www.bunkerspot.com Volume 12 Number 1 February/March 2015

BUNKERSPOT

THE RIPPLE EFFECT

NEW REGULATIONS COME INTO PLAY

INSIDE:

LNG

RISK MANAGEMENT

CREDIT INSURANCE

FUEL ANALYSIS

Upside down

Why have oil prices fallen so fast and so far? Looking at historical supply and demand trends, and recent investment strategies in the financial markets, Chris Thorpe suggests that there were early indications that the price of oil was heading for a fall

'With new supply unchecked inventory continued to build. Slowing demand growth and more consistent global supply fundamentals eventually caused the entire market to tip over and oil prices began to fall'

Oil is no longer a product reserved for refineries to make gasoline, diesel and bunker fuels. It is now the world's most widely held commodity financial investment, and that investment is now a bust. Other commodities, including copper, iron ore, dry bulk ships, corn, coffee and natural gas, are in a similar funk. A strengthening US dollar may have been the catalyst but the overwhelming questions remain: why did oil prices fall so fast and so far?

Perhaps investors or speculators are to blame. Or maybe the answer is hidden within a financing story where easy money found its way into the North American oil and gas industry. Some may see similarities with shipping, an industry which has traditionally rested on leveraged financing despite volatile commodity-linked risk. Abundant tonnage in the shipping industry led to low prices, operating losses and debt restructurings. Could a similar fate befall oil producers?

The North American oil and gas renaissance evokes a tale from the Wild West of old where pioneers secured land rights to drill for

oil. Some of the oldest oilfields in the United States, including Bakersfield, California and the Permian basin of West Texas, were left all but dead in the 1990s. Majors such as Occidental Petroleum, Chevron, and Conoco Philips shut in wells or abandoned underperforming wells in favour of larger higher yield projects.

Improving technology, primarily driven by hydraulic fracturing with horizontal drilling (known as 'fracking'), completely changed the cost economics for producers just as oil prices were driving higher. New drilling technology led to greater yield from existing wells which created a boom for oil producers. Meanwhile, rising oil prices created attractive incentives to keep drilling and producing. Prolonged periods of high oil prices, however, eventually intoxicated investors who became convinced an oil well was as safe as a corporate bond.

The use of high leverage debt financing quickly became the norm for smaller and medium-sized oil and gas companies. Even larger companies such as Chesapeake were able to raise debt for negative cash flow businesses purely based on growth and promises that new investment in oil wells would promise attractive returns in the future. One would imagine this kind of higher risk investment would be more appropriate for equity investors. Yet persistently high oil prices convinced more conservative bond investors that underlying assets (in this case oil and gas reserves in the ground) were security enough to support higher levels of debt. Management teams rejoiced as their personal stakes became more significant without outside investor dilution.

Bond investors' investment theses continued to be supported by global oil industry fundamentals from 2009 through 2013. Supply uncertainty had been continuously flamed by clashes in Libya and the Middle East. Demand growth in emerging markets was strong and stable, underpinned by a government-fuelled Chinese economy. It was all but certain that emerging market growth would provide the global oil markets with enough demand to offset slowing growth in the West despite increasing supply. Financial markets told a story of complacency, with little or no fear of an oil price slump.

Oil prices, however, have no sympathy for investor philosophy, past or present. After all, the financial crisis was merely a short intermission for oil markets when prices briefly breached $33 dollars per barrel in January 2009. Although other commodity markets had stumbled since 2009, oil seemed to recover in defiance, once again breaching $100 dollars per barrel by early 2011. With the spectre of global turmoil on its side, oil prices remained buoyant. Volatility remained well below historic norms and memories of 2008 market instability were long forgotten.

By 2013, it was clear that demand growth was slowing in developed countries, including the United States, and it seemed as though the amount of new supply had not been well understood by investors. Given increased domestic oil supply, the United States was importing volumes at 1995 levels, decreasing imports from the Organization of the Petroleum Exporting Countries (OPEC) by 40%. Given that the United States is the largest consumer of oil, the shifting supply and demand imbalance foreshadowed something more significant on a global scale. What seems strange is that new supply did not suppress prices or cause increased levels of fear in the financial markets in late 2013 or early 2014.

> 'Bonds for levered oil and gas companies are already selling at deeper discounts and bankruptcies are likely on the horizon'

Financial markets may be partially to blame. Oil is the anchor product for commodities as an asset class for indexes, pensions and funds looking for broad portfolio diversification. As a result, the financial markets now account for a significant portion (as much as 30%) of oil demand which is typically supportive of prices. Since financial investors make up a material portion of demand in the futures markets, there is no question that oil has become more of a financial asset than a physical product to store and hold. For broad market investors, the absolute value has become more important than inherent fundamental supply and demand risk.

Why should investors worry? Financial products do not need storage, transportation and infrastructure. Therefore, investors can shift positions rapidly using the liquidity of oil futures to enter or exit when desired. Liquidity, or the ability to trade in size with an abundance of buyers and sellers, is one of the most valuable attributes of any investment. But while large financial oil investors in oil can swing from long (buyers) to short (sellers) in a matter of seconds, an oil well driller who invests millions in geological surveys and wells cannot change its capital investment plan so quickly. Patient capital investment is often a sage strategy, but timing is everything.

July of 2014 may have been a high water mark for oil prices, at least for the current decade. Fundamentals had already pointed to increasing volumes of production in North America with oil filling every pipeline and storage tank to capacity. Rail cars and transportation routes were showing signs of stress, as evidenced by the catastrophic crude oil derailment at Lac-Mégantic, Quebec, where 42 people perished. With new supply unchecked, inventory continued to build. Slowing demand growth and more consistent global supply fundamentals eventually caused the entire market to tip over and oil prices began to fall.

Facing an oversupplied oil market and slower than expected demand growth, financial investors sensed distress and began to sell in earnest by the fall of 2014, which only increased the speed of the price drop. North American oil and gas producers, however, were not so nimble and, if anything, took a bullish view that markets would rebound sooner than later. Saddled with high levels of debt, many smaller and medium-sized North American producers believed production at lower prices would be necessary to service debt. Oil prices continued to fall and financial markets became bearish, leading to oil prices dropping below $45 dollars per barrel for the first time since 2009.

There is an eerie similarity between the oil and shipping industries. The latter may now be considered a zombie industry, saddled with idle ships and upside down corporate capital structures. If oil prices remain depressed, energy producers will face similar distress. Bonds for levered oil and gas companies are already selling at deeper discounts and bankruptcies are likely on the horizon. Following in the footsteps of distressed shipowners, oil and gas companies could begin to sell assets to remain solvent, despite their claims that prices should recover soon. If the shipping industry is any indication, soon may not be soon enough.

Chris Thorpe is a Managing Partner of Brick Consulting Partners and Brick Investment Partners.

Tel: +1 646 790 5777
Email: thorpe@brickipllc.com