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Why the Oil and Gas Industry Will Never be the Same

When a staple commodity collapses to negative value it signals that something is clearly amiss in the global economy. When it is a global energy source like crude oil, it does not just signal pain in the oil patch, but an economic dislocation evocative of the Great Depression. Rare is the time when a commodity over which nations have fought wars in the past presents itself as something that traders would literally pay you to take it off their collective hands.

To be sure, there are good technical reasons why U.S. West Texas Intermediate crude oil (WTI), the underlying commodity representing the NYMEX's oil futures contract, actually traded negative in the second half of April, and continued to stay low (even though the June contract has now turned positive). Put simply, there is virtually no storage capacity left for a supply glut of the commodity, which likely puts a cap on the price, especially in a world of virtually nonexistent demand. That doesn't mean you'll be getting paid any time soon to fill up your car the next time you choose to fill it up with gasoline, or even rewarded for storing some in your swimming pool; after all, Brent Crude, the North Sea oil that serves as a benchmark to the majority of worldwide oil markets, is still trading around $20/barrel. But the economics of production have radically shifted against a huge number of deposits. How does the oil industry respond to these challenges?

Oil wells aren't like sink faucets; if you stop the flow, it's a lot of work to get the systems running again. And many oil-producing countries and private companies live basically paycheck to paycheck on sales to pay their bills. Economic pain in the United States will

lead to more mergers and consolidations across the oil and gas industry, and, for the world's leading oil export producers, difficult choices to privatize more of their nationalized industries to foreign buyers like China and Western petroleum companies.

For many countries that have relied on crude oil for export revenues, notably most of the OPEC countries, the collapse in price spells big trouble. In addition to the largest swing producer, Saudi Arabia, there is Iran, already suffering from the twin ravages of harsh U.S. economic sanctions and a massive outbreak of COVID-19. Venezuela is in dire straits. These are countries with debts to pay off, and investments that require steady—and predictable—flows of capital to sustain. Russia, to its credit, has developed a strategic hard currency position that can see the country out of price crashes, and oil revenues are just cash on the barrel. Its economy is far less exposed to international finance, but still vulnerable as it does not have a mixed export economy. Leaders in these countries will likely have to make some devil's bargains with China, Germany and Western oil majors and the IMF just to stay afloat.

The United States has had so many oil-price crashes in its economic history that dealing with another one is a matter of bureaucratic and financial muscle memory: a matter of forcing mergers for future efficiency, renegotiating debt and subsidizing the idle workforce. While the oil and gas companies may not volunteer to merge on their own at a time when their core products have cratered in value, banks and governments will see the value in simplifying the playing field.

Major net importers like India, Turkey or China should benefit only somewhat, as they only can store so much oil, so the effects of any consumer stimulus are limited, given storage capacity constraints and the fact that the entire global economy is still shut down.

We're now experiencing the legacy of Saudi Arabian Crown Prince Mohammed bin Salman's ill-conceived attempt to flood the markets with oil in the hopes punishing Russia (which had previously refused to support Saudi Arabia's decision to cut production to elevate prices), and the American shale-oil industry, "whose burgeoning output had transformed the United States into the world's biggest oil producer and one of its biggest oil exporters," writes Eric Reguly of Canada's Globe and Mail. How did we get to this point?

Crude oil is mostly traded between producers and refiners on futures markets. The refiner is the buyer of futures; they need to take delivery of the commodity, and they need to have some predictability about price and supply stretching out over many months. The

seller of the future is the producer, the oil company that has pumped the black stuff out of the ground, and similarly they are selling their product at a price that will cover costs and be profitable. Then there is a third category of participant, the speculator, that has no interest or capacity in taking delivery of any oil, but just wants to profitably express views on the direction of the price (this source of demand has rapidly expanded over the years, as investment banks have created all kinds of new investments in commodity-linked products—China's biggest bank has just suspended all new retail investments in products linked to oil and other commodities because their investors were taking huge losses in them).

In theory, the speculators help ferret out errors in the calendarized price structure of the trading model, but as we have all experienced, it is typically the speculators that distort the true price and value of our commodities. And they are the ones that gave the world the bizarre negative pricing phenomenon in the WTI markets earlier this month. Any trader buying a WTI oil futures contract commits to receiving a tanker full of oil in the next couple of weeks. The problem is that demand for oil products globally has collapsed—no flights, no factories, dramatically lower car usage.

At the same time, oil producers have continued to pump at levels that do not reflect the new demand paradigm, thanks to the decisions taken by Saudi Arabia weeks ago. Even though the Saudi crown prince and Russia came to a recent agreement to cut back production, the impact of the cutbacks will not come for weeks and in any case is insufficient, given the wholesale cessation of global economic activity. That means seeking refuge in a future oil contract won't be easy.

Coming up to the expiry of a future, as a buyer, you have three options. You can keep the contract through the expiry point and subsequently receive oil. You can sell the contract before expiry and release yourself from obligation. Or you can roll your contract to next month, delaying your obligation, by selling this contract and buying next month's. But even in the case of the third option, if you're buying oil futures via leverage (as many speculators are doing these days), you face the risk of margin calls as and when the price declines.

