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By Herman Trabish

FUEL'S *GOLD*

Could Plummeting Oil Prices Make or Break Industry?

Drivers across the U.S. and around the world are celebrating as oil prices continue to drop. And the rig count, the oil industry's most predictive statistic, says the price will not soon go back up.

But the oil industry is laying people off and canceling spending at a rate that is raising the specter of a 1980s-like industry-crippling recession. For the already overstressed breakbulk transport sector, this adds new uncertainties.

Breakbulk carriers saw improved regional and sporadic cargo volumes and freight rates in 2014, and falling oil prices have already helped improve returns on voyages contracted for high cost fuel assumptions, according to Intermarine Operating Chairman Andre Grikitis. But the oil price drop is also a signal of a looming falloff in oil industry related cargoes.

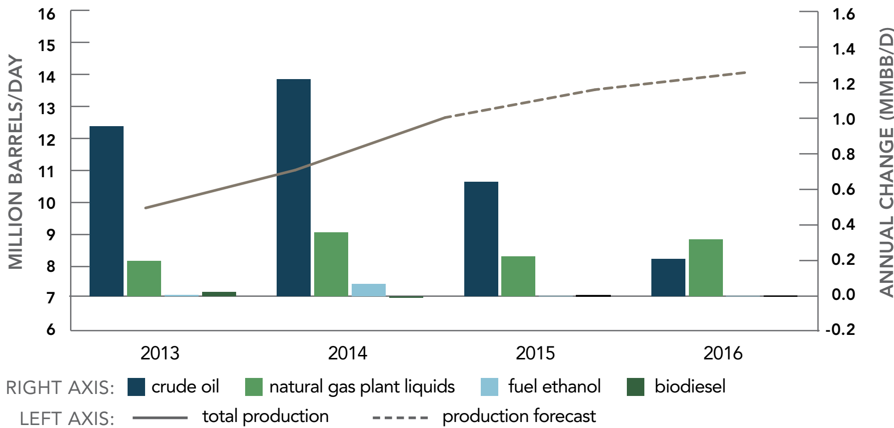
The New York Mercantile Exchange and Brent crude oil prices were near US$110 per barrel in July 2014. They fell to below US$50 per barrel in January 2015. Affirming that industry planners do not foresee oil's price coming back to a level justifying more drilling, rotary drilling rigs in use in the U.S. fell from more than 1,925 in mid-2014 to about 1,750 in January 2015, according to WTRG Economics. Early in January, the use of the horizontal drilling rigs preferred by U.S. shale oil drillers took its biggest one-week fall since the U.S. shale oil boom began. It was the seventh week in a row horizontal rig use declined, according to Bloomberg.

In another strong indication the price will not soon bounce back, Halliburton, an industry leader in engineering, procurement, and construction, or EPC, laid off 1,000 workers in Europe, Russia, the Middle East, and Africa. Schlumberger, one of the world's biggest providers of oil field services, will lay off 9,000 workers.

Finally, a Rystad Energy survey of 800 global oil projects valued at US$500 billion awaiting a 2015 green light found that a US$150 billion portion of them are no longer considered economically feasible.

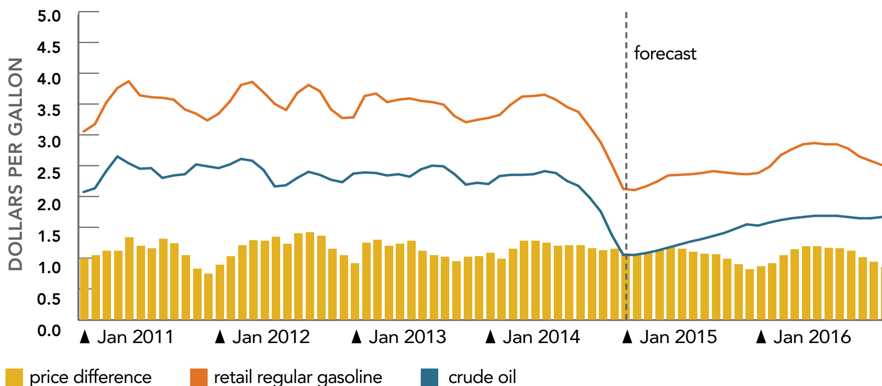
The price drop is widely thought to have been provoked by the Saudi Arabia oil ministry's decision not to reduce its oil production in the face of increasing output from U.S. shale and Canadian tar sands. In response to the glut and decreased demand from weakening Chinese and European economies, the Saudis would normally be expected to cut back their production and call for proportional output reductions from other members of the Organization of the Petroleum

