Resilience in Energy: Collective action to weather the storm

KPMG Global Energy Institute

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With you today

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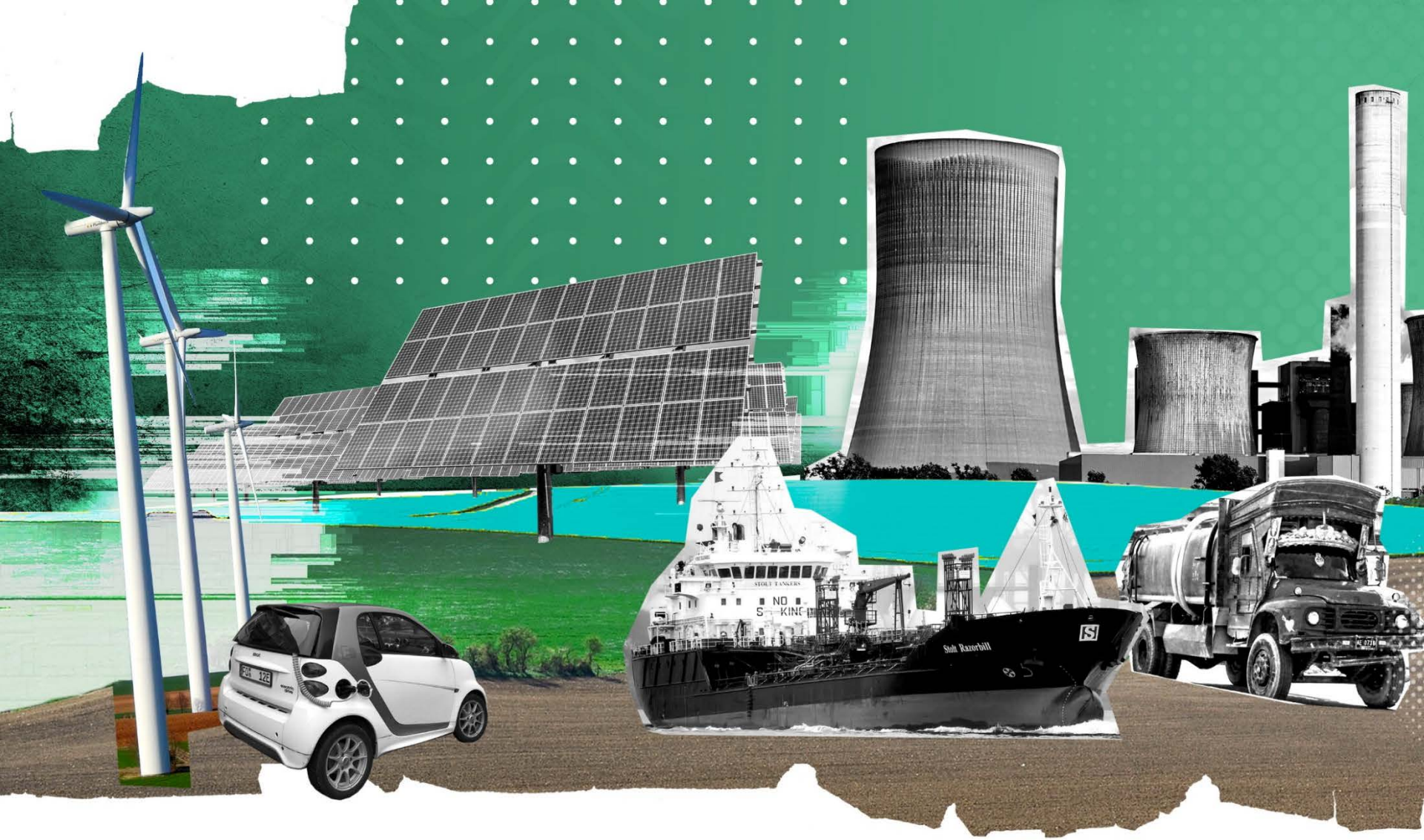
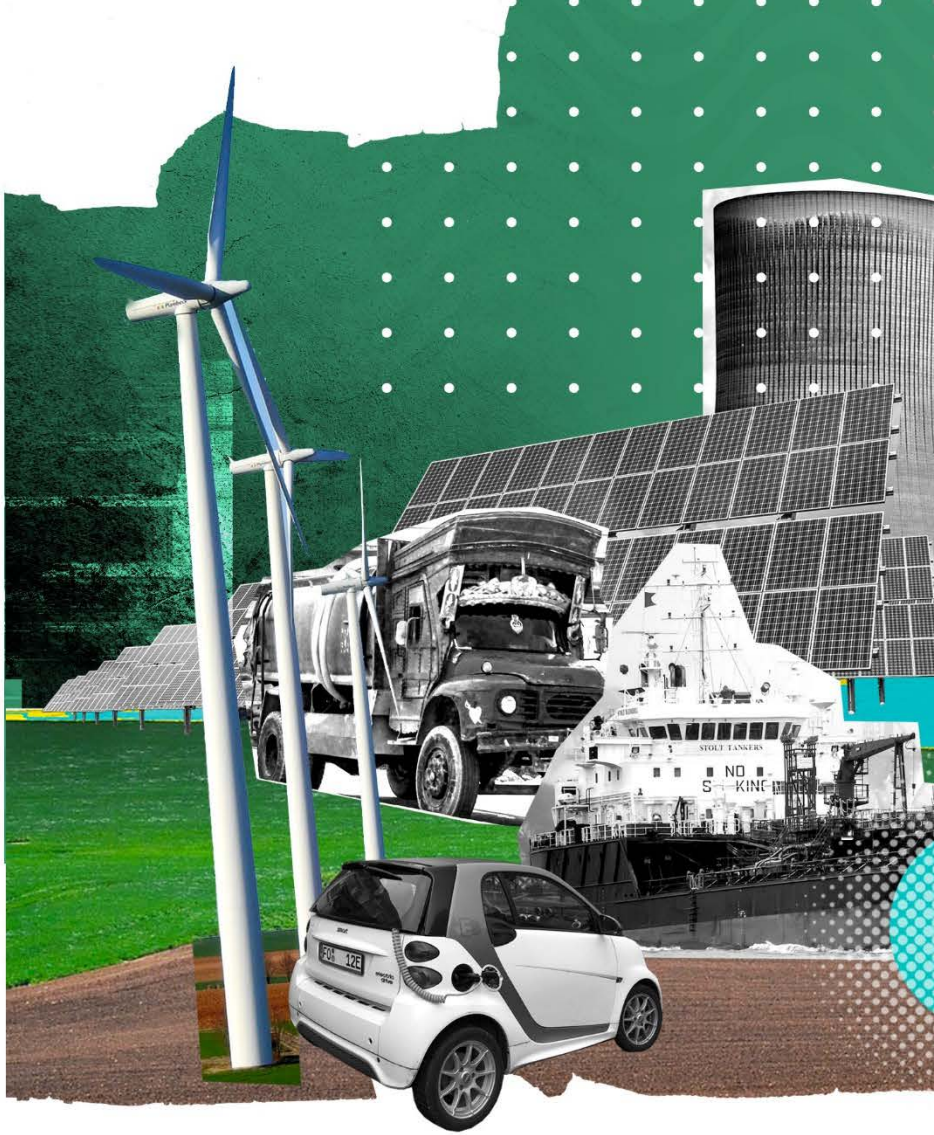


