Restructuring Trends

A crude awakening: what next for oil?

In recent months the sharp decline in the oil price has been daily news. Whilst there has been some short-term respite from the price falls that were being recorded, in this article we explore how the new lower price will impact corporates in the short and medium term.

What has caused the oil price crash?

From early 2011 until June 2014 oil traded in a very narrow band, with Brent crude prices largely remaining between US$100 and US$120/bbl. Since breaching the US$100/bbl level for the last time in September 2014, oil has fallen sharply to current levels of around US$50/bbl.

Whilst that is a dramatic fall, it is far from unheard of, and indeed on a rolling six-month basis, the current drop represents the fourth most severe six-monthly fall in the last 30 years, making this the sort of event that businesses should have planned for. Of course, further falls may move this event up the "crash table", but whether there are further falls or not, there are already some profound changes to the market.

It is the combination of a number of factors that has caused oil prices to halve. In economic terms there is a simple mismatch of supply and demand. New supply is available in North America, both from shale oil in the USA and from tar sands in Canada. Simultaneously, demand is falling. This is not a new phenomenon and is driven by GDP growth reductions in large consumers of oil e.g. China (down to 7.4% in 2014 from 7.7% a year earlier) and the shift from large vehicle engines, to smaller more efficient engines in response to both regulatory challenges on emissions and the high fuel costs associated with high oil prices. Whilst we may expect an increase in demand if prices remain low, legislation, decarbonisation and vehicle efficiency gains all point towards long-term demand contraction.

So far there has also been limited impact on production from the geopolitical tensions in the Middle East. While parts of Iraq are now occupied by ISIS, and Libya's production has all but ceased, there hasn't been any significant recent major supply disruption. The Organization of the Petroleum Exporting Countries' ("OPEC") output rose by 80kb/d ("barrels per day") in December to 30.48mb/d, as Iraqi supply surged to 35-year highs, offsetting deeper losses in Libya.

Historically, OPEC has announced that it will cut production as prices have fallen to arrest the decline, but this time OPEC has stated that it will not. In practice, among OPEC countries it has generally only been Saudi Arabia, the lowest cost major oil supplier, which has actually cut production. In the short run it suits Saudi Arabia to have lower prices, to reduce supply from higher cost producers, but it also suits them to have price volatility, where new investment projects have higher risk profiles and lower profitability, if they are profitable at all.

The last thing that Saudi Arabia wants in the long run is for the supply/demand imbalance to worsen as new investment improves supply while demand continues to fall. So really we shouldn't be surprised that there has been a rebasing of the oil price, but neither should we expect oil prices to return to the stable US$100/bbl-US$120/bbl range that was being thought of as the norm.

Where might the oil price stabilise?

This is the billion-dollar question. Unfortunately, it's not one with a clear answer. Forward curves are predicting a future price that is higher than the current price, with a 12 month future price for Brent crude of just under US$65/bbl, some US$5/bbl higher than it was in the middle of January. In our latest Global Economy Watch, we predict oil prices to remain around $55 throughout 2015, in line with recent forecasts from the US Energy Information Administration and World Bank. In the medium term prices are forecast to rise to around US$80/bbl, although it won't necessarily be a smooth recovery and the future price is clearly dependent upon a number of factors, even beyond those discussed above.

However, if supply imbalances remain, it is not necessarily logical to extrapolate the recent price rises into the medium term. In the short run, it is the marginal cost of production that really matters. Producers are, somewhat counterintuitively, inclined to produce more as the price falls, to try to maintain absolute cash returns. As long as prices are above the variable costs of production, supply should not be expected to drop.

Of course, new development will be curtailed and as fields mature, and production rates decline, the supply and demand balance will be restored. This may happen more quickly than it has historically, because of the nature of the supply, but anecdotal evidence continues to point towards inventory build-up. In the short-term prices could fall further.

What is different this time, compared with previous oil price crashes, is the nature of the oil supply sources. Conventional wells, in basic terms, require an infrastructure to be built to tap into a "pool" of oil below the crust of the earth. Once the well is in production oil will flow, sometimes for decades, at relatively little cost.

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Shale oil has a very different production profile. A typical new shale oil well producing, say, 1,000b/d at the commencement of production is likely to produce 30% of its total output in the first year, and to only be producing around 350b/d at the end of year one. While the production tail is long and economic production may last for many years, if new wells are not constantly being drilled, then the total supply falls quickly.

