AUDERE PARTNERS

Consolidations and Bankruptcies Ahead for the Oil & Gas Industry

The oil and gas industry is undergoing an unprecedented "perfect storm" of events. The breakdown of OPEC+ talks, the outbreak of the COVID-19 pandemic with its knock-on effects on the world's financial markets, combined with diminishing storage capacity add up to difficult times ahead for the Shale producers.

By Barry Samria

April 6, 2020

The harsh reality is that with events leading up to, and the breakdown of the OPEC+ talks last month, oil prices were already heading towards the cliff edge, COVID-19 outbreak happened and unceremoniously pushed them over the edge. We believe that with the demise of the OPEC+ talks, oil was heading to the $20s anyway; the pandemic just added more momentum. Sadly, it is going to get uglier given the unusual scenario of negative impacts on both the demand and supply sides. Analysts are projecting more downside ahead as demand has already fallen by as much as 20%-25% driven my actions in place to manage the spread of COVID-19. We also saw OPEC+ production cuts expire on March 31, meaning that cartel members are free to set their production quotas.

The Saudi's are geared up for a price war to gain market share, with the Russians unlikely to make it easy for them. Comments from the POTUS suggesting that the

Russians and Saudi's might come up with a deal to cut production seem to lack credibility given that it is hard to imagine they could in any way cut 10 million barrels a day between them? Especially given that the world is currently using 20-25 million barrels a day less, which is still an excess of 10 million barrels a day. You now also have the issue of diminishing storage capacity! The comments did, however, have the desired effect on oil prices, likely to be short term only. The bottom line is that the Shale boom in its current form may get confined to the history books, and if price action in the first quarter is an indication of things to come, we are indeed in for a rough ride.

The last three months have posted numbers that we have not seen for some time. March was the worst single month for oil as we saw prices for WTI fall by 55%, which also led to the worst quarter in history with prices for WTI down by 67%. So, let's take a closer look at what brought the oil markets close to the cliff edge before we take a look at the compounding impact of COVID-19.

TO THE EDGE OF THE CLIFF

In the days when the U.S was a net importer of oil, a collapse in oil prices would have had industry as well as the average consumer jumping for joy. After all, lower oil prices in those days would be a positive factor for the economy, true today for large net importers like China, Germany, and India. However, the Shale boom significantly shifted the Macro-economic picture for oil and gas in the United States. Bloomberg Economics' Chief Economist recently noted that the U.S. "in the past had a lot to gain from lower oil prices, now has something to lose", which in my book, is somewhat of an understatement.

The warning signs for downward pressure on oil prices had been evident for some time. The slowdown in growth in the Chinese economy because of the prolonged trade war with the U.S, and the impact of tariffs on Chinese exports. The ongoing disputes amongst the OPEC+ cartel, and their inability to agree to essential production cuts before the agreement expired on March 31. A milder than average winter, etc., to name just a few of the factors driving downward pressure on oil prices. According to Ali Khedery, former senior Middle East advisor to Exxon and currently CEO of strategy firm Dragoman Ventures, "$20 oil in 2020 is coming." Pointing to failed/failing petro-kleptocracies, such as Iraq and Iran, as well as the current COVID-19 global crisis. I doubt that even Ali Khedery suspected that his prediction would come to fruition as quickly as it did!

OVER THE EDGE

All of these factors played a part in driving oil prices to the cliff edge, but it took a global pandemic to ravage countries like Italy and Spain, then hitting the shores of the U.S to push prices over the edge. Global consumption had already been in slow decline, but the onset of COVID-19 has seen consumption reduced by between 20-25% depending on sources. With major governments significantly restricting the movement, or in some cases, grounding parts of their populations entirely, the impact on both oil prices and their economy was always going to be drastic. Airlines are grounded, businesses working remotely, factories are either closed or operating with skeleton crews, and people are confined to their homes except for essential journeys, which are mostly local. It is not surprising that consumption is down drastically.

