Jeremy Baker subjects the fundamentals to the same intense scrutiny that he once devoted to pipeline welds

'High oil prices are here to stay'

Jeremy Baker, a former professional diver for the offshore oil industry and now UBS's head of commodity research, discusses price trends in the energy and natural resources sectors

In the last year we've seen a dramatic run-up in oil prices. Where is the upper limit?

Looking first at the demand side, the good news is that pure consumption factors alone are unlikely to drive oil to or above $100 per barrel for any appreciable time. To some extent, this is because oil prices have a self-correcting tendency – if they move too high, they can crimp economic growth, thus dampening demand and hence prices. The right way to look at it is probably this: prices have to go up to get demand to slacken. It's not that oil prices must come down due to slackening demand.

What do you mean when you talk about oil prices moving too high?

In nominal terms, oil is certainly expensive. Adjusted for inflation, though, prices have not yet reached – although they have approached – the peaks seen during the 1979–82 oil shock. The problem for would-be price forecasters is that price trends are not decided wholly by hard drivers such as strong demand and limited spare capacity. In fact, price

Economic growth in the developing world pushes worldwide oil demand. Pictured: production centre in Dhahran, Saudi Arabia

spikes tend to be driven by unpredictable soft factors such as political upsets in key producing countries. In this context, it is worth remembering that Saudi Arabia is still (by far) the world's largest oil producer and that production growth in non-OPEC countries has levelled off in recent years.

Leaving aside these unpredictable factors, where do you see the floor?

If you take longer-term futures contracts as a guide, the 10-year contracts currently point to a floor for oil prices of around $50 per barrel. The behaviour of futures is a particularly significant indicator. During previous price spikes – for example, during the first and second Gulf wars – spot prices soared but the two-year future price remained relatively constant. This suggested that the global oil market looked beyond the short-term crisis and focused on longer-term stability. By contrast, the spot and futures prices have moved up in tandem in recent months, suggesting that the market sees the threat of political instability and tight capacity as factors that will continue to dominate.

So futures prices reflect, among other things, long-term capacity constraints?

Exactly. Supply cannot easily rise to match demand because of underinvestment in both exploration and refining capacity in the past two decades. High prices are, of course, encouraging a new wave of investment, but new oil fields and refineries take years to come on stream. A case in point is a new deep water offshore production project off the West African coast. The time horizon from appraisal to final development was around 10 years. New refineries also take a long time to construct and projects are further complicated by environmental regulations, which means many new refineries are being built and planned in emerging market regions. We're not running out of oil, it's just that the oil industry hasn't kept pace with demand.

What role does demand from China and other large industrializing nations play?

Growth in demand from China, India, Brazil and other industrializing economies is naturally much higher than in OECD countries. While demand is steady or creeping up in the developed world, China's appetite for oil grew at an average annual rate of almost 8% between 1995 and 2004. And yet China still consumes less than two barrels of oil per head of its population every year, compared with something like 25 barrels per person in the US. As living standards continue to climb in China, that suggests that demand will continue to climb strongly.

Are you saying that the oil market is dancing to China's tune?

That would be to greatly overstate the case. Although China and the other industrializing economies certainly

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Jeremy Baker started his career in the oil industry in 1989 as a professional diver, specializing in non-destructive testing and weldment technology. He worked in the North Sea on the maintenance of oil platforms and pipelines, before moving in 1991 to the Middle East where he worked for several national oil companies before gaining a supervisory role. He worked in Saudi Arabia, Qatar and other regions of the Gulf. In early 1994 Baker moved to Nigeria where he spent three years working for a company that specialized in deep water surveying and oilfield inspection. In 1995 he moved to project management and was jointly responsible for the operational management of key projects. In late 1996, Baker left the oil industry and moved into banking, first with Lehman Brothers and then in 1999 to Credit Suisse where he was employed as an equity analyst covering the energy and basic resource sectors. Baker joined UBS in March 2005.

account for a very important part of the increase in overall demand for oil, they still represent quite a modest part of total consumption worldwide. In 2004, for example, China accounted for just over 8% of the world's oil consumption, while the US alone accounted for almost one-quarter. So the current upward pressure on oil prices has to be ascribed to a combination of factors, as we discussed above. Demand is certainly one factor, but supply constraints are equally important. On top of that is a fear factor that cannot really be quantified.

How far do these supply and demand drivers affect other mineral resources, such as base metals?

Like the oil sector, the mining industry – particularly in base metals – contracted during a period of low prices during the late 1990s, leaving it ill-prepared for resurgent demand from 2002. After peaking in the late 1980s, worthwhile discoveries of new ore deposits tailed off almost to nothing in the second half of the 1990s, reflecting both geological factors and underinvestment in exploration. Capital spending is now recovering, but, as in the oil sector, new production will take some years to come on stream, depending on the timing of investment. As in the oil picture, China is also prominent in the base metals story. The country accounted for more than 80% of the world's estimated demand growth in iron ore between 2004 and 2005 and about half of all demand growth in nickel. Meanwhile, inventories of base metals remain low worldwide, so that sustained economic growth should continue to underpin prices.

All that certainly echoes the oil story. Where do you see the differences?

One factor is that base metals – aluminum, copper, zinc, nickel, iron, steel – are perceived as less vitally strategic than oil supplies. For at least some of them, supplies are diversified across the world. And, to a certain extent, other materials can be used instead of these metals. Fibre optics, for example, are a partial substitute for copper cables, and plastic composites for aluminum. But there are clear limits to that process.

So you would expect prices to stay high for quite a while?

Yes. We expect a secular bull-market for commodities over the next five to 10 years. The strong fundamentals do not rule out – and may aggravate – plenty of volatility around the trend line. One last thought: a factor that is often overlooked is lack of experienced staff, such as geologists and petroleum engineers. Even equipment such as tyres for earth-moving trucks is in short supply. For me, that is another sign that high prices are here to stay. /

Martin Hood is an editor for *Wealth Management* magazine

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