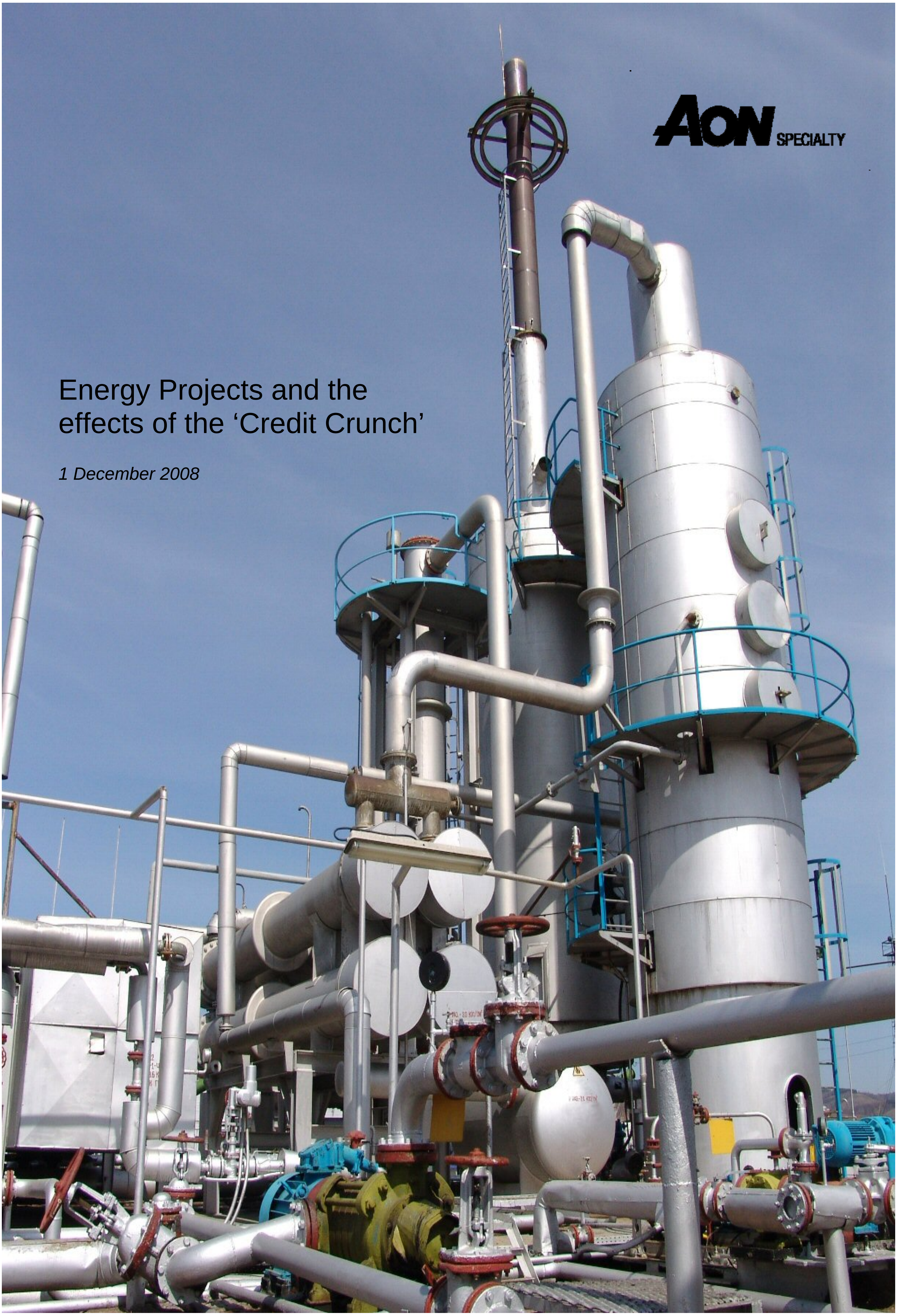

Energy Projects and the effects of the 'Credit Crunch'

