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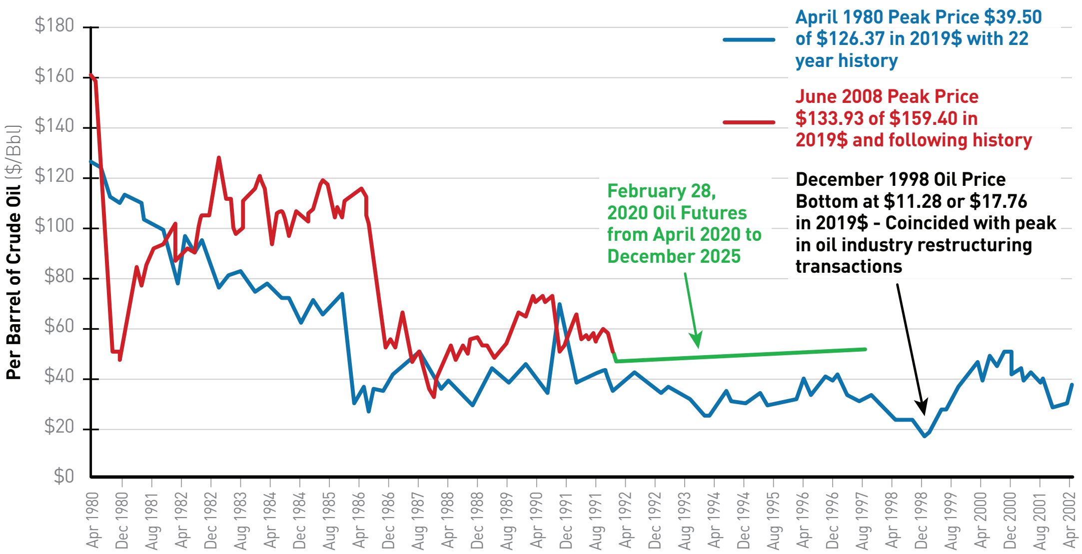
His fortnightly "Musings From the Oil Patch" is among the most widely read newsletters in the industry.

**How Current Oil Price Decline Compares to 1980s History** (Oil Prices in 2019$)




# DOUBLE WHAMMY

## WILL COVID-19 AND THE SAUDI-RUSSIA PRICE WAR KILL THE OIL INDUSTRY?

**A growing COVID-19 pandemic has forced governments and citizens around the world to embrace extraordinary steps, sapping economic activity and sending oil use and prices down sharply. The demand collapse comes at the same time a battle over market share has erupted between Saudi Arabia and Russia, two of the world's largest producers. Falling oil prices would normally be welcomed by consumers, but many are confined to their homes and unable to enjoy the cost relief.**

There's little confidence about the energy outlook either. The industry we knew will not be the one we deal with in the future. The restructuring that people have clamored for is here and about to transition from discussion to action – not because anyone wants it to but because it needs to be done.

A soothsayer warned Julius Caesar about the Ides of March. The oil market, however, was sending warning signals long before then, telegraphing an impending inventory glut and sharply lower prices. A glut was building as output, especially in the U.S., continued growing despite weakening demand. While slowing demand came from an aging economic recovery, the COVID-19 virus introduced a whole new dynamic, completely upending global economic activity.

Although international oil markets might have adjusted, no one expected, or predicted, a cessation of economic activity along with an oil price war between two of the world's largest producers, who had previously cooperated to manage global oil supply. Their cooperation was a radical development, helping reshape the global market. Given this oil war, analysts now wonder if Russia and Saudi Arabia can ever cooperate again.

### CRUDE CONFLICT

The oil war erupted as the important geopolitical pursuits of the key combatants diverged. Saudi Arabia wants and needs a higher oil price to bring revenues in line with its large budgetary needs. However, it's been losing market share to U.S. shale producers. Faced with falling demand in Asia due to COVID-19, Saudi Arabia sought to spread its pain among all its OPEC+ partners, including Russia, by limiting output.

Russia's focus, on the other hand, was more geopolitical. Its leaders and top industrialists were upset with the aggressive use of sanctions by the U.S. that have made their daily lives more challenging. As a result, they saw lower oil prices as a way to strike back at the U.S. with its "energy independence" program based on the high-cost shale industry. The virus impact on global demand, however, complicated solving the market's supply/demand imbalance. As a result, in its effort to damage the U.S. it may inflict severe damage on its own economy.

Since the 2014 oil price drop, Saudi Arabia has targeted Asia as its primary export market. Led by China, the region has experienced the highest economic activity anywhere, sharply boosting oil demand. For example, China's airports dominate the top 15 global airline routes in terms of activity, and jet fuel accounts for 15 percent of the nation's

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petroleum consumption. Due to the virus, fewer planes are flying these routes today.