Oil Price War and COVID-19 Demand Shock: Resetting Energy Geopolitics and Climate Policy

eurasia group
politics first

Overview

- COVID-19 demand shock
- Eurasia Group scenarios
- Saudi strategy & risks
- Russia strategy & risks
- US responses- industry and policy intervention
- Storage pressures & a looming supply glut
- Price Wars: 1985-86 & 2015-16
- Impact on climate/ESG policy



Oil Markets: Simultaneous Demand Shock & Supply Shock

Bearish

- Coronavirus outbreak craters demand in China and beyond
- Chaos in global financial markets
- Saudi, UAE, Russia move to max production
- OPEC+ price defense collapses
- Expected pressure on global crude oil storage capacity

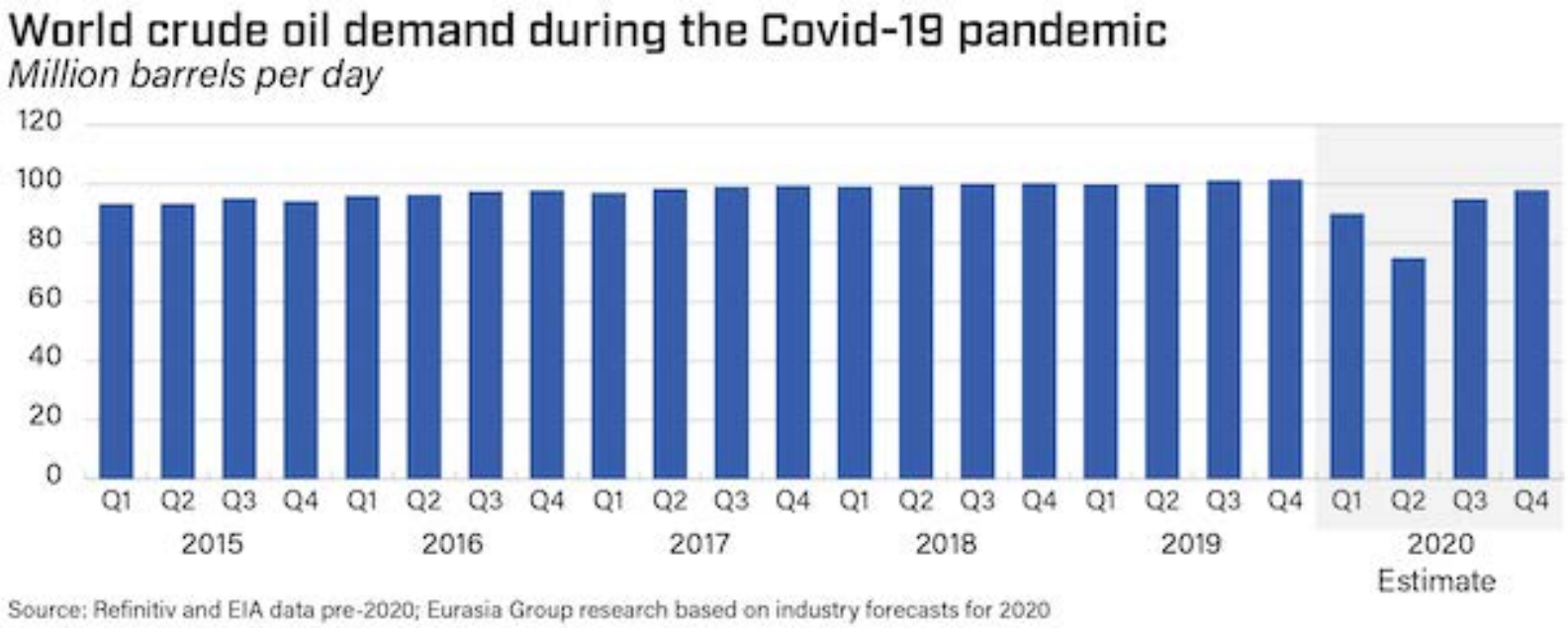
Bullish

- Middle East conflict, esp. US/Iran confrontation fought out in Iraq
- Escalating conflict in Libya
- Slowdown in non-OPEC supply, especially US