1 December 2008

Contents

Robert Glynn
Aon Specialty
55 Bishopsgate
London EC2N 3BD

t: +44 (0) 20 7522 8327
f: +44 (0) 20 7578 7176
e: Robert.Gylnn@aon.co.uk

Background

During the last few months a majority (if not all) of the financial institutions through-out the world have suffered significant losses which have led to there being a freezing in the lending markets or a "credit crunch". The credit crunch in its simplest form can be described as an inability of financial institutions (mainly banks) to lend to third parties including other banks. Banks and other financial institutions' balance sheets have come under severe strain as they have been unable to value much of their own exposures to failing mortgages, Credit Default Swaps (CDSs), Collateralised Debt Obligations (CDOs) or other financial instruments that could call upon their funds. This has additionally led to banks hoarding any cash they do have as they are concerned that if they lend funds to other banks /financial institutions that the counter party may not be able to repay the loan.

Various commentators suggest that the overall loss from all of these CDOs and CDSs through-out the worldwide financial system could be anything between US$ 2 and US$4 trillion (12 zeros).

Governments across the world, but especially those in the USA and Europe, have so far pumped billions of USD, Euros and UK£ into the banks and reduced interest rates so as to stabilise the financial system. It seems that this co-ordinated intervention has brought some stability to the financial system however it will take time to see if this results in the banks starting to free up lending to businesses and households.

What of the Future?

The contagion of the financial system is now spreading further into the insurance market as stock market values collapse and underlying asset values continue to fall. Pension funds are coming under further strain and even the larger life companies could find it difficult to retain the required level of solvency. Many final salary pension schemes are once again potentially significantly under funded.

As the markets / commentators / politicians now appear to accept that there is likely to be a world wide recession, the big question is - how deep it will be? Whilst people feel their jobs and houses are at risk, they are not going to spend freely. Confidence and stability needs to be restored so that consumers are once again willing to purchase general non-essential items. Already we are seeing significant decreases in commodity prices (copper, oil, iron ore etc.) as people's spending habits are factored into a reduction in demand for products.

In recent days the G20 top countries have come together in order to try and work together to minimise the effects of what could be a world-wide recession. Presently commentators are suggesting that the western world could be in recession for somewhere between half and all of 2009.

Where does this leave construction of energy related projects going forward?

For projects to receive the final go-ahead there must be a good prospect of reasonable profit margin over the period that the project is intended to be operational. Many of these projects take many years to bring together (plan, design, finance and contract) before contractors move onto site. Many large projects then take anything between 2 and 4 years to build and commission and once operational they are expected to operate for anywhere between 25 and 50 years. Obviously, during this operational phase, large swings in commodity prices can occur which can significantly affect the viability of a project.

During the last few years there has been dramatic cost escalation in commodity prices, manufacturing costs and contracting costs. These have mainly been caused by many projects being built around the world at the same time, significant economic project activities in the Middle East, China and India, major contracting firms being over stretched as they try to keep up with the project opportunities and manufacturers' order books being full for anything up to a four or five years ahead. This has meant that project costs have ballooned with contractors generally being more in control and therefore able to charge more for their services.

However the sudden reduction in commodity prices due to the perceived worldwide downturn is certainly going to make people look carefully at their financial models. Only a few months ago oil was reaching US$147 per barrel and Copper was at US$8,500 per tonne. Now oil costs between around US$ 50/bbl and copper is around US$3,750 per tonne.

As with any project the net profit before tax is calculated by how much the turnover exceeds the continuing fixed costs (including the servicing of any debts relating to the building of the project and /or taking account of the opportunity cost if financed directly from balance sheet). Therefore commodity, manufacturer, contractor and forward sales prices need to be in phase to make a profit. Now that commodity prices have fallen significantly (feed stocks, materials and products) contractor and manufacturing costs also need to fall into line so as to make a project viable.

On the financing side, once banks have been recapitalised they should be in the position to under take their traditional function of lending money for long term investments like projects. Therefore, although banks may be quite cautious as to whom/what they will lend to, it is likely that they will start lending again in the reasonably near future.

