid by the contractor - if the developer is able to prepare a budget for sanction, the contractor can calculate target cost) such cost is controlled by commonality of interest. To minimize the budget, the "cost plus" strategy must cascade as far as possible down the chain to avoid incurrence of risk-related contingencies at multiple levels with multiple mark-ups. A client's budget will still contain the usual contingencies for the overall project (the contractor remaining incentivized by an allocation system of costs against relevant targets in target-based contracts).

To manage risk in large and complex projects and minimize the cost of such control requires innovative ideas.

Traditionally, risks were covered by insurance policies or devolved to various contractors (hopefully still solvent and existing and/or insured possibly 20-30 years later when claims arose). Many such policies duplicated coverage or left certain risks uncovered.

Serious consideration must now be given to project life insurance.

Operators/developers have large international portfolios in some of which they may only be minor joint venture partners. Most have sufficient business in construction and operation insurance to generate market interest in mutual agreement of a suitable scheme. Alternatively, consideration could be given to managed mutuals or captives.

As Ken Arnold stated in his article, I trust these comments will result in a dialogue leading to a workable and mutually acceptable solution to contracting in the offshore industry in the 21st century.

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