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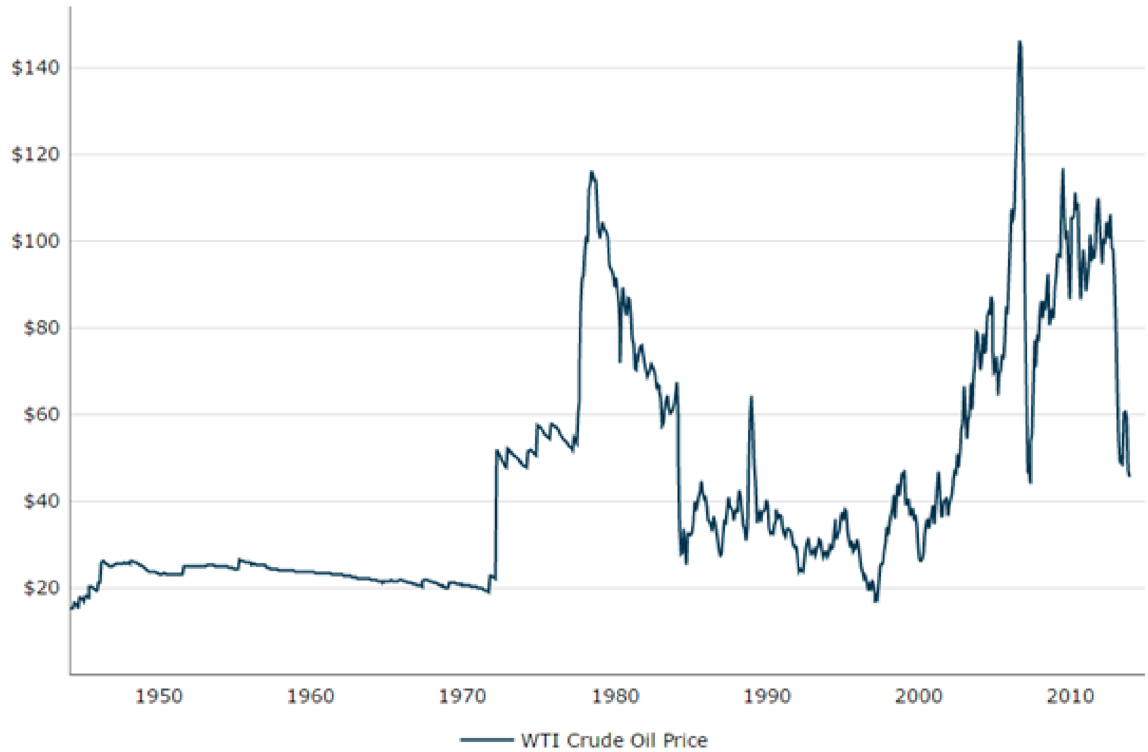
*" If I had asked people what they wanted, they would have said faster horses "* Henry Ford

# Low Oil Price: A Perspective

**October 2015**

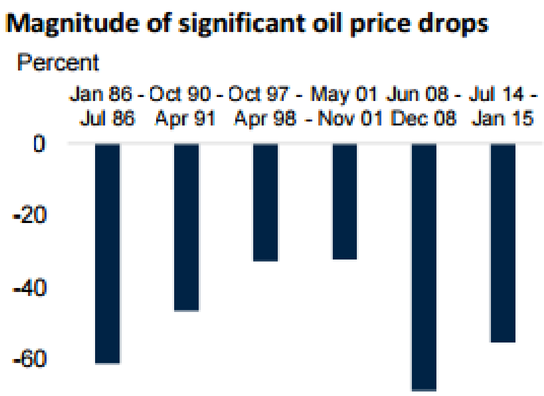
Since June 2014, the price of WTI Crude Oil has fallen from around US$105 per barrel to presently US$45 per barrel. In the four years prior to this sharp fall from 2010, crude oil had been trading in a relatively stable price range between US$90-110.

The graphs below demonstrate how the oil market is highly volatile.




The WTI Crude Oil price is in inflation adjusted prices and, as can be seen, there have been several previous episodes in the past 30 years where prices have fallen by 30% or more in a very short period of time.

The following graph shows the size of price drops from peak to trough for the six periods in the past 30 years where oil prices have fallen more than 30%. The time period is also given in the graph.




(Source: World Bank Group, Policy Research Note, 2015)

In reading the daily press reports and the multitude of reports analysing the current price collapse, it can be difficult to gain clarity whether the forces of supply, demand or price manipulation by speculators are to be blamed.

Furthermore, it is also important to highlight the impact of oil price falls on other related energy products and other commodities. In an Australian context, the drop in price of LNG is of particular importance.

**Causes of the Current Fall in Oil Price**

The World Bank in its Policy Research Note, The Great Plunge in Oil Prices (PRN/15/01, March 2015) writes that there are a number of factors:

- A significant shift in OPEC's policy objectives;
- Unwinding of some geopolitical risks;
- Appreciation of the US dollar;
- Several years of upward supply surprises in the production of unconventional oil, US shale oil in particular; and,
- Weakening global demand.