U.S. CRUDE OIL AND LIQUID FUELS PRODUCTION



Source: Short-Term Energy Outlook, January 2015

U.S. GASOLINE AND CRUDE OIL PRICES



Crude oil price is composite refiner acquisition cost. Retail prices include state and federal taxes.
Source: Short-Term Energy Outlook, January 2015

Exporting Countries, or OPEC.

Instead, the Saudis announced in October they would make no such moves. They also announced they expect a US$38.6 billion 2015 budget deficit and made it clear they are prepared to use their US$750 billion in foreign currency reserves to drive U.S. and Canadian producers out of business and take back control of the oil business, according to Forbes.

Subsequently, the U.S. Energy Information Administration, or EIA, projected U.S. production to rise by 600,000 barrels per day to 9.3 million barrels per day in 2015 and by 200,000 barrels per day to 9.5 million barrels per day in 2016.

The EIA numbers were heralded by some as an indication the Saudi strategy will fail. "Anybody who says Saudi Arabia will put the shale producers out of business by continuing their production is naïve," said CEG Partner Edward Osterwald. "These producers are entrepreneurial. They can switch it on and off. It is a flawed assumption to think these producers are going to behave like a national oil company that is high cost and influenced by politics."

Others noted the EIA projections were lower than earlier numbers and clearly indicated diminishing output. "Many oil companies have cut back on their exploration drilling in response to falling crude prices and will concentrate their drilling activities in established areas," EIA noted.

Impacts are already being announced, according to Bloomberg. Canada's Husky Energy said in December it will delay a US$2.8 billion offshore drilling expansion and cut its 2015 exploration and production (E&P) budget by one-third. British Petroleum announced a US$1 billion to US$2 billion cut from its 2015 capital spending budget.

A United Arab Emirates oil minister said OPEC will not alter its strategy.

Challenges Facing Breakbulk

How does all of this impact the breakbulk industry?

For at least two years, an overcapacity in breakbulk vessel tonnage induced by competition from dry bulk and containerized carriers has depressed freight rates, said Susan Oatway, senior consultant of Drewry Shipping Consultants. "Even heavy-lift project cargo carriers are seeing some of their cargo cannibalized by container lines."

"We lose on every ton we carry," Rickmers Holdings Chairman Bertram Rickmers was recently quoted, and "40 percent to 50 percent of project-carrying vessels of 8,000 to 30,000 deadweight tons are in severe financial difficulties *("Marriage Counselor," November-December Breakbulk, page 28)*."

With the improving economy, Oatway late last year foresaw improved demand, better rates, and reason for optimism about 2015 *("MPV Stand By," November-December Breakbulk, page 32)*. But the loss of cargo volume to a depressed oil industry could easily undermine that optimism.

Breakbulk is still plagued by "exuberant ordering" and especially "the ordering of vessels that are retarded in design and inappropriate for our real world trading patterns," according to Intermarine's Grikitis. Negative returns create an urgent need for cost cutting. "Vessel maintenance suffers," he explained. "Personnel recruitment, training, retention deteriorates, and all this results in poorer service capability in an industry that was already lagging."

