

For Oil and Its Dependents, It's Code Blue



If oil has been laid low by the coronavirus, then the nations whose economies most depend on it might soon be on ventilators. By any prognosis the great oil price collapse of 2020 has pushed the world's most volatile commodity into Code Blue.

No one expects oil, its peddlers or consumers to emerge wealthier or wiser from this crisis. Oil company bankruptcies, already happening before the pandemic, will escalate. And more petro states will begin to stumble, like Venezuela, down the rabbit hole of collapse.

The pandemic, combined with suicidal overproduction and a brief price war between Russia and Saudi Arabia, has reduced oil consumption and revenues on a scale that is mindboggling.

Prior to the pandemic, the world gulped about 100 million barrels a day, filling the atmosphere with destabilizing carbon. Today it sips somewhere between 65 million and 80 million barrels.

At least 20 to 30 per cent of global demand has vanished and nearly two dozen petro-producing countries including Canada have agreed to withhold nearly 10 million barrels from the market. Few expect this agreement will stop the price bleeding.

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In fact, the price of Western Canadian Select or diluted bitumen remains below five dollars a barrel – cheaper than hand sanitizer. That’s a drop of more than 80 per cent compared to the month before.

Because the spending of oil fertilizes economic growth and expands national GDPs, most of the world’s economists now predict a long depression after the pandemic.

A depression, by definition, means less energy spending, which translates into ongoing low energy prices that already no longer cover the cost of extraction in many places.

And what happens if the pandemic comes in three waves like the deadly Spanish flu of 1918?

The patient was already sick

Art Berman, one of North America’s most astute and consistently reliable oil analysts, admits the pandemic is compounding the problems of an industry and global economy already in waning health.

“Energy is the economy, and oil is the largest and most productive part of world energy. The global economy has been dying of accumulated debt for 50 years. Coronavirus has sent

it to the intensive care unit.

“If the economic patient survives the ICU, it will need a long period of recovery and therapy before returning to its previous life.”

Wood Mackenzie, the British consultancy, now estimates that 10 per cent of global oil production is uneconomic insanity at prices below \$25 a barrel.

Heavy oil of the sort Canada produces requires extensive upgrading and pricey transportation costs. It's always the first to feel the pinch of any volatility because of its high cost – about \$45 a barrel.

In comparison, the petro states of Russia and Saudi Arabia can pour oil into the marketplace for less than \$10 a barrel – though as the brief price war attested, not for long. Saudi Arabia actually needs \$80 a barrel oil to balance its budget, which like every typical petro state, it is not doing.

The fading dream of Canada as petro-power

Canada, the world's fourth largest oil exporter, banked its destiny on the export of low-grade bitumen with no strategic risk planning. As a result it will experience huge economic losses and roller-coaster volatility for its currency.

Alberta promoted over-production and pressed for new pipelines to carry the increased flow. Now, as global demand plummets, it can no longer fill the pipelines it has.

Rystad Energy, the proficient Norwegian-based analyst, has already noted that of all the world's oil producers, Canada will be “the most affected so far.” Lacking buyers at a suitable price, it will produce well below its capabilities this year, “shutting in” nearly 1.1 million barrels per day.

Investment in the oilsands, which reached highs of \$30 billion in 2014, has now dropped to below \$6 billion this year. In

addition, Canadian oil and gas companies have further trimmed their spending by more than \$10 billion.

The U.S.-based IHS Markit, another big data firm, describes the price collapse as “unprecedented” and says “the impact on the basin is expected to be protracted” with “long lasting ramifications” for the region.

Canada’s six largest banks, which loaned \$58.8 billion to the Canada’s overleveraged oil industry in 2019 – a 59 per cent increase in the last five years – might quietly be panicking in board rooms at an appropriate physical distance.

Robyn Allan is an independent economist who before the pandemic and oil price wars persistently challenged the economics touted to support the Trans Mountain pipeline. She foresees much trouble ahead for the industry.

“After this crisis, things will not return to where they were. All economic activity is affected by the virus outbreak. And just like some people who catch it and move from home to hospital to ICU because of weak systems or pre-existing conditions, the tarsands were already an aging and compromised activity that was on the downside of its life cycle. Big Oil in Canada was going to be hard hit without COVID-19. With it, many companies are going to go under – and go under quickly.”

Allan says the trend lines will sharpen the choices Canada’s political leaders must make. “As long as government continues to pander to the needs of Big Oil at the expense of the needs of society and the environment, it will spend money unwisely.”

‘Gasmaggedon’ hits BC

Natural gas, whose price is often tied to oil, is another sick patient on oxygen. Many analysts refer to that fuel’s price collapse as “gasmaggedon.”

A global glut plunged prices to record lows last year, and now

the pandemic has lowered them again. A succession of warm winters has flattened the demand for gas heating, which just adds to the economic storm.

Rystad Energy predicts that if low prices persist – and most forecasts suggest low prices for years – “nearly 42 per cent of Australia’s gas resources would be rendered uneconomic – a scary thought to the world’s largest gas exporter.”

Such prospects must weigh heavily on B.C. Premier John Horgan. His government has actively subsidized the province’s faltering fracking industry, along with Shell’s LNG Canada terminal.

