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The Story Behind Collapsing Crude Oil Prices

Impact on the Global Economy and Uganda

CRUDE OIL

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1. Introduction

Though the crude oil market has frequently been volatile, current trends are unprecedented. On 20th April 2020, West Texas Intermediate ("WTI"), the United States ("US") benchmark, traded as low as -$40.32 a barrel implying that sellers were paying buyers to offtake their crude oil in order to mitigate their storage costs. Brent, the international benchmark for seaborne crude oil trading, fell to about $ 18 a barrel the lowest price the market has seen in about 20 years.

Prevailing supply and market fundamentals have induced a crude oil glut on the international market. Over 80% of the global economy is now in lockdown as countries strive to contain the spread of the coronavirus. As a result, there has been a slowdown in worldwide travel and business activities significantly decelerating the demand for petroleum products.

The collapse of the OPEC+ pact at the end of March 2020 could not happen at a worse time. OPEC+ had brought together several members of the Organization of the Petroleum Exporting Countries ("OPEC") and other oil producing countries since 2017 to curb excess crude oil production. Feuding Saudi Arabia and Russia have since April 2020 ramped up production flooding an already saturated market pushing down crude oil prices to historic lows. While Russia, Saudi Arabia and other oil producing companies have now agreed effective 1st May 2020 to reduce daily crude oil production by over 9 million barrels, it is uncertain whether this alone is enough to prop up the immediate recovery of global crude oil prices considering the adverse economic bearing of the coronavirus pandemic.

This publication gives an account of the tumbling crude oil prices as well as highlighting the impact this will have on the global economy and Uganda in particular.

2. 2014 -2016 crude oil price slide

Crude oil prices fell precipitously between 2014 and 2016.The prices had dropped to lows of about $ 26 a barrel by 2016 from momentous highs of $115 a barrel in 2014 when industry pundits had even predicted the possibility of prices reaching $ 200 a barrel. This had followed a decade of high prices hovering over $ 100 a barrel driven by soaring demand in the developing world as well as conflicts in key oil producing nations like Iraq and Libya and significant restrictions on Iran's ability to export oil.

As the prices increased, it made commercial sense for companies to embark on the exploration, development and production of crude oil from more complex and expensive fields. Energy companies in the US deployed the use of fracking and horizontal drilling techniques to recover oil from shale rocks in North Dakota and Texas leading to a boom in "unconventional" oil production. Though there were other demand related factors, thriving US shale oil production significantly influenced the crude oil price slide during this period.

3. Stabilisation of the crude oil prices

It took the concerted intervention of the OPEC and other oil producing countries in what was dubbed as the OPEC + pact to stabilize the price of crude oil which had been in free fall during this period. The Kingdom of Saudi Arabia, which is the de facto head of OPEC, Russia and other oil producing countries came together to form the so-called OPEC+ alliance in 2016 after oil prices plunged to lows of $26 a barrel. The pact underpinned a strategic partnership which had since 2017 led to the stabilization of the oil markets with the pact parties allowed a reduction or increase in production depending on the market demand conditions.

4. Russia-Saudi Arabia rivalry

At the beginning of March 2020, Saudi Arabia had proposed to cut daily crude oil supply by an additional 3.6 million barrels through 2020 cognizant of weaker consumption due to the coronavirus pandemic. Russia objected as it wanted to produce more hoping that lower prices would drive some smaller U.S. producers towards bankruptcy. Infuriated Saudi Arabia moved to teach Russia a lesson by pulling out of the OPEC + alliance with effect from 1st April 2020. This alliance had placed a restriction on crude oil production since 2017. Saudi Arabia has since drowned the market with an additional 2 million barrels a day as well as discounting prices for customers in Europe, a key market crucial for Russia.

This precipitated a free fall of crude oil prices to historic lows exacerbated by the coronavirus pandemic which is projected to wipe away over 16 million barrels of daily demand during the months of April and May. Prior to the coronavirus crisis, daily global production was around 100 million barrels. Concerned that this rivalry would create more harm than good, Saudi Arabia and Russia have since struck a deal with other oil producing nations to slash production in the attempt to stabilize the market that has been upended by the coronavirus. Members of the OPEC and their allies, including Russia and Mexico, announced on 19th April 2020 their agreement to cut daily production by 9.7 million barrels effective 1st May 2020. These are the deepest cuts ever agreed to by the world›s oil producers. There are however questions whether the production cuts are large enough to offset the loss in demand connected to the coronavirus pandemic.

