Trading and Risk Management IssueAlert

UtiliPoint® International Inc.

Trading & Risk Management | Utility & Energy Technology | Energy Investment & Business Planning | Market Research | Pricing Products & Services

Peter C. Fusaro
Gary M. Vasey

February 18, 2005

A Major Structural Shift in Energy—But Where are the Majors?

By Peter C. Fusaro, Chairman, Global Change Associates and Dr. Gary Vasey, Vice President, UtiliPoint® International

Earlier this week we had the opportunity to attend Institute of Petroleum Week, an annual oil and gas forum comprising a comprehensive programme of conferences, seminars, exhibitions and social functions in London where Global Change and UtiliPoint® International presented a seminar on Energy Hedge Funds[1] in Europe. IP Week is an annual event that also provides a networking opportunity via a series of parties and receptions thrown by oil companies, banks and service providers. During our own networking activities, we learned much about the current state of oil markets and trading in particular and this week's TRM IssueAlert summarizes a number of those observations.

Oil Prices—Bulls & Bears

We believe that global energy commodity markets are now undergoing a fundamental structural change. For each energy and energy-related commodity, global and regional markets are now displaying a new level of supply/demand tightness. We have argued that energy commodities prices will remain high for some time to come as a result. In London, we found this to be a view readily shared by the bankers and hedge fund contacts that we met but not one apparently shared by oil company traders. We heard comments that recent relatively small downward movements in oil price were symptomatic of mean reversion. Indeed, many oil companies are still holding on to oil price forecasts of around $25 to $30 per Bbl and, at times, seem to be in denial of the current supply and demand environment.

At a time when OPEC's ability to be the "swing" producer is diminished and when Asian nations such as China and India are busy securing supply to feed their increased demand forecasts, one is forced to ask why the major oil companies appear to be looking for a low price future. China's net oil imports are set to rise by 33 percent over last year to 140 million metric tons according to Gao Shixian, director of the China Energy Institute with demand predictions of 7 million Bbls of oil per day. Only Saudi Arabia among OPEC members has any real spare capacity estimated at 1.6 million Bbls per day and there are increasing questions over the accuracy of that estimate among industry pundits since it has never been audited by an independent third-party. At the same time, major oil companies continue to downgrade their own reserves estimates and have singularly failed to add any major new finds over the last decade or so. Estimates from Duestche Bank also suggest that oil companies have reduced their Exploration budgets by more than a quarter and the IEA has estimated that something of the order of $2200 billion needs to be spent on E&P between now and 2030 if future oil demands are to be met.

What we observe is a strange dichotomy in views on where future oil and other commodity prices are headed. On the one hand, the oil companies and their traders see a return to a lower price while the "speculators" view a $40-50 per Bbl or higher price as being the norm. A recent poll on our Web site, the energy hedge fund center (www.energyhedgefunds.com) also shows the same dichotomy of views with two peaks of between $20-30 per Bbl and $40-50 per Bbl. In Q4 of 2004, hedge funds and other speculators went long on oil prices and their gamble paid off in the form of good returns. They were right and the oil companies were wrong.

Once Bitten—Twice Shy?

Perhaps the oil companies have been caught out too many times in the past when price rises proved to be temporary price spikes. In those instances, incremental monies spent on E&P resulted in diminished returns as the oil price reverted back to levels that made new developments sub-economic. On the other hand, could it be that exploration is too much risk for oil companies to bear after all, increased exploration activities, and therefore risk, have simply not been rewarded by analysts and Wall St.! Instead, Wall St. likes share buy back programs and large dividends. In fact, in recent years, majors like BP, ExxonMobil and others have apparently spent more on share buy backs and other programs designed to improve share price than they have on their E&P activities!

On the surface anyway, the evidence seems to suggest that major oils have been conditioned into a behavior set based on meeting or exceeding the expectations of Wall St. analysts in a prolonged regime of low oil prices to see and/or react to the major and fundamental shift in markets we are now witnessing. Given the current supply/demand tightness (as opposed to supply shortages), projections for increased demand in Asia and other markets such as the United States, any potential for supply disruption through industrial dispute, terrorism, or natural disaster is likely to have a serious impact on prices. The speculators see this clearly and are betting significant sums on it. In the meantime, if the majors delay too long in re evaluating their views of future oil prices, the situation will simply become worse.

Increased Potential for Acquisition Activities?

According to Dundee University, a $1 per Bbl increase in the price of oil translates into a 6 percent increase in earnings for major oil companies. Perhaps the easiest way for major oil companies to increase reserves in the short-term is to acquire them in the ground via acquisition of independents. However, even on this front, the oil companies seem to be lagging the speculators as investment banks have already been active buying reserves in the ground. Morgan Stanley is reported to have purchased 24 million Bbls of reserves for

$775 million from Anadarko over next 4 years and in conjunction with Deutsche Bank to have also purchased equity production in North Sea between 2007 and 2010, amongst others. Plainly, they see an opportunity for profit in their activities.

Summary

When we look to the future of oil supply we assume that it is oil companies that have the expertise and know how to find, develop and exploit new reserves. In fact we are relying on them to do so. Today however, both the anecdotal evidence that we have collected and the published evidence suggests that the investment banks and hedge funds are ahead of the majors in terms of understanding that we have entered a new paradigm of oil supply and demand almost unannounced. Perhaps the oil companies are reluctant to believe that the structure of the industry has changed or perhaps their executives are now rewarded for taking lower risk strategies after finding that exploration and production activities in the past have failed to bring new profits? From where we sit, the speculators have it right and if the oil companies don't react and respond soon then supply issues could take on even more importance in the coming years.

The Energy Hedge Fund Center is a free online community designed to provide information, discussion and articles on speculator's activities across the energy industry—please visit it at www.energyhedgefunds.com.

EHFC
ENERGY HEDGE FUND CENTER
Sponsored by
KIODEX

[1] You may purchase a CD of the presentations from this recent seminar at www.energymediagroup.com. Speakers included Peter Fusaro and Gary M. Vasey, Ph.D. as well as Dr. Nedia Miller of Miller CTA and Mr. Tom James of Global Risk Partners.

© 2005, UtiliPoint® International, Inc. All rights reserved. This article is protected by United States copyright and other intellectual property laws and may not be reproduced, rewritten, distributed, redisseminated, transmitted, displayed, published or broadcast, directly or indirectly, in any medium without the prior written permission of UtiliPoint International, Inc.

UtiliPoint's® **Issue*Alert***® articles are compiled based on the independent analysis of **UtiliPoint**® consultants, researchers, and analysts.. The opinions expressed in **UtiliPoint's**® **Issue*Alert***® articles are not intended to predict financial performance of companies discussed, or to be the basis for investment decisions of any kind. **UtiliPoint's**® sole purpose in publishing its **Issue*Alert***® articles is to offer an independent perspective regarding the key events occurring in the energy industry, based on its long-standing reputation as an expert on energy issues.

Reprinted with permission from UtiliPoint® International **Issue*Alert*®.** Further reproduction or distribution is prohibited without permission.