How Fears of Impending War Already Take Economic Toll

Nova Chemicals Sits Tight, Shelving Growth Plans Until the Clouds Clear

By Bob Davis and Susan WarrenStaff Reporters of The Wall Street Journal

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PITTSBURGH -- Nova Chemicals Inc. is spending about $5 million on the engineering drawings it needs to expand its Bayport, Texas, petrochemical plant. But Nova is waiting until summer before deciding if it will spend $40 million more to overhaul the plant. By then, Nova figures, it will better know how a U.S. war in Iraq could affect its future.

In one scenario, a long, bitter war sends energy prices skyward and slashes demand for Nova's chemicals, made with oil and natural gas. The more benign possibility is a short, decisive war that sends oil prices plummeting. That could be a boon for Nova, but only if it isn't stuck with high-priced inventory. "We won't get a real spurt in the economy until we see Iraq resolved," says Jeffrey Lipton, chief executive of Nova, which has about $3 billion in annual sales.

Even before the U.S. launches a single cruise missile into Baghdad, war is taking a toll on the U.S. economy. The stock market is swooning as businesses delay investments and consumers grow rattled. The uncertainty and nervousness probably won't dissipate until a war begins or Saddam Hussein flees, so companies are watching and waiting rather than spending and hiring. The start of hostilities may be less harmful to the economy than the threat of them.

Every month the Federal Reserve surveys companies around the country. In January, New England insurance companies, Texas high-tech manufacturers and airlines and Southeastern bankers said war worries were stalling their businesses. Last week at a World Economic Forum session in Switzerland, top officials of Nissan Motor Co. and Hewlett-Packard Co. said they are scaling back their projections of industry sales because of the war threat.

After a third-quarter spurt, the U.S. economy, at best, barely grew in the fourth quarter. The prospect of war is clouding consensus forecasts of 3% growth this year.

Concerns that oil supplies may be disrupted are adding $5 a barrel to oil prices, says Robert Ebel, an energy analyst at the Center for Strategic and International Studies. The oil "war premium" acts like a tax that diverts money from other uses and shaves about 0.25 percentage point off growth. Economy.com, a West Chester, Pa., economic forecaster, calculates that business investment is about $50 billion a year less than its model of the economy would predict, given the current pace of growth. It attributes the gap to corporate war worries.

That reduces growth by another 0.5 percentage point, bringing the total war-fear costs to 0.75 percentage point, or $75 billion less in goods and services and 900,000 fewer jobs, says Economy.com.

President Bush says the economic costs of uncertainty won't affect his war plans. "We don't risk lives with an eye on the stock market," Mr. Bush last week told a group of economists invited to the White House, according to several attendees.

Geopolitical Risks

Nova Chemicals operates in an industry where geopolitical risks play a large role in strategic planning. Oil and natural gas, whose prices are buffeted by political events, are the industry's key building blocks. Chemical makers must gauge long-term economic and political trends before deciding whether to build plants, which cost hundreds of millions of dollars and take years to complete. Since the Sept. 11 terrorist attacks, chemical companies have tightened security at their plants and made contingency plans to deal with transportation and supply problems that could stem from a possible future attack.

"Until we see some resolution of the Iraq situation, it's going to be hard to have a healthy recovery," says Charles Holliday Jr., chief executive of chemical-industry giant DuPont Co.

For decades, Nova has been shaped by political events beyond its control, sometimes with dramatic results. Nova makes tiny beads of plastic, which manufacturers melt and turn into television casings, packaging material, automobile dashboards, toys and garbage bags, as well as some other chemical products.

Launched as an Alberta, Canada, natural-gas pipeline firm in 1954, Nova added a chemical business in the 1970s under pressure from Alberta politicians who dreamed of making the energy-rich province into a kind of Saudi Arabia of the North. In 1998, the chemical company was spun off as a separate entity as a financial crisis swept across Asia and Russia, and demand for imported chemicals vanished.

Over the next two years, Nova spent about $1 billion acquiring U.S. chemical operations and expanded those facilities in anticipation of a market rebound. In 2000, Nova moved its headquarters to Pittsburgh in a bid to raise its profile on Wall Street. The following year, Nova invited analysts to hear the company's prediction that profits would soar the following two years. The date Nova chose for the conference: Sept. 11, 2001.

Into the Red

Nova's business sank deeply into the red at the end of 2001, as orders evaporated, and the company posted a $98 million loss in the last quarter of the year. Mr. Lipton, the company's chief executive, went on the road to assure the company's seven major banks that Nova wouldn't go broke. For the first nine months of 2002, Nova's losses moderated somewhat, but it still reported a $64 million loss on $2.25 billion in revenue. The company reports its fourth-quarter results Wednesday.

Now, once again, Nova thinks it is poised for a turnaround -- but only if the U.S. economy strengthens. Customers' inventories are so low that orders are bound to pick up, Nova managers reason. And investment in new chemical plants has been so sluggish recently that supply could be tight if new orders materialize, letting Nova boost prices and improve its profit margin.

But a war could change the economic outlook in ways Nova hasn't figured. After Iraq invaded Kuwait in August 1990, and the U.S. gathered forces in Saudi Arabia in preparation for battle, oil prices soared. Nova managers huddled regularly to try to predict the direction of oil prices. At one meeting, 28 of the 30 managers were convinced oil prices would slide to $20 after the U.S. attacked, says Rick Henson, a Nova vice president. The prediction turned out to be right, but the company didn't have a hedging operation in place at the time to take advantage of the insight. Saddled with higher-priced crude, Nova's chemical business earned only $8 million, before taxes, in 1991. The following year, with Iraq out of Kuwait, Nova earnings increased tenfold.

