

Powering the brave new world

The Oil Sector

With BP's tribulations very much in the Press at the moment, it seems apposite to take stock of the investment opportunities in the Oil and other Energy sectors. For many years, BP has been a bedrock constituent of many portfolios including pension funds. It has been a very solid performer with a consistent and high dividend yield. The company is a World player with massive resources and a strong cash flow. Well, that is until the oil rig blew up in the Gulf of Mexico in April!

Whilst BP has made a number of PR gaffes, it has also been a victim of US Politics as a great diversion from US domestic and economic issues. This perhaps shows that even the largest companies can face unexpected risk, with a catastrophic impact on their share price and dividend stream. Of course, this reinforces the mantra of diversification within portfolios to reduce risk – hence avoiding too many eggs in too few baskets. With BP so publicly suffering, it is easy to let the hyperbole disguise the long term investment potential of both oil and other energy sources.



There has long been a discussion about 'peak oil'. That is when oil production reaches its zenith, after which new finds from exploration cannot keep pace with the number of fields in decline. At the moment, there is some spare capacity in the system but this is partly due to the World recession lowering overall demand. It is generally accepted that oil demand will peak at about 95-105 million barrels a day¹ which can be met from current production. There is also a huge amount of oil still within the ground which becomes more economically viable to extract as prices rise. For example, there are enormous reserves within the Canadian Tar Sands fields but this is estimated to be only viable to extract with oil prices of at least \$80 per barrel.² The price is currently \$76 but this has risen substantially since the market price fell to \$35 per barrel in March 2009. Then again, the price had reached \$147 per barrel 8 months earlier in July 2008!³ This extreme volatility undermines oil exploration where timescales can be 10 years for fields to be fully operational. With vast costs being expended on research and with many blank wells, it is vital the oil companies have long term confidence in a stable minimum price. Add into this mix political factors such as the US stopping licences for deep water drilling in the Gulf of Mexico, no exploration in massive parts of Alaska (over environmental concerns) and massive corruption in many oil producing countries, then the oil business is a risky but potentially rewarding one in which to have some exposure.

Alternative Energy Sources

The last 150 years or so have seen a global change in our major source of energy from wood to coal, then to oil and gas and, more recently, to nuclear. Economic factors will continue to play a dominant role in further changes. A growing World population, a burgeoning middle class in vast economies like China and India, the impact of climate change and so on, will in effect, force developments and new opportunities to power this brave new world. The use of bio-fuels, wind and wave energy, solar and hydro power, are all increasingly viable alternatives; for at least part of our growing energy needs. Huge sums are being committed to development and research and technical advances allow apparently esoteric concepts to become viable commercial ideas in shorter timescales.

At the same time, current energy usage is becoming more efficient in many ways, such as more mpg from our cars, improved insulation, more locally sourced produce etc. At the same time, there is Government action to encourage greater efficiency or reduce usage via grants and more importantly, taxation policy, e.g. air passenger tax or fuel excise duty to modify consumer behaviour. Whilst this will all help, the simple numbers are quite worrying. World energy consumption in 2008 was nearly twice that in 1965 and developed nations use an average of 5 times more energy per person than their developing counterparts⁴.

With large populations in countries like India, China and Russia growing rapidly, it is inevitable global energy consumption will rise quickly too. This economic imperative will increase commercial pressure to find solutions to a potential energy shortage. This, plus the World moving towards less reliance on oil, will put alternative energy sources increasingly under the spotlight.

We have already seen nuclear power undergoing a renaissance as a source of clean and cheap energy, where the environmental dangers can be mitigated by technological development and outweighed by political expediency e.g. the reactor building programme in France. Socially responsible investing (SRI) is also gaining considerable critical mass as more affluent middle classes can afford to indulge their moral conscience (when you are on the breadline this is rarely a priority!). Hence, they can use their voting and economic power to support developments to benefit the planet in the form of sustainable and cleaner energy. This in turn can result in increased regulation which itself can be a driver to create opportunities for improved efficiency, energy saving and alternative solutions.



Investment Opportunities

The energy sector, including oil, is a massively important and growing factor in our future economic prosperity. On top of all this, is the recognition of the impact of global warming and climate change, on which hundreds of billions of dollars are being spent each year. Overall, there is considerable potential for attractive profits and it is sensible for an investor to have exposure to this as part of a balanced portfolio strategy. There are many ways to access this market. This can be in the form of individual shares (but BP is a case in point of the concentration of risk when investing in a single company) and collective funds such as unit or investment trusts. There are now many low cost alternatives such as Exchange Traded Funds (ETFs) and other more exotic cousins. The key as always is to understand what you are investing in. Analysis and research is vital to sort out the limited wheat from the considerable chaff. New funds in this sector are being regularly launched and a healthy degree of scepticism can be useful when assessing their viability. Investment managers have the facilities and expertise to do this on behalf of clients and ensure a balanced portfolio is not over-exposed to either this sector generally or individual aspects within it.

Many investors may already have exposure to the energy sector via mainstream companies such as BP and Shell, as well as the utility companies like Centrica. This may be via direct shareholdings or more likely through collective funds. Whilst it is a recognised sector within equity investment generally, increased opportunities (for some of the reasons mentioned above) are likely to mean such exposure will increase. This is particularly so as viable, sustainable and politically/socially acceptable energy production and supply move increasingly centre stage in the public consciousness. "I think, therefore I am" is all very well, but without energy perhaps I am not!

References

1. International Energy Agency (IEA)
2. Investec
3. Organisation of Petrol Exporting Countries (OPEC)
4. Fidelity

Peter Osborne - Investment Director
 Email: peter.osborne@theovalgroup.com
 Tel: 01630 653596