Oil price: the stormy seas

Some time ago we decided to invite personalities from outside the insolvency profession to explain the evolution of an industry, to discuss a point of economy or to impart an experience in a different field than ours, from their own viewpoint. Here is Sandy Shaw's take on the impact that the current oil prices are having on the economy at large.

SANDY SHAW
Non Executive Director, Velocys plc

Sandy Shaw qualified as a US attorney-at-law before moving to the UK where, whilst working in the oil and gas industry, she also qualified as a UK barrister. With nearly 40 years in the energy industry Sandy's experience spans from large multinational corporates to small start-ups, listed companies and private equity, including Mobil, Marathon, Exxon, LASMO and Consort. She was a founder of Valiant Petroleum.

> THE INDUSTRY AT LARGE IS FACING REDUNDANCIES, PAY CUTS AND BUDGET CUT-BACKS IN ALL AREAS

It was 1978. Demand for oil was high, supply appeared tight and governments were beginning to stockpile supplies in order to avoid a repeat of the supply crisis of 1973 when Saudi Arabia cut production to support oil price. That was the year that this (then) newly married, newly qualified US attorney-at-law relocated to England and took up her first oil industry employment. The oil price was around $14 per barrel.

The industry I joined was young, vibrant and growing rapidly. By 1981 the oil price reached $35 per barrel following the Iranian Revolution and further OPEC production manipulation, before the price stabilised in the mid-$20's per barrel. Since that time, over a 38-year career in various companies and positions, I have 'surfed the waves' of oil price rises and falls and the consequent effects of volatile oil prices on the industry generally and the individual companies in different sectors within the industry. Whilst supply and demand played their part, politics and perception played an even larger one. Therefore, oil prices were never certain or predictable: the only certainty was that any prediction of a future oil price was likely to be wrong.

Seasoned oilies

The recent, rapid plummet in oil prices is not unique. Like the stories my parents told of the Great Depression, seasoned 'oilies' recall the oil price collapses of 1985/86 and 1998/99 and more recently the short-lived but nearly as severe price drop in early 2009. The current collapse is all the more significant because of the extremely low oil prices reached (not seen since the end of the last century) compared to the unprecedented high prices generally prevalent since 2008, and the potential duration of a low-price environment.

Industry scars

Industry commentators are comparing the severity of the current situation to that of 1985/86. The industry's scars and my own experiences of that period are still obvious and painful; the concern is that there will be a repeat, perhaps an even more severe re-enactment, of that trauma.

I clearly recall an oil price of $8.50 and resulting massive redundancies; slashed budgets including those for research, development, exploration, training and recruitment; the delaying/cancellation of projects; the sales of assets, both core and non-core; corporate restructuring; hiving off of shipping, refining and other less lucrative but previously linked businesses, and major re-financing initiatives.

Those understandable industry reactions to the rapid shrinking of income resulted *inter alia* in the disappearance of new projects/developments, which took years to cure and a major lack of skills/personnel with the consequent 'ageing' of the industry, which has never been fully remedied. This did not affect only the oil companies, but also the myriad service and related companies that depended upon oil and gas work.

Crashing prices

The current price crash is already having a similar effect in the United Kingdom Continental Shelf (UKCS) oil and gas production projections. Last year, the exploration and appraisal of the number of wells dropped to its lowest level since 2001, just a quarter of the levels seen at peak time around the turn of the century. The industry at large is facing redundancies, pay cuts and budget cut-backs in all areas. Albeit inevitable and necessary, it begs the question of where tomorrow's technical expertise will be found and whether there will be available drill ships and other capital intensive plant and equipment to support future development.

Increasing costs

More so, due to the increased costs basis of exploration, extraction and operation in the UK, particularly for offshore, deep water and other non-conventional reserves, many existing developments will no longer be economic to produce. Already in 2016 announcements have been made that several UKCS and Norwegian fields will be shut down and their infrastructure abandoned, in at least one case citing poor profitability at current oil prices. Whilst it is not clear if these fields are being abandoned "prematurely", the permanent removal of existing potential host infrastructure will add costs to any future developments and there is already concern that UKCS offshore reserves will never be fully exploited.[1]

Financial stress

Whilst merger and acquisition activity happens in all cycles of oil prices, the sale of assets and take-over activity rises at times of financial stress and significantly higher levels of M&A have been reported for 2015 compared to the previous two years. Those companies with funding capability and the courage to act counter-cyclically will take advantage of the fall in share prices that inevitably results from an oil price decline. More such activity is likely if and when the oil price begins to recover, as share price recovery generally lags behind. The positive here though is that buyers remain interested in oil and gas assets at the right price.

Financially, even the most robust and far-sighted oil companies are suffering, including the majors. Those producers who hedged their forward sales can only be protected for a limited time and volume and will be waiting with some concern on the duration of this market. Low oil prices affect more than the balance sheet; they can have an even more severe, negative correlation to share price, particularly for smaller, independent, listed companies. This jeopardises the satisfaction of loan-to-value covenants in existing financing arrangements and the ability to renew or increase borrowings will consequently be hampered notwithstanding that current obligations may be met on an ongoing basis.

Insolvencies rising

Saliently, for the insolvency practitioners who read this publication, the number of restructurings, re-financings and insolvencies in the energy industry has sky rocketed. At least 28 UK oil and gas services companies declared insolvency in 2015, up from 18 the previous year and just six in 2013[2] and, almost unheard of in my youth, oil and gas exploration and production companies have not been spared.

In upstream oil and gas activities, where interests are generally held as jointly operated licences, the insolvency of a participant is a major risk for the other, solvent, participants who will be liable for increased costs in a default, including decommissioning liabilities at which point the upstream asset becomes a liability. In the worst case, because of the licence obligations, participant insolvency could result in the loss of the licence assets and/or create solvency issues for other participants, in a domino-effect.

Making progress

Yet, all is not doom and gloom. At a recent industry function in London, amidst the dour faces were some more up-beat attendees, people who reported that the oil companies and service contractors were working together to establish the 'real cost' of development and operations and were making good progress in bringing costs in line with current oil prices.

Finding more cost efficient ways to work with suppliers would be a good thing. Even some media commentators, whose effects on perceptions are often as influential as supply and demand actualities, have been reporting that the industry is resilient enough to weather the storm. After all, petroleum has always been a 'boom and bust' business. Let's hope they are right. ■

Footnotes:

1 16 February 2016 reports cite statements made to the British government by John Swinney, Scotland's finance minister and deputy first minister, urging tax cuts on oil and gas companies to avoid early field shut-downs and more job losses, and voicing concern that some of Britain's remaining North Sea oil will never be recovered as companies active in the area have scaled down investments due to the weak oil price.

2 According to Moore Stephens, the accountancy group.

"OIL COMPANIES AND SERVICE CONTRACTORS WERE MAKING GOOD PROGRESS IN BRINGING COSTS IN LINE WITH CURRENT OIL PRICES"

Share your views!