There are other factors influencing the global oil markets in this current price downturn impacting price expectations going forward:

- Iraq has increased its daily crude oil production by 20% in the past year, to four million barrels;
- Iran expects to add at least 25% of output equivalent to one million barrels to its daily production to at least four million barrels from 2016 if sanctions are lifted;
- The US Shale Oil production is likely to be a swing factor for the international oil market for decades going forward, eventually making the US self-supplied with oil; and,
- The state of the Russian energy sector is opaque at present.

**Previous Declines in Oil Prices**

There have been six episodes of price declines since 1984 where oil fell 30% or more over a relatively short period of six to eight months. They are highlighted in the previous graph. As the World Bank points out, these declines coincided with major changes in the global economy and oil markets:

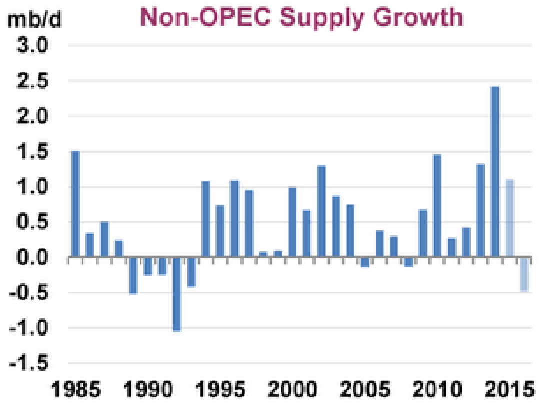
- The decline in 1985-86 was mainly associated with a significant shift in OPEC policy;
- The 1990-91 and 2001 declines were driven by weakening global demand following U.S. recessions;
- 1997-98 was associated with the Asian Currency crisis; and,
- 2008-09 was directly related to the Global Financial Crisis.

**Parallels with 1985-86**

The World Bank concludes that the current oil price drop has some significant parallels with the price collapse in 1985-86 which followed a period of strong expansion of supply from non-OPEC countries, in particular from the North Sea and the Gulf of Mexico. Extra production from these two sources alone added around six million barrels/day to global markets in the period from 1973-83. This increase in new supply from outside the cartel eventually led to a decision by OPEC to forgo price targeting and increase production to defend their market share.

From 1979 OPEC reduced production to maintain high prices and over the next six years supply reduced from 30 million barrels(mb)/day(d) in 1979 to 16 mb/d in 1985. However, despite this reduction, real oil prices dropped 20% and OPEC started increasing supply from 13.7 mb/d in June 1985 to 18 mb/d in December 1985. The World Bank writes that partly because of this policy change, oil prices collapsed and remained low for almost two decades.

The World Bank, as well as many other sources like The Economist and the International Energy Agency, concludes that a range of sectoral factors drive the current price collapse episode, but supply is the main reason.




(Source: International Energy Agency, August 2015)

## Forecast

Following the arguments put forward in the World Bank report, current trends point to continued soft oil prices in the medium term. The report highlights that unconventional oil supplies are likely to continue to be a highly elastic source of oil supplies. It is possible that the unconventional oil producers can become the new swing producers in the global oil markets, and hence affect the dynamics of oil markets in a lasting way.

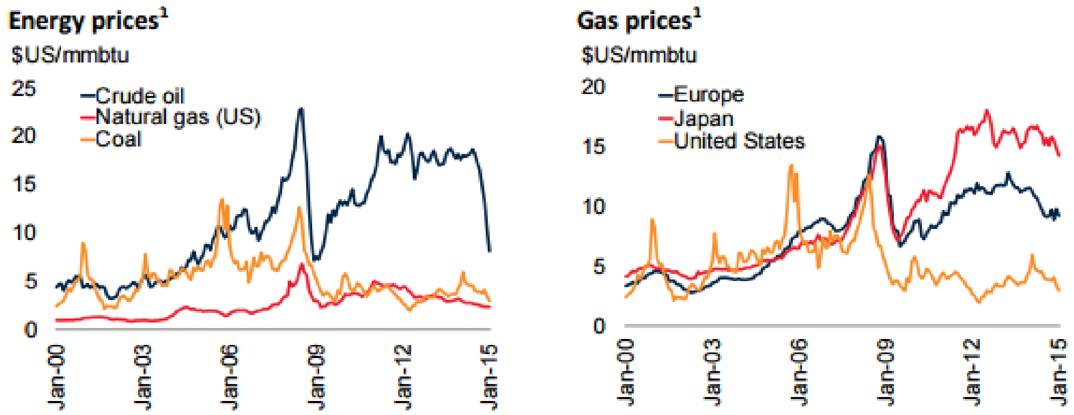
The key aspect in this new possible scenario is that unconventional oil production, the U.S. shale industry, can expand and contract quickly in response to changes in oil prices, hence the baseline outlook are to the downside on prices.

