Is crude oil dead?

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It was a historic day in the oil world, April 20, 2020. My e-mail and phone were flooded with messages and texts from friends and colleagues alike, all asking the same question.

"… How can we lose money buying oil right now?..."

Curiosity had spiked as US oil futures turned negative for the first time in history. The US benchmark West Texas Intermediate (WTI) crude futures for May delivery plunged more than 300%, deep into negative territory, touching -$40.32 before clawing back to settle at -$37.63 for the day.

My immediate response was that it's not the actual oil price that has dropped into negative territory but rather the crude oil futures contracts. I explained that these futures contracts are primarily used to connect producers with consumers of oil. Oil producers can sell futures contracts that match up to their expected future production, and by doing so, they can effectively lock in current prices. The upcoming expiring futures turning negative on this day meant that sellers were actually paying buyers to take the oil out of their hands to avoid having to take delivery of oil and incur storage costs.

However, this left me with one question: Is crude oil dead?

Oil prices were already weighed down by oversupply going into 2020, and were further suppressed by coronavirus containment measures that obliterated demand bringing the world to a standstill. Prices went into a free fall after Saudi Arabia initiated an oil price war in retaliation for Russia not agreeing to output cuts to offset the blow from COVID-19 disruptions.

Even after OPEC and its allies finally agreed a record deal to slash global output by about 10%, the largest cut in oil production ever, the slump in demand remains a headwind. According to the Federal Reserve Bank of Dallas many firms need crude oil to fetch between $48 and $54 a barrel to be able to break even. The current price ranging in the $20s has put unsurmountable pressure on oil producers.

Energy giant, Royal Dutch Shell (Shell) recently cut its dividend by two thirds for the first time in 75 years (since World War II). Will other oil producers follow in this same direction? Ben van Beurden, Shell CEO said it was "money they didn't have in the first place," and rebasing the dividend does not give the company more money to spend but means it no longer needs to borrow to pay for it. Shell is not defining this as a temporary pause with intentions to move back to its prior base but as the new normal. Warning of a continued deterioration in the macroeconomic outlook Shell is preparing for a prolonged downturn and wants to rescue its financial health.

On the contrary, Total, Chevron, and BP raised their dividends in 2020 whilst Exxon Mobil held its dividend flat. However, a closer look at the debt structures of these five giants tells a very similar story. Shell, Exxon Mobil, and Total recorded comparable net-debt-to-equity ratios in the 40% range whilst Chevron boasts the best debt measure (19%), and BP the worst (56%). Should we expect a convergence in dividend policy in the near future from these giants?

The COVID-19 outbreak has caused a global market crisis with a magnitude not seen since 2008. However, the two crises are different in many aspects. Back in 2008, the crisis started with the banking system and subsequently dragged down the global market. Now, the crisis has been caused by concerns around the pandemic spread and the slow-down of the entire economy.

The pandemic has already started to bring structural change to the way of doing business and our general livelihood. Both business and leisure travel have been temporarily eliminated with most people working from home using technologies like Zoom meetings to connect with the world. The idea that businesses have not seen significant disruptions using these methods could be an impetus for structural changes into the future. Will people go back to normal travel? Recently Twitter and Square offered its employees an option to work from home forever.

The shelter in place policy is inevitably putting a hole in oil demand as factories and corporates continue to operate below capacity. In April, the US Labour Department reported that non-farm payrolls fell by 20.5 million and the unemployment rate shot up to 14.7% both the worst since the Great Depression by large margins. One may argue that factories will go back to normal once a vaccine is found. However, it's not only about whether factories and corporates can use oil in the future, but also the ability of producers to profitably store oil until the lockdowns are eased, allowing them to take advantage of additional demand.

To put the question about crude oil into perspective, remember what happened to coal?

For years, coal was the dominant fuel for electricity production, accounting for over 60% of its generation in the US in particular. But the expansion of natural gas displaced coal in many parts of the world. According to the US Energy Information Administration, since 2008, coal production has dropped nearly 40%, from almost 1.2 billion tons to less than 760 million tons in 2018. In 2019, the share of electricity fueled by coal fell to 23%, yielding mainly to natural gas which took 38% of the share.

Could oil become the new coal in the near future? Imagine being gifted with coal 10 years ago and holding on to it right now? The replacement of coal was a structural change caused by the availability of natural gas, decreased consumption, renewable power, and more stringent environmental regulations.

The structural changes that the pandemic has triggered together with existing developing new technologies (electric vehicles), regulations (climate change) and ESG (renewable energy) have all become imminent forces which could inevitably shift the demand or steadily replace crude oil.

Is crude oil dead? Or rather is crude oil dying?

Sources:

BBC News; the Washington Post; US Energy Information Administration and Insideenergy.org