5. Impact of plunging crude oil prices

The economic impact of plummeting crude oil prices can be complex. In some regard, a fall in crude oil prices can spur economic growth by reducing the costs of doing business and giving consumers more spending power. In other respects, a significant fall in the prices can point to economic ruin if it is occasioned by the expectation of a global recession as is currently the case. Oil producing countries dependent on oil revenues can struggle to balance their budgets. Oil companies can be forced out business causing job losses, default on debt repayments and investment also falls.

a) Saudi Arabia

Riyadh currently pumps 9.7 million barrels of oil per day but has the capacity to increase production up to 12.5 million barrels daily. The fall in oil prices risks new turmoil in Saudi Arabia, as Prince Mohammed bin Salman's plan to modernize the economy relies at least in part on higher energy revenues to fund the transformation. Saudi Arabia is among the countries that produce oil at the lowest cost estimated at $2-$6 a barrel but due to high government spending and generous subsidies for citizens, the Kingdom needs a price in the range of $70 a barrel or higher to balance its budget.

b) Russia

Low oil prices and international sanctions pushed the Russian economy into recession in 2015-16 and enduring lower prices are likely to plunge the country into another recession as it will be starved of oil revenues. During the month of March 2020, daily oil revenues for Russia were about $200 million.

c) USA

With daily production of about 13 million barrels, the US is presently the biggest producer of crude oil in the world spurred by the shale oil revolution. Break-even costs for production in the US average about $50 a barrel. Even the bulk of already drilled wells that companies have not yet brought into production require a price of $25 a barrel. The US shale industry has struggled to generate consistent profits with tightening access to financing, leaving it vulnerable. Low oil prices are already hurting the US with some shale producers on the brink of bankruptcy, and this will have a ripple effect on credit markets.

d) Other oil producing countries

Countries like Iraq, Algeria and Nigeria will be in serious fiscal deficits. Iraq is for instance particularly exposed to an all-out price war because it has one of the least diversified economies of the producer group despite its relatively low production costs and is heavily dependent on oil revenues.

e) International Oil Companies ("IOCs") and service companies

Goldman Sachs projects that IOCs will on average need about $51 per barrel to fund their capex budgets this year, let alone pay off debt or send money to shareholders. To adjust to the new reality of much lower oil prices this year, oil companies will or are already undertaking the following measures.

- A wave of brutal cost cutting is being undertaken, slashing discretionary spend, including on share buybacks and exploration. Unsanctioned conventional projects are also being delayed. In a recent interview with Bloomberg, Matt Johnson, Chief Executive at Primary Vision, an industry data tracker, noted that "*E&P spending could come down 40 percent before the end of the year and that, in the US Permian basin alone, 1,500 to 3,000 oilfield service jobs could be at risk of disappearing in the next two months.*"

- Oil firms are turning to their suppliers and service companies asking for further discounts to help them achieve a sizeable reduction in costs. But oilfield services are arguably in a worse position. Either way, oil field service companies might not have a choice, and will be in a "sink or swim situation" if prices don't rise to at least $40+ per barrel within the next few months.

- The Royal Dutch Shell announced on Monday 23rd March 2020 that it would cut spending by about 20 percent, or about $5 billion, and has also suspended its share buyback plan. French oil giant Total SA and Norway's Equinor took similar measures. ExxonMobil and Chevron have also indicated that they too would be slashing their budgets, with Exxon under particular pressure. Goldman Sachs estimates that Chevron needs $50 per barrel in order to cover spending and its dividend. ExxonMobil, on the other hand, needs an estimate of $70.