Industry sources we have talked to also highlight the importance of the expected increase in supply from Iran if or when sanctions are lifted, which looks increasingly likely to happen in 2016 at this point in time (October 2015). The Iranian Oil Minister Bijan Zanganeh stated last months that Iran expected to immediately increase its export by 500,000 barrels and this would be followed by another 500,000 shortly after. It should be noted that Iran also holds one of the world’s largest proven gas reserves (34 trillion cubic metres) which will inevitably also cause downwards pressure on gas prices (including LNG gas prices) as Iran seeks to re-establish itself on the global markets and build market share in both the oil and gas sectors.

## Impact on Non-Oil Commodity Prices

Other energy related commodities have also seen significant drops in their prices.

*The oil price decline can be expected to affect natural gas prices, especially in Asia and, to a lesser extent, in Europe.*




Source: Baffes (2007), World Bank,
[1] mmbtu is million of British thermal units, a measure of energy content.

(Source: World Bank, op. cit)

If low oil prices persist, the price of LNG, mostly destined to Asian markets will drop further given tight linkages in pricing contracts.

The pricing linkage between LNG off-take contracts and the oil price is of particular importance to the debate in Australia and the financial health of a number of companies in the energy sector.

Ultimately, the question is whether the new LNG plants that have been built in Australia in recent years will be able to be operated profitably. The investments have been massive, the cost-blow out spectacular and the delays significant.

As one source remarked, “It now remains to be seen if the risk management including management of the financial risks profiles, forecasting, scenario planning and models of return on investments were more robust than the design and construct phases.”

In the Financial Review, as recently as 10 September 2015 Origin Energy’s Chief Executive Officer, Grant King, made firm statements that the APLNG joint venture in Gladstone is still profitable, which some have argued appears to be based on the assumption that the oil price over the next ten years will be US$75, against the current US$45.

Last week it was announced Finance Director, Karen Moses, will be retiring from Origin Energy February 2016.

What happens to the profitability of the APLNG plant and the financial health of Origin Energy itself if oil prices stay subdued at current levels of US$45 for the next couple of years at least?
(source: [http://www.afr.com/news/politics/origin-energy-boss-grant-king-happy-with-lng-at-us75-a-barrel-20150909-gjijxd](http://www.afr.com/news/politics/origin-energy-boss-grant-king-happy-with-lng-at-us75-a-barrel-20150909-gjijxd))

Santos has experienced significant changes already. New Chairman Peter Coates took over in April 2015 and Chief Executive Officer David Knox will be departing in the near future. Sources have previously suggested a new CEO and a new strategy are needed. The market capitalisation of Santos has dropped 68% in the past twelve months, after a rather academic debate on whether or not the company needed to raise capital. It has also exposed the serious consequences for shareholders and employees when market perception is that the Executive team made fundamental mistakes and hesitated taking action when disruptive forces hit their industry.

No company in the energy sector has been spared significant drops in share value. The mining engineering and oil/gas service sectors have also suffered significant destruction of value, and unfortunately the medium term forecast for the whole energy market is subdue judging by the forecast of oil prices.

Most recently (October 2015), the American hedge fund manager Jim Chanos, who specialises in short-selling strategies outlined his negative views on the natural gas export sector, in the USA as well as Australia and elsewhere in the Pacific. He highlighted that production out of Australia is about to double but this LNG will be sold into a market where demand has remained basically flat for a few years already. (source: http://www.businessinsider.com.au/chanos-we-have-a-looming-oversupply-problem-2015-10)

When researching for this note, industry sources were keen to point out to us that during the producing life of a field the majority of money is spend on OPEX. These costs include the maintenance of the production equipment, payments to contractors, transport of people and products, salaries, insurances etc, rentals and other overheads and training. Hence, the companies that manage their OPEX/barrel ratio most effectively stand a better chance of survival.

Into this should be added the costs of servicing debt accumulated to acquire exploration assets and undertake infrastructure and production investments. Hence, it is estimated that at present more than US$200 billion worth of oil and gas assets are currently for sale globally as companies undertake further capital management initiatives. Whether investors and bankers have an appetite for taking on more risk in the sector is questionable at this point.

However, as the chart at the beginning of this short paper indicates, making predictions of the development of the oil markets remain highly uncertain. This includes the rather optimistic predictions of oil remaining at US$80-100 for decades when the decision to invest in US$200 billion of new LNG plants were made some years ago.

A few messages can be taken away from the current dramatic downturn in oil prices:

- Ensure risk management and analytics teams in-house are state of the art;
- Apply critical thinking when analysts promote their ‘stronger for longer’ price scenarios in commodity markets;
- Welcome contrarian views;
- Master the arts of both Capital and Cash Management;
- Don’t fight the market; and,
- Develop Succession Planning strategies for your critical hires and place yourself in a position to be able to act swiftly.

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