Therefore it is likely that in the short to medium term the following will occur:-

- Major oil companies are presently cash rich and therefore will want to pursue viable projects although they will want the fundamentals to settle so that project viability is more assured
- Projects that now look marginal will be shelved, delayed or re-tendered. Certain types of project (e.g. oil sands/deep sea drilling or working in difficult environments) require minimum levels of oil price to make them viable. Oil sands projects normally require an oil price in the region of US$50 to US$70 /bbl to make them viable.
- Projects are likely to have severe difficulties in obtain finance if they are deemed to be in territories where there are major political or financial concerns.
- Projects that have long term pre-agreed off-take agreements which still look financially viable are likely to go ahead
- Although oil and commodity prices are presently suppressed due to the impact of a worldwide downturn in demand there is still a perceived shortage of oil and commodities through-out the world thus in a few years the commodity prices will rise again once demand picks up.
- Countries with many projects already ongoing are likely to co-ordinate the start of new projects with the commencement of de-mobilizing from other projects already being undertaken in those countries. This enables the best prices to be negotiated as much expense is associated with initially mobilizing a work force.
- Lenders will become more willing to lend to viable projects although their criteria could become even more cautious and their requirements more onerous. Certain governments are now pushing for the recapitalised banks to lend to businesses and get the economies moving again.
- Decisions are made based upon long term opportunities not short term blips – it will be the long term prognoses that will determine project activity over the coming years. It can be a good opportunity to build in lean times whilst looking to be producing in the good times.
- Presently the major oil companies are cash rich whereas many smaller energy companies are stretched therefore it is likely that there will be many mergers / takeovers of smaller companies or project owners will be looking to sell down their projects / bring in joint venture partners.
- Fossil fuel and nuclear power projects will still be required over the coming years to replace existing aging plant and to address local needs.
- Wind-farms and other renewable type projects are likely to go ahead where there still is the political will and/or incentives in place to make them viable.
- Exploration / drilling for oil /gas is likely to see a downturn during 2009 especially in high cost/deep well areas.

Project Insurance – the way forward

The big question for the all those people involved in insuring energy projects through-out the world is how will this affect them?

It is likely that there will be a lull for a few months whilst the financial situation stabilises. The significant government intervention should mean that banks should be lending again during 2009. Additionally the cash rich oil companies will be looking to get viable projects on the move so that they are fully operational when the cycle turns for the better.

Specific Insurance Issues

During the recent boom time for major projects concerns have been raised as to the ability of over stretched contractors, engineers and manufacturers to provide the required quality assurance and quality control. During this period major projects have had to fight hard to obtain top quality engineers whereas other projects have had to accept engineers who have less experience. A downturn in project numbers may enable projects that get the go-ahead to obtain the pick of the best engineers/contractors.

Significant additional worldwide insurance capacity has become available during 2008 and is likely to remain stable and/or even increase in 2009 especially for projects that are not in natural catastrophe areas. This should mean that there is still much capacity available even for the largest projects especially if project values start to fall.

Underwriters will be aware that it will be exceptional hard to replenish capital if it is lost through excessive claims thus profitable underwriting will be their most important consideration. Countering this however it is likely that fewer projects will commence in 2009 thus much competition should be generated especially in regions like the Far and Middle East where much indigenous capacity has been created.

The next 12 months will be very telling as to how the oil, gas, petrochemical and power companies see the worldwide economy progressing. This will be born out by how many projects successfully achieve FID (Financial Investment Decision). Hopefully the worldwide economies will stabilise enabling many projects to be given the final go-ahead.

Aon Specialty Recommendation to best address these difficult times

To obtain the best results from international underwriters of project insurances the following should occur:-

- A detailed presentation for underwriters which clearly identifies all pertinent risks/exposures should be made to underwriters.
- This presentation should be supported by relevant clearly sectioned documents to support the underwriter presentation.
- The risk allocation under construction contracts should be carefully drafted so that this is deemed reasonable by the parties.
- The drafted insurance policy wordings should already address the traditional lenders issues/requirements before they are presented to underwriters.
- Obtaining the best balance between lenders demands and underwriters' willingness to meet these will be an important consideration going forward.
- A professional approach to the overall design of the insurance programme will boost lenders and underwriters' confidence in any project during uncertain times.
- Treat underwriters as partners in the project in order to obtain the best responses.

All of the above can be initiated by an experienced insurance broker who will support the project through-out its lifetime. The more underwriters feel that projects have spent time considering their risks and how to mitigate them the more likely it will be that underwriters should feel comfortable with the project.