In the near term, customers will find space at "very competitive rates" as long as they ignore "the fragile nature of many of the carriers to which they entrust their cargo," Grikitis observed.

More significant, he believes, is "the

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lack of bulk and homogenous cargoes." Because every segment of the shipping industry is overbuilt and scrambling for business, "breakbulk cargo ends up shipping in containers, never to return as breakbulk cargo. We lose cargo to conventional bulkers, large ro-ro vessels, deck carriers and specialized car carriers."

It will get worse, but that will lead to it getting better, Grikitis believes. "The growing demands of project and heavy-lift cargo will not be serviced by cheap space." Ultimately, competent operators are necessary. "Perhaps 2015 will provide us a combination of vessel and carrier failures, which seems more likely quarter by quarter, as the catalyst for market stability."

Cheap Fuel

"With a significant reduction in the cost of fuel, there will be a reduction in the cost to provide transport," said Greg Gowans, director of logistics and expediting for CH2M Hill Logistics & Expediting. The maritime market sectors' overcapacity has made it a buyer's market for a number of years. Lower fuel prices will ease that on the cost side, he added.

"In many breakbulk trades, which are tramp type services and not operated in liners, there is not an established rate," Gowans explained. "With no established price, and given the quick fall in pricing for new contracts, the benefit for the next few months will more likely be accrued by the transportation company. The market won't drive the price down as quickly as the cost of fuel is falling."

The price paid by the buyer of the services will go down less quickly, allowing carriers to retain some benefit, Gowans said. "They will get a little bit of a bump in their operating margins for a period of time."

The first effect of the oil price drop is "the cost of consuming heavy fuels is decreasing and that is a short-term effect the entire industry can enjoy, like any consumer who fuels up a car," agreed Raymond Fisch, vice president of BBC Chartering.

It will not be as big as the drop in the price of oil, he added, because bunkering is an average calculation and some fuel has already been "bunkered in" at higher prices. Nevertheless, the impact to a carrier like BBC, one of the leading players in the multipurpose heavy-lift sector, can be enormous.

"BBC has 1.5 million tons of annual carrying capacity. Its fuel expenses are in the multi-hundred millions of dollars per year," Fisch explained. "The vessels average 10,000 to 11,000 tons and use 15 tons to 30 tons of heavy fuel per day, depending on the vessel and the speed, and BBC operates approximately 140 vessels to 150 vessels."

"For shippers, this is a long-term reduction in their fuel costs and for anybody in the shipping business, that has to be very good news," Osterwald said.

Refiners are not complaining either. "We buy oil in the marketplace," said Bill Day, Valero Communications vice president. "Low oil prices are good for us and we have passed those lower prices on to consumers."

Major expansions in refining, including an estimated US$100 billion in petrochemical and refining projects, will go ahead, Rickmers believes.

Industry sources report 80,722 chemical projects worth an estimated US$13.2 trillion in various stages of planning and development around the globe, according to Dennis Devlin, vice president of sales south and head of business development energy solutions for Panalpina USA. Components for these projects will be breakbulk cargo from China, South Korea, India, Turkey and Europe, he said.

Others have noted continued breakbulk activity coming from the wind industry. A domestic trucking company

U.S. PETROLEUM PRICE SUMMARY

Forecasts show prices bottoming out in 2015 with some recovery in 2016.

	2013	2014	2015*	2016*
Crude Oil Prices ($ per barrel)				
WTI Spot Average[1]	$97.91	$93.26	$54.58	$71.00
Brent Spot Average	$108.64	$99.02	$57.58	$75.00
Imported Average	$98.12	$89.09	$51.26	$67.52
Refiner average acquisition cost	$100.46	$91.73	$53.71	$70.05
Retail Prices (including tax, $ per gallon)				
Regular Gasoline[2]	$3.51	$3.36	$2.33	$2.72
Diesel Fuel[3]	$3.92	$3.83	$2.85	$3.25
Heating Oil	$3.78	$3.71	$2.71	$3.03
Natural Gas ($ per 1,000 cubic feet)	$10.30	$11.00	$10.63	$11.00
Electricity (cents per kilowatt hour)[4]	$12.12	$12.50	$12.63	$12.86

** Forecast*
1 West Texas Intermediate
2 Average regular pump price
3 On-highway retail
4 U.S. residential average.
Source: U.S. Energy Information Administration

U.S. PETROLEUM PRODUCTION AND CONSUMPTION

Despite falling petroleum prices, U.S. production is forecast to continue to grow.

