GECF Expert Commentary

Oil and gas companies under the price war and the demand shock

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Oil price storyline

On the 8th of March 2020, the oil price went down to $40 per barrel due to oversupply in the market and decreased demand because of the impact of the black swan Coronavirus (COVID-19) that caused a shock to the global economy. The supply and demand shocks caused the US demand to drop by 3 million barrels per day and oil demand in China to drop by around 4 million barrels per day. The situation went worse because of the disagreement between OPEC and Russia (OPEC+) on regulating the oil market and controlling supply.

On the 9th of March 2020, the oil price followed a free fall trend to $30 per barrel in response to the price war after the collapse of the OPEC+ negotiations and the announcement of ARAMCO that the company will supply the market with 12.3 million barrels per day in April.

Oil producers and exporters will have a tough time ahead due to the price war that in one scenario may not hurt the US shale as severe as required to regulate the market. The 2014 oil price crash showed the resilience of the US shale as technology development in hydraulic fracturing helped in reducing the operational costs. Going through the same strategy now under the COVID-19 impact will hurt oil producers in the first place in terms of draining government budgets. COVID-19 caused economic sudden stops driving the global economy into a recession suggesting the severity of the current situation to be of much higher severity that the 2014 oil price crash.

2 days later, on the 11th of March 2020, the oil giant in the UAE (ADNOC) announced its plan to increase its oil output to 4 million barrels per day in response to the OPEC+ collapse of negotiations adding more complications to the oil price recovery in the short-term.

Regulating the market will benefit the market in terms of highlighting stability and ensuring the flow of investments in the challenging decarbonisation future.

What is happening to natural gas prices?

The gas industry is under a similar pressure from what is severely impacted in long-term contracts that are oil-indexed. According to Platts, the majority of the LNG market, around 75%, is under long-term contracts that are oil-linked and revenue for LNG exporters will drop if the situation lasts long. On the other hand, the spot market is under huge overburden from the impacts of the COVID-19 outbreak. Prices are falling in Asia, Europe, and the US. The low gas price will foster the coal-to-gas switching in

Japan and South Korea as the economics of switching will be enhanced in case of policy support. In the European market, the situation could be different. The fluctuation in oil and gas prices will make them more cost-competitive than renewables, however, some markets may foster diversification away from oil and gas due to the steep rise in volatility.

Projects and operations in the downstream industry is facing what the upstream is facing. Projects will delay and panic between workers will harm the industry over the short term.

What is happening with oil and gas companies?

The big giants in the industry, Royal Dutch Shell, BP and ExxonMobil, have managed to get adapted to low oil price environment after the oil price crash in 2014 from over $100 to an average of $65 per barrel as they implemented leaner and more efficient ways of managing the business. With oil price below $40 per barrel and share prices of companies heading down, many investors are expected to doubt the possibility of maintaining profits and will consider the high probability of highly leveraged companies to be severely impacted. According to Wood Mackenzie, for each $10 per barrel change in oil price will cause $40 billion loss to global cash flow per quarter while the United Nations expects the COVID-19 will cost the world economy around $2 trillion this year.

Goldman Sachs expects Brent crude oil price to go down to $20 per barrel a case that will severely impact high-cost producers especially for companies working in unconventional reservoirs. The top performers in the US unconventionals (shale) are 16 companies in exploration and production having their oil cost below $35 per barrel and they are proceeding with cutting spending.

On the 19th of March, the Brent oil price crashed again to $26 per barrel and WTI dropped to $20 per barrel. The majority of shale producers will not able to bear the situation and many are expected to go bankrupt considering the situation of lack of lending, demand shock and an oversupplied market. The economic stress has been transmitted to the hydraulic fracturing giant, Haliburton, with the company starting furlough about 3,500 employees in Houston for 2 months as the shale producers are cutting spending. Smaller service companies decided to implement pay cuts while others decided to stop operations.

BP will go for a global shut down of its offices to comply with the social distancing philosophy of fighting the COVID-19. The company thinks it is in a better position compared to the downturn cycle of the oil and gas industry in 2014 as the company has built a “wall of liquidity” that can support the company during the compilation of effects caused by the COVID-19 and the oil price war over the short term. The situation is expected to get harder in April with more oversupply in the market and the unknown duration of the lockdown of countries over the fear of COVID-19.

On the other side of the game, risks are surrounding operations all over the supply chain in the oil and gas industry. COVID-19 has made its way to Equinor, Shell Aberdeen and other assets in the North Sea. This is causing panic among employees due to the difficulty of handling the situation in terms of transporting the infected employees from offshore platforms by helicopters.

The industry is facing another challenge related to equipment delay that will force projects to be postponed. The risk will come from the delay of safety-critical maintenance. Some safety-critical equipment is manufactured in Italy to support the North Sea operations. Critical maintenance operations are risky to be delayed to avoid the likelihood of catastrophic events.

Conclusion and recommendation

The oil and gas industry faced several challenges during the past few decades but this one is very unique in terms of its global impact on all industries worldwide. The combined effect of COVID-19 and the price war is harming the oil and gas industry severely through reduction of spending, delaying of projects, fear on some platforms and fields caused by the spread of COVID-19 between workers and delay of critical maintenance operations. The hopes are low that the downstream industry will manage to help the upstream sector in the oil and gas industry as in the 2014 oil crash. Instead, the oil demand will be dragged down with the world economy during the time of global lockdown as the world is fighting the spread of the COVID-19.

The best scenario for the industry is for top producers to come together to regulate the market for the benefit of everyone to get production levels to what was before the COVID-19 with hopes of the containment of the virus outbreak by Q2 2020.