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BHP's 'measured creep' of risk appetite

Glencore chief Ivan Glasenberg has routinely blamed BHP for blowing the resources boom by over investing in production growth. **Chris Ratcliffe**

by **Matthew Stevens** Ivan Glasenberg wondered recently how it was the BHP had moved into mining frontier of Ecuador when management at Australia's Smart Thinking resources house was supposedly content to sustain and grow its business around its existing sites.

This bemusement is well founded.

Among the themes consistent through Andrew Mackenzie's evolving reformation of BHP are that it has little or no appetite for investment in frontier opportunities and that the company's growth aspirations will be best afforded through a laser focus on the Global Australian's existing six-strong fleet of mega-resource basins.

But that message is in the process of being massaged into something more nuanced, and not just because BHP's two-stream play to possibly shape Ecuador's future in copper stands an obvious test of the past house line in emerging mining sovereignties.

To refresh here, BHP has so far spent $131.9 million in a two-step onto the register of an Australian-based, UK listing called SolGold. It has found what could be big copper in Ecuador and BHP 11 per cent stake in SolGold gives it a call over whatever happens next.

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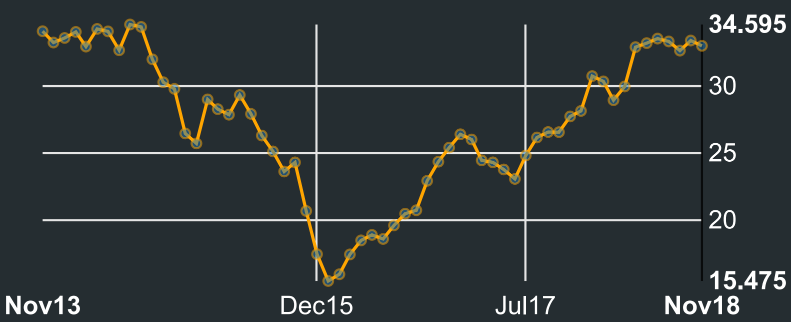

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At the same time, BHP has acquired virgin exploration country on the fringes of SolGold's Andean copper finds, and it has recently moved to open an office in the Ecuador's capital of Quito. All of that is despite the inescapable fact that Ecuador is not an OECD destination and neither does it have a mature mining law or a legacy mining estate.

Inside BHP they define it as "measured creep" of the portfolio strategy envelope. And it has resulted the now two obvious exceptions to the rules that preference investment in stable OECD destinations or in the basins that BHP knows best.

In the hours before last Thursday's annual general meeting in Adelaide, BHP revealed it it had won the right to go looking for oil in the deep, cold waters to the east of Canada's Newfoundland and Labrador.

The successful bid arrives with a minimum work commitment of $US157 million and a six-year commitment of $625 million given that the exploration project walks through its various investment gateways. BHP will spend $US140 million on the two blocks by 2021 and that will be built into existing budgets.

Patently there is nothing that risky about investing in Canada. The fiscal regime is as attractive and its promise can be trusted as secure. And BHP knows the place well. Its original diamond play was under the tundra of Canada's distant north-west and, if the Australian has a future in potash, its home will be in the western Maple Leaf province with the coolest of names, Saskatchewan.

There is no reason, either, to doubt than the deep water plays BHP has secured sit in the diversified miners' technological wheelhouse. BHP Petroleum is, for example, one of the most productive and cost efficient operators on the American-side of the Gulf of Mexico, which plays host to most of oil's first world operators.

For all of that, there is something new and thematically challenging about BHP's new Orphan oil play. It is a big step into the unknown and a giant leap away from the company's basin hub strategy.

That public disclosure on the successful Orphan pitch arrived just a week after that BP deal closed and was immediately translated into $US10.4 billion of capital management, was a telling coincidence.

As it turns out, Orphan was identified in the same 2016 Global Endowment Study that proved to be the death knell of BHP's expensive, wasteful and reputation scarring dalliance with the US onshore shale business.

