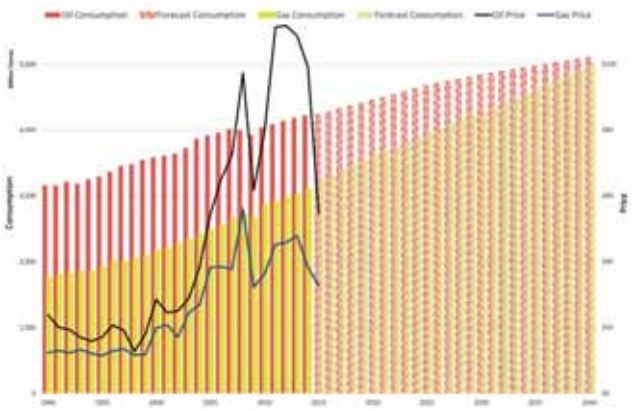
PORTLAND MARKET REPORT

IT'S STILL TRUE TO SAY THAT GAS IS NOT READY TO DISPLACE OIL JUST YET

May update

Oil & Gas: Consumption in Million Tonnes per year and Price in US$ / Barrel Oil Equivalent



Big oil companies and their shareholders tend to panic when oil prices plummet and the result is often a splurge of corporate mergers. Indeed, it was the low oil price at the end of the 1990s, that led Lord Browne (then head of BP) to first merge with Mobil and then buy the American oil giants Amoco and ARCO in quick succession. At about the same time, Exxon bought out the remnants of Mobil, Chevron merged with Texaco and Total gobbled up Elf and Fina.

So it was no surprise that on the back of such a momentous drop in the oil price that we saw at the turn of the year, a big merger would soon be in the making. And we didn't have to wait long, as April saw the mighty Shell swoop for BG (what was British Gas) – Britain's 3rd biggest energy company – in a $70bn takeover. Shell execs must be pleased with themselves for the new combined entity will indeed be a Leviathon – particularly when it comes to gas. In fact, the new company will be the 3rd largest gas producing company in the world, after Gazprom (Russia) and the Iranian State Gas Company.

And it is the importance of gas in this merger that is so interesting for in itself it signifies a massive sea-change in the energy landscape. Whereas the mergers of the 90s were all about the economies of scale of oil exploration, here we have blue-blooded oil aristocracy in the form of Shell spending all its money on a gas takeover. Why? Well…to put it bluntly, it is gas and not oil that represents the future of the fossil fuel industry.

In operational terms this is actually rather good news for the oil majors. In recent times they have increasingly found themselves on the fringes of oil exploration, toiling away on cost-heavy and inhospitable fields (deepwater reserves, polar regions etc), whilst the National Oil Companies (Saudi, Iran, Iraq, Venezuela) enjoy lower exploration costs in more accessible places. Gas on the other hand is a much more open playing field, where the majors seem to have the upper hand when it comes to newly discovered fields. Not to mention (AGAIN!), the shale miracle, which of course represents just about the most openly-accessed energy market in the world and where there is not a National Oil & Gas Company in sight.

But the main reason why the oil majors (who should probably nowadays be called "oil and gas majors") are rushing headlong into the gas world is its relentless growth as an energy source. True, the graph shows that crude oil demand continues to grow going forward until 2040, but the rate of growth for gas is far, far more impressive, meaning that consumption of oil and gas by 2040 is more or less equal. There are 3 main reasons for this. Firstly, it has been and looks likely to continue being cheaper than oil. Secondly, burning gas generates unrivalled energy efficiency and finally, linked to this second point, the leaner hydro-carbon chains (lower carbon content) means that gas is by far the greenest fossil fuel on the planet.

That's why it's already projected to overtake coal as the world's largest power generation source by 2020 – a remarkable fact when you consider that at present, the world's largest energy user (China) relies on coal for 70% of its power generation and gas for only 5%. But demand for gas in the East is booming and overall, demand in Asia is set to quadruple over the next 30 years. This is a massive modal switch in global energy demand, reminiscent in many ways of the last time coal was overtaken as the prime source of energy (by oil) at the turn of the 19th century. So when Shell was considering who to buy next, it hardly seems much of a coincidence that they pursued a company with huge gas operations, rather than another oil major with a portfolio of elaborate and complicated oil plays.

It's still true to say that gas is not ready to displace oil just yet and without doubt, it is likely to lag behind oil for many years to come. Particularly in the transportation sector where the infrastructure required for mass gas supply is enormous. Here crude and refined oil have huge advantages, for although flammable, transportation of these grades is pretty straight-forward. Gas on the other hand requires liquefaction plants, compression pipelines, specialised (pressurised) rail cars, not to mention roadside refrigeration and regasification facilities, if it is to become the prevalent fuel grade at petrol forecourts. But for a blue-chip oil & gas major, a few years is but a short period of time to wait, when all the projections seem to suggest that one day, gas will triumph over oil as the world's main energy source. In this light, Shell's latest acquisition represents both a prudent and canny long-term bet. Shame Portland is an oil man mind…

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