Oil Market Report – February 2015

Back in 2013, Portland described London's Oil Week as "where the great and good of the oil world convene for a "Davos style" oil event…which each year goes from strength to strength" (see Feb 13) . But last month we predicted that with the recent drop in oil prices, this year's event might be a more moribund event with far fewer attendees. Were we right? Well, the traditional giant delegations from West Africa and China were noticeable in their absence and perhaps a few of the fringe events (loved by Portland!) had spare seats, but on the whole we weren't right – London's Oil Week was as busy and vibrant as ever.

Discussions did of course centre on the consequences of the lower oil price and by morning coffee on the Monday, delegates had already been told that investment in all forms of oil exploration would be down by circa 35% – 40% in 2015. They'd also learned that Shell's capital investment programme would be reduced by $15bn and BP's by $5bn. However, Speakers were still keen to point out that demand for oil continued to be robust and that paradoxically, low oil prices were likely to drive even further growth in oil consumption (purchases of SUV's in the USA for example have rocketed since the drop in oil prices – up by an incredible 29%). As the Commercial Director of one oil trading firm pointed out, "just because the product is worth a lot less, it doesn't mean that we are moving any less of it about".

In fact many of the operators had slightly bigger smiles than might have been expected 6 weeks earlier when the crude oil price hit a low of $45 per barrel. By the time Oil Week came around, the price of oil had actually significantly recovered, hitting $60 – a 33% price rise in the space of 6 weeks. Here surely was proof that Saudi Arabia's hardball tactic of maintaining production whilst prices crashed around them was actually working – the major OPEC members would weather the storm of low prices, whilst the private operators would either be squeezed out of business or forced to cease their more expensive operations.

But the shale revolution has defied conventional thinking from day one and it continues to do so. Six months ago there was general agreement that shale oil could not survive in a $75 environment, but that figure has been rapidly revised downwards – some even saying that $40 per barrel is now a manageable level for the shale industry. How can this be? Well firstly the shale oil operators have demonstrated remarkable innovation in the face of lowering prices, such that "refracking" and "double fracking" are ensuring that the same rock formation can generate twice the oil yield for the same original cost. The operators are also finding ways of switching shale production on and off ("like a light switch") to deal with price fluctuations – very different to the commissioning and decommissioning of conventional oil wells which can take several years. Plus, don't forget that crude isn't the only thing that has dropped in price. Costs of labour, steel, chemicals, transport and of course energy, have all been reduced in the shale producing areas, because this is what happens in a free market. Costs have to adapt to the environment and profits have to reduce, but it doesn't mean that the industry dies. Far from it, lower prices normally mean technological innovation and industry advancement.

Moreover, the companies behind shale oil are unique in the context of conventional oil. Whereas the State Oil Companies and Oil Majors have their exploration and borrowing levels scrutinised at every level, the shale industry is made up of a set of players for whom there is no clear modus operandi. Nobody is quite clear on how these operations are funded or if they are funded at all. And unlike the State Oil Companies (who need large profits to fund national infrastructure) or the Oil Majors (who need equally large profits to pacify shareholders), it is totally conceivable that these small, independent businesses are happy to breakeven for a few years, so long as salaries can be paid and lifestyles maintained. Wow…this nascent industry is a game changer in so many different ways.

But the last 3 months should have taught us that things can and do change quickly in the world of oil. We are rightfully amazed by the adaptability of the shale industry, but profitability from day to day is not necessarily the same thing as long-term sustainability. We may not know the exact figures, but many shale oil operators will have borrowed significantly over the last 3 years and that cost of borrowing will look

very different, if for example, US interest rates were to rise. So as things stand, the old maxim that “the best cure for low prices is low prices and the best cure for high prices is high prices” seems to adequately fit the bill. The shale producers will start acting as the pivot for the world oil market – winding down when low prices make drilling unattractive and then rapidly ramping things back up when prices become more buoyant. Once again, they are changing the rules of the game...