Any see the 2014/2015 oil price plunge as a test of financial endurance between OPEC and US shale producers, with all other players (be they majors or minor E&P companies) caught in the middle ground. Shale producers have added 4mn b/d of crude to global oil supply since 2010 and reduced the US need for Saudi imports. Canadian tar sand producers have nearly added another 4mn b/d in less than a decade. Indeed, rising output of US shale oil and the Canadian tar sand producers threatened to erode OPEC’s world market share, as the growth in global oil demand led to a rise in market share only for the non-OPEC producers.

That is what Saudi Arabia and its OPEC members want to halt — by putting the new entrants out of business. The 2014/2015 oil price plunge is being deliberately prolonged by OPEC, which continues to over-supply the market by more than 1.5mn b/d at a time of reduced global consumption. By contrast, back in 2008/2009, it was OPEC who helped restore oil prices rapidly by steep production cuts in response to lagging oil demand due to the global recession.

The oil price collapses during the crises of 2008/2009 and 2014/2015 are comparable and of similar severity (see Figure 1). However, the profitability decline of the majors from the year before was much greater in 2009 than in 2014 (see Figure 2). Oil majors, with their diversified portfolios, have embarked on faster and substantial cost cutting, deferring project investments and forcing headcount reductions to absorb the impact of lower oil prices. Such measures may lead to a substantial output reduction from 2020 onwards when the projects scheduled to pass the financial investment decision (FID) stage in 2014–2015 would have been due to come onstream.

Ruud Weijermars and Crispian McCredie, Alboran Energy Strategy Consultants, think OPEC’s present oil dumping policy may backfire and achieve the opposite of its intended result; industry consolidation and innovation in the long-run will see US shale oil output increase rather than contract.
For many OPEC members and other NOCs faced with diminishing revenues, now would be the time to undertake a detailed external audit to improve operational practices and root out waste and corruption.

In spite of such remedial action, the 2015 quarterly results so far remain suppressed by low oil prices. Further projects are being cancelled or FIDs delayed. Over 46 big oil and gas projects have been cancelled by the majors, amounting to $200bn in capital reduction, according to Wood Mackenzie.1 All E&P companies continue to seek project cost reductions to help offset price risk volatility by squeezing their contractors, who in turn must reduce input prices, including labour costs. This affects the oil service companies, where, for example, Schlumberger’s peak workforce of 126,000 in 2014 will be reduced by 20,000 during 2015.

Meanwhile, OPEC policies inspired by the face-off between Saudi Arabia and US shale producers have forced many shale oil companies to refinance debt and diminish shareholder equity. However, at the same time, the situation has benefited shale operators by necessitating better use of technology, reducing cost and well completion times with consequent cash flow savings. Projects have been simplified to permit quicker adaption to changing circumstances and timeframes and expenditures are being reduced accordingly.

For OPEC members other than Saudi Arabia, with their higher operating costs and lower treasury buffers, there is less evidence of cost savings. National oil companies (NOCs) are left with little alternative but to keep pumping crude to compensate their government treasuries and avoid the drastic dwindling in oil taxation revenue consequent to oversupplied markets. This, in turn, has a knock-on effect where governments maintain subsidies on food and fuel financed by petroleum revenues. Oil producing countries including the United Arab Emirates, India, Indonesia, Mexico and Egypt have commenced reducing energy subsidies.

Showing restraint
So far, E&P company equity holders, many of whom are long-term institutional funds, have restrained from dumping energy stocks as in 2008.2 This can be concluded from the market capitalisation of a peer group of 25 oil and gas companies which included majors, private public partnerships, independents and unconventionals players being almost 38% lower in 2008 than 2007 and only 15% lower in 2014 compared to 2013 (see Figure 3). The first quarter of 2015 has even seen a modest recovery of energy stocks.

As a result, investors holding on to their stocks have averted the drop of total shareholder returns (TSR) which in 2008 on average eroded 20% of the value gained the year before. The 2014 TSR decline was only a fraction of that number.2

Protecting interests
Assuming the present low oil price environment cycle is a short-term phenomenon lasting only, as in the last downturn, a number of quarters rather than years, what should the oil industry do to protect the interests of their stakeholders and employees? For many OPEC members and other NOCs faced with diminishing revenues, now would be the time to undertake a detailed external audit to improve operational practices and root out waste and corruption. Realistically this is easier said than done, as there are too many vested interests.

However, this must be weighed against the longer term consequences caused by rising unemployment, reduced government spending and the severe turbulence that already exists in many oil producing regions.

For non-OPEC nations with post-peak production hydrocarbon basins, eg the North Sea, E&P activity in many marginal fields has become uneconomic. Governments may attempt to stimulate E&P by reducing taxation, but such measures are slow in materialising. The reduction of government expenditure has already slowed the development of Western government’s subsidised wind and solar energy, while nuclear energy remains either unpopular or necessitating lengthy lead times measured in decades between initial planning and the first megawatt of production. European shale gas extraction will remain mired in ever increasing legal costs associated with fighting environmental court battles. Hence the European shale explorers, in a low oil/gas price environment, may consider it not worth the battle in terms of return to investors.

There is a silver lining for part of the industry, as refiners have...
experienced cheaper feedstock and increased profitability. Oil importing countries have seen their import costs decline. For example, Europe’s annual energy bill on oil imports has been halved, which may boost the Eurozone economy, and partly offsets the impact of the continuing Greek problem and a generally weak euro currency.

So, is the present silver lining of low petroleum prices likely to last?

The need for reserve replacement is a key requirement for the survival of any E&P company. The ‘keys’ to offshore (shallow and deep water) and land-based conventional reserves are held by the NOCs. However, many can only open the doors to their oil fields using considerable outside assistance. As internal pressure mounts on OPEC’s financial reserves, it is in the cartel’s interest to see a higher oil price which will in turn attract the E&P and the service companies back into the game. Should this not happen anytime soon, then the NOCs and IOCs alike, both under pressure to see reserve replacement, will move into acquisition mode – as has been seen with Shell’s acquisition of BG.

Many minors will become fodder for the majors and NOCs.

Finally, a definition of a cartel is a group wishing to regulate production usually downwards or manipulate price usually upwards for the benefit of the cartel members. To increase oil production and reduce price shows little benefit for many OPEC members, who may feel, in the present environment, the definition no longer fits. The overbearing need to show shareholder return on investment will not diminish but rather increase. The recent thawing of Western relations with Iran may be the wildcard that determines the next stage of the pricing cycle.

References