Alam Maritim In The News
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Oil – how low can it go?

By TEE LIN SAY

MARKETS have long kept their fingers crossed that the uproarious oil prices would reach its crescendo and start its downward descend.

The relief when it finally did a week ago is unmistakable; financial markets are the first to exhibit its blatant glee. The joy is palpable and the cry of ecstasy from stock owners clearly audible. Across all stock exchanges around the world, its a sea of green, as stocks enlivened and re-energised back up north.


"Sooner or later, the real cost of producing oil will dictate oil prices. Currently, speculated oil prices are much higher than production cost" - Mokhzani

Barely two weeks ago, markets were a mess, as commodity prices continuously teased new highs on a back drop of slower economic growth.

The break arrived on July 14, when unyielding high oil prices finally buckled after reaching its high of US$147.27 on July 11. Since then, oil futures have declined more than 15% to US$124, which is also its new 7-week low as of Wednesday.

The oil plunge came after reports showed demand in the US and Japan, two of the three largest oil consuming countries, are falling as high prices crimp fuel consumption.

The US Energy Department says that US fuel demand averaged 19.9 million barrels a day last week, the lowest since January 2007.

Oil prices also fell as the Energy Department report showed that gasoline supplies rose 2.85 million barrels last week. Stockpiles of distillate fuel, a category that includes heating oil and diesel, climbed 2.42 million barrels.

The Significance of Oil


"As long as we live in a geopolitical environment ... there will be excuses to push oil prices up" - Azmi Ahmad

Oil has been on an unstoppable roll since the early days of 2002 when it was merely at the US$20 level. Since the emerging economies of China and India took off, oil has spiralled up by almost 600%.

The revolution of oil has seen the rallying of food commodities, the record profits of oil producers and the tears of airline operators.

In a booming world economy, surely there are some who triumph, while others ache.

But with oil comfortably above the US$100 level, it was no hilarious affair, especially with the suburban middle class also grappling with far reaching effects of inflation.

High oil prices have been the nucleus of all problems. Of all the eerie visions black gold generates, the one most unnerving is surely that of inflation.

Couple this with a slower rate of expansion, and the results are almost to dreadful to bear ï stagflation.

In the last few months, countries such as India and Indonesia have been pulling out their fuel subsidies, as governments announced its inability to cope with the unbearable prices.


"There is no shortage of oil, natural gas or any resources in the world" - Anand

The Dow Jones Industrial Average has shown a direct correlation to the drop in oil prices. In the last two weeks, the Dow has added approximately 610 points to 11,632 as oil dropped some US$22 to settle at US$124.

On Tuesday, despite Americaõs fourth largest bank Wachovia Corp announcing a staggering second-quarter loss of US$8.86bil, oilõs US$3 slide far offseted the dampening news. The Dow rallied up 135.16 points.

Evidently, financials are not a factor for stocks. Oil is.

ñThere could be an acceptance that the market has seen the peak of oil prices, at least for the mid term,ò says a market observer.

With oilõs drop coinciding with a firmer dollar, analysts say this may further reduce the appeal of commodities.

Technical analysts say that oil can now head lower, with the next area of support around the $120 to $121 mark a barrel for US crude.

i Capital says, it sees crude oil price falling over the next 3 to 6 months to possibly US$100 to US$110 per barrel before bottoming out and starting another rally.


"I think its a matter of time before oil prices touch US$200 ... but it wonõt be this year" - Tengku Yusof

ñPrices of selected soft commodities have peaked or also peaking. As a result, inflation is also peaking and by the end of 2008, inflation rates in most countries will be lower than now,ò it says.

ECM Libra believes the fall in oil prices are largely due to profit-taking, and says that the retracement was waiting to happen, partly because of the speculative element in oil prices.

ñOn an economics viewpoint, our economist believes that the US Dollar will continue to see a decline, hence we expect that speculative activities will help to keep oil prices buoyant in the near term,ò says the research house.