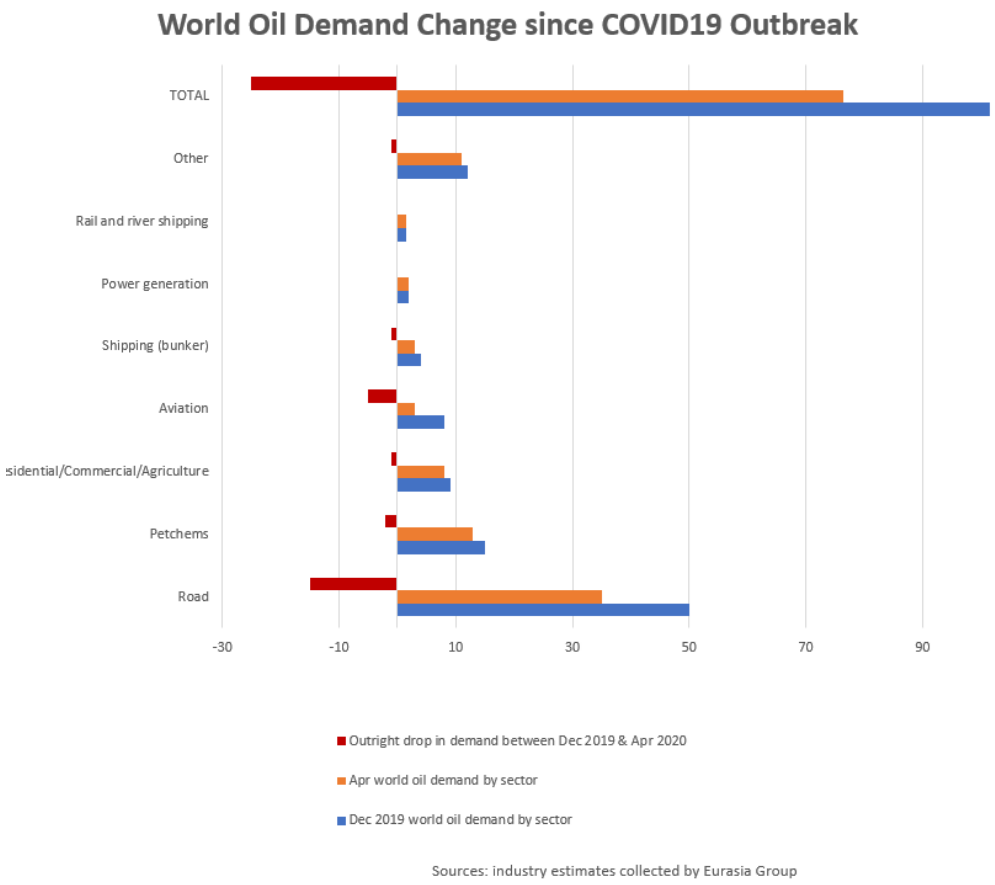
Flexible US shale supply & drilling activity

First, the demand shock…

The IEA has revised down its 2020 global oil demand forecast, and it now foresees the first contraction of oil demand since the financial crisis of 2009– with further deep downward revisions expected in months ahead