The internal assessment of a whole world of petroleum geographies and geologies found that, outside of Russia, there was no obvious home for a repeat of the US shale phenomenon. Given that Russia is a sovereignty actively avoided by BHP, the growth options were limited to the US. And, given its modest rates of return, the existing shale business was just never going to crack it for the investment it needed because the internal race for capital has become so contestable at BHP.

BHP was destined to retreat from shale from the moment that study landed. The only question was when. Despite external pressures from some anxious agitators, BHP waited on a recovery in oil prices, eventually flipped its oily shale business to BP for $US10.5 billion.

While BHP quietly went about organising an exit from shale, Mackenzie opened the capital spigots for oil exploration. In August 2016, Mackenzie confirmed a new tempo to the quest to drive future value through the drill bit. But the focus of this circa $US750 million a year investment in his petroleum division's ability to find oil has been contained to the known.

BHP has revealed new gas plays around its West Indian home base of Trinidad and is excited by a series of oil plays north of its existing Shenzi project on the US side of the Gulf of Mexico.

Until now the nearest BHP has got to a frontier is in stepping over the border to the Mexican side of the Gulf with the acquisition of a senior stake and project management of a known oil discovery called Trion. But Trion does not push the portfolio envelope. Mexico is in the OECD and its oil is effectively in BHP's operational backyard.

This move to the deep waters of Canada, on the other hand, announces that BHP's offshore ambitions are rather more expansive and risk-indulgent than investors had been led to imagine.

Of course, as Mackenzie is want to say, managing risk is what successful resources companies do. The only reason the rewards can be so high is that the geological and capital risk is material.

The Orphan Basin, which lies 400km west of St Johns, the capital of Newfoundland and Labrador. It is what BHP's Mackenzie calls an "exploration fairway". It is the host of two long-dated oil discoveries by Shell that were followed-up by less successful drilling through the 1970s and 1980s. If we are reading the technical papers with any insight, then it appears the appraisals failed because they could not crack through to the deeper sedimentary layers that were the wellsprings of the oil discoveries.

Needless to say, drilling technologies have advanced a long way over the past 40 years given drillers the ability to accurately target ever deeper plays in ever deeper stretches of water.

Seen through the Mackenzie lens, Orphan arrives an opportunity for resource replenishment that could see BHP's oil boots full until that period in the distant future where oil finally passes peak demand. Sustained drilling success between now and say 2025 would see Orphan join the BHP production family at a point after 2030.

Between now and then, BHP and its operating partner BP, will introduce about 140,000 barrels a day of new crude oil production from the $US9 billion Mad Dog 2 project by 2022 while working through its options around Shenzi and Trion plays.

Finally, just to get back to where we started here, there is a long history, past and still fomenting, of tension between Glencore's legendary principal and successive BHP management teams.

Glasenberg has, for example, routinely blamed BHP for blowing the resources boom by over investing in production growth, a position he has consistently contrasted with his own version of the now industry ubiquitous value-over-volume approach to production and investment.

But Glasenberg's frustration with BHP pre-dates any rhetorical jousting over the triggers and outcomes of the end the once in the century resources boom.

Through BHP's ultimately successful drive to force short-term, index-based pricing on to the iron ore market, Glencore attempted to invite itself to the new market party.

Glencore recommended itself to BHP as the best possible marketing partner for iron ore's new era. But BHP's then chief executive, Marius Kloppers, decided to capture all of the new value in-house and instead invested in beefing-up BHP's Singapore trading hub.

Now, from what we hear, there is now a new bone of private contention that most recently flared up through the recent very private Melbourne sessions of the International Council of Mining and Metals.

The story doing the rounds – and it needs be said we have not been able to confirm it – is that BHP's Mackenzie found himself at odds with Glasenberg over whether or not the ICMM had a role to play in managing investment protocols in frontier mining destinations.

Glasenberg arrived seeking support for the idea that the ICMM might have drawn up something akin to a set of protocols that governments of next-gen mining economies might use as a framework for both discussions on fiscal settings and for securing the results of those discussions.

But Mackenzie demurred, arguing that the ICMM's role should be contained to issues like safety and he went on to recommend that relationships between nations and miners are best managed directly by governments and miners they select as partners.

BHP

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