Over in the US, the Senate Democrats has cleared the first hurdle for legislation to curb energy market speculation. Democrats said the measure could reduce oil prices as much as 50%.

Its still boom time ..

Malaysiaõs key attraction has always been its position as a net oil exporter. With the discovery of the first deepwater field, Kikeh by Murphy Oil in 2002, it has been a significant turning point in Malaysiaõs oil and gas sector.

Since then, its been a frenzy of activity with 26 deepwater fields discovered. Seven of these fields are slated for development over 2008 to 2012.

Meanwhile, many are still under the misconception that oil and gas service support companies are direct beneficiaries of high oil prices. Hence lower prices ought to also trim its prospects.

It would certainly be simplistic to assume that all the immense activity will come to a screeching halt just because oil prices drop.


"... an equilibrium will be reach in the next 6 -12 months. My estimation is range-bound between US$100 and US$130 per barrel" - Tengku Ibrahim Petra

With billions hoarded into the sector, how can oil prices render a sector of gargantuan proportions high and dry.

Petronas has pledged that it will continue to invest actively next year and its capital expenditure spending should be 5% to 10% higher than this years RM37.6bil, driven by deep sea exploration.

High oil prices or not, its business as usual for the oil and gas sector in Malaysia.

A slew of contracts continued to be announced this week.

Muhibbah Engineering Bhd received RM166.2mil in crane orders and RM245mil in offshore support vessel orders.

Petra Energy Bhd, the brownfield services arm of Petra Perdana Bhd, also received an RM40mil service contract from Shell. Coastal Contracts Bhd, a shipbuilder in Sabah, received vessel orders amounting to RM718mil.

Kencana Petroleum Bhdõs unit Kencana HL Sdn Bhd secured a RM48mil contract from Murphy Sarawak Oil Co Ltd.

Where do oil prices go?

When contacted, most corporate chieftains of Malaysiaõs oil and gas service support companies, feel that oil prices are really a function of speculation, geopolitical tension and the cost of oil production.

The current dip in prices is a welcoming relief as it eases the economyõs inflationary pressures.

Kencana Petroleum Bhd executive chairman Datuk Mokhzani Mahathir does not see oil prices going south to the US$100 per barrel for a very long time to come.

ñHowever, I qualify this statement by stating that the exorbitant prices of oil today isnõt due to supply and demand issues. Prices are being speculated just like any other tradable commodity on world markets. The only difference is oil is a finite resource which no one can really estimate how long before the last drop is consumed. Geopolitical issues have a bigger impact on oil prices than consumption does.ò

ñAlso, discoveries are now being made in deep water areas, which means higher cost. Sooner or later, the real cost of producing oil will dictate oil prices. Currently, speculated oil prices are much higher than production cost,ò he says.

Petra Perdana Bhd executive chairman and chief executive officer Tengku Datuk Ibrahim Petra says that oil prices are experiencing great volatility, and likens what is happening today to a share market ócorrectionô or óconsolidationô

ñI believe an equilibrium will be reached over the next six to 12 months, where prices are expected to remain high. My estimation is range-bound between US$100 and US$130 per barrel,ò he says.

With factors such as a slowing economic growth, escalating inflation and the financial downturn, Ibrahim says this may reduce the demand for fossil-based fuels.

Ibrahim adds that countries are also already looking at alternative energy such as nuclear energy, which many governments may seriously consider.

ñIn Malaysia, we are looking at tax incentives to promote renewable energy and emphasis on bio-fuel technology continues to increase. Ultimately, this would reduce our dependence on fossil fuel, gradually easing the price of crude oil,òhe says.

SAAG Consolidated (M) Bhd chief executive officer Anand Subramanian sees oil prices coming off.

ñI see oil prices trading between US$90 to US$110. Probably by year end, oil prices will reach the upper bandwidth of the forecast. The price of US$90 will perhaps be reached in the medium term.ò

Surprisingly, Anand says that high oil prices arenõt just bad for the world economy as a whole, but also for oil and gas service providers.