	2013	2014	2015*	2016*
Production (million barrels per day)				
Crude Oil	7.45	8.67	9.31	9.53
Natural Gas Plant Liquids	2.61	2.96	3.19	3.51
Fuel Ethanol	0.87	0.93	0.94	0.94
Biodiesel	0.09	0.08	0.08	0.08
Consumption (million barrels per day)				
Motor Gasoline	8.84	8.94	9.00	8.96
Distillate Fuel Oil	3.83	4.00	4.06	4.12
Jet Fuel	1.43	1.47	1.47	1.47
Total Consumption	18.96	19.06	19.32	19.43

**Forecast*
Source: U.S. Energy Information Administration

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BBC Chartering does about 70 percent to 80 percent of its work in the oil industry and about half of that is in the production, or upstream, part of the industry. / Credit: BBC Chartering

spokesperson who asked not to be named concurred with this. "Wind transport is about 5 percent of turbine cost at most and fuel is only part of that," he said. "Trucking companies are unaffected and the wind industry remains busy."

Domestic rail shippers have not yet been impacted. "It looks like shipping volumes are going to remain fairly stable," according to Lowell Rothschild, senior counsel for Bracewell & Giuliani. Production at the wellhead has held steady but is not increasing. "But if prices remain low for some considerable period of time, the increased flexibility offered by rail shipping over pipeline shipping could become less favorable."

Current contracts cover the short term, Rothschild said. "But a pipeline company will build a line if you agree to use it. When producers start thinking about renewing those contracts, do they start thinking about shipping less by rail and encouraging the construction of a pipeline?"

Loss of Carrying Volume

If low oil prices are only temporary, it would benefit BBC Chartering, Fisch said. But his company does about 70 percent to 80 percent of its work in the oil industry and about half of that is in the production, or upstream, part of the industry. If oil prices fall below a certain level and stay there, he explained, a significant portion of BBC's customers will find it uneconomic to pursue projects. "A large share of the non-standardized cargo business depends on the energy business."

Upstream activity in the oil industry will slow down, CH2M Hill's Gowans predicted. "Exploration activity is going to be reduced. That will quickly reduce the amount of freight that gets moved."

"The falling price of oil is the result of technology. It is a permanent change," Osterwald insisted. "Maybe a few rigs will shut down, but it is not going to have the effect people think. This is a fundamental shift."

Some shale producers are producing at a cost that makes it affordable for them to sell at US$40 per barrel, while others are not, Osterwald said. It might be uneconomic in the short term but they will keep producing for other reasons. Some will keep drilling to avoid losing their leases. Others will make up losses on associated gases and liquids. "The blanket assumption that if the Saudis are going to keep producing then everybody in North America will shut down is just naïve."

There will eventually be an equilibrium of about US$50 to US$60, he guessed. "But as long as they keep producing from shale, which they will, prices will not go back to US$110 per barrel."

The only limit on project development is the availability of capital, Osterwald said. He expects activity in the oil and gas industry to increase and shift. For companies in downstream operations, refining margins have increased and capital investment is going into refining systems.

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U.S. OIL AND GAS COMPANIES CUT CAPITAL SPENDING

List of U.S. exploration and production companies and reductions in their budgets.