Early last fall, as U.S. war threats over Iraq were escalating, company executives feared, once again, they weren't protecting themselves adequately against wild swings in energy prices. Malcolm Turner, a Nova political analyst, put together a memo mostly examining how different scenarios -- an assassination of Saddam Hussein, an Israel-Palestinian ceasefire -- could drive energy prices lower, as they had following the start of the Persian Gulf War. But since writing his first memo, the Calgary, Alberta-based analyst has become much more convinced that the U.S. will be caught in a lengthy war in Iraq, pushing prices higher for an extended period.

"Saddam Hussein isn't talking like a person who capitulates easy," says Mr. Turner, who figures the Iraqi leader would try to destroy Iraq's oil fields, as he did Kuwait's in

1991. He also believes that opposition to the war will grow rapidly in the U.S., which could damp consumer confidence and spending.

His pessimism may be a product of his Canadian upbringing and outlook, he says, which many Nova executives share. "The relationship between the U.S. and Canada shapes your view," says the 52-year-old Mr. Turner, who came of age during the Vietnam era. "If you look what happened to the U.S. in Vietnam and Iran, it points to indications of a messier war" than many Americans expect.

Hedging Strategies

Mr. Turner's thinking has become central to Nova's hedging strategies. The company buys options covering the future purchase and sale of oil and natural gas, in an effort to keep costs below $30 a barrel, rather than the $33 a barrel that oil has been trading at lately. From Nova offices in Sarnia, Ontario, and Calgary, two full-time traders watch several computer terminals to track energy markets, news and Mr. Turner's frequent memos. After digesting the information, the traders make recommendations for trading activities to the "decision board," which is made up of eight raw-materials managers and executives, who have the final say over hedging activities.

Nova's hedging specialists have put together different trading strategies depending on how events unfold in the Middle East, including the start of an Iraq war, or Mr. Hussein fleeing Iraq. Based on Mr. Turner's analysis in the fall, the release of oil from the U.S. Strategic Petroleum Reserve would be an early signal that war is imminent, and prices would likely fall, stabilizing around $25. Mr. Hussein's exile would have a less-dramatic effect, reducing oil prices by a dollar or two, but leaving plenty of uncertainty in the market.

Every week, a dozen or so Nova managers examine whether crude prices are cutting into Nova's profits. Margins are so narrow that Nova calculates that wringing a single penny of extra profit out of each of the 14 billion pounds of chemicals and plastics it sells in a year can translate to $90 million in after-tax earnings. But the managers have regularly underestimated the oil market's skittishness. Unexpected political turmoil in Venezuela, for instance, has helped push oil prices to levels about 30% higher than Nova managers had forecast back in October. Nova has raised prices several times since then to try to avoid deeper losses.

"Are you saying we should prepare for costs to continue to climb?" a Nova manager asked, by telephone hook-up, during a recent pricing meeting in a Toronto suburb.

Exasperated, John Eade, a production planner, shouted into the speaker phone: "Yes. Climb. C-L-I-M-B! -- the wrong way."

Mr. Lipton, Nova's CEO, has a theory that prolonged turmoil in the Middle East actually benefits the company because Nova's competitors in Saudi Arabia and Iran won't be able to attract investment to expand capacity, while Nova isn't hindered. Nova's natural gas comes from Alberta, one of the cheapest and most reliable sources of energy outside the Middle East, giving the company what it calls an "Alberta advantage."

But the company hasn't acted on the theory, indicating that the health of the U.S. economy, more than a fractured Middle East, is key to Nova's business prospects. Indeed, the company is waiting for the confrontation over Iraq to end before boosting investment plans. Nova sells exclusively to manufacturers, who are also looking for signs of an economic upturn. "Our customers have to feel confident about the future" before they ramp up orders, says Mr. Lipton. "That means getting beyond a war in Iraq."

As Nova waits, it conserves cash. Between 1998 and 2000, Nova averaged $475 million a year in capital spending. Last year, as war worries mounted, its capital spending shrank to $70 million, about half the level the company says is necessary to sustain production at 2000 levels.

Among the shelved expansions: constructing a series of warehouses in the U.S. to store output from Nova's Canadian plants in case the U.S. shuts down the border as it did after the Sept. 11 attacks. Over the last two years, Nova has reduced its work force by about 13% to 4,200. The company recently ended an informal hiring freeze.

This year, Nova is again planning to spend only $70 million. But it may decide to double that amount if the war clouds clear. Along with the $40 million expansion at Bayport, Texas, Nova is considering another $50 million in oil and gas projects, including expansion of the company's railcar system, building new storage tanks and improving pipelines. At Sarnia, across the river from Michigan, Nova is looking at a major expansion, which could cost between $150 million and $200 million. No decision is expected until the summer, when the company should have a better fix on whether a U.S. upturn is likely. A pipeline under the St. Clair river connects the Sarnia plant to a Michigan plastics maker that sells plastic padding for dashboards and other interior parts to U.S. car makers. Mr. Turner, Nova's political analyst, says he's rethinking one of the scenarios that could affect Nova's business. He's no longer sure that if Saddam Hussein fled Iraq, oil prices would decline as the crisis receded. Maybe the U.S. would still invade, he reasons, to make sure the new regime was disarmed, thus keeping oil prices high.

Last week, Mr. Turner addressed about 30 Nova managers gathered in Sarnia to examine the company's strategy. "I think it's fair to say we're actually in the first energy crisis of the 21st century," he told his colleagues.

Write to Bob Davis at bob.davis@wsj.com and Susan Warren at susan.warren@wsj.com