ñThis is made worse especially when such high prices have little or no fundamental reasons for increase other than geopolitical concerns. At US$80 to US$100, that was supply and demand being played out. But beyond US$100, it is driven purely by speculative rage. Once the speculators take over the trading mechanism, fundamentals no longer are at play. Prices become so sensitive, that the slightest news such as Iran will cause oil prices to run up.ò

Anand says that if oil prices skyrocketed, longer term contracts of service providers would be affected.

ñCosts will rise. I will have to pay higher salaries. Inflationary pressures will affect the profitability of my contracts hurting my bottomline. Inflation will snowball throughout the entire economy, and that is when we will see no growth,òhe adds.

Nonetheless Anand adds that speculators do have an economic function to play as they even out price variances which enables businessmen to protect their margins.

This allows price movements to be evened out as the speculator absorbs some risk as well as provide liquidity to the market.

ñIt is when the speculators become superlatively strong (like in the last 3 months), that their actions start to hurt the economy,òhe says.

Adds Anand, ñThere is no shortage of oil, natural gas or any resources in the world. Do you see people lining up for corn, wheat or oil?ò

Meanwhile, integrated offshore provider, Alam Maritim Resources Bhd group managing director Azmi Ahmad also personally feels that oil prices will come off.

ñThere is a lot of speculation, and people are playing it up. Its difficult for me to give a forecast or to put an actual figure to oil prices. As long as we live in a geopolitical environment; where the issues in Iran are not solved and tornadoes happen, these will be excuses to push oil prices up,òhe says.

A contrasting opinion comes from Dayang Enterprise Holdings Bhdôs managing director Tengku Yusof Tengku Ahmad Shahruddin who believes oil will eventually head back up.

ñThe days of us enjoying oil prices at US$60 or US$80 are over. Iôm pretty bullish on oil prices. I think its a matter of time before oil prices touch US$200. . . but it wonôt be this year,ò he says.

Whither O&G sector?

Most corporate figures from the sector scoff at the notion that jobs will dwindle with retreating oil prices. At present, the situation is one where oil and gas (O&G) service support companies are trying their best to cope with demand.

Service providers basically provide their services based on an agreed scope of activities to be undertaken within a specified time-frame, for which a contract is developed.

Therefore, the upward or downward trend of oil prices has no impact on the contract value.

ñHowever, it must be noted that when oil prices are ôhighö, there is a likelihood of increased activities upstream, resulting in more contracts to be issued, and when prices are ôlowö, contracts would still be issued to ensure proper support and maintenance activities of all O&G facilities offshore,òsays Ibrahim.

Mokhzani says that earnings and margins for Kencana should continue to be on the uptrend for the next few years, not only because of the current order book but because it has already announced plans to diversify into other O&G support services.

ñThe oil majors will continue with their development programs at this fast pace until the oil price drops significantly below US$100/barrel. We saw a surge in E&P activity when

oil rose to US$60/barrel and beyond. I donôt believe this level of activity will subside which means Kencanaôs services will continue to be in demand,òsays Mokhzani.

Ibrahim says that as part of the nationôs growth vehicle, O&G exploration & production activities, which includes refurbishment of ageing fields and possibilities of revival of marginal fields will continue irrespective of oil price.

ñIt is the same for the region where more E&P activities including brown field activities will continue to be the mainstay of activities. Coupled by the demand for offshore marine services, it is therefore safe to conclude that it is highly likely that we would be kept busy over the next few years and safe to say that it doesnôt really matter what the oil price is pegged at, so long it is above the extraction cost,òhe says.

Presently, Petraôs vessels are operating in both shallow and deep waters in the Asia Pacific Rim.

Although increased exploration, production and development activities especially in deep waters were somewhat obvious in recent years, demand for Petraôs vessels have been gradually escalating over the years. One of the main reasons for this is scarcity of supply.