Unfortunately, production has not been reduced by the same amount to maintain supply-demand balance, creating a significant problem for producers in the U.S; the immediate issue now becomes one of storage. According to analysts at Eurasia Group, "Even if OPEC and other producers start restricting their output again soon, the supply overhang from the global lockdown is so big that storage capacity will likely hit its limit by midyear." That may be true for operators and markets that have access to major storage facilities. Still, for landlocked operations with limited access to pipelines and ports, storage capacity will be an issue in a matter of weeks.

If everything points to continued downward pressure on prices, could we see oil at $10? According to a recent Bloomberg article, we have already seen oil at sub-$10. Western Canadian Select reached a record low of $4.51 a barrel towards the end of March; Oklahoma Sour at $5.75, $8 for Nebraska Intermediate, and Wyoming Sweet at $3 a barrel.

DIFFICULT TIMES AHEAD FOR THE SHALE PRODUCERS

A major outcome for Shale producers is that we will see consolidations and bankruptcies in record numbers. Whiting Petroleum became the first victim of the current crisis as it became the first U.S. shale producer to file for bankruptcy protection on April 1. Whiting Petroleum is the first of many because Shale economics does not stack up with the current market realities. Data shows that many independent shale operators have high levels of debt, and (more worrisome), breakeven points in the $40s. According to Commerzbank, "Many U.S. fracking companies already had their backs to the wall before the price slump, due to high debt and financing difficulties" Oil.com predicts that U.S. shale growth was about to decline as a result of the current Saudi-Russian price war, never mind adding the impact of the COVID-19 outbreak!

We are seeing operators slashing budgets, Diamondback Energy, and Parsley Energy announced plans to cut spending and reduce drilling; Marathon Oil is reducing spending by $500 million. Even though many Operators were quick to introduce budget cuts, we suspect that many of those same Operators will be revisiting those cuts and coming back with more aggressive measures. In the current climate, even the most efficient Shale operator will struggle to make money.

Oil companies are innovators by their very nature and usually turn to technology and operational efficiencies to survive market downturns. Strategies utilized during previous downturns will not hold sway in 2020. Four years ago, when OPEC last drastically increased supply, U.S. shale firms were able to finance their way through the downturn. Given the current turmoil in financial markets, and the significantly increased likelihood of bankruptcies amongst Shale producers, financing at $15-$20 oil is going to be considerably more difficult (Fed intervention notwithstanding). They are leaving operators with very few options other than to halt capital projects, drilling of new wells, completion of wells, and choking current production. None of these scenarios are ideal given the already high ratios of debt. We already see this in real-time, drilling rigs across U.S and Canada reduced by 248 in the last weeks alone and by 477 since the start of 2019.

SURVIVAL IS AT STAKE

There is no other way to put this other than survival is at stake, pure and simple. Operators have to take a good hard look at their current operating model and philosophies. We are in a potentially lengthy low oil price environment; operators have to find ways to deliver additional operational efficiencies aligned with deeper budget cuts, at least in short to medium-term time horizon. In terms of operating producing assets, operators will need to turn to innovation and technology. The need to rapidly develop and implement what we have termed as "Remote Operations Strategies." This also suggests that they need to understand what that means for their organization, the people, the structures, the processes, technology, and operating philosophies.

Many organizations transitioned to Remote Operation Centers after the last downturn, which also enabled them to grow production more rapidly after the markets picked up. We see the incredible value of driving "out-of-the-box" operational improvements through A.I./IoT, rapidly driving significant efficiencies. Sadly, A.I./IoT is vastly underutilized by the majority of Shale operators (see the recently published article here).

Our O&G team at Audere Partners has been developing and executing operational strategies with our clients to address the challenges, much like the ones we face today. In sustained markets of $15 or $20 oil, it is going to take bold, daring, and decisive actions from committed executives to see the other side of this downturn. We are here to help in any way we can. We need a strong Oil and Gas sector in the U.S. Millions of jobs, both direct and indirect, are at stake, the livelihood of entire communities. As a nation, we cannot strategically afford to go back to becoming a net oil importer again, something the Saudi's and Russians will work hard to make a reality. Actions will need to be meaningful and rapid. Are you ready?