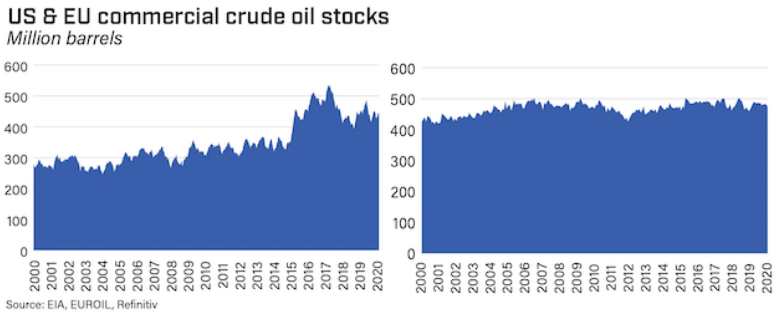


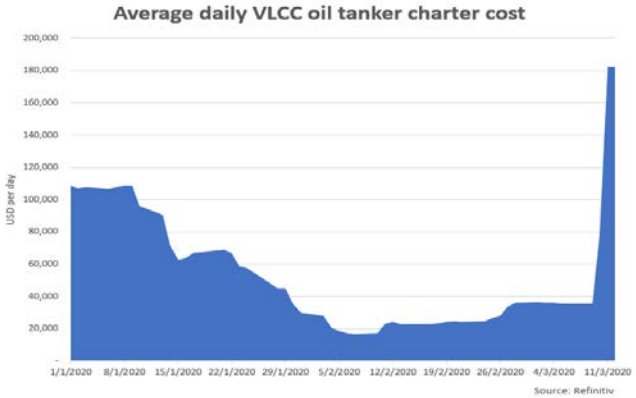
… across different sectors



Storage glut will haunt global oil markets

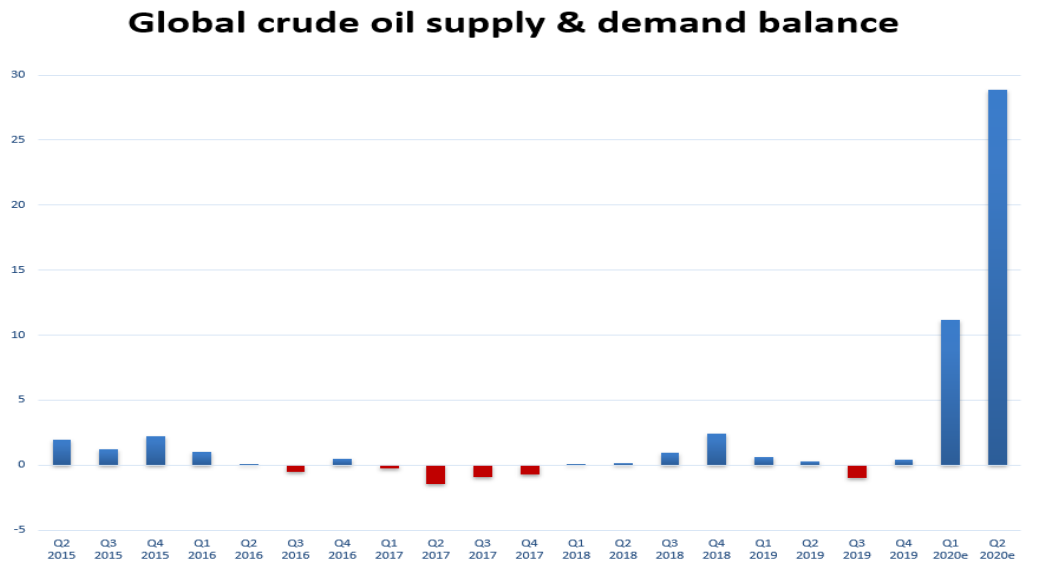
- US storage capacity will be under pressure but can likely absorb at least 100mm bbls- plus an expected 75mm bbls into the Strategic Petroleum Reserve
- EU storage will likely need to resort to floating tankers once 500mm bbs is reached by April or May.
- China's stockpiles have built up due to opportunistic buying of private refiners, who have been importing crude without refining orders, and as state-owned oil firms build up China's strategic reserves.
- Overall, China's crude inventories are now above 850 million barrels, at almost 90 day's worth of import needs.
- Floating storage will be needed to absorb price war-driven barrels. A storage fleet is already amassing outside Malaysia & Singapore, and tanker rates have soared amid the surge in floating storage demand.
- Outlook is for a storage glut far in excess of 2015 when stocks reached 400mm bbls above the five-year average.





Supply shock: if the price war continues, a record glut looms

	SUPPLY (million bpd)	DEMAND (million bpd)	SURPLUS/DEFICIT
Q3 2019	100.3	101.3	-1
Q4 2019	102	101.6	0.4
Q1 2020e	101.2	90	11.2
Q2 2020e	103.9	75	28.9



Sources: EIA for 2019 data, 2020 estimates

Key risk: “top of the tank” or max global storage capacity could be hit in 2-3 months; prices would have to fall below $20/bbl and possibly even below $10/bbl to shut in supply

Oil price war scenarios

Extended price war: >12 months

- Saudi Arabia and Russia “pivot” from tactical confrontation over short-term OPEC+ allocations to deeper longer-term market share strategy
- Russia digs in to target US shale even at risk of economic pressure from weakened ruble with “Sechin view” carrying the day
- Saudi resists Trump administration trade/diplomatic pressure
- COVID-19 extends well into 3Q20 meaning no new baseline for OPEC+ to negotiate from
- US shale drops only gradually in 2020 before a sharper fall in 2021
- Brent crude exits 2020 at $20/bbl to force extensive shut-ins in shale, oil sands, and deepwater in 2021 as hedges and credit expire
- Long term glut of oil builds up in excess of 2015 levels

Limited price war: <12 months

- Economic pressure on both Saudi Arabia and Russia drives renewed talks- particularly if Brent prices <$20/bbl in 2Q20
- “OPEC++” involving Texas production restraints set stage for early talks OR Trump administration successfully pressures Saudi Arabia through trade/diplomatic action
- OPEC weaker members pressure Saudi for action
- Weaker ruble spikes inflation and moves Putin to more cautious stance
- Brent crude exits 2020 at $35/bbl but prices stay low into 2021 and even 2022 to manage inventory drawdown

Past as precedent: 1985-86, 1997-98 and 2014-2015 price wars

	1985-86	1997-98	2014-15
Cause	OPEC over-production; non-OPEC growth in Alaska/North Sea; post-oil shock efficiency & fuel-switching	Asia financial crisis; Venezuela-Saudi-Mexico market share battle; Iraq production recovery	Surging US shale supply
Saudi spare capacity	7mmbpd	4mmbpd	2.5mmbpd
Annual Brent crude price year/year	$27 (1985) to $14 (1986)	$19 (1997) to $12 (1998)	$98 (2014) to $54 (2015)
US rig count decline to trough	1,950 (Nov 1985) to 754 (Apr 1987)	1009 (Nov 1997) to 496 (Apr 1999)	1,925 (Nov 2014) to 407 (May 2016)
Exit catalyst	Saudi implementation of production cuts in 1987	“Troika” agreement in March 1998	OPEC+ agreement reached November 2016

All three price wars ended with a return to production restraint, led by Saudi Arabia