- The lower prices will also force several consolidations or acquisitions especially among the smaller exploration and production companies in some shape or form. Tullow Oil has recently announced the divesture of its oil interests in Uganda to Total.

f) Banking Sector

The oil and gas industry accounts for about 2-3% of total loan portfolio at the biggest banks in the world. While a reduction in the oil prices is adverse, it is the resultant recession that will inflict more pain to the banks with likely debt defaults. It is therefore not surprising that the stocks of some of the biggest banks in the US have fallen by more than 15 percent already.

g) Airline Industry

The airline industry has experienced a massive decline in demand over the past couple of months and a significant proportion of the fleet has been grounded, and workforce slashed. Falling crude oil prices present the airline industry with a mix of opportunities and challenges. The International Air Transport Association ("IATA") notes that the oil price slump could cut airline costs by $28 billion though this may not benefit airlines that hedge their fuel. For example, Irish carrier Ryanair has hedged 90% of its fuel requirements for the year beginning April 1st at an average of $606 per metric ton.

6. Impact on Uganda

As highlighted above, the economic impact of plummeting crude oil prices is complex and this will be the case for Uganda. While reduced oil prices can with time reduce or stabilize pump prices, IOCs will only sanction the development of Uganda's crude discoveries if the prices are high enough or projected to rise to such levels that will enable the project to meet commercial thresholds.

a) Final investment decision ("FID")

IOC's are likely to sanction Uganda's FID if the crude oil prices are high enough (or projected to rise in the foreseeable future to such levels) for the project to be economically feasible. FID represents the point at which the oil companies and the government (through the Uganda National Oil Company) will make an irreversible commitment to move ahead with developing the necessary infrastructure for oil field development. This is the point at which the project execution phase will begin and big money will start to be incurred on project construction including the associated supplies and services.

The unprecedented capital programme will cost between USD 10 Billion and 20 Billion, equivalent to about two thirds of Uganda's gross domestic product (GDP). That will be spent at the investment stage in the first 3 years even before first oil flows will have a massive positive trickle down impact on the economy.

To unlock the long awaited FID for crude oil development, an investment decision must be made for both the pipeline and refinery, though the decision for the crude oil pipeline is more critical to kick start Uganda's oil development but this can only be taken if the project is evaluated to make commercial sense.

- **Oil development and production costs**

Uganda's oil exploration, development and production costs are projected at about $ 28 per barrel of oil. This includes the cost for finding the oil, construction of the production facilities and the crude oil pipeline but excludes the royalties payable to the government as well as the investors return on investment. It is therefore likely that the breakeven cost of production for Uganda's crude oil is over $40 a barrel and it is a price above such levels that will fast-track the FID.

- **Engineering, Procurement and Construction contracts**

Low crude oil prices on a positive note provide an opportunity to the IOCs to put pressure on their suppliers to lock in cheaper construction and related contracts generating cost saving deals. This will enable a greater share of the wealth arising from the crude oil production to be distributed all the stakeholders.

- **Coronavirus pandemic**

It is uncertain how long the coronavirus pandemic will endure and how soon the world will open up and normalize from the present lockdown. In the circumstances where travel and physical interaction remains restricted, the IOCs and government are likely to find it difficult to conclude all the preliminary work required to sanction the FID for Uganda's crude oil development.

- **Funding government participation**

Through the Uganda National Oil Company, the government of Uganda is expected to participate in the oil development projects in concert with the IOCs. This means that the government must commit to footing the requisite capital pro rata to its share of participation. With the looming global recession and projected weak local economic growth, the government may struggle to domestically raise or obtain financing for its capital requirements.

b) Pump prices

The pump prices of petroleum products are likely not to respond symmetrically with a fall in crude oil prices. This is largely

because of the market power of refiners and traders in most of the world. Any changes in product prices will be minimal and to lag the crude oil price drop significantly. Inventory adjustments could also increase the lag between crude and refined product prices. In Uganda just like Europe, taxes and surcharges make up a significant share of pump prices, so the effect of falling crude prices is less marked. The appreciating US dollar against the shilling will also erode the would be benefit of reduced pump prices.

7. Conclusion

Market conditions, the coronavirus pandemic and geopolitical factors have converged creating an unprecedented environment that has battered oil prices sliding to historic lows. The situation remains fluid with an extraordinary degree of uncertainty of how the immediate future will turn out especially the impact of the coronavirus pandemic that is projected to cause a global recession. Ugandans are anxious that the prevailing low crude oil prices may delay further the development of the country's crude oil discoveries. While prices are outside of the country's control, we would urge the Ugandan government to clear all outstanding obstacles to facilitate completion of all the preliminary works to get the point of the final investment decision.

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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