His province’s billion-dollar subsidies include the construction of the Site C dam to provide cheap electricity to the LNG industry. Horgan and his predecessor Christy Clark promised that an LNG windfall of revenue and jobs would justify the low royalties, loosened environmental restrictions, strained First Nations relations and gambled taxpayer money on the emerging export industry.

Now that promise looks undeliverable, as the pandemic rocks B.C.’s economy and a healthy global LNG market recedes from view.

Fracked oil’s business model ‘does not work’

By any measure, the pandemic found the oil industry suffering from the financial equivalent of obesity, high blood pressure and diabetes. Already half the industry, inflated by cheap credit, was struggling with high-cost technology, chronic overproduction and low prices.

Although fracking tight oil formations in the United States turned that country into a temporary oil exporter, the artificial boom contained the seeds of its own bust.

Because fracking requires constant drilling due to rapid

depletion of shale formations, most companies have spent more money than they've earned over the last decade. In fact, most frackers started as pure speculative plays designed to be flipped like some super-hyped stock.

Even before COVID-19 exploded in the U.S., public lenders and the Wall Street Journal repeatedly flagged the industry as unsustainable.

"By now, it should be abundantly clear that the current shale oil business model does not work – even for the very best companies in the industry," the investment firm SailingStone Capital Partners explained in a recent letter.

The imminent deaths of 'zombie companies'

Bankruptcies in both Alberta and Texas have been rife. Bernard F. Clark Jr., a lawyer with Haynes and Boone, explained to the Wall Street Journal on Jan. 27 why so many companies were going broke long before the virus arrived.

"They're called zombie companies. The creditors would keep them on life support by not calling the notes and just restructuring them and extending the maturity, kicking the can down the road. Now there's no incentive for the creditors to continue to keep those companies on life support."

The proliferation of zombie companies, which has left Alberta with tens of billions worth of orphaned and inactive wells, reflects a systemic crisis that has been gnawing away at the industry for years.

In the 1980s, the oil and gas sector occupied 28 per cent of the Standard and Poor's Index; today it barely accounts for 2.6 per cent. For the last decade the industry has consistently delivered poor returns in the stock market because fracked oil, like bitumen, costs more to extract and requires higher prices to pay off debt, let alone make a profit.

Most importantly, fracked oil and sulfurous bitumen deliver lower energy returns than cheap oil. Lower energy returns mean diminished financial rewards, profits, revenues and taxes.

To understand the importance of energy returns, consider what your own body needs. If you expend more energy procuring dinner than you can extract from it, then your future will likely involve rapid weight reduction or starvation.

One hundred years ago, cheap oil was easy to extract. It was, says Spanish analyst Antonio Turiel, comparable to drinking a glass of water. Today that glass is either full of abrasive sand or so empty that a complex operation to condense water from the air is required.

When civilizations, just like humans or any other animal, experience diminishing energy returns, they either shrink or collapse or do both.

It was once feared that the extra effort and expense needed to extract "tight" or difficult oil would result in such high prices that the economy would be brought to a standstill.

But that's not how things are falling out. We haven't run out of oil. Instead, we have run out of demand for oil at high enough prices to smoothly run the petro-economy. This is tied to "excessive wage and wealth disparity," notes the accountant Gail Tverberg.

In short, "commodity prices that are too low for producers" are in other places too high for consumers.

The financial casualties will surge

In a recent presentation to the Texas Railroad Commission, which regulates that state's oil production, the Institute for Energy Economics and Financial Analysis noted that North America's industry is contracting due to high debt, risible cash flows and extreme costs.

IEEFA, which supports a move to cap or “shut in” a million barrels of production a day in that state, described the industry’s future in frank terms. It will consist of fewer companies. They will extract less oil and gas. They will be highly competitive – much like Canada’s top five oilsands producers. They will produce fewer revenues for their dependent states, and as a result their outsized political power will gradually erode.

Art Berman predicts shale plays won’t vanish, but their output will be lower. “Many companies will disappear. I doubt that oil production or prices will return to 2018 levels for many years.”

He ends with this tidy summary of the crisis: “It seems unlikely that what is happening today will cause society to experience some transformative epiphany that will end the age of oil. If anything, we will need inexpensive liquid fuel more than ever in a poorer world. Rather than seeing 2020 as a year of unspeakable loss, it is my sincere wish that we somehow find ways to live better with somewhat less.”

In the meantime, jurisdictions particularly dependent on oil and gas extraction are having to jarringly recalibrate their budgets and expectations amid rising political tensions.

Alaska, which garners about 34 per cent of its revenue from oil, thought the resource would be selling for \$66 a barrel right now. Alberta, which depends on oil to cover 10 per cent of its budget, said it needed \$58 a barrel. Nigeria, Texas, New Mexico, Iraq, Iran, Algeria, you name it – all made similar projections.

All face plummeted prices – U.S. crude, for one example, tumbled to an 18-year low of \$18 a barrel on Friday.

Newfoundland once boasted, in 2009, that 30 per cent of its revenue came from offshore oil. Now it is less than 10 per cent, and as runaway debt due to its hydroelectric megaproject

takes its toll, that province sits on the verge of bankruptcy.

Add Newfoundland to the list of petro-states small and large that were already wheezing before Code Blue. Now the pandemic has put them on economic ventilators with no guarantee of quick recovery. 🤒