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The Star Online - Economic Impact Of Resurgent Oil Market

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By FINTAN NG

Oil prices are moving up again as the so-called green shoots start sprouting in the global economy.

THE crude oil market is showing signs it may re-ignite. Prices are on the march again as the so-called green shoots start sprouting in the global economy. But does the rally have legs, given the still weak conditions in major energy-consuming countries such as the United States and the eurozone nations?

Chandran Rajadurai ... 'Should prices come down, there may be opportunities for mergers.'

There is also the fear the buoyant prices may spark cost-push inflation which will suppress world demand and therefore trip the economic recovery.

But these are short-term considerations. The long-term view of many in the oil and gas industry is that the crisis has led only to a pause. They believe that prices will eventually resume their climb, powered by urbanisation, industrialisation, population growth and changing lifestyles, especially in the emerging economies.

While oil is still far below the peak of US$145 per barrel reached in July 3 last year, the fact remains that the commodity has risen 50% from this year's low of US$34 on Feb 12 to around US$71 on the evening of June 19.

Naturally, some observers have turned bullish on the commodity. Earlier this month, Goldman Sachs revised upward its oil price deck to US$59 a barrel for this year (from US$50 previously), US$80 for 2010 (from US$70) and US$100 for 2011.

This is based on the limited Opec (Organisation of Petroleum Exporting Countries) spare capacity, non-Opec supply declines, demand growth recovery over 2009 and 2010 from non-Organisation for Economic Cooperation and Development (OECD) countries, and stabilising demand near current levels from OECD countries.

On the other hand, Macquarie Research global oil economist Jan Stuart says despite tightening global oil fundamentals and growing demand from emerging economies in the second quarter, recovery will remain weak through the second half of the year. He argues that because oil demand across the OECD economies will continue to contract, inventory surpluses will be big enough to depress prices. "For 2009 as a whole, we keep US$53 per barrel as our target although the futures markets indicate US$59 per barrel," he adds.

A surging concern

Despite the differing opinions, the reality of the moment is that the oil market is resurgent, and there is likely to be an economic impact.

Lee Heng Guie ... 'Demand-induced inflation will not be likely at this point.'

Maybank Investment Bank Bhd chief economist Suhaimi llias says the global economy is still fragile and a sustained rise in oil prices will just add speed bumps on the road to recovery. "There's a risk that from facing deflation, we may now be facing stagflation," he warns.

He adds that the concern among businesses will be whether they can pass on the increased costs to customers, given the weaker economic outlook this year.

CIMB Investment Bank Bhd economic research head Lee Heng Guie says with the collapse of global demand, any inflationary pressure will come from cost-push inflation and this will dampen recovery at a time when we are only seeing the first signs of stabilisation.

"Demand-induced inflation will not be likely at this point," he points out. He adds that it will be difficult for businesses to shift cost increases to customers because the economy is still shaky.

According to a June 11 report by the International Energy Agency (IEA), global demand for oil is on the rise again but this may only reflect a slowing decline instead of an actual economic recovery.

The agency has bumped up its forecast for the year by 120,000 barrels per day (bpd) because demand in the first three months of the year was stronger than expected. Global crude oil demand is now projected to hit 83.3 million bpd, which is still nearly 3% lower than the 85.4 million bpd last year.

Production by Opec members increased by 160,000 bpd in May to 28.4 million bpd although the oil cartel in its last meeting had opted to maintain its target production at 24.85 million bpd. To stem the decline in prices, Opec has cut production by 3.2 million bpd since late last year.

The IEA has also upped its projection for non-Opec oil supply for 2009 by 170,000 bpd on stronger growth at new Russian fields, more robust North Sea production and higher crude output in Colombia. However, year-on-year, the projected non-Opec output of about 50.5 million bpd will fall short of the 2008 figure by 100,000 bpd.

