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Special Report
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Slippery Business: Oil prices and UK industry

Oil prices affect numerous industries in the United Kingdom, with fluctuations hitting margins and increasing costs, particularly for industries for which oil is a major feedstock. In this special report, IBISWorld analyst Nadine Fisher asses the effects of recent trends in oil on a number of key UK industries

The low oil price environment hit the performance of UK petroleum industries

Over recent years, oil prices have seen some of their highest highs and lowest lows. In the three years through 2013, global prices of crude oil inflated to over US$100 per barrel. This surge was due to a combination of strong global demand and political turmoil in oil producing countries. Despite declining UK oil and gas production since the late 1990s, UK extractors responded to rising prices and low global production by ramping up investments, and new fields have come onstream as investments have come to fruition. In 2017, eight new oil and gas fields started production, and a further 12 fields are due to come onstream by the end of 2018, ensuring that the UK market is relatively well placed to benefit from the expected rise in oil prices over the current year, following a prolonged weakness in the oil price environment.

Rising US production caused prices to level off in 2013, before they tumbled over the following two years due to sluggishness in the global economy causing significant oversupply. The price of oil continued to decline, reaching a low in January 2016 with Brent crude oil falling below US$28 per barrel. This low oil price environment hit the performance of UK petroleum industries, with revenue in the Crude Petroleum and Natural Gas Extraction industry (IBISWorld report B06.000) falling by 23.4% and 23.8% in 2014-15 and 2015-16, respectively.

OPEC intervention

On 30 November 2016 the Organisation for Petroleum Exporting Countries (OPEC), in cooperation with some non-OPEC major oil producers such as Russia, responded to low oil prices by agreeing to cut the production of oil. These countries

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removed 1.8 million barrels per day from global supplies, followed by further extensions that would have run until the end of 2018. Despite soaring North American production, oil prices in January 2018 recorded the strongest start to the year in five years and reached US$80 in May 2018. The rise has been exacerbated by political tensions, particularly the withdrawal of the United States from the Iranian nuclear deal. Rising oil prices are expected to cause revenue to increase significantly for all industries that play a direct role in the petroleum supply chain, with revenue in the Crude Petroleum and Natural Gas Extraction industry expected to rise by 12.7% in 2017-18 and 5.6% in 2018-19. Additionally, revenue in the Petroleum and Natural Gas Support Activities industry (IBISWorld report B09.100) is expected to increase by 3.4% in 2017-18 and 7.3% in 2018-19. These industries will also benefit in 2018-19 from a range of tax breaks being introduced from November, as well as £5 million in government funding for exploration. Exemplary of these increases in production is BP's April announcement that it would invest £420 million in bringing two North Sea Oil fields online, which are expected to produce 50 million barrels.

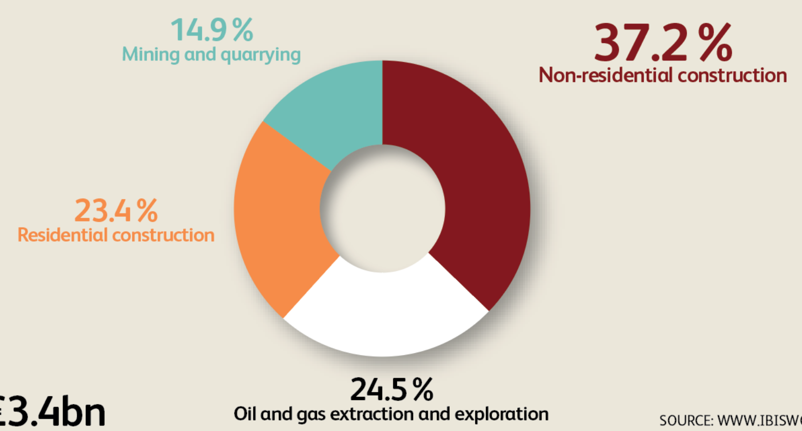
On 22 June, OPEC and allies decided to increase production by an effective 600,000 barrels per day, which was less than originally anticipated. While this led to an initial increase in oil prices, higher production will mitigate the growth in oil prices that has been recorded in recent years.

Petroleum sector

The petroleum sector is a major market for a number of UK industries, and demand for these industries is affected by fluctuations in world oil prices. For example, the oil and gas extraction and exploration market is the second largest market for the Mining, Quarrying and Construction Machinery Manufacturing industry (IBISWorld report C28.920), accounting for approximately 24.5% of revenue. Low oil prices have contributed to significant declines in this industry in recent years, with revenue falling by 10.1%, 10.6% and 18% in 2014-15, 2015-16 and 2016-17 respectively.

Low oil prices also affected producers of speciality chemicals utilised in exploration activity. For example, baryte, or barium sulphate, is primarily used as a weighting agent in drilling fluids in oil and gas exploration to

Mining, Quarrying & Construction Machinery Manufacturing industry
Major market segmentation (2017-18)



Total £3.4bn

SOURCE: WWW.IBISWORLD.CO.UK

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reduce pressure build-ups. While baryte only accounts for 3.8% of revenue in the Chemical and Fertiliser Mineral Mining industry (IBISWorld report B08.910), this share has been negatively affected by the low oil price environment.

Revenue is expected to rise over the two years through 2018-19 as stronger oil prices support demand for harsh-environment exploration, particularly for North Sea drilling, supported by government investment. This is likely to affect associated industries throughout the industrial supply chain.