Auto sales, a key economic driver in China, fell by 80 percent in February compared to last year as the government isolated millions of people for several weeks to control the spread of the virus. The lockdown undercut China's economic activity and energy consumption, which is barely recovering.

Under urgings from the Trump Administration, America's corporations have been revamping their supply chains by shifting production out of China to other countries, including back to the U.S. Due to the virus, China's industries are struggling to rev activity back up to where it was prior to COVID-19's disrupting the nation's life.

Russia's goals are similar, yet different. It wants to weaken U.S. political influence, which has been boosted by the growth of the shale business. At the same time, it wants to boost its own oil exports, which leaders see as helping its economy grow and its petroleum companies prosper since they have access to relatively cheap oil. The geopolitical benefit of driving down U.S. oil investment by dropping prices has been undermined by how much the virus is erasing consumption.

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## COLLAPSE IN DEMAND

Adding fuel to the fire is the rapid fall in oil demand forecasts for 2020. Initially, they called for an increase of 1-1.5 million barrels a day. In January, COVID-19 emerged as a serious health problem for China and forecasters began rolling back their projections. From initial revisions that projected 20-25 percent less growth, forecasts soon grew to 50 percent.

Now it's no longer a question of growth but of how much oil demand will fall. Investment bank Goldman Sachs was the first to project a year-to-year decline, projecting a drop of 150,000 barrels a day. Other forecasters quickly fell in line.

The International Energy Agency's March Oil Report presented three scenarios for oil demand. Its optimistic case, assuming a quick containment of COVID-19, projected world oil consumption growing 480,000 b/d. If the virus is not contained, the IEA's worst-case scenario projects a 780,000 b/d drop in oil use. The IEA's base case suggests a modest decline of 90,000 b/d, but that's beginning to look unrealistic.

Forecasts in such an uncertain environment are fraught with risk of being wrong. The problem is we have no understanding of how much or in which direction they will prove wrong.

It appears differences in the demand outlook were at the heart of the Russia/Saudi Arabia impasse. According to knowledgeable observers, Russia believed the OPEC+ cut needed to be 3-4 million b/d to offset the growing oil glut, which would need to expand as second quarter consumption drops by 7-10 million b/d. Russia wants the high-cost oil producers to make the first output cuts – meaning U.S. shale oil producers, offshore drillers and North Sea producers – before it will agree to work with Saudi Arabia on balancing the market.

## DÉJÀ VU

Expectations are it may be June before the oil market outlook clouds begin clearing. Between now and then, substantial damage will be done to the global petroleum industry. Bankruptcies, as many as 200, and forced M&A within the industry will become commonplace.

The outlook suggests a repeat of the 1980s-1990s, the last petroleum cycle that ended in significant industry restructuring. The oil boom of the 1970s created large new oil supplies. Once flowing, they couldn't be reined in despite drastically lower prices.

The low oil prices of the 1980s extended through the 1990s, eventually forcing producers to acknowledge the structural changes to the energy world. The significant merger wave of the late 1990s came as the industry embraced the view that U.S. exploration and development opportunities no longer existed. Producers needed increased scale and balance sheet strength to compete in the international oil arena.

The accompanying chart compares real oil prices from spring 2008 with those from 1980. Adding oil futures prices as of the end of February suggests a flat oil price scenario for years. In fact, that scenario makes this downturn's duration almost as long as the prior one. The earlier cycle ended with a frenzy of petroleum industry M&A activity.

We caution that oil price forecasts are seldom accurate, especially for those extending well into the future. However, oil prices are unlikely to soar in the foreseeable future. And if they did, would anyone believe them?

## WHITHER OIL?

Although COVID-19 demand cuts and falling oil prices dominate stock and commodity markets, long-term structural changes were already underway in the energy industry before these events surfaced, and the future of the petroleum industry remains questionable. Environmentalists have been attacking crude oil and natural gas for years. The pressure to limit fossil fuel use as a way to fight climate change is growing, and politicians will respond, despite failing to understand the impact and cost of their policies.

Investors are shunning energy stocks over disappointment with managers' record of generating positive returns. Investors now demand a share of company cash flows rather than merely betting on asset growth.

The future of the energy industry is, and will continue to be, shaped by money or its availability. Zero interest rates fueled the oil boom of the 2000s and the shale revolution. Even though rock-bottom interest rates continue due to COVID-19, the oil and gas industry will be constrained by its lack of access to financial markets.

Nonetheless, oil and gas will be needed for decades. Creating a profitable industry is the challenge.

**MarEx**