The Canadian tar sands face a different and more fundamental problem. Extracting crude oil from tar sands is expensive, although there are very significant reserves. However, due to the heat involved in the process, it is also not easy to restart production if the well is allowed to cool. Whilst producers in this region will be able to survive a short price blip, if oil stays under US$60/bbl producers will eventually abandon projects, with the decommissioning costs that this will bring.

Whilst the past is not always a good predictor of the future, history would suggest a three-year hiatus/recovery period could be expected and should certainly be planned for.

Short-term impacts

Before focusing on the restructuring issues caused by the low oil price, it is worth remembering that lower oil prices are generally good for the non-oil economy, and in this respect the UK should be a net winner. Transportation is cheaper, chemicals and plastics feed stocks are cheaper and inflation has already fallen as a direct result of the lower oil price. All of these factors should mean that consumers have more disposable income, which should in turn stimulate demand.

That said, the early-stage impacts of the price drop are already visible in the oil sector: discretionary spending, particularly in the prospecting and planning stages of the exploration cycle, is being cut; rigs are being taken out of service and mothballed and utilisation is falling. Companies exposed to the oil sector are experiencing sharp share price falls and bonds, where listed, are trading down.

The first casualties have been the smaller, independent exploration and production companies, without the deep-pockets or diversified revenue streams of the oil majors, and the oil services companies – particularly those that support early stage oilfield development: seismic acquisition and processing, drilling, and geophysical appraisals. The problems are arising in those jurisdictions where long-run production costs are highest: Canadian tar sands, US shale oil and deepwater Gulf oil and the UK's North Sea oil are all producing at a full cost well above current prices.

The news flow we've seen since the New Year, which is dominated by cuts to major projects and overall capex budgets, confirms this. One point of interest, however, is where the actual distress is emerging. While the service companies are showing the need to accommodate lower activity levels and rates in their forecasts, so far there have been few cases of real financial distress in this sector. This seems likely to be linked to the very short timescales we're currently dealing with: service companies can see the pain coming (hence the announcements) but are in large part contracted and funded for the first half of 2015. It seems likely that the real pain will be felt as the effect of contract cancellations and renegotiations manifests itself later in 2015.

In contrast, the smaller exploration and production companies, which are on average more exposed to higher cost opportunities while being funded by an historically high share of debt, are seeing the first wave of distress. Quarter end payments, price redeterminations and failures on overall debt/equity covenants, have already brought a slew of these players to the negotiating table, and we expect to see more of this as the year evolves. The big challenge for lenders and investors now becomes how to assess the value in these companies when the fundamental economics – oil price, future production, and costs – are all up for material revision.

Medium-term impacts

Oil is not quickly substitutable. Other energy sources are not going to re-price at the same speed that oil has, but in the medium term businesses will invest, adapt and we should expect to see changes. The gas market is not as volatile as oil, as most gas is sold on long-term contracts, but it is re-indexed periodically and the crude price is a crucial component of that indexing. We have seen traded liquid natural gas prices fall significantly (almost as much as oil) and lower pricing will trigger issues in companies with fixed price contracts.

Coal prices have been in the doldrums for a long time now and lower oil prices will simply heap more pressure onto an already embattled sector. Those players without significant cost advantage, or that are producing specialty coals, will continue to be under stress.

The renewables sector has been growing and developing rapidly, but a period of lower oil prices might halt its growth. Issues have already arisen in Southern Europe where Governments that are no longer able to afford them have cut feed-in tariffs. As electricity prices fall, which they inevitably will, so will the economic viability of new renewable programmes.

Much like the oil sector, we expect viability issues to arise in the, generally smaller, support service and supplier companies before they arise in the actual operators. These companies need to be planning and reacting now, so that they are not caught out later.

Conclusion

Whilst the oil price fall is far from unprecedented, it has fundamentally changed the market and whatever your long-term view on price is, the damage is now done. Like any major market shock, winners and losers will be polarised and that is going to drive deal activity. Strong players will look to acquire niche businesses cheaply and we can expect a wave of consolidation. Meanwhile, we should expect much of the real economy to show improved profitability and for the growth of UK PLC to benefit.

However, there will be companies that are not targets that find that their profitability, investability and prospects have been dramatically altered. Some of these will fail, while others will be restructured to ride out the storm. Those businesses that require long-run oil prices of US$80/bbl or more to remain viable are going to need a rethink. Hoping for a price recovery looks like a strategy doomed to failure.

Additional PwC coverage on this topic can be found in our report: Opportunities in Adversity.

Design Services 28969 (02/15).