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MEMO

To:	BusinessNZ Energy Council (BEC)
From:	Tina Schirr, Executive Director, BEC
Date:	2 April 2020
Subject:	**What is happening internationally with the oil price collapse?**
Action Required:	For your information

Purpose

As mentioned in our last update, COVID-19 and a disagreement between Russia and Saudi Arabia have had a major impact on energy prices due to disruption in oil demand and supply.

Therefore, the purpose of this memorandum is to update the BEC on what is happening internationally with the oil price collapse.

The following has been but together in conjunction with the of the World Energy Council's Regional Manager, Middle East and Gulf States.

What is happening internationally with the oil price collapse? Key points below:

There seems to be little chance that the Saudis and the Russians will call off their oil price war.

The Saudis have enough spare production capacity to increase supply substantially and say they will supply 12.3 million barrels per day to the market. Saudi Aramco's current production capacity stands at 12 mbd so some will come from storage. Aramco, on the government's directive, is speeding up plans to expand capacity to 13 mbd. Contracts had already been awarded in July 2019 so this is not new. What it will do is make it harder for Aramco to ease up on production from its older fields, which is what it does when it brings new capacity online. The kingdom has 12.5 mbd capacity though the 500,000 b/d from the Neutral Zone with Kuwait has been offline because of a dispute but is due to come back online imminently. One way the Saudis intend to boost volumes for export is by using more gas rather than liquid fuels for power generation in order to free up more crude for export. Restoration of Neutral Zone production will allow Kuwait to boost its output and the UAE is planning the same. Russia also says it can put an additional 500,000 b/d on the market gradually.

According to analysis and experts, Igor Sechin, the CEO of Rosneft and the so-called Russian energy tsar has Putin's ear and he was opposed to the OPEC+ deal to cut production from the start because he could see that it was benefiting U.S. shale. The Saudi officials I have spoken to say the Russians have shown no sign of wanting to negotiate. They do admit that even if they were to reach agreement to cut by 1.5 mbd, as they had proposed during the March Vienna meeting, it would not be enough to lift prices because it's too little too late. The Saudis are under pressure as current President of the G20 to show some leadership and call off the price war but the G20 communique after they held their teleconference made no mention of the oil market.

The problem now is that the market is facing an unprecedented supply and demand shock. Nobody can put an exact figure on just how much demand will decline this year, but experts say it could be anywhere between 15 mbd or as high 20-30 mbd at its peak. This means a lot of the oil will go into storage or onto floating storage so there will be price pressure for some time to come. Gasoline and jet fuel demand have taken a big hit because of the lockdowns. This puts pressure on refineries that are producing light ends.

Production from some areas where current oil prices have squeezed margins will likely be halted. We have already seen Canadian oil sands production shut in because of bad economics. For shale producers, we are seeing some netbacks as low as $5 a barrel or close to zero for some central U.S. producing wells. Just how much will be curtailed is unknown but there will be some attrition because they will have difficulty moving the oil. Refineries in the U.S. are designed to produce light ends like gasoline and jet fuel so with demand down -- estimates are that gasoline demand is down by 40% in the U.S. -- storage will soon fill up and it will be difficult to evacuate the oil given pipeline capacity and storage limitations.

Gas prices have also sunk along with oil and while some of this is seasonal, it is also tied to demand destruction in some key areas like China. The fall in crude oil prices will affect the LNG market, where most contracts are linked to crude oil. According to the price reporting agency Platts, roughly 70-75% of the LNG market is still under long-term contracts and exporters like Australia, Qatar and Malaysia, which have a high dependence on oil-linked contracts, will see revenues impacted by lower oil prices. But this is good news for LNG buyers.

For New Zealand, which is phasing out its offshore oil and gas production, this offers the possibility of locking in some supplies while prices are competitive.

For the upstream sector, oil services companies are likely to agree to cut their costs to secure contracts in a shrinking market. The multinational oil companies are reviewing capital spending plans for the year and streamlining their operations. Italy's Eni has said that it is reviewing its projects in the Middle East.

ENI is considering pulling out of some Middle Eastern countries and a number of the multinational oil companies now reviewing their capital expenditure plans for the year. BP has said it will cut spending by 25% this year.

Upstream investment fell by 25% in the two years that followed the 2014 oil price collapse. The IEA warned at the time that this would cause a supply shock in the early part of the 2020s. The cuts to upstream spending are likely to be far steeper this time but it is difficult to see by how much since the companies have not all declared their intentions. Even Aramco has slashed its capital expenditure for 2020 and says 2021 spending is being reviewed.

The industry is likely to see several consolidations. Some of the smaller U.S. shale oil producers are heavily indebted and face possible bankruptcy because their lines of credit have dried up. BP says that its capex cuts include $1 bn at the group's shale business.

Gasoline demand is down sharply, by 40-50% as is jet fuel because of the lockdowns. Gasoil demand is also slightly lower with demand down by 10-20 percent because there is still demand for transporting goods. Refineries that produce more gasoline and jet fuel will have a hard time because they will have to shut down units, and storage space for products is filling up fast.

Low oil prices make it easier for governments to remove energy subsidies. There seem to be no signs of that yet but it is highly likely that in countries where energy and electricity are subsidised, governments will move to ease or scrap the subsidies all together because they need the revenues.

Conclusion

The IEA’s narrative for the last 5 years has been that there hasn’t been sufficient investment in oil & gas production capacity to meet projected demand growth and that this is likely to lead to a supply crunch in the early 2020s.

The combination of the demand destruction from COVID19 and the price war will knock-out many of the US shale producers in the short-term and slash upstream production investment, as highlighted by above. This could be problematic if there is a quick return to previous oil demand levels leading to a new oil supply crunch with massive price spikes.

Traders will be anticipating this and trying to fill as much storage as possible with oil at its current low price with some using underemployed oil tankers as floating storage (that can make economic sense if a significant price spike is expected within a few months).

A rapid return to previous demand seems highly unlikely and we are more likely to experience a reasonably deep recession with a slower recovery. This will slow the return of oil demand that is also likely to be affected by some structural changes (e.g. much slower recovery in aviation with reduced business travel/tourism). This is likely to delay the potential oil supply crunch a few years, possibly to the mid-to-late 2020s.