COMPANY	2015 CAPITAL EXPENDITURE	2015 VS ESTIMATED 2014 CAPITAL EXPENDITURE	OUTPUT FOR QTR. ENDED SEPT. 30	RIG PLANS FOR 2015 (AVERAGED)
ConocoPhillips	US$13.5 billion	Down US$3.2 billion from US$16.7 billion	1.47 million min.	Not disclosed
Continental Resources Inc.	US$2.7 billion for non-acquisition CAPEX	Down US$1.85 billion from US$4.6 billion	182,335	Plans to cut average rig count from about 50 to about 34 by end Q1 with average of 31 rigs for Q1
Marathon Oil Corp	US$4.3 billion to US$4.5 billion	Midpoint down US$1.5 billion from US$5.9 billion	409,000 net*	Not disclosed
Apache Corp	US$4 billion in North America	Down US$1.4 billion from US$5.4 billion	637,000	Reducing to 55-60 rigs in North America from 93 as of Q3
Oasis Petroleum Inc.	US$750 million to US$850 million	Midpoint down US$630 million from US$1.4 billion	45,873	Reducing rig count to 10 by end of January and to 6 by end March. As of Sept. 30, 2014, was running 16 rigs
Denbury Resources Inc.	US$550 million	Down US$550 million from US$1.1 billion	73,810	Not disclosed
Laredo Petroleum Inc.	US$525 million	Down US$475 million from US$1 billion	32,970	To operate equivalent of about 2.5 horizontal rigs and 1.5 vertical rigs on its Parmian-Garden City acerage in West Texas
Rosetta Resources Inc.	US$700 million to US$800 million (with flexibility to spend up to US$900 million)	Midpoint down US$450 million from US$1.2 billion	73,500	Plans to operate 1-2 rigs in Eagle Ford and 2-3 horizontal rigs in the Delaware Basin
Sanchez Energy Co.	US$850 million to US$900 million	Midpoint up US$250 million from US$600 million-$650 million	38,613	Cut 2015 drilling program to 6.25 from 8 rigs
Emerald Oil Inc.	US$62 million to US$81 million for drilling and completion	Midpoint down US$178.5 million from US$250 million	3,855	Cut to 2.25 rigs in late Q1 2015 from 3 now
Halcon Resources Corp.	US$750 million to US$800 million	Midpoint down US$175 million from US$950 million	43,554	Reducing drilling to 6 rigs from 11 originally planned
Swift Energy Co.	US$240 million to US$260 million	Midpoint down US$145 million from US$390 million-$400 million	2.99 million[1]	Not disclosed
Abraxas Petroleum Corp.	US$54 million	Down about US$136 million from US$188 million-$192 million	7,076	Plans to let go off a rig drilling in Texas' Eagle Ford and cancels 2015 Permian program
Energy XXI (Bermuda) Ltd.	$670M to $690M	Midpoint down US$135 million from US$815 million	58,600	Cut to two rigs by December 2015 from 4 now

BOEPD: barrels of oil equivalent per day
** Total continuing operations excluding Libya*
1 Barrels of oil equivalent
Source: Multiple sources including Reuters.

For a shipping sector, with an ongoing 10 percent to 15 percent tonnage overcapacity, even a small loss of shipping volume could hurt, Fisch said. The oil price is providing some relief but "we are observing very closely."

The Winner: Economic Activity

One of the first things to think about is a hedging strategy through the oil futures market, Bracewell & Giuliani's Rothschild said. "Southwest Airlines was successful in the late 1990s because it bought lots of low-priced oil for future delivery. When the price shot up, the legacy carriers were buying US$100-per-barrel oil while Southwest was still using US$50-per-barrel oil. It is much easier to make money when you are paying half as much as your competitors for your biggest expense."

If supply doesn't shrink much and demand doesn't grow because of a slowed economy, Rothschild said, "prices will stay low until people start buying Hummers again or until the producers can no longer afford to not make money and cut back on production."