EIA, Baker Hughes, BP World Review of Energy Statistics

Saudi Arabia: Pros and Cons of a Price War

Incentives for a longer term price war

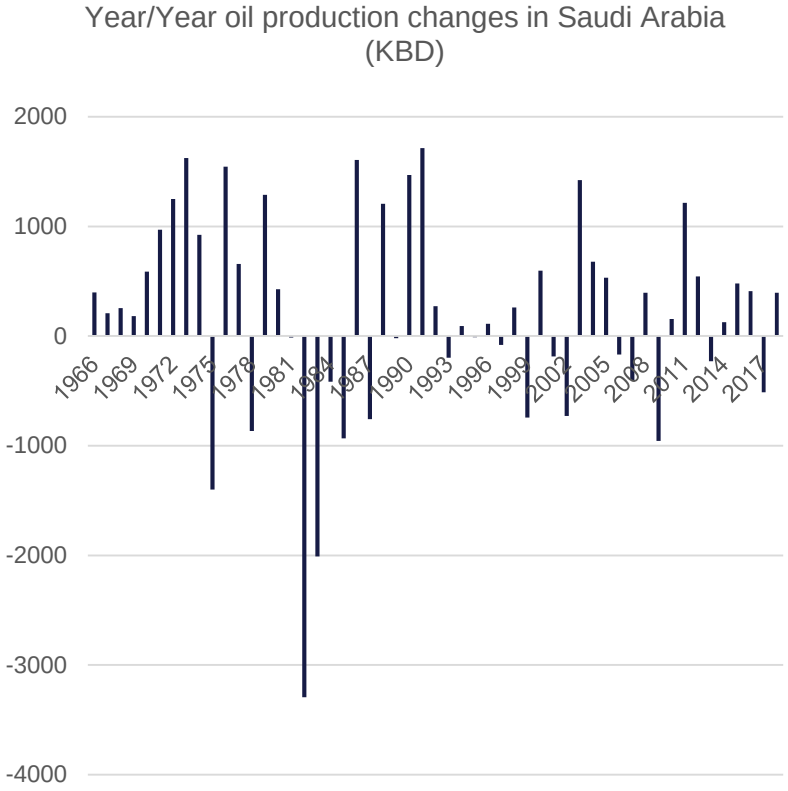
- MBS cannot afford to look weak and lose confrontation with Putin over oil policy
- Saudi Arabia has the most spare capacity and the lowest lifting costs
- Foreign exchange reserves are ample at $490bn
- Access to credit is considerable
- Saudi has strongest interest in disciplining OPEC particular in anticipation of quota renegotiations with Iran over medium term if sanction lifted

Incentives for a shorter term price war

- Economic shock could weaken MBS domestic spending capacity costing him political support
- FX reserves fell by 1/3 in last price war in 2015- a similar drop could put pressure on the riyal peg
- More volatility and political risk for minority investors in Aramco could impact further issuance

Saudi Arabia Oil Sector Overview

- Saudi Arabia has capacity to go to 13mmbpd but only with significant investment- short-term can top up with storage drawdowns
- All time production level is 11mmbpd from October 2018
- Expectation is capex will be directed to upstream gas and integrated refining/petchem projects but 23% capex cut has already been announced
- Saudi will be concerned about Biden victory and potential return of Iranian barrels to market- medium term need to renegotiate quotas
- Saudi recent positioning has been to partner with shale in support of market stability and geopolitical alliance with USA



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Russia: Pros and Cons of a Price War

Incentives for a longer-term price war

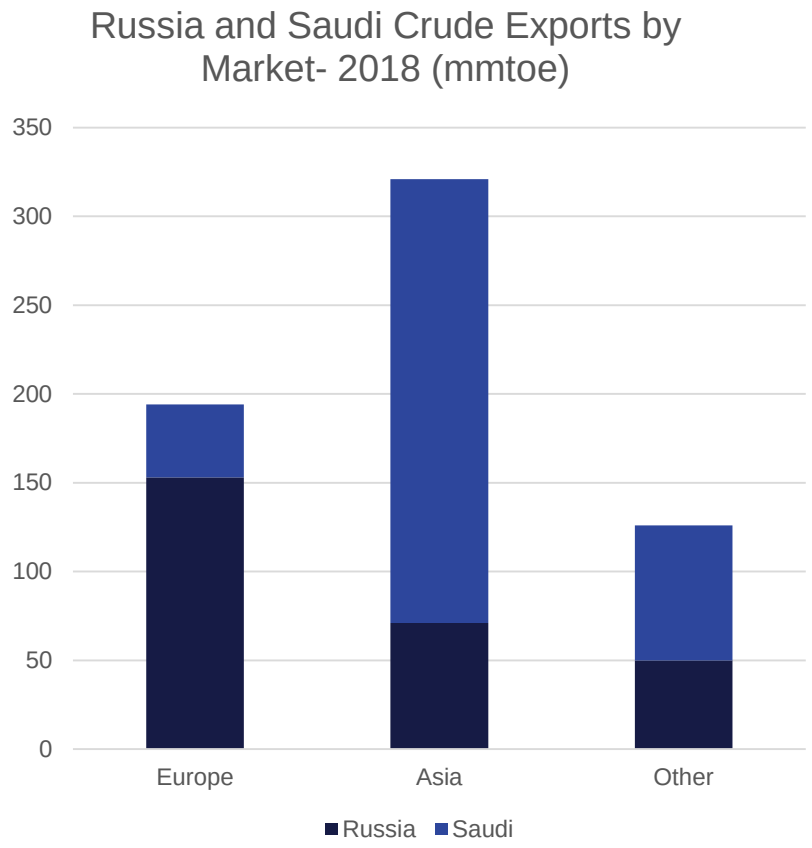
- Putin has extended ability to rule until 2036 and less political pressure than Trump or MBS
- Putin/Sechin have longstanding desire to limit growth of US shale but are realistic that growth in a $50/barrel world is inevitable- goal is sharing production restraint and limiting growth vs “liquidation”
- Foreign exchange reserves are ample at $435bn supported by Stabilization Fund with $100bn- FX reserves 1/3 higher than 2015

Incentives for a shorter term price war

- Revenue losses would be $35-50bn/year at $40 Brent
- NWF resources needed for government priorities- acquiring Sberbank, infrastructure spending
- Russian industry/government elites divided- most actually support OPEC+ including Energy Minister, head of central bank, industry CEOs
- MBS/Saudi are strategic relationship for Putin given other interests in Middle East- hence Russian Foreign Ministry support for OPEC+