ñThis demand has caused the charter rates to escalate. In 2007, our average vessel utilisation was 75%, and in 2008 and beyond, we expect a higher utilisation given higher exploration and production activities and revival of marginal fields. In fact, our market reach includes both new and developing and ageing O&G platforms, which number more than 250 in the country, and over 600 in the region,òsays Ibrahim.

Azmi says that perhaps, if oil corrected significantly, it would then have an impact on demand and defer certain expenditure programmes,òhe says.

ñAt US$35 per barrel, Petronas was already drilling for oil. Furthermore, even if oil prices come down, demand for oil consumption is still up.ò

He says that in Alam Maritimôs case, the cost of fuel for its vessels are passed on completely to the oil major.

ñWe are benefiting from the increased activity in the sector. This in turn increases demand for our offshore vessels. For every project that we go into, we ensure that we can make decent profits. Alam is well positioned in this environment, as our contracts span between 3 to 20 years,òhe says.

Azmi says that while the attention is on deepwater exploration, production in shallow waters still need to go on.

ñIn todayôs environment, people are rushing to bring out oil. It is this activity and urgency that is causing marine vessels charter rates to increase. Some vessels are more than 20 years old, needs to be replaced, and this creates a vacuum between the demand and supply, and is another factor why charter rates increase,òhe says.

On this note, Alam Maritim is spending some RM400mil to buy 12 new vessels, to be delivered in the years until 2010.

The group will take delivery of 10 new vessels this year, and the two remaining vessels by 2010. The new buildings will increase the companyôs fleet size to 34 by 2010.

Meanwhile, Yusof says that Dayang has been generating revenue of over RM100mil over the last seven years even when oil prices were at much lower levels.

ñOf course there is slightly more work when oil prices are high, as the oil majors donôt want disruption of their planned production.ò

ñBut when oil prices were at much lower levels, there was still scheduled maintenance works to be done. So no, weôre not at all affected,òhe says.

Dayang too, is looking to acquire more vessels in the near term to complement its network of three accomodation work boats, and one supply boat. Another accomodation work boats, with a 189-pax capacity, will come on stream by the first half of 2009.

Summing it up, Mokhzani points out that as long as the oil majors find it viable to explore, develop and produce oil, Kencana will have a market to cater to.

ñWe provide engineering and fabrication services just like any other construction company. The fluctuation in the price of oil effects the oil majors more than it does us. Having said that, should the price of oil drop to very low levels, that the oil majors will review their exploration and production program, which then would effect us. Our margins are quite consistent but the amount of work varies with the oil price,òhe says.

Breakeven point?

Mokhzani says he is unsure at what level would the oil majors find it not viable to explore for oil.

ñIn the last few years the emphasis has been on deep water exploration, which is very expensive. Large reserves discovered in Malaysia and Brazil have renewed interest in the O&G industry and have seen some huge investments being made for marine vessels and equipment to work these deep water projects. To make these investments pay, the oil majors will be looking at keeping the prices of oil relatively high,òhe says.

Anand says a breakeven level for production of oil would probably be at about US$30 which might rise a little more due to the heavy capital expenditure and costlier sources such as deepwater and oil sand being tapped.

ñIf oil prices continue to go down, it will not affect our margins or our ability to secure projects unless it goes well below US$50.ò

Ibrahim says that the extraction cost of crude oil could vary from US$20 to US$35 depending on various circumstances in the extraction logistics.

ñAny price above this rate would make it viable and profitable for oil majors. So even if the prices head downward, it would still be viable and lucrative for oil majors to extract so long it does not breach the extraction cost for that field,òhe says.

Of course, given lesser prices, hence lesser margin, Ibrahim says there would inevitably be a change in strategy, in terms of lesser quantum for investments and capital expenditure, and increased focus on maintenance-type activities.

ñSuch a scenario would benefit Petra Perdana which is involved in offshore marine services in both the green and brown field sectors,òhe concludes.