Transport sector

The UK transport sector is heavily reliant on fuel as an input for day-to-day operations. However, the effects of fuel price fluctuations differ depending on the specific transport mode. For example, fuel costs are estimated to absorb 15.6% of the Freight Road Transport industry's (IBISWorld report H49.410) revenue, while fuel costs are expected to capture as much as 18% of revenue in the Sea and Coastal Passenger Water Transport industry (IBISWorld report H50.100). This is because in the case of road transport, oil prices only partially cover the total fuel price and fuel tax largely determines the final fuel price. Conversely, for the maritime and aviation sectors, the absence of specific taxation means that the impact of oil price variation on fuel prices is much more pronounced. However, over recent years road transport has progressed in terms of energy efficiency by switching towards alternative sources.

Rising oil prices can also affect competitiveness between transportation industries, by displacing demand. As rail freight is more fuel-efficient than road freight, rising fuel prices are expected to make rail freight more competitive by comparison. The benefits of the levelling off of oil prices are expected to be somewhat limited for operators of road transport vehicles, as fuel price fluctuations are less pronounced than oil price movements. High UK fuel taxes limited the extent to which the sector benefited from the previous low-price environment.

Petroleum is a key feedstock in petrochemicals and secondary products, such as rubber, plastic and synthetic fibres. Revenue derived from petroleum-based chemical products is expected to follow oil price fluctuations. When the price of oil falls, the price that can be charged for products containing high levels of oil will also contract. This causes revenue for industries that sell products containing oil to fall due to internal competition. Conversely, revenue increases in these industries when oil prices rise. For example, due to rising oil prices and high demand over the three years through 2018-19, conditions in the Organic Basic Chemical Manufacturing industry (IBISWorld report C20.140), the industry that produces the most petrochemicals, are strong, and industry revenue is forecast to rise at a compound annual rate of 2.8% over the next five years.

Chemical sector

Fluctuating oil prices can also significantly affect the level of profit in the chemical sector due to the time lag between purchasing petroleum feedstock, manufacturing products and inventory turnover. In 2015, chemical manufacturers that had purchased oil stocks when prices were high were forced to make a decision between revenue and profit. Manufacturers had to choose between selling expensively made products at low prices in order to stay competitive or passing costs on to customers and therefore risking losing revenue to rivals. For instance, Basell Polyolefins UK Ltd, the largest firm in the Primary Form Plastics Manufacturing industry (IBISWorld report C20.160) saw a 10% fall in revenue in 2015. The company attributed this to the fall in

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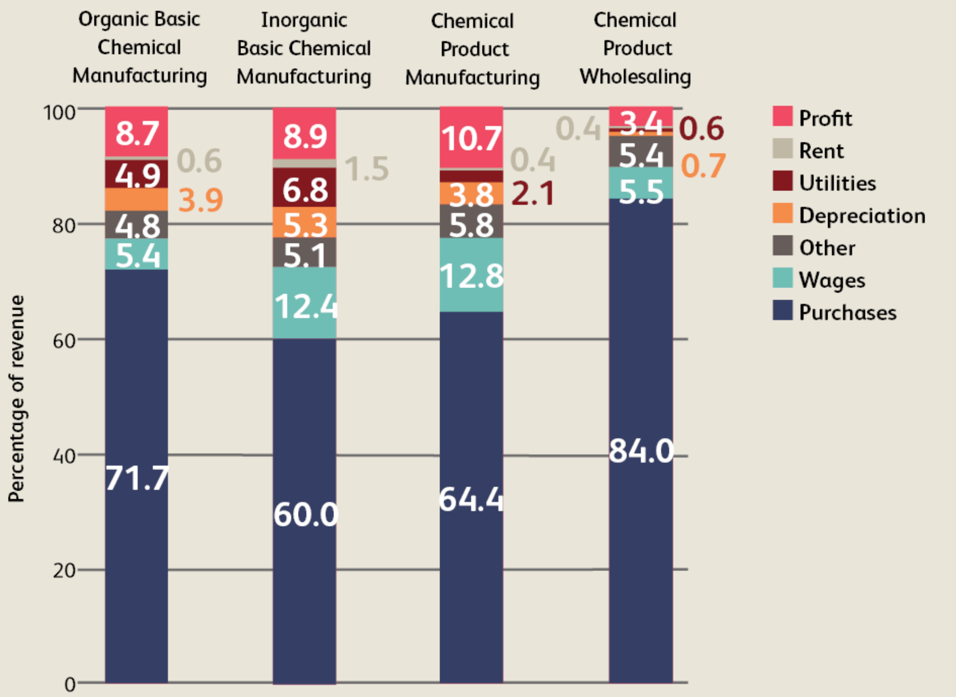
global oil prices and resulting feedstock rotation problems as the company was reluctant to register a loss on inventory. This was indicated by production in 2015 being approximately 140,000 tonnes under the company's target.

While some stability has been provided by the latest round of OPEC talks, views on future price movements remain conflicting, due the volatile nature of oil as a commodity. Standard Chartered raised its crude oil price forecasts for 2018 and 2019 in April, but the company's estimated average price for 2018 remains below current prices, at US$71 per barrel. Conversely, the IMF and World Bank have both predicted that oil prices will continue to rise through to 2020. Despite the loosening of production limits, production in both Iran and Venezuela is expected to remain constrained.

Cost Structure of Chemical Industries



SOURCE: WWW.IBISWORLD.CO.UK

IBISWorld Industry reports used in this special report:

B06.000	Crude Petroleum & Natural Gas Extraction in the UK
B08.910	Chemical & Fertiliser Mineral Mining in the UK
B09.100	Petroleum & Natural Gas Support Activities in the UK
C20.140	Organic Basic Chemical Manufacturing in the UK
C20.160	Primary Form Plastics Manufacturing in the UK
C28.920	Quarrying & Construction Machinery Manufacturing in the UK
H49.410	Freight Road Transport in the UK
H50.100	Sea & Coastal Passenger Water Transport in the UK