Few expect demand to stay flat. For every penny the price of gas falls, the savings per year to U.S. consumers is about US$1.5 billion, according to Gluskin-Sheff's David Rosenberg. That puts more than US$150 billion into consumers' pockets. The oil and gas industry only accounts for about 2 percent of gross U.S. economic output, so 98 percent of the economy has lots more money to spend.

The upside is expected to be even bigger in Asia, according to the Wall Street Journal. Lower fuel expenditures will allow governments in India and Indonesia to invest in urgently needed infrastructure and growth projects without fear of inflation. China's slowing economy will get a crucial bump.

Based largely on anticipated low oil prices through the rest of the year,

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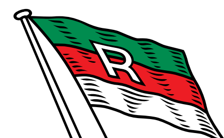

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UTC Overseas moves manifold subassemblies from the Midwest where they were manufactured to the Gulf for export to a new overseas LNG processing facility. / Credit: UTC Overseas

consultant Capital Economics boosted its forecast of emerging Asia's gross domestic product growth from 2014's 4.3 percent to 4.7 percent for 2015. IHS concurred, predicting the oil price impact to be a 0.25 percent to 0.5 percent GDP increase.

Only oil exporting countries like Malaysia, Myanmar, Brunei, and Australia are expected to take a hit.

Solution: Diversification

While BBC Chartering remains anxious about the business it gets from oil's upstream, it also has clients in the downstream and carries wind turbines and natural gas equipment, Fisch noted. "It looks like major oil projects could be postponed and halted," he said. "But we are also seeing the benefit of the shale gas revolution. Wherever equipment is needed for that, we are involved."

Oil and gas majors have had their

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upstream budgets sliced in half and are delaying projects, said Marco Poisler, executive vice president of UTC Overseas. "That is the negative side. But UTC is sort of the mutual fund of project cargo, and we see other industries picking up thanks to the decrease in oil prices. New plants and facilities are looking to North America to take advantage of more reasonable energy costs."

UTC has clients in mining, heavy equipment, oil and gas, cement, and several other business sectors, Poisler said. "There are plenty of industries that move breakbulk cargo, and there is a benefit for a company like us that is not dependent just on oil and gas clients."

Even in the oil and gas sector, he added, "there is always something to move. We might not be moving E&P equipment, but we might be moving refining equipment. And we are moving it at a much more reasonable fuel surcharge than before."

Oil and gas project investment is either being diminished or delayed, but volumes in sectors not related to oil and gas are increasing because there is new capital investment, Poisler added. "In an era of lack of profitability for the carriers and lack of stable revenues, the carriers are going to be forced to be more creative in making a successful voyage."

The message may seem kind of depressing, especially in Houston where there is the memory of the oil price plunge and local depression in the 1980s, Poisler said. But it is a cycle and things turnaround. "From the feedback I am getting from clients, I think oil may turn around by the end of the year."

"CH2M Hill is not heavily involved in upstream energy so this is not affecting our business," Gowans said. In the midstream and downstream, he added, the estimated US$265 billion backlog of mega-projects that are fully committed and funded are continuing and taking advantage of the lower fuel prices.

"That money is already committed and is going to get spent over the next two or three years," Gowans said. "On the international marine side, I don't think it will make more goods travel. But in domestic transport, outside of breakbulk, it will make more goods travel. In rail and trucking and air freight, companies will be spending less money on their transportation systems and will therefore have more to spend and invest elsewhere."

Spending will go less to a few energy companies, but "the U.S. economy overall will be better off with lower oil prices," Gowans said. "And there are opportunities in transportation infrastructure, fuel storage, and warehousing and factory construction that will start to deploy, based on low cost energy. We will look to shift our activities toward those." BB

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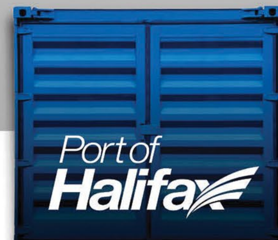

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