What happened recently is that a lot of late buyers of oil found that there was no liquidity, no new buyers, to sell on to. After all, you can only take advantage of a ridiculously cheap oil price if you have somewhere to store it. To be sure, WTI contracts represent only a very tiny fraction of oil output globally, and do not fully capture the underlying

supply and demand situation. But we do know that storage in the U.S. is at full capacity; otherwise, there would have been ample grounds for new buyers to arbitrage away the negative prices. That such a process has not yet occurred suggests a world swimming in oil. Oil producers likely must dramatically slash production to accommodate collapsing demand and nonexistent storage. We know that with such a glut, oil prices are going to remain extremely soft for the foreseeable future.

For years, the U.S. shale patch has been sustained by Wall Street-driven Ponzi financing, in which drilling and production for natural gas have not generated cash flows that come even close to offsetting costs of the debt service. The latest collapse should finally constitute the death-knell for this sector, even as the president and the GOP in particular (which largely represents American oil-producing states) scramble to provide funding to the sector. Storage capacity will take several months to build up and, at a time of increasingly fraught relations between the United States and China, the latter is hardly likely to do U.S. oil producers any favors, particularly when there are ample other (geopolitically friendlier) sources of crude in other parts of the world, which are also far cheaper.

In the past, such collapses in conventional energy sectors would represent a disaster for the renewables, because historically the latter have been viewed as economically viable only in an environment in which fossil fuel prices were becoming too expensive. But the economics for alternative energy sources has significantly improved over the years. Additionally, the very lack of a need for storage in wind and solar means they are facing far less collateral damage than crude and its related products. As Robin Harding of the Financial Timesnotes, they "have minimal operating costs and generate power as long as the sun shines and the wind blows." Their challenge is the intermittency of supply, not storage, so there are challenges fitting the output curve to the demand curve.

Of course, this whole situation is unlikely to have happened in a country with a coherent national industrial policy that would have otherwise regulated other policies in the interest of its designated domestic strategic sectors and supply chains. Ideally, countries do not want the energy costs of manufacturing, along with other inputs, to vary wildly and unpredictably. A country with a rational industrial policy would combine buffer stocks with some sort of national quota and price support system to modulate the price of oil and gas. Since that could only be done on a national (or bloc) basis, it would be

incompatible with a genuinely free global market in oil and gas—though of course there could be trade.

This is in fact what OPEC sought to do when the oil-producing nations effectively seized control of the global oil market (superseding the price-setting powers of the old Texas Railroad Commission). But as the United States lost control of the oil market, it became a national foreign policy goal for many years to destroy the oil price cartel and re-establish U.S. energy independence (even as the country continued to envelop itself in Middle Eastern affairs, the Carter Doctrine declaring that the United States would use military force, if necessary, to defend its national interests in the Persian Gulf). When the shale oil revolution began, we listened to shills for the finance industry who told us to put our faith in Mr. Market (but that didn't stop U.S. foreign policy adventurism in the Middle East).

The collapse of the crude oil market today presents different kinds of challenges. Forget the idea of shale oil/gas reviving. Much like Monty Python's "dead parrot," there is no chance of reviving a sector whose economics were marginal at best, even when the oil price was much higher. Thanks to the coronavirus, these questionable economics (and correspondingly high depletion rates associated with the deposits) will kill the industry. Bargain basement shale gas prices, a byproduct of credit bubble finance and shale oil production (which enabled operators in aggregate to generate positive cash flow, even though the natural gas outputs in isolation were otherwise non-economic), will disappear. From the point of view of carbon emissions, this is an unfortunate development, given that cheap natural gas has catalyzed the transition away from dirtier forms of energy, such as coal.

Even if there weren't a coronavirus pandemic, it would still be a peculiar moment for the global energy market, where many conditions are rapidly changing. The debt-fueled shale oil bonanza has hitherto enabled the U.S. to flood world supply and weaken the revenues of perceived geopolitical rivals. That leverage is now gone. Furthermore, as John Dizard of the Financial Times has observed, "Asian LNG prices have collapsed much faster than U.S. prices. That means it no longer pays to chill American natural gas, load it on to LNG tankers, ship it across the Pacific, and re-gasify it. So U.S. LNG exports are ex-growth." That shifts the balance of geopolitical power in the energy markets in the near and mid-term back to countries like Russia and Tajikistan, as they are likely to re-establish a pipeline primacy that it looked like they had lost.

By the same token, the relative position of the major oil-consuming economies has improved. And all the petroleum producers continue to see their necessity undermined by the day with the growth (and rapidly improving economics) of renewable energies, climate change policies that encourage de-carbonization, and what looks like a rebirth of the nuclear industry. Although Russia and China now dominate the export of nuclear power plants, national security considerations are likely to push the United States more aggressively toward reviving its own nuclear industry. Uranium could over the next decade join the cadre of traded energy commodities with crude oil and natural gas as a geopolitical flash point. In any case, there is no need to lament the loss of a phony U.S. energy independence, which was built on the mirage of a credit bubble that artificially skewed the market toward otherwise uneconomic and environmentally degrading modes of production.

We are going to see a new set of political imperatives guiding the energy policy of the industrialized world. Much like needed medical supplies, or sensitive high-tech developments, new crude realities will force a similar discussion over national interest versus overreliance on multinational supply chains, as well as forcing ugly geopolitical compromises, vast increases in research and development, and a growing distaste for being at the mercy of any one energy source.

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