Russia: oil sector overview

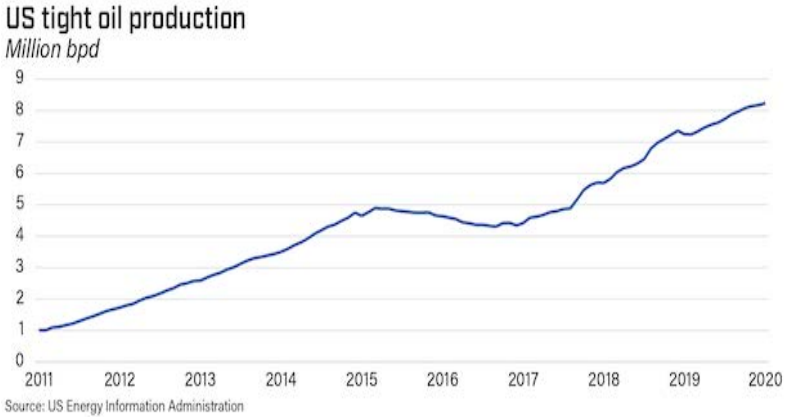
- Russian disadvantage is limited spare capacity
- Crude exports heavily dependent on pipeline delivery to EU but growing share in Asia
- Sanctions on Rosneft Trading add further complexity, but Russia may offer selling oil to China in yuan to gain market share and protect itself from US sanctions.
- Russia has technical constraints to implementing further production cuts
- Russia has high decline rates and needs higher prices/revenue for new greenfield investments



BP World Review of Energy Statistics 2019

US shale- slow decline or quick “OPEC++” deal?

- US shale oil production vulnerable to sharp correction but will likely remain positioned for rebound- “hibernation” scenario
- Longer term price war (+3 years) would be necessary to bring “liquidation” scenario
- Texas Railroad Commission “mandatory curtailments” could bring an orderly wind-down and ramp up- but larger players oppose
- High yield debt problem is significant- but generally most acute for weaker, gas-leveraged operators
- Trump administration could intervene in credit markets or with direct capitalization of shale sector in worst case
- Trade/diplomatic pressure on Saudi Arabia & potential sanctions on Russia unlikely to drive results absent meaningful US production cuts/declines



US shale- slow decline or quick “OPEC++” deal?

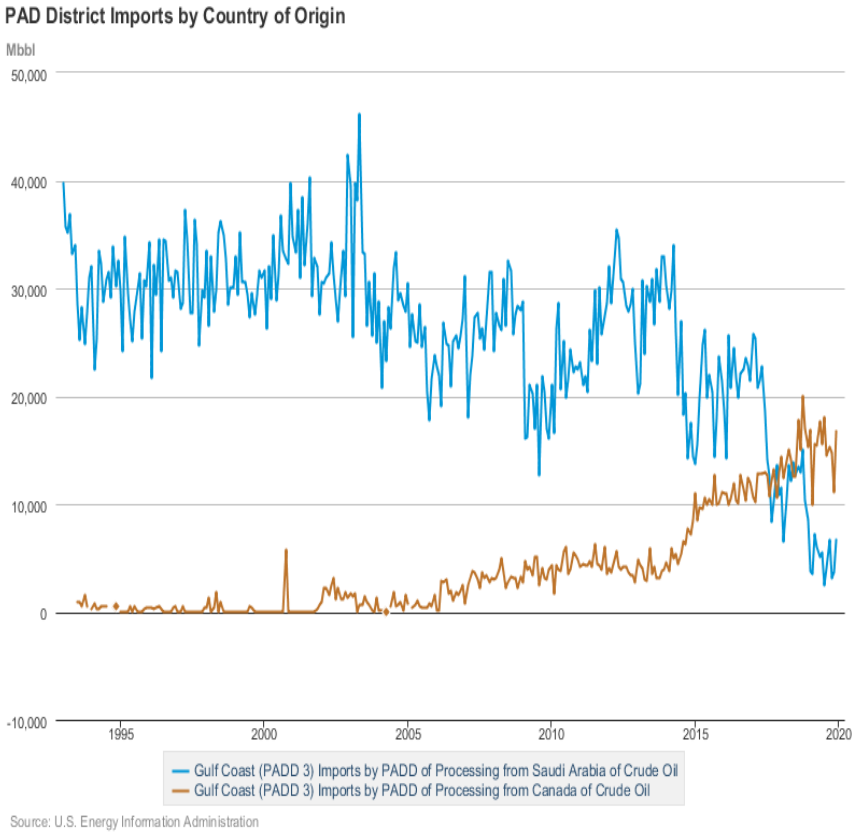
- Capex cuts and reduced drilling activity will drive US production lower- $30/bbl WTI could lead to 1-1.5mmbpd drop in US production in 2020- and more in 2021
- Many producers are hedged based on forward sales set in January 2020 and will not feel the impact of lower prices until later in the year
- Many producers will seek refinancing and restructuring through private and public markets as well as through potential liquidity from the Federal Reserve
- Consolidation activity could take place as larger operators absorb smaller players- while market uncertainty is high, valuations are at extraordinary lows and the larger US players still view shale as a foundational long term resource
- Storage capacity of 100 million barrels in commercial US inventory and another 77 million barrels of SPR purchases will take some time to fill.
- Likely build up of drilled but uncompleted wells inventory

Operator	2020 Capex Cut %	2020 Production Revision
ExxonMobil	TBD	10% in Permian over 2 years
Chevron	TBD	“Lower short term production, preserve long term value”
Occidental	40	TBD
EOG	31	0
Pioneer	45	-24,000-35,000
Apache	40-45	TBD
Devon	30	TBD
ConocoPhillips	10	-20,000boe
Concho	25	0
Continental	55	-9,000
Diamondback	40-45	Will be lower than 4Q19
Cimarex	40-50	0