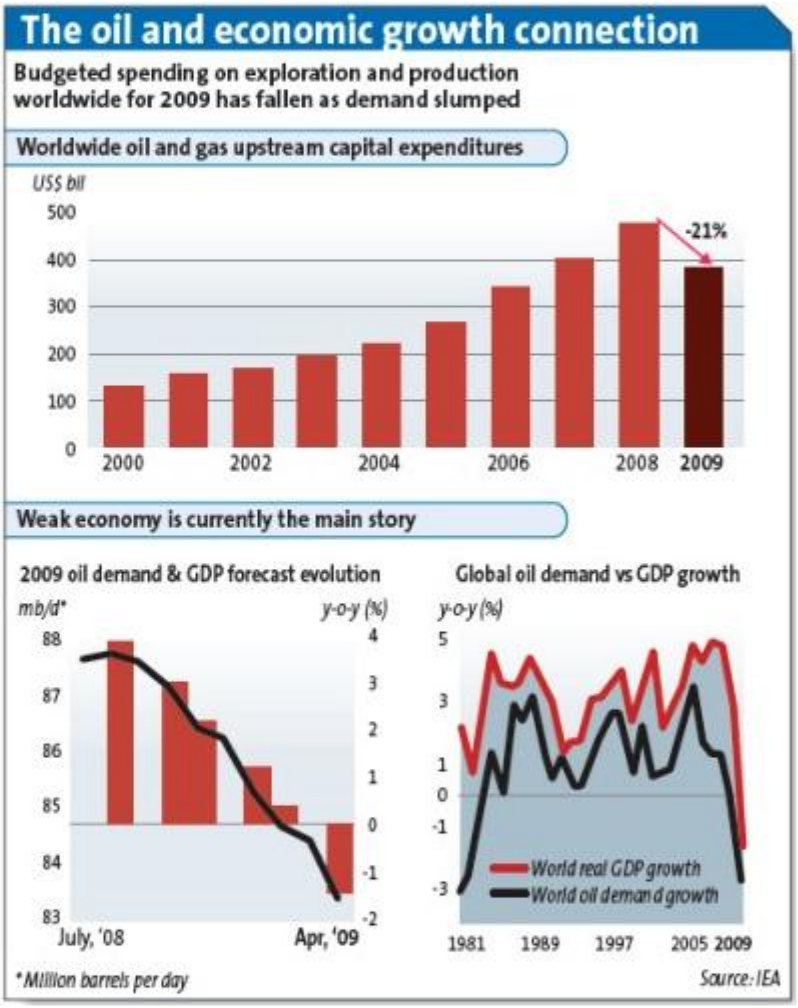
The real issues

Industry experts say although oil prices may have reacted to the prospects for future growth, the real economy must grow first before the rise in prices are sustainable.

"That is not happening yet and may not do so until next year for the world as a whole," says Energy Intelligence Research managing director Dr David Knapp. He adds that the growth in oil demand will come from non-OECD countries, while demand in OECD countries will continue to fall in 2009.

"The OECD members will see flat growth going into the next decade and will be overtaken by non-OECD countries before the mid-2010s," Knapp says.

Even liquefied natural gas (LNG) has seen a slump in demand. FACTS Global Energy Group chairman Dr Fereidun Fesharaki says demand in Asia - Japan, South Korea and Taiwan accounted for more than 60% of the global market - has dropped.



"The outlook for Asian LNG demand will be challenging, at least until the first half of 2010," he adds.

He points out that 50 to 60 million tonnes of LNG will come into the market by the year-end, and finding buyers will be a problem. "The market in this part of the world cannot take the volume," he says.

When speaking to the media recently, Petroliam Nasional Bhd (Petronas) president and chief executive officer Tan Sri Mohd Hassan Marican said demand would come back only when the economy had rebounded.

Petronas is the second largest natural gas producer in the world and its payments to the Government totalled RM67.6bil or 63.1% of its profit for the financial year ended March 2008. The oil and gas industry accounts for 8% of Malaysia's gross domestic product.

Hugh Thompson, chairman of ExxonMobil subsidiaries in Malaysia, says the world has tremendous energy challenges before it.

"Today, the world uses approximately 245 million barrels per day of oil-equivalent energy (MBDOE) to fuel transportation, generate electricity, run farms and factories, heat and cool homes, and more," he tells StarBizWeek.

Thompson says by 2030, driven by population growth and expanding economies, the world's total energy demand is projected to rise by approximately 35% to 310 MBDOE despite significant gains in energy efficiency.

"Power generation will be the largest and fastest-growing energy-demand sector through 2030. Transportation, currently responsible for more than half of total oil demand, is expected to grow substantially," he adds.

Slippery speculation

Economic well-being is not the sole factor behind the volatility of the oil market. Speculators are to be blamed as well. For example, the US dollar has declined against most major currencies with the exception of the yen since mid-March and concurrently, the price of oil has moved up as speculators hedged against the weakening dollar and possible inflation.

