Portland Market Report

JUST BECAUSE THE PRODUCT IS WORTH A LOT LESS, IT DOESN'T MEAN THAT WE ARE MOVING ANY LESS OF IT ABOUT

March update

Report on London Oil Week (aka IP Week)

Back in 2013, Portland described London's IP 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*". Last month however, 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 IP Week was as busy and vibrant as ever.

It certainly says something for the industry that a 60% drop in prices in the space of three months is greeted by a collective shrug of the shoulders and a general "*we've been here before*" demeanour. As you would expect, discussions on the consequences of low prices did dominate and few spoke out to challenge the consensus view that investment in all forms of oil exploration would be down by circa 35% – 40% in 2015. After all, by the time delegates took their seats on the Monday, Shell had already announced that their capital investment programme would be reduced by $15bn and BP's by $5bn. But speakers were still keen to point out that demand for oil continues to be robust and that paradoxically, low oil prices are likely to drive growth and oil consumption even further (purchases of SUVs in the USA have rocketed since the drop in oil prices – up by an incredible 29%). Or as the commercial director of an 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 IP Week came around, the price of oil had actually significantly recovered, hitting $60 by the middle of February – a 33% price rise in the space of 6 weeks. To the hopeful producers at least, here was proof that the Saudi's hardball tactics of maintaining production whilst prices crashed around them were actually working. The big 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 oil revolution has defied conventional thinking from the start. 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*" ensure 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 years and years. Plus remember 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.

Plus 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 possible that these small, independent businesses are happy to breakeven for a few years, so long as salaries can be paid and lifestyles maintained. Boy oh boy, this nascent industry is a game changer in so many different ways.

All of that being said though, one thing the last three months should have taught us is that things can and do change quickly in the world of oil. We are rightfully amazed by the resilience and 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 three years and that cost of borrowing will look very different if and when US interest rates rise. So 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 accurately sum up what we can expect in 2015. The shale producers will start to act 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…

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