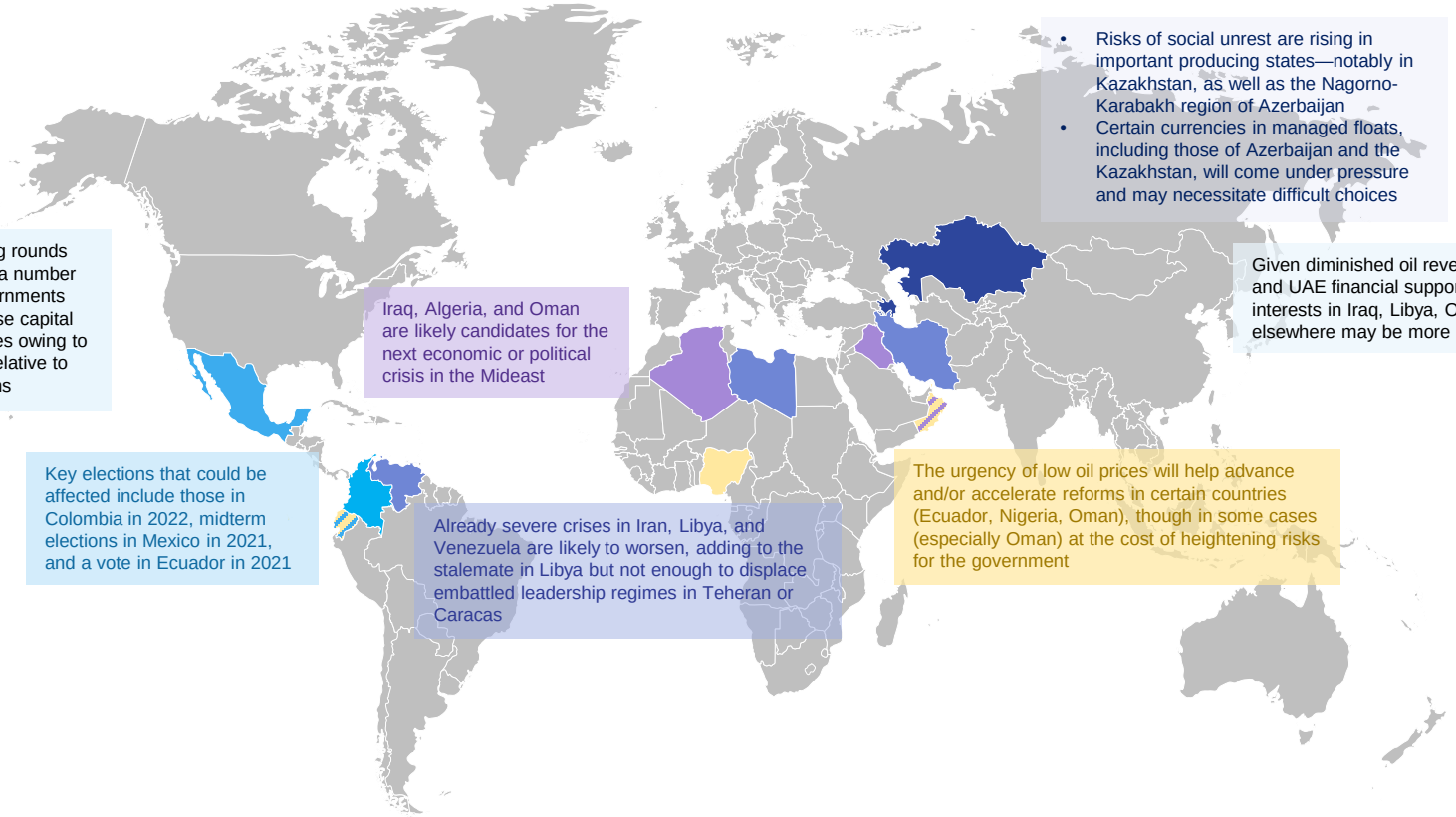
Source: Company filings

Canada: oil sands better prepared but still face unique challenges

- Oil sands producers have lowered debt and break-even costs for existing operations but are vulnerable below $25/WTI
- Minimal supply shut-ins during 2015 downturn
- Market access/congesti`on remains key challenge particularly if incremental Saudi exports find their way to the USGC/PADD III market
- Government curtailment policy to maintain “minimum viable price” for producers likely to deployed again
- Government also likely to provide financing backstop
- Expected push for “green stimulus” from federal government
- Conventional heavy production and shale oil likely to fall off similar to 2015 (-300kbpd)



The impact of a 2020 average Brent price of USD 35 per barrel on major exporters



- Risks of social unrest are rising in important producing states—notably in Kazakhstan, as well as the Nagorno-Karabakh region of Azerbaijan
- Certain currencies in managed floats, including those of Azerbaijan and the Kazakhstan, will come under pressure and may necessitate difficult choices

Expected licensing rounds will be delayed in a number of countries; governments will struggle to raise capital through asset sales owing to a lack of buyers relative to previous downturns

Iraq, Algeria, and Oman are likely candidates for the next economic or political crisis in the Mideast