The price surge was boosted by the now famous "green shoots" statement by US Federal Reserve chairman Ben Bernanke and backed by sequential economic data over recent months that appeared to be signs of stabilisation and, in some cases, even of expansion.

(In a rare television interview on March 15, Bernanke said the US government's efforts to revive the economy had produced results, and he described these as green shoots that were beginning to appear in different markets.)

Other factors that may influence price movements are the output and spare capacity of the major producing countries, especially those of Opec, which accounts for 40% of global production and 80% of reserves.

In recent years, Opec's limited spare production capacity, coupled with demand growth from the emerging economies and geopolitical concerns, have spurred investors to speculate, thereby driving the price of oil to the historical high in the middle of last year.

Goldman Sachs believes that while there is now a greater cushion of spare capacity than existed during 2004 to 2008, when oil demand was higher, stabilising demand and declining non-Opec supply will eat into the capacity by the end of 2010 or 2011.

"We estimate that the Opec spare capacity will peak at around 5.5 million bpd in the second quarter of 2009. Adjusting for ongoing issues in the Niger delta and uncertainty over Saudi Arabia's ability to sustain production above 10 million bpd, this suggests that Opec has no more spare capacity than the circa 3.5 million bpd it removed from oil markets over the past few months," says the investment bank.

Goldman Sachs adds that if Opec's spare capacity is to be compared to total crude oil supply capacity, there will be an estimated trough utilisation rate of 93%.

Natural disasters and stockpiling are also causes of oil price hikes. For instance, oil prices spiked when US output fell after oil rigs and refineries in the Gulf of Mexico were destroyed or shut down in the wake of Hurricane Katrina in August 2005.

More recently, analysts believe that the stockpiling of oil by China contributed to the price surge. China's economy along with India's are among the only major economies that are expected to grow this year. China registered a first-quarter growth of 6.1% while India had a 5.8% expansion.

Impact on local players

The cost of exploration and extraction has jumped as readily extractable oil becomes harder to find and the energy companies start to look for oil in deeper waters, thus requiring costlier technology.

And when oil prices were soaring, obtaining oil from unconventional sources such as tar sands, oil shale and heavier crude grades turned viable, particularly in politically stable countries. In tandem with the investments in technology, the cost of infrastructure has also gone up due to the rise in the price of building materials such as steel, boosted in part again by the demand from China, India and other emerging countries.

These costs may swell again. For one thing, steel prices, which bottomed in the fourth quarter of 2008 due to the global downturn, has since rebounded. "It rose again after the global economy began to stabilise," says AmResearch Sdn Bhd analyst Mak Hoy Ken in a phone interview. In his June 9 report, he says billet import prices from South-East Asia has surged to the US$420 to US$430 per tonne levels, rising close to 20% in April alone.

In his special address at the 14th Asia Oil & Gas Conference in Kuala Lumpur recently, IEA executive director Nobuo Tanaka said energy investment had been affected as companies in the industry found it more difficult to obtain credit or faced higher costs of capital.

"Lower prices and cash flows have made new investments less attractive, while falling demand caused by the recession has reduced the urgency and appetite for suppliers to invest," he added.

On the local front, companies that provide services to the oil and gas industry have been little affected by the drop in oil prices because many of their projects stretch over several years, while other services such as repairs and maintenance work, are delivered on a recurrent basis.

OSK Research Sdn Bhd analyst Jason Yap says these companies were not hurt much by the weak oil market as their earnings were underpinned by strong order-books, and the preference of Petronas for local service providers and long-term contracts.

Fabricators such as Malaysia Marine and Heavy Engineering Sdn Bhd (a subsidiary of MISC Bhd) and Kencana Petroleum Bhd did see their orders slightly impacted due to the slowdown in the development of new oilfields, but Yap says the recovery in oil prices may reverse the situation. He points out that the players with larger presence abroad, such as KNM Group Bhd and Wah Seong Corp Bhd, were also affected as their operational costs were higher than if they had operated at home.

Deleum Bhd group managing director Chandran Rajadurai, whose company provides oilfield services and distributes related equipment, says the impact of the lower oil prices on the local players depends on the segment of the industry they are in.

"It depends on time in motion, demand and supply factors, as well as where the cycle is," he points out, adding that from the time of first strike to first oil, it may take between five and seven years to see a project through.

He says in an environment of higher oil prices, there may not be much incentive for companies to merge since jobs will be plentiful. However, should prices come down again, there may be opportunities for mergers and acquisitions.