Oil prices refuse to follow the oil companies' script

by DIETER HELM

The market stuck two fingers up at the latest attempt by Russia and OPEC to jack oil prices back up. Instead of the expected rebound, prices fell below $50. Yet still the companies, notably BP, reaffirm their faith in the ability of a small number of producers to rig the market.

The latest is Spencer Dale, BP’s highly respected Chief Economist. Presenting the latest BP Statistical Review, Dale explained the short-term market as “balancing” in 2016. He sees it as a game between US shale oil increases, OPEC output cuts, gradually falling inventories, and rising demand. Further out he points to the budgetary needs of the key OPEC states. In answer to my question at the presentation about whether he thought $50 was a high or low price, and whether he thought prices would fall in the medium, he argued that because key producers will need to balance their budgets in the medium to longer term at prices higher than $50, there will be a floor in the price. Since several of them need oil prices closer to $100 to balance their budgets, this can only mean that oil prices will rise above $50 and stay there.

Dale’s arguments reflect a deeper failure across many of the oil companies to come to terms with the end of the commodity super-cycle from late 2014 onwards. The companies have repeatedly forecast price recoveries since 2014, and several have been borrowing to cover their dividends, presumably on the assumption that prices will soon go back up again.

Let’s start with the short run. In the short run, the most important increases in production are coming from some OPEC countries. The increases in production are not just in the US. They are in Iran, Iraq, Nigeria and Libya. OPEC overall is increasing supply. The extra US production is the icing on the cake. Dale did not mention these in his presentation or in response to my question, and they make a big difference. It is not all about shale. It is all about shale and conventional production and the incentives to cheat amongst OPEC. It simply is not a very effective cartel, if indeed it ever has been apart from a very brief period in the 1970s.

In the longer term, the argument that because these countries need a price of more than $50 to balance their budgets, they will be able to enforce higher prices is rather like a child who “needs” lots of pocket money and therefore gets it. Life is not like that, and neither is the oil market. Lots of us would like lots of things. Wanting and getting are two different things.

My book - Burn Out: The end game for fossil fuels - March 2017 - covers this topic in more detail...

Indeed, suppose it proves impossible to get the price back up high enough to cover their budgets, and they are forced to try and realise as much money as possible. They can mortgage the family silver – like selling off chunks of Saudi Aramco – and they have little option but to pump more not less oil. If the marginal cost of oil is below $10 and the price is $30 or $40, it is profitable to pump, and as much as possible to keep getting the money coming in. This is exactly what happens when cartel discipline breaks down. No wonder it is OPEC countries that have been
increasing output as the price has fallen back. As the price fell, supply went up not down.

This raises an interesting question for the oil companies. Do they really believe in rising oil prices? To admit that they do not has massive implications for their business models and for their investors. If oil companies admit that prices might fall, and carry on falling, then their dividends will come under pressure. Further ahead, falling prices makes nonsense of some of their high cost new ventures, notably offshore and even still in the Arctic.

The obvious consequence of admitting the possibility of falling prices is that the companies should seriously think about what would then be the most profitable strategy – harvest-and-exit. They would slash their capital expenditure even further, abandon high cost prospects and gradually prepare for the end of fossil fuels and, with them, their corporate rationale. As with tobacco companies, this might prove a very profitable long run exit strategy.

It is however too much to expect BP’s chief economist to admit this, and unfair to expect Dale to do so. It would be front page news, and investors would question the companies’ guidance. But then it is BP’s Statistical Review, and BP cannot be neutral.

The really interesting question is whether Dale really believes in his short or long run outlook. Investors clearly have doubts: that is why Shell has a jaw dropping 7% and BP 6.5% yield.

Both cannot be right, and time will tell whether the share prices are grossly undervalued or the dividends are slashed.