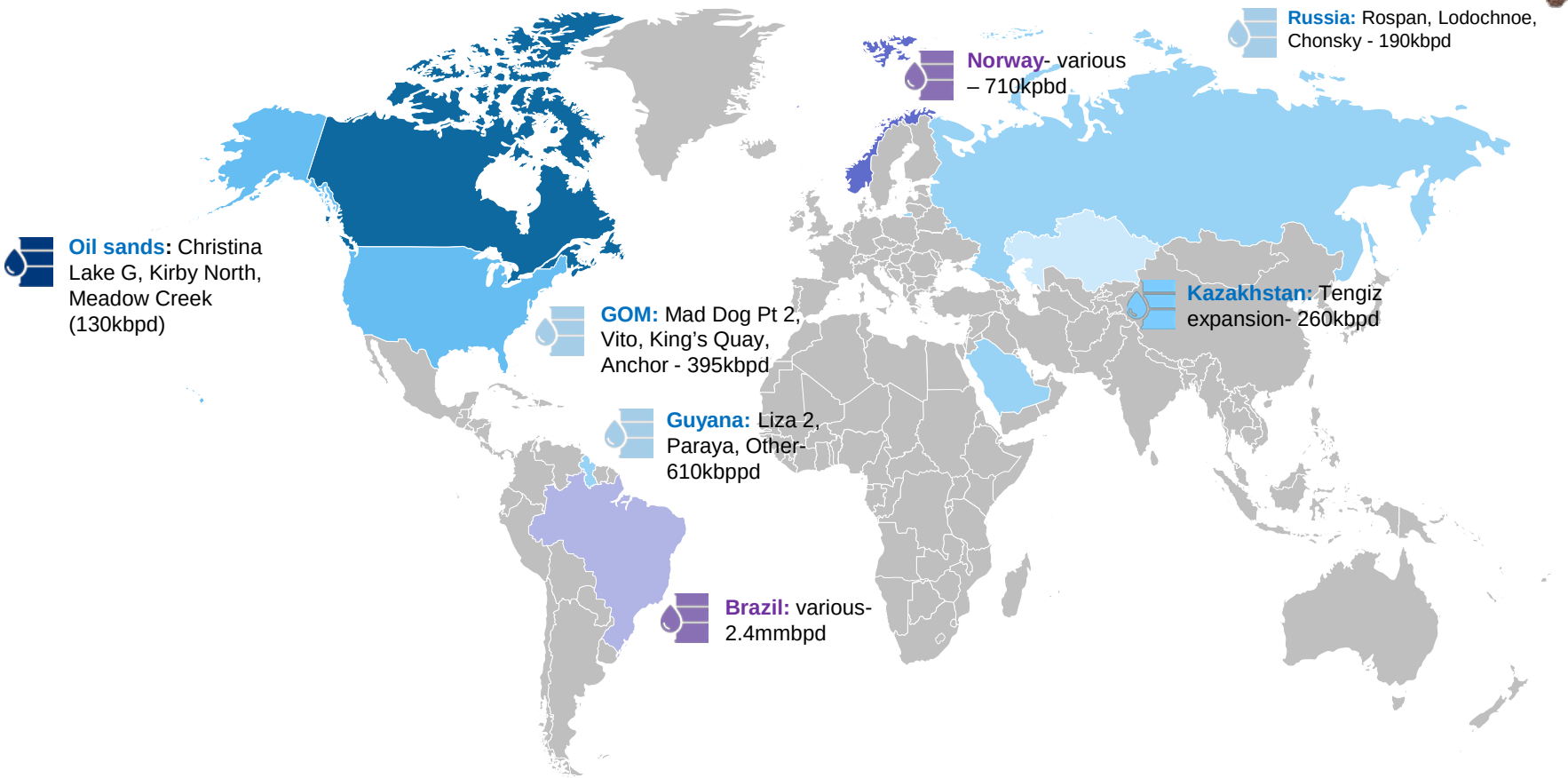
Given diminished oil revenue, Saudi and UAE financial support for their interests in Iraq, Libya, Oman, and elsewhere may be more constrained

Key elections that could be affected include those in Colombia in 2022, midterm elections in Mexico in 2021, and a vote in Ecuador in 2021

Already severe crises in Iran, Libya, and Venezuela are likely to worsen, adding to the stalemate in Libya but not enough to displace embattled leadership regimes in Teheran or Caracas

The urgency of low oil prices will help advance and/or accelerate reforms in certain countries (Ecuador, Nigeria, Oman), though in some cases (especially Oman) at the cost of heightening risks for the government

Key Growth Projects at Risk in Global Oil Price War Through 2024



IEA Medium Term Oil Outlook 2020

Polling Question 4

What is the most significant action your company is taking to cope with the simultaneous global economic crisis coupled with the oil price crash?

A.) Adjusting the Supply Chain for agility and lowest cost

B.) Cutting Op Ex but not workforce reductions

C.) Delaying project FIDs / starts

D.) Focusing on working capital improvement and cash flow

E.) Reducing the workforce

F.) Securing access to debt / liquidity

G.) Slashing capital expenditures

Climate action in a crisis

- Civil society actors will turn to cyber and online tools to inflict pressure on companies and governments to act with social distancing for pandemic control diminishing large-scale protest activity
- A test for climate-oriented governments, 2020 will be the first recession response significantly constrained – at least in principle – by Paris commitments
- Short-term crisis management and low consumer and market confidence will undermine the ability of all actors to factor in and solve for long-term, systemic risks like climate change
- Countries will deploy their fiscal and monetary space on targeted measures to blunt the economy-wide impact of the virus, which will often be focused in hard-hit industrial and energy-intensive sectors
    - Fiscal stimuli will only be partially “green” in nature, to varying degrees across economies: brown in Asia, green in the European Union, mixed in the US and Canada
- Momentum behind a growing Environmental, Social, and Governance (ESG) investing movement has been undercut
    - ESG mandates will likely become weaker at least in implementation if not in spirit, as investors and companies will feel that they need to pursue recovery and growth above all else – asset preservation and an emphasis on liquidity will reign supreme
    - With opportunity for high returns on a post-recession upswing, it is likely that once-risky ESG investments will be screened into investing portfolios - this would be short-lived and a return to “true” ESG investment would be expected in the near term

Rethinking the stranded asset narrative

- The growth case for oil/gas significantly more bearish than in 2015 – market focus is shifting from population/economic growth as drivers of demand to climate change as a constraint
- COVID-19 demand shock & Saudi-Russia price war flip short term narrative from slowing shale, rising geopolitical risk, and healthy global demand growth to massive over-supply and market chaos
- Capital markets skeptical on short-term and long-term demand case for oil/gas, growing investment gap will be exacerbated by market downturn
- This aversion from capital markets will worsen the outlook for short- and medium-term supply scarcity – more long-cycle projects likely to be deferred/canceled and shorter-cycle projects like US shale will survive but be weakened and even more cautious on supply growth
- The absence of OPEC production management and the behavior of shale as swing/flexible production will exacerbate volatility

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Audience Q&A

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