Monthly outlook – July

Gulf syndrome

One of the world's most expensive cost-saving experiments: this is how one might characterize the oil rig accident that occurred on 20 April, leaving a blotch of oil as big as the Carpathian Basin in the Gulf of Mexico. The current extent of the contamination eclipses many times the Exxon Valdez tanker accident of two decades earlier, which resulted in almost a quarter of a million barrels of crude oil flowing into the ocean along the shores of Alaska. At the same time, the important distinction to be made is that while in the case of tanker accidents the ship's capacity serves as the natural upper limit to the size of the leak, in the case of deep-sea wells the extent of the contamination is potentially almost limitless.

Based on the data currently known, for the time being one can only guess at the exact nature of the failures and construction faults that may have led – despite ample precautions – to the April disaster, as a consequence of which crude oil continues to pour from the damaged wellhead into the Gulf of Mexico to this day. Opinions in the industry hold that excessive cost-saving measures may partly explain the disproportionately great assumption of risk, although it is also conceivable that this suspicion will only be partially confirmed in future and that negligence may have been at least as great a contributory factor in the events. In any event, things do not look good for BP after the emergence of a letter from one of the company's engineers in which the scarcely elegant phrase "will probably be fine" was used by way of approval of the less thorough than usual well-capping operations.

The large quantities of crude oil appearing on the Florida coastline represent one of the surest signs that on this occasion there is more at stake than a loss of image for the production company concerned. Bowing to increasing political pressure, BP has set up a gigantic USD 20 billion fund from which it will finance compensation over the coming years, but there is a good chance it will have to pay even more than this. In any event, the market is counting on it, given that some USD 100 billion of BP's market capitalisation has been wiped out since the April disaster. The market value of the other two owners of the Macondo deep-sea project has suffered a further USD 100 billion decline, as has the combined market value of the companies of the OIH (Oil Service Holders) ETF. The total USD 200 billion in market capitalisation wiped out in this way amply represents the combined compensation payments and lower oil price, meaning that the capital market, with its low tolerance for uncertainty, has inflicted an excessive punishment on affected players on this occasion as well.

Besides the three owners of the Macondo deep-sea project (BP: 65%, Anadarko Petroleum: 25%, and Japan's Mitsui: 10%), others that may be held responsible include Halliburton, which was responsible for cementing the well casing, the oil rig's owner Transocean, and Cameron, the manufacturer of the blowout preventer. What is entirely sure is that the gigantic compensation claims will entail protracted and extremely complex legal proceedings. The players involved, with registered headquarters in several different countries (the UK, US, Switzerland, Japan), will in all likelihood pursue a circle of counterclaims against each other, involving procedures that are bound to last for years. As a consequence, the name of Macondo, having become a feature of the media, may well enter the indexes not only of Greenpeace publications, but also of legal case studies and finance textbooks. At the same time, we can also envisage a scenario where even deeper-reaching changes will occur in the oil industry itself, which will eventually impact every consumer by way of changes in the price of crude oil.

The accident in the Gulf of Mexico has opened up a new dimension of risk in the oil industry, where, until now, it was considered almost inconceivable that a single accident might demand compensation of as much as USD 40-50 billion – a sum on a scale which is only rarely experienced even in the case of buyouts and mergers. If it were not the world's second largest oil company that was the operator of the currently uncontrollable deep-sea oil well, then it would almost certainly be the case that the company would not survive the catastrophe due to the gigantic scale of compensation entailed. This is true to such an extent that even the bankruptcy risk priced in to the bonds of a giant of the industry such as BP has jumped dramatically in recent weeks. In response to compensation claims, BP has been forced to take out a significant amount of credit and sell off substantial assets; moreover, it will need to cancel dividend payments and cut back its investment program in order to survive.

As a result of the disaster the American authorities have suspended deep-sea drilling in the Gulf of Mexico for six months. For the moment, major uncertainty remains around the final political stance, although we believe that in the end there is a far greater chance that deep-sea exploitation will not suffer an administrative ban – quite simply because the United States needs the one and a half million barrels of oil extracted from the Gulf of Mexico daily. At the same time, the regulatory environment may become significantly stricter. Add to all this the fact that the tightening measures are generally overzealous, and it can be regarded as a realistic scenario that deep-sea project costs will increase substantially in the mid-term – at as much as a double-digit rate. It might also be important to stress that this increase in costs is occurring at a phase of the supply curve that could have a direct effect on the price of oil.

As regards its mechanism and cost structure, the oil market represents a dichotomy: around half of the extracted crude oil originates from low-cost fields of the players in a dominant market position (including primarily fields in the Middle East and CIS countries). In this cost range, an external event resulting in more expensive production would be irrelevant as it would not greatly impact the price of oil, but would at most reduce the cost advantage of players with a low cost structure.

The segment that contains the higher-cost fields – known as the "competitive fringe" – is much more of a genuinely competitive market, where significantly lower returns can be achieved. Oil extracted via deep-sea drilling is traditionally high-cost, and, based on industry cost models, the costs relating to the full investment cycle – depending on the depth and geology of the drilling fields concerned – fall in the range of USD 60-80 per barrel. All this means that certain deep-sea projects, given current oil prices, can be operated at barely symbolic rates of profit, meaning that in practice the marginal producer with a determining influence on prices is omitted from this group – as is the last barrel of oil extracted at the highest cost which is still worth bringing to market at the prevailing price of oil. For this reason, the rise in cost levels for current marginal producers that determine the oil price (partly oil sand and partly certain deep-sea projects) directly justifies a higher oil price in the mid-term.

Besides the impact that expected stricter regulations will have in terms of increasing costs, it may also be worth considering that companies' investment decisions are taken based on long-term assumptions regarding the development of oil prices, as well as on the expected return on a given project. The expected return on deep-sea projects will necessarily increase sharply in the wake of the events of recent weeks, which may lead to the cancellation or postponement of less attractive investments. While investment projects in the period 2008-09 were typically called off as a consequence of the low price of oil, on this occasion it may be the deteriorating returns as a result of the six-month moratorium on drilling and the unaltered development of oil prices, together with the changing economic environment, that will lead to delays in certain deep-sea projects.

Due to the potentially high compensation risks for smaller companies, financing risks may be assessed differently, which may lead to the gradual squeezing-out of smaller companies from deep-sea projects, in favour of extraction from fields, which is far easier to plan. Deep-sea projects – no matter how low the likelihood of individual catastrophes occurring – may increasingly become the sole speciality of major players in the industry in the longer term due to the high potential damages, whether this means the operation of drilling rigs or the given services carried out.

With all these impacts taken into account, we believe that the accident in the Gulf of Mexico, on a time horizon of several years ahead, with its direct and indirect effects on costs, and with the accompanying selective and delayed effects arising from higher expected yields, has brought factors to the market that support the price of oil.

In the short term, however, the effect is modest for the time being: we expect the price of crude oil to fluctuate on the market this year unchanged in the range of USD 65-85 per barrel. In our judgement, uncertainty may grow as a combined effect of the tailing-off of state-sponsored economic stimulus programs and the introduction of restrictive measures, leading to a possible slowdown in the global recovery in the second half of the year that will scarcely help the rising prices of raw materials. At the same time, it follows from the cost structure of the supply curve that the price of crude oil enjoys strong fundamental support at the level of around USD 65 per barrel. The lower end of the range – if it is reached – might provide a purchase opportunity in light of the fact that we expect cancelled investments and the narrowing of supply to appear in the oil price over time, as a result of which we believe that an oil price of USD 100 per barrel will be within reach within three years even without a more pronounced economic upturn. The events in the Gulf of Mexico, by causing a further narrowing of the supply side, may have substantively strengthened the upward pressure on oil prices in the medium term.

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