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IJ Energy Forum: EPCs - the worst is over

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While the liquidity crisis hinders the flow of project finance deals, the boom in EPC costs that squeezed developers for much of the last two years may finally be behind us.

Speaking yesterday on the side of *IJ Online's* 2008 Energy Forum in Gleneagles, Scotland, Taylor-DeJongh director Afonso Reis e Sousa said that the era of soaring EPC costs in the traditional power and oil and gas sectors may have passed due to fewer projects looking for contractors.

"We're starting to see a lot more responsiveness on the part of EPC contractors to requests for proposals, to discussions, to flexibility on terms," Sousa told *IJ News*. "Fewer projects drive two key costs down - steel and labour. China is still going to have a big pull on steel, but nevertheless I think that at least the rise will have slowed down or possibly stopped, and I think we are going to see costs coming down again."

For much of the past year, developers have struggled to secure the lump sum contracts due to rising costs and contractors' ability to pick and choose projects on their own terms due to the shortage of supply relative to demand.

The impact was keenly felt in this summer's Middle East power sector bidding rounds, as Shuweihat 2, Al Dur [[Projects Database](#)], Salalah [[Projects Database](#)] and Ras Al Zour [[Projects Database](#)] tried to secure fixed price EPCs in time to meet often-delayed deadlines. Many bids collapsed at the last moment as talks with contractors broke up without agreement.

However, Sousa said the consequence of high costs - project delays and cancellations - has rebalanced supply and demand: "Just look at what happened to all the LNG projects that were supposed to get FID in 2007, and then 2008, and now 2009 - these projects keep being put back and cancelled. EPC contractors are realising that maybe they need to start getting new orders up."

But beyond simple demand issues, he said other factors that drove the EPC boom have now tailed off. "The rise was very fast. It was linked to steel prices, it was linked to demand, it was linked to very high oil prices driving a number of projects, it was linked to refining margins going up. So there were a number of factors, all of which seem to be reversing.

"The one thing I don't know is where the fabrication slots are, because that's a key indicator. For example, in refining there's a very long lead time to get a reactor slot in any of the fabrication yards in the Far East. I don't know if that's started to come down yet, but that's the next place I'd look."

Sousa felt that prices had now peaked - with Australia's Pluto LNG [[Projects Database](#)] a high water market - but that they wouldn't start to fall until early next year when deals currently stalled due to the credit crunch get moving once more.

Indeed, developers eyeing the next round of big Middle East power deals have been more concerned about the difficulty securing financing for the projects than the familiar EPC troubles.

If EPC costs are set to fall next year, the question then arises as to whether sponsors should sign any contracts now when they could get a better deal in a few months. But already, contractors are easing up on terms and conditions.

"What you might find is you can already get a better deal, not necessarily on price, but on conditions," Sousa explained. "You might be able to get your contractor to take a greater number of risks even though the prices haven't started to come down yet - moving away from cost-plus, moving back towards some kind of lump sum.

"At least with parcels of the contract, maybe those where risks are knowable in advance and costs are more predictable, contractors can take a view and wrap it for a reasonable premium, as opposed to a very high premium."

However, after a five-year period in which developers strong-armed contractors during a supply glut, only to subsequently get the blowback from EPC firms when demand outstripped supply, Sousa felt we could now finally see a more harmonious relationship develop.

"You're going to see a changing back, perhaps to a more balanced relationship where the EPC contractors need the client, the client needs the EPC contractors - hence the